

Opening remarks

Dr Andrew Sheng

I feel honored to be present here and chair this important session. The opening speeches by Governor Subbarao and Mr Caruana have given excellent overviews of the key issues on regulation in the face of the challenges of growth and equity. Before we turn to Deputy Governor Anand Sinha¹, who has written an excellent paper on regulatory implications for growth, let me present some broad related issues as I see them.

Is finance helpful to growth and is it helpful to equity? First, the problem is that standard finance theory has been turned on its head. The orthodoxy is that finance is initially helpful to growth, but as Governor Subbarao rightly pointed out, there could be issues about how much or to what extent finance can support growth. Perhaps, finance can go too far in terms of leverage, which can indeed hurt growth if it becomes a generator of speculative bubbles, instead of a facilitator of stable growth.

Moreover, the question whether finance helps social equity is very debatable. The Chairman of the United Kingdom FSA, Lord Adair Turner, has written an excellent paper recently on credit growth and social optimality². I think it is a worth reading by all of us. The paper argues that finance cannot grow forever, and especially it cannot grow by leveraging. But, we have now turned the whole finance theory on its head. This is because all economic theory and finance theory start from the assumption of normality. But we are not living in the normal world. We have prices that are totally distorted all over the place. What is the price of capital? It is zero or near zero because of quantitative easing and zero interest rate policies in the advanced markets. What is the price of labour? It is very cheap because of huge supply of young mobile labour force from the emerging markets. What is the price of commodities? They are highly volatile because of speculation.

We are therefore living in the world of massive price distortions. But these distortions have an equity element. What do I mean by this? If the growth in wage rate is lower than the real growth rate, which is happening in many parts of the world, that means workers are subsidizing the rest of the economy. That is exactly what has happened since 1989, when 3 billion workers joined the global labour force. The world had suffered a massive wage shock whereby wage rates have been kept way below real growth rate of the world. So, in a sense, the poorer workers of the world are subsidizing the better off countries.

Secondly, as we all know from finance theory, if the deposit rate is lower than the real growth rate, then there is financial repression. Since currently, global interest rates are near zero, there is massive financial repression. This financial repression means that the savings of the poor people are again financing the over borrowing of the rich. The combination of “wage repression” and financial repression is the underlying reason for growing income and wealth inequity around the world.

The third question that we are debating hotly in the emerging markets today is what is the biggest source of profit margin for banks? Today, it is no longer from the banks operating the payment system. Actually, increasingly profits from banks are from wealth management or from private banking – managing the wealth of the affluent customers. Instead of actually

¹ Anand Sinha, “Financial Sector Regulation and Implications for Growth in the Post-Crisis World”, CAPRAL November 15-16, 2011

² Adair Turner, Speech at Southampton University, 29 September 2011, available at fsa.gov.uk

adding value for the customer, in many parts of the world – even in sophisticated markets like Hong Kong – certainly we have heard about the investors who bought Lehman Brothers bonds and lost almost most of their money when Lehman failed. These bonds were rated to be very very good. So, even middle class and poor people are now asking whether the banking sector is looking after their interests or not?

There is a risk that finance today has become not only an engine of speculation that can hurt investors, but because of incipient inflation, access to borrowing creates inequality. Governor Subbarao's view on financial inclusion suggests that besides many people not having access to financial services for savings and transaction services, they do not have access to borrowing too. The latter effectively means that people who are not even able to borrow are subsidizing those who are readily able to borrow. In effect, those who are able to over borrow have greater wealth and leverage opportunities than those who do not have access to financing in a period of inflation and therefore wealth and income is getting more and more concentrated.

Furthermore, finance today is knowledge centric and those people who have superior knowledge have a huge advantage over those who do not have knowledge about finance. Consequently, the whole financial system is at present designed to be concentrating income and wealth, not flattening and that is an issue that I think we need to deal with in order to achieve social stability.

Let me now try to relate the current financial crisis with the real world as I see it. Since I have left the official sector – although I remain an advisor to the China Banking Regulatory Commission – I have become more aware of the impact of finance on the real sector. I look at this crisis with amazement. In 2008, when Lehman Brothers failed, trade stopped. What we care most about today is trade and jobs. Jobs are destroyed in the real economy when trade stops. When Lehman Brothers, which had nothing to do with trade – it is not even a trade bank – failed, the whole trade finance almost crunched to a stop. After three years of reform, have we ring-fenced trade financing from another possible incidence like Lehman Brothers? And can anybody swear to me that another incidence like Lehman Brothers will not happen? In fact, counterparty risks between the major banks are now bad, which is causing contraction of credit in the European markets. To deal with institutional failure, the current trend is to ask the financial institutions to have a living will. It is my understanding that if you look at the living will of many banks, you will note that the first thing that they will cut in the event that they are failing is trade finance. This is because trade finance is highly short-term – usually 30 or 90 day credit – and self-liquidating. But if trade financing is not obtainable, trade cannot continue and jobs will be destroyed. So, we have solved the problems of finance industry, but we have not solved the problems of trade and the real sector.

In the post-crisis reforms, I congratulate the Basel Committee for sorting out some of the issues of capital adequacy and liquidity requirements. But the banking system worldwide is struggling with provision of credit to the SMEs. We all understand that SME financing has high risk, high cost and even though the bulk of SME funding is short-term, the most important credit is revolving credit over the long term. If I were a banker, I would be the last to lend to the SMEs, why? This is because if a bank is provided central banking funds at zero interest cost, its first preference is to buy long term government sovereign bonds. The more it owns government sovereign credit, the more the profit from the maturity mismatch, positive carry with almost zero credit risk. If I lend to SMEs, everybody knows that a minimum of 10% would be non-performing loans. If the whole economy worsens, it could be even 20%, 30%, or 40%. So, why should I venture lending to such sector? These issues are totally dynamic and interrelated to each other. We know that access to credit is crucial for the real sector to survive. But during the cyclical downturn, it is the poor people who have difficulty in accessing credit. Consequently, are we surprised that in China and other places, the kerb market and the shadow banking in the emerging markets is growing. If the SMEs have difficulty getting money from the formal financial sector, it will try to get funding from the

informal markets at very high interest rates, putting these SMEs in a vicious circle. Thus, if the formal sector is not going to respond positively to the demand for credit from the real sector and channel credit to what Professor Richard Werner calls credit that do not generate GDP growth, then we will confront looming problems of disconnect between finance and the real sector.

Finally, let me address the demand for infrastructure investment. In advanced markets where infrastructure is readily available, there is ample understanding that infrastructure investment is crucial for their growth. But, in emerging markets infrastructure investments for many of the poor areas is absolutely critical to the solution of poverty. This is the real problem that I have learnt based on my experience in China. Banks have a tendency to overlend to infrastructure because they have a collective problem of the fallacy of composition. No single bank knows that the highways, the airports and water works that they are financing are not going to be credit worthy. If every local authority embarks on similar projects, the collective whole may be a huge oversupply. Neither the local authority, the bank or even the financial regulator knows the collective picture. This may have been available under central planning, but there is a lack of system-wide information that creates the fallacy of composition.

The whole idea of imperfect information in these areas of credit management for the banking system as a whole is very difficult, where we have not paid too much attention. The recent trend towards macro-prudential regulation and supervision requires banks, financial regulators and central banks to pay attention to system-wide information and carefully assess pro-cyclical herd behaviour. Bank management incentives for banks to become larger through scale and also one-stop customer supermarkets have led EMEs banks to want to replicate Citibank, whereas the emerging market investment banks want to replicate Goldman Sachs. And hence they concentrated on consumer financing which are considered to be low risk and tended to ignore the more difficult areas of SME and long term infrastructure financing that is crucial for growth, stability and inclusivity.

Look at what is happening with the core bank businesses of payment systems, savings protection and wealth management. The payment mechanism function has now being commoditized and cannibalized. Banking is facing new sources of competition because technology is switching payment systems into mobile phones. To make small payments, you don't need a bank anymore; you don't need high branch costs and more paper trail, because mobile payments are so convenient and easy, provided the data security problems can be resolved. Consequently, if banks are not careful, they cannot make money in the payment area and they will face concentrate on the activity of wealth management for their clients, where they can make money from transaction, custody and advisory fees. But, look at what is happening recently in the area of retail customer wealth management. The banks have taken lot of high intermediation fees upfront by selling complex and high-risk products that may not be suitable (in terms of risk profile) to retail customers and then the consumers and investors have found that they have lost money. This is hugely damaging to the faith and trust in the banking system. Here, I am generalizing for both advanced markets and emerging markets. Even the sophisticated middle class investors have begun to question whether the banking system is meeting their needs or not. The fundamental question that Governor Subbarao has asked is completely valid. The banks need to revamp their controls and systems and the incentives, particularly to ensure that the conflicts of interest are not at the expense of the consumers.

We now move on to the impact of Basel III on growth, and here I want to give my personal views. I totally agree that Basel III has made tremendous progress. I think the Basel III rules are very relevant for advanced markets. The emerging markets has not objected to Basel III because it was recognized that they were not that badly affected by the crisis in the advanced markets. However, in the post crisis scenario, the emerging markets realize now that it is the time to rethink. I agree with Mr Caruana that it is not yet exactly the post crisis period. But, we may be in the middle of a turning point. What we really need to think through is to what extent the banking rules should fit more in with emerging markets conditions *per*

se. I am not saying that the whole set of Basel III rules is not vital. All I am saying is that the key lies in implementation. This is a really difficult issue.

We need to come back to the very fundamental rules of regulation which I think are absolutely important. For regulation to be effective, it has to be easy to understand, easy to implement and easy to use. But, if it is too complicated, people do not get it in the sense that they do not understand the core principles involved. In fact, if it is too complicated, it could lead to regulatory arbitrage, which is exactly what is happening. Consequently, to a large extent, my personal view is whether it would be possible to evolve a set of Basel III rules that are very much like that of IFRS, the International Financial Reporting Standards which has been simplified for SME usage. In short, whether we could use a more simplified set of Basel III for emerging markets that fit in more with ground conditions of less advanced EME markets.

Emerging markets do not have too much skilled bankers, regulators and central bankers to implement very complex rules. They need to prioritize and devote attention to the most important areas of reform that fit in with local conditions. The more complex the fit, the more likely that implementation will go wrong.

I have focused on implementation because I am practical. It is better to get a simple system better regulated, than a complex system that is half implemented with incomplete understanding by bankers and regulators alike. We need to focus on the most important and urgent problems first, because resources are scarce and the political will to do some hard reforms is never going to be easy.

I am offering these thoughts on the topic of regulation, growth and equity in a constructive manner to stimulate more debate on these important issues.

Thank you.