Zhou Xiaochuan: Instability and evolution of the financial system

Speech by Mr Zhou Xiaochuan, Governor of the People's Bank of China, at the "Global Management Forum" organized by Qing Hua University, Beijing, 30 October 2007.

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Financial instability or turbulences occur every few years. As it is almost impossible to avoid mistakes completely, the key is to learn how to live with the instability or turbulences, and consequently draw lessons to improve the financial system.

The recently concluded 17th National Congress of the Communist Party of China (CPC) stressed the objective of keeping the momentum of good and fast economic growth. That means, in the financial sector, we should do our best to prevent financial instability or turbulence. The recent subprime turbulence has created fairly large disruptions in financial markets in the U.S. and the world at large, and consequently put China on high alert. For the past five years, China's economy has basically maintained a steady and rapid growth without any real bumps. In fact, I am a bit worried that some young people may think that this kind of smooth, stable status is normal. In fact, the more likely norm is that a financial system faces instability or turbulences of varying degree every few years; free from all such instability would be, in fact, abnormal.

What's important to realize is that all economic distress including the current subprime turbulence, contain within themselves valuable lessons worthy of discovery and scrutiny. Indeed, these lessons can serve as an important source of insight for China as it improves and develops financial markets and macroeconomic policy-making.

Financial instability or turbulences are not unusual

The financial markets in the U.S., the most developed in the world, have experienced turbulence and distress one after another in the past decades. In the 1970s, there was a high inflation; in the 1980s, the S&L crisis occurred and prompted the authorities to create a Resolution Trust Corporation around 1990 to deal with the consequences of the crisis. In 1987, the stock market crashed on Black Monday; in autumn 1998, as the financial crisis in Asia spread to Russia and Brazil, the collapse of Long Term Capital Management triggered a distress; in 2000, enormous amount of wealth evaporated as a result of burst bubbles in the NASDAQ market; after this, the Enron and WorldCom scandals shook the securities market in 2002; and most recently, this year has seen an ongoing subprime turbulence.

Instability or turbulences have occurred in succession. Each is caused by as yet unidentified mistakes. As mistakes are unavoidable, the key is to learn how to live with the instability or turbulences, and consequently draw lessons to improve the financial system. As a matter of fact, the financial authorities have introduced significant and substantive policy or institutional improvements after every crisis.

By reviewing the above-mentioned turbulences in the U.S., we get a rough idea of how improvements have occurred. In the period of high inflation through 1970s and 80s, the role, independence and governance of the central bank were carefully studied. As a result, operations of the central bank made lots of improvements. We can read about these developments in the biography of Paul Volker and the autobiography of Alan Greenspan. After the Black Monday in 1987, it became known to the general public how the central bank used liquidity management in a flexible manner in response to the crisis that might otherwise spread quickly. After the S&L crisis between 1980 and early 1990s was resolved, the regulators carefully examined the potential moral hazard in the deposit insurance scheme. In 1991, the Federal Deposit Insurance Company Improvement Act was adopted to strengthen

the supervision function of the FDIC, establish an arrangement for prompt corrective actions and adopt differentiated premiums to mitigate adverse selection and moral hazards. After the Long Term Capital Management problem, the financial sector watched the leverage ratio of hedge funds more carefully and urged commercial institutions, commercial banks in particular, to strengthen internal control over the leverage ratio. With the burst of NASDAQ bubbles, people began to get a taste of bubbles and their harms. In the aftermath of Enron and WorldCom scandals, Sarbanes-Oxley Act was passed. Though some may view a small number of its codes as over reaction, the Act contains remarkable improvements in response to the problems of the listed companies. A lot of reflection has been seen in the recent turbulence triggered by subprime mortgage. As we usually say in China, there is a good chance of turning bad things into good ones.

Parsing China's experience

Looking back at China's economic and financial development since the period of opening up and reform, a similar picture emerges in which we could see financial distresses, big or small, always occurred.

In 1985, China experienced a high inflation rate of 8.8 percent. In the anti-inflation process, the decision-makers learned how to build a two-tier banking system. The blind optimism about the balance of payments existed at that time was also corrected in this process. The high inflation rate recorded in 1988 was a result of several factors, including a so-called theory of “harmless inflation ” that had been influential in 1987-1988. After 1988, this view fell completely out of favor.

The next round of inflation, starting in 1993, caused the third plenary session of the 14th CPC Central Committee to lay out a formal macroeconomic policy framework as well as various guiding perceptions and principles, including what kind of macroeconomic policy framework should be established? What is the role of the fiscal policy? What is the role of the monetary policy? What exactly is government plan attempting to coordinate? Based on these deliberations, the macroeconomic policy-making has improved significantly, and we have also learned how to apply economic leverages appropriately and timely, and how to deal with the inflation.

Through the 1990s, the Chinese banking sector faced a predicament characterized by the underdevelopment of a sound “credit culture.” During this period, shortcomings of the credit culture were exemplified by two main types of bank lending. The first was policy lending, including those determined by the government plan or under variety of administrative interventions. The second was so-called “relationship-based lending”. At that time, there existed large deficiencies in the standards of accounting, information disclosure and financial statements reporting. Enterprises’ access to credit was largely based on their management’s personal relationship to the banks, and only those with good relationship got the loans. Rectifying China’s unsound credit culture has been a long and painful process. A key step on this path was the nation’s first National Financial Work Conference held in November 1997, which set out a vertical management system for the commercial banks. Both the central and local governments were thus prohibited from interfering with loan decisions. This change was considered an important step forward in transforming the credit culture.

At the end of 1997, the Asian financial crisis spread to its full scale. Although China averted a head-on hit by the crisis, its aftermath had produced long-term effects on the Chinese economy, including, most obviously, the problem of non-performing loans (NPLs). According to accounting standards used domestically at that time, in 1998 the Chinese banking system had an NPL ratio of 25 percent, although international accounting standards would have put the rate as high as more than 40 percent – a figure underscoring a NPL crisis. Indeed, many banks were technically insolvent. A banking system in such a status would be difficult to support a sound economic development. Such a reality buttressed China’s resolve to carry out reforms.

In February 2002, at the second National Financial Work Conference, plans were made to strengthen financial supervision (later on in 2003 the China Banking Regulatory Commission (CBRC) was established). It was also decided to kick off a new round of reforms on the commercial banking sector, clean up bank balance sheets, and proceed with financial restructuring – measures designed to make major commercial banks to be financially healthy. Over the next five years, China carried out a series of reforms on the financial institutions, including not only the commercial banks, but also the rural credit unions and other financial institutions, such as security firms and insurance companies. The decision to carry out reforms was the result of lessons learned, and it also laid a foundation for future development.

Just before the Enron and WorldCom cases were exposed in the United States, the Chinese media had unveiled a fund scandal in its securities trading. In this case, some institutions were found of manipulating stock prices. The year 2001 also saw the Yin Guang Xia case, which was similar to the Enron scandal in that the listed company disclosed false information and engaged in unlawful trading in its stock. In 2003, a larger scandal of listed company broke out with the collapse of the De Long Conglomerate. Following these incidents, China's financial regulations and corporate governance standards were improved and toughened to counteract the misconducts by using complex corporate structures, which occurred in the De Long Case.

China's financial system is thus gradually improving its knowledge to deal with instability or turbulences of varying degrees. While it's difficult to avoid mistakes completely, the key is to learn the right lessons, make improvements, and achieve substantive progress.

A Chinese saying goes like this "if you frequently suffer minor illnesses, you may be finally exempted from a major disease". China must avoid at all costs the kind of disease that plagued Japan's economy through the 1990s and even into the new century.

The mirror image

In reviewing international financial instability or turbulences since the 1970s, we may have two observations.

First, while many kinds of instability or turbulences afflict financial systems, only minority is created by the financial system itself. The majority reflects problems in the real economy – the so-called "mirror image" in financial sector. The real economy and the financial system mirror each other, such as NPL problem usually reflects troubles with firms in the real economy. At the same time, it may also reflect problems in accounting practice, information disclosure, and corporate governance. One characteristic of the modern economy is that the financial system is a barometer for the entire economy: troubles in the real economy are often first broken out in the financial system. Problems in the financial system, however, are not caused by the financial system alone.

Second, problems in developed countries, particularly in those emerged in mature market economies, are often relatively new as these economies are often places where financial innovation activities are concentrated. These problems are so new that market participants and regulators alike have a hard time predicting their course. Naturally, it's a big challenge to find solutions. In comparison, problems faced by the emerging markets or developing countries are more often a repeat of those already experienced by the developed economies. Thus, the way for dealing with instability often can more probably be drawn from the international historical experience.

Rethinking financial instability or turbulences

First, if an economic system or policies are flawed, sooner or later they will be forced to be corrected; this is an objective law in the functioning of the market economy. The US

subprime turbulence is a clear case. Individuals without sufficient ability to repay and failing to meet loan standards were nonetheless given large amount of home loans. At some point, such hidden risks would have to surface. When an obvious bubble forms in an economy, bursting problems are bound to emerge with time.

Second, risks to the financial system brought by indirect financing are much higher than those tied to direct financing. So we say "debt is more dangerous". Institutional investors including pension funds, mutual funds, hedge funds, private equity funds, etc, presumably know and undertake relevant risks inherent in the investment. Problems that arise are thus comparatively less painful to be absorbed. A recent estimate of the amount of the subprime mortgage securities is about US$ 200 billion. If these risks are truly spread among the institutional investors and other direct investors, it should not be so hard for an economy as large as the U.S. to absorb the losses (all the more so given some of the burden will fall on Europe, Japan and even, to a much less extent, China). So why, against most expectations, did this turbulence continue spreading? An understanding lies in the fact that while some of the investment risk was carried by direct investors, certain risks were in fact left within the indirect financing channels. As we know, these are the so-called structured investment vehicles (SIVs), which are often off-balance-sheets of banks and other financial institutions.

Financial institutions kept a huge amount of debt exposure off their books – without being detected by the regulatory bodies. Off-book supervision has actually been rather relaxed, and many people including the regulators even don't necessarily have relevant experience in this field. Because these off-book investment institutions usually borrowed from the banks, in the end commercial banks were left holding a sizeable portion of subprime and its derivative products. The Basel II banking guidelines set requirements for debtors to bring certain off-book services back on-book in a timely manner. But most banks, with the exception of those large European banks, have not yet taken these guidelines. And the Chinese banks are currently not subject to the Basel II.

As long as the banking system doesn't get dragged into the mess, the subprime mortgage problems would only have limited impact. As far as direct investment risk is concerned, investors will have to absorb their losses, and central banks generally would not stand to provide support. As for debt risk within the banks that bear systemic implications, actions have to be taken to curb its spread. As illustrated in Northern Rock case when the drying up of market liquidity begins and threatens to spread, the bank of England must act.

Reviewing the debt instruments, we learn that the creditor-debtor relationships imply greater systematic risks. Similar cases can be found by reviewing lessons from the Asian financial crisis and the Japanese experience. To reduce risk and increase financial stability, great effort should be made to develop direct financing. However, it's vital that direct investment products are not twisted to simply shift the risk back to the banking system. In such a process, the key is to foster and develop investors, including institutional investors as well as individual investors, who can recognize specific risk and have the ability to undertake risks.

Third, analyses and research should be strengthened to detect bubble risks and prepare for different scenarios. A book called Extraordinary Popular Delusions and the Madness of Crowds describes the bubbles of early years of western financial markets. The title of the book is interesting because it reminds participants in the financial markets to keep rational. When the market goes to overheat, participants often see their reasoning weakened and even many of them try to explain away or defend such irrationality. During his tenure at the U.S. Federal Reserve, Alan Greenspan used the term "irrational exuberance" to alert the overheated situation. This, too, was a reminder that a more rational attitude should be maintained in the process of economic and market overheating.

Fourth, in the process of diagnosing problems and prescribing solutions, it's important not to misread history. When making corrections, efforts should be exercised to avoid overshooting, lest such efforts end up sowing the seeds for another crisis. Among the analyses of the current state of global excess liquidity and the US subprime turbulence, one line of thinking

draws its origins from the Fed loosening monetary policy following the bursting of the NASDAQ bubble in 2000. Amid the large amount of analysis about the spillover effects of the subprime turbulence on China, some have voiced cautions about the development of securitized products, and traced the origins of the subprime turbulence to the development of these securitized products and other derivatives. Worrying that more complex product might generate greater troubles, these embrace a vision of "simpler is better." But we need to remain sober: the securitization process should not be jettisoned quickly. To develop financial market and support economic growth, resolute efforts need to be made to develop direct financing and related securitization. It is almost impossible to avoid securitization in the contemporary development. Rather, great efforts should be made to develop an array of financial products, including the hybrid products such as debt-equity mixed and some derivatives. We need to recognize that problems arise not because the securitization or derivatives as a product are somehow flawed. Instead, most of these troubles result from problems in information disclosure or the pricing mechanisms, or because the design of the mechanisms implied moral hazard.

Fifth, flexibility and adaptability must be improved. In dealing with the crisis it's important to realize the fluidity of the situation and thus the need for a nimble response. The Governor of the Bank of England was criticized for his response to the Northern Rock on the floor of Parliament, where he was blamed of changing his position over a few days. In fact, financial markets are fast changing, and judgments must be made according to specific conditions. It's normal for one's conclusions to be updated within a few days. From the perspective of the adjustment capabilities in dealing with the crisis, the key is to increase microeconomic flexibility. In other words, the adaptability of the micro entities to changes in prices as well as in market supply-demand should all be improved, thus avoiding the introduction of excess rigidity in pricing, supply, demand, and institutional design.

Sixth, to guard against and manage instability, developing countries must raise levels of confidence in their currencies, markets and central banks. Key points here include maintaining the stability of currency value, adopting a flexible exchange rate policy, supporting confidence in currency convertibility, increasing the economy's ability to deal with all kinds of shocks, and exercising regular assessment of the economy, so as to provide early warning about risks forming within the economy, and research and prepare contingency plans. IMF's annual surveillance mechanism – including the "Article IV Consultation" – functions as an effective tool for regular health check-up of the member economies.

Seventh, it's truly an art to find the subtle balance needed for anti-crisis policy-making. It's important to avoid creating too much moral hazard by bailing out institutions whose own operations lead to major mistakes. At the same time, it's necessary to consider the impact on the real economy: if a crisis impact on the real economy and social confidence are severe, or it may result in a system-wide chain reaction, a prompt action would be required. Of course, the reactions will vary under different circumstances.

As the subprime mortgage crisis develops, we are carefully observing two recent policies. First, about 2 million American subprime home loan recipients face their problem to fully repay their mortgages. If foreclosure is enforced, it may lead to further declines of the housing prices. During the process, the government may wish to take steps to help poor people through their difficulties. But the fundamental issue is that people who didn't meet loan conditions probably should not have bought such large houses. Will the government's provision of aid or subsidies lead to moral hazard? Should the resulted loss be borne by the taxpayers? Second, some US (as well as a handful of European) financial institutions employed SIVs or other conduits to take on additional risk exposure. Should these institutions be bailed out? Several big US banks have recently created a "super conduit" worth US$ 75 billion, trying to help alleviate the crisis. But in so doing, how it is going to price the risk of related products? Will this simply create even greater moral hazard?

Above all, we need to pay close attention to and deeply think about the turbulence underway as well as the remedial measures adopted by the financial regulatory authorities in the mature economies to deal with it. Such a reflection bears great significance for China to develop its financial market, improve financial supervision and regulation and macroeconomic policy-making.