China's Emerging Role in the International Financial System

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Honorable Chairman, distinguished guests, ladies and gentlemen:

Good afternoon. I am very pleased and honored to be invited here to Shanghai and discuss with you, my friends at the International Academy of Management (IAM), current hot topics in the arena of international finance during this once-in-a-century period of global financial turmoil. I will initially avoid the phrase "financial crisis" because it simultaneously overemphasizes patterns of change in global financial growth and underemphasizes systemic failures of today's international financial agencies to effectively address certain important issues and efficiently alter monetary and fiscal policies.

Today's International Financial System – A Chinese Perspective

The present phenomenon of extreme volatility in financial markets is often described by Western mass media as a financial crisis that sprang as a deadly, fully-developed virus, with US sub-prime mortgage loan problems as its root cause; it is said to have spread from America to Europe and then to virtually all of the rest of the world. It is characterized by reported economic and financial shocks, with differing impacts upon the various countries. Due to the nature of the media, greater emphasis is placed on negative news and the dislocations that result from those shocks than from rebounds and recovery. In turn, these events are linked to manifestations in the real economies and presented as an all-engulfing pattern of crippling economic and financial symptoms and outcomes. There is no reported prevention method or effective treatment for this alleged disease.

Such an analysis is simplistic and superficial and generates unnecessary and undesirable fear in the general population. In essence, the present situation is not an isolated phenomenon arising from one cause; instead, it is a consequence of continuous accumulation and intensification of internal conflicts naturally occurring in the long-term development of the present international financial system. That system is intended to harness market forces to self-correct deficiencies by means that include financial crises but has flaws that are becoming ever more obvious.

We therefore need an in-depth understanding of the developmental process of the international financial system in order to appreciate where economic and financial systems stand today.

Conflicts and Problems in the Development of the Modern International Financial System

First, we need to understand that the conflict between the strength of the US economy and the relative power of the US dollar has always existed in the post-WWII international financial pattern. Historically, Europe was virtually destroyed in the course of that war and lost its best opportunity for development. America seized the opportunity and emerged as the great economic, military, industrial, scientific-and-technological and political superpower. In 1944, a year before that six-year war ended, the US economy dwarfed that of other nations and so it virtually imposed the "Bretton Woods System" upon the other developed nations. As of the end of WWII, the US had half of the manufacturing capacity of the world and 65% of the gold and foreign exchange reserves, very different from its position today. This gave rise to a US dollar-centered international fixed exchange rate regime almost by default and established the US dollar as the single measure by which all currencies would be evaluated and trade negotiated. The Bretton Woods System officially came to its end due to the oil crisis in the early 1970s and was replaced by the US dollar-centered floating exchange rate system set up by the "Jamaica Agreement". It is significant that the monopoly position of the US dollar determined by the Bretton Woods System has been kept to the largest extent possible even until today.

However, the preeminent status and market share of the US economy to that of the rest of the world has continuously declined in the six-plus decades since WWII. Not only have post-war Europe and Japan revived but also there has been the surge of emerging countries, most notably China. Moreover, the world economy has begun showing a diversified development trend, with the growth of emerging countries outstripping that of developed nations by a large margin. The irreconcilable contradiction between declining US economic status and the monopoly position of the US dollar in monetary policy came into being almost from its 1944 inception, a contrast that is becoming ever more dramatic in terms of economic and financial development. This latest "financial crisis" occurred just against such a background.

Second, financial globalization and liberalization have accelerated risk concentration and transfer. The information revolution starting from 1980s expedited financial globalization and liberalization and made the link between the real economy and the virtual economy increasingly close. With continuous economic development and deepened finance, the assets of almost all companies now take the form of shares for circulation in capital markets, the strength of which can materially affect the worth of any financial product moment by moment. In essence, a company's financial strength is largely measured by its market capitalization, which in turn is subject to the collective investors' instantaneous perception of the probable value of its discounted after-tax income stream, a figure that may have little correlation with its historíc value, net worth or other analytical measure of its value. Further, it is largely influenced by investor uncertainty or, as is the present case, fear and misinformation. In aggravating fashion, financial globalization and liberalization also increase the imbalance of the world economy and finance by concentrating wealth flow to developed countries, highlighting regional differences and increasingly widening the gap between the rich and the poor. Of course, except for wealth itself, this also heightens risks in the developed countries, especially capital markets represented by Wall Street. This exacerbates unsteadying factors in market development. Given the loss of payment capability of a particular large financial institution, the "butterfly effect" will be triggered, involving other financial institutions in trouble in just one night and even leading the entire world economic system into shrinkage and turbulence. To give an analogy, the present capital markets allow one institution's problems to become the ripple that emerge as the tsunami that affects countries all over the world.

The perception of financial crises promotes international financial pattern adjustments that take on profound proportions. The latest data released by .The Bank of England show that in the ongoing "financial crisis", the losses to the global financial system will amount to USD2.8 trillion. Bailout plans of the world's countries have elicited commitments to contribute cumulative funds amounting to USD4 trillion to banks and money markets. This has an obvious effect in terms of stabilizing banking systems and building confidence, but it exerts unexpected influences upon the real economy. Where and how will those governments obtain those funds? What previous and proposed fiscal policies will be altered in order to accommodate those commitments? In particular, governmental assistance only can take the solution that central banks issue more currency, exposing the world to bigger inflation risk and transferring the "crisis" to developing countries, another unanticipated result of the adjustments of the international financial system.

Instead of anticipating problems and pro-actively steering clear of them, the current system often acts as a self-fulfilling prophesy of worrisome possibilities. Consider the effects of the latest rounds of macroeconomic adjustment:

1. The US economy has been struck a hard blow and the position of the US dollar has been challenged. At present, the financial crisis has hit market confidence severely. People's pessimistic expectations on economic growth, financial system integrity, investment security and future consumption patterns bringing ever further down the stock market statistics. Many financial institutions face disruption to inter-bank funding and financing chains, even drying up their ability to operate at all. The bankruptcy and transformations that occurred concerning the five largest investment banks on Wall Street, together with US government takeover of Fannie Mae, Freddie Mac and AIG, are examples of this domino pattern. Currently, the financial crisis has impacted the US real economy. A large number of enterprises are going bankrupt, provoking further unemployment. It is increasingly forecast that the US economy will enter into a relatively longer period of adjustment and decline, possibly getting the financial position of US dollar to drop greatly as the expected period of economic recession lengthens.

2. The EU has rebuilt much of the international financial system proactively, leading itself and much of the rest of the world. After its eruption, the financial crisis spread to

3. In its competition with America and EU, Japan has taken preemptive opportunities. Heretofore, Japan has allowed its currency to largely be pegged to the US dollar in trade transactions, despite benefits emanating from its export-driven manufacturing and other industries, and despite its considerable GDP. This dollar pegging has probably undervalued the yen, at least before the current financial turmoil. After the financial crisis broke out, Japanese financial institutions, being relatively stable, entered rapidly into a pattern of US acquisitions. They acquired major interests in such troubled American financial institutions as Morgan Stanley, Merrill and Lehman Brothers as early as possible in order to seize market opportunities arising from the adjustment of financial patterns. Further, they have consolidated their advantages in Asia, expanded their business scale in America and Europe and enhanced their influence in international financial markets. Today, exchange rates for the Japanese yen against the US dollar, Euro and GBP show that the yen has fared the best. This also mirrors the confidence of international investors in the future growth of the Japanese yen. However, the financial crisis is far from ending. The seizing of many global financial markets by the Japanese yen will tighten its liquidity and affect Japanese economic and financial development, perhaps rather adversely.

The above indicates that there is a reciprocal process in the ongoing global financial system of the West, with America declining and Europe and Japan growing. This description of American and Western financial systems is not enough to depict the world economy and we should take the development of emerging countries into account as well. The steady improvement of China's overall economic and financial scale and development level has caused it to be perceived as a key power, drawing the attention of the whole world.

Development and Influence of China's Finance Sector in the International Financial System

The development of China's finance sector has been materially influenced by financial globalization. The period when China's finance sector developed most rapidly also witnessed the acceleration of financial globalization, which unavoidably subjected China's financial sector to the influence of the international financial system. In particular, the Asian financial crisis in 1997 and China's entry into the WTO in 2001 provided the most remarkable influences.

First, the Asian financial crisis alerted China's finance sector to the need for risk mitigation. During the 1990s, Asia experienced unprecedented prosperity; Korea, Thailand, Singapore, Indonesia and Chinese Hong Kong were regarded as the most successful emerging markets during that time. However, the bursting of the Asian financial bubble during the ensuing crisis of 1997-8 engulfed all of the wealth accumulated in these countries and regions during the previous decade of prosperity. During this process, China learned the importance of financial security and stability, and started to pay attention to the mitigation of financial risks. The huge non-performing assets in China's banking industry had by then become an extreme burden, hindering the overall economic growth of China. In such a context, the Chinese government rapidly responded, taking a number of severe but beneficial measures to dispose of bad debts in its banks in order to improve the banking system. The central government released a number of detailed policies and standards setting forth risk-mitigation measures that would inevitably curtail unwise banking operations. At the end of 1997, China held the first nationwide financial work conference and explicitly stated the importance of reform in state-owned commercial banks. In 1998, it issued RMB270 billion of ad hoc treasury bonds and injected capital into the four largest state-owned banks in rapid succession. In 1999, the establishment of four financial asset management companies was approved for acquisition and disposal of the non-performing loans stripped from state-owned banks in mitigation of their potential risks. Thereafter, China's finance was separated from the concept of fiscal financing and obtained a relatively independent and important position within the Chinese economy. Policy loans incompatible with sound financial practice were aggressively curtailed.

Second, China's entry into the WTO inspired China's finance sector to accelerate its development to be successful in international competition. Entry into the WTO meant China would fully open up its finance sector to foreign countries. Along with the introduction of foreign financial capital, this meant that advanced finance philosophy, finance techniques, market experience, high quality services as well as competition over capital, customers and talents would put intensive pressure on the finance sector of China to modernize, then largely a mere fledgling in world financial circles. We Chinese bankers could survive the fierce and ruthless market competitions with foreigners only when we could change pressure into power and actively respond to the challenges. China's finance sector was forcibly made to identify the gaps with their international peers and learn advanced finance theories and operation practices from Western countries:

1. First, the Chinese banks regulated their operations in accordance with the basic principles and operation practices of the international finance sector. For example,

2. Second, China's financial enterprises accelerated financial innovation and financial product research and development, activated new forms of transactions in financial markets, and effectively improved their service level and financial efficiency. The issuance of Kaiyuan ABS and Jianyuan MBS in 2005 marked the initiation of asset securitization in China and was of critical importance to the improvement of bank operation management, development of Chinese capital markets and improvement of financial stability.

3. Third, China's financial enterprises increased IT input, accelerated the building of an electronic, automated and modern financial service system, and upgraded their financial modernization. These measures not only renovated the finance system of China but also improved the competitive edge of their financial enterprises in the domestic market and facilitated their fast growth.

Once China's finance sector recognized the requirements of working competitively within a system open to multinational financial institutions, it soon took on both the policies and procedures necessary to aggressively adapt and prosper. China has become the fourth largest economic entity and the third largest trading country in the world through rapid economic development. It enjoys a very large share of the volume, scale, growth potential and contribution to aggregate world GDP growth, and has assumed a key role in the international economy. Along with the development of this burgeoning economy, China's finance sector has also achieved exponential growth. Currently, China's financial enterprises have established a diversified system, one in which multiple institutional forms co-exist, functioning to supplement each other while developing in a coordinated fashion. The range of available financial products and services has been vastly expanded, and many financial innovations have been incorporated within China's financial markets and financial intermediary services.

The development of China's finance sector is being recognized by the global sector. In the first instance, the market capitalization of China's financial enterprises has vastly increased. In the banking sector, major state-owned commercial banks have successfully executed IPO initiatives. BOCOM, CCB, BOC and ICBC have become listed companies and arranged financing on the Hong Kong stock market. Increasingly Chinese banks, securities companies and insurance companies have won the favor of international capital markets and garnered private investors for strategic blocs of their ownership. Second, the market position of the RMB has improved. RMB has now become convertible on current accounts and partially convertible on capital accounts, and a regime of managed floating exchange rate was adopted as of 2005, which markedly improved the position of the RMB in the international currency system. In particular, after the managed exchange rate of RMB was loosened, the exchange rate against such major currencies as the US dollar, Euro and British pounds continues surging, in particular, the exchange rate against the US dollar has appreciated by over 20%, which reflects the international market's confidence in RMB and the economic and financial development of China.

Meanwhile, the rapid development of China's finance sector also remarkably boosts the development of international financial system. Early in the Asian financial crisis 10 years ago, China demonstrated the long-term, internationalist financial view of a leading economic power. Facing the severe shock suffered by East Asian and Southeast Asian countries, the Chinese government took a responsible attitude and declared that the Renminbi would not be subject to depreciation in a view to maintaining the stability and development of the region. This measure effectively avoided further expansion of the then-ongoing currency crisis, mitigated the economic pressure on surrounding countries, maintained economic order in East Asia, Southeast Asia and even the whole of Asia, and contributed to the stability, recovery and development of Asian and even the global finance market.

Currently, when the global finance market is operating in the face of another period of general decline and austerity, China's economy and finance have steadily operated in an environment and manner consistent with its rapidly growing GDP. China achieved a growth rate of 9.9% in GDP in the first three calendar quarters of 2008, despite export shrinkage; its banking system continues to operate soundly, profitably and in a stable fashion that has promoted confidence from its depositors, customers and investors. These factors also inspire the confidence of non-Chinese Asians and even that of non-Asians as to the Chinese economy. Many of the people of the developed countries of the world now appreciate the growth of emerging market countries as represented by China. They look for China to inspire and facilitate Western nations in efforts to reconstruct their finances to end this negative segment of a global economic cycle. As the largest developing country, China, with its steady economic growth, is held up as a positive example, giving the world the confidence and hope that it will work itself out of the current recession-crisis cycle. This is China's most significant contribution to the stability and development of international economy and finance.

Opportunities Ahead for China's Finance Sector

Nowadays, with the development of economic and financial globalization, the global financial turmoil has engendered a strong, systematic negative factor into the real economies of the world. No country can reasonably be self-centered, paying no attention to others. China is no exception to this. In the short run, a fall in exports has had an adverse bearing on China's real economy, but there are many development opportunities open for China's finance sector in the short and long run. Nothing will prevent China from maintaining world-leading growth of its GDP, not in 2008, 2009, 2010 or later. Financial development will proceed because strong financial initiatives from the central government have allowed us to maintain much of our economic momentum regardless of export fluctuations:

From a domestic point of view, China's urbanization has provided a good opportunity for financial development. On the one hand, urbanization construction can drive investment by spurring infrastructure construction; on the other hand, urbanization promotes the development of industry and consumption, which play an important role in accelerating autonomous development under unfavorable export market conditions. For many years, China's leaders carried on an economic development program that developed systems and markets in a predetermined urban-rural, dual-structure development pattern. However, this pattern turned out to be unsuitable for the rapid sustained development of China, where rural peasants accounted for 60% of the Chinese population. The dichotomy meant that 60% lost out on meaningful opportunities for advancement in employment; increased ability for financial prosperity was inhibited for them and everyone else as well. By means of urbanization as an ongoing long-term driver of overall national economic prosperity, a long process of "Peasant to City Dweller" will exist for at least the next several decades. This creates huge domestic market potentials, which in turn inspire the development of private industry, enlarge and accommodate domestic demand growth. As a result, the great market potential and room for China's urbanization will promote the development of the economy, providing a continuing excellent opportunity and putting forward an ever higher set of urban living standards as well.

This requires development of China's finance sector:

1. First, the financial infrastructure construction must be strengthened and the medium to long-term investment and financing market should be cultivated and developed. Medium or long-term finance is the foundation and driver for the economic and social advancement of all developing countries, but China has a lot of bottleneck industries and weakness. For example, public infrastructures need large investment and long construction periods, thus centralizing risks; short-term funds could hardly provide the stable development of such projects over the long term, and would inevitably lead to the unacceptable risks of maturity mismatch and liquidity crises. The economic foundation in the Midwestern and rural areas of China is weak and enormous funds flow out. Many social bottlenecks, such as small and medium-sized enterprises, low-income housing, educational loans, and environment protection, generally lack financing support and have exposed a serious financial gap that has existed for a long time. All these call for accelerating the development of the medium or long term financing market. In this process, we should not only learn from the regulatory standards widely accepted elsewhere in the world and by the experiences of foreign medium or long term financial institutions, and emphasize the development of capital markets and the credit support from the government, but also explore and develop a risk management framework and rules suitable for China.

2. Second, market construction should be speeded up. The advantages of the government, market and society should be integrated to promote a financing system with sound development by coordinated building of markets, systems and credit. The proportion of finance, credit and securities should be adjusted, the share of capital market be enlarged and the management of the credit market strengthened to realize commercialized operation and sustainable development of many immature industries through cultivation of the market players' own energy.

3. Third, China's finance sector should actively assume the social responsibilities of

From an international point of view, the adjustment of the international financial system provides China's finance sector with an opportunity to effectively engage in the development of international cooperation initiatives. First, China's abundant foreign exchange reserve and the stable financial environment provide a favorable condition for the internationalization of China's finance sector. Second, a unique characteristic of this financial crisis is that virtually all of the developed countries are taking joint actions, such as interest rate reductions and coordinated bailout plans, when confronted with systematic risk to global financial markets. These coordinated actions have played an active and positive role in curbing market fluctuations and preventing the financial situation from worsening. Reinforcing international coordination and cooperation of finance is an effective way to deal with true crises and represents a development trend of the international finance system. Third, although nowadays Chinese enterprises routinely "Go Global" for international cooperation and have a pressing need for investment abroad, corresponding financing support is not in place. Therefore, China's finance sector should grasp the opportunities, actively promote international competition and cooperation and develop the interaction with international finance sectors during the cooperation, with the view to realizing win-win for all the cooperating parties. This is not only a requirement of adapting to the development trends of international financial competitors but also the requirement to improve the international status of China's finance sector.

Ladies and gentlemen, China's finance sector is in a crucial period of its development. Both opportunities and challenges lie ahead. The real Chinese economy is largely immune to the so-called global financial virus, so I believe that we shall grasp the opportunities and accelerate development by our individual and joint efforts, and promote the continuous upgrading of the competitiveness and international influence of China's finance sector.

Thank you.