Financial System Reform and Economic Development

--Speech for Seminar on Development and Reform in India and China

New Delhi, November 15, 2003

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Mr. Rakesh Mohan, distinguished guests, ladies and gentlemen,

I am delighted to be here in New Delhi, which is indeed a city of history, vigor and vibrancy. In my opinion, this is a wonderful time to share experiences on economic development and reform in India and China, as both our two countries face fundamental and profound challenges as we review our growth and consider our future development paths.

We are pleased to witness the improvement of relations and strengthening of ties between our respective countries in recent years. One particular index of this change is our bilateral trade, which has soared from 340 million US dollars in 1992 to 4.9billion US dollars in 2002, an increase of over 1,440% in ten years! Even this large figure may be dwarfed ten years from now, as we foresee tremendous market potential for fostering a series of social and economic developments between our two countries.

Now that the world economy is apparently in a stage of readjustment and recovery, our current key focus is to work towards long-term sustainable economic growth. I speak cautiously regarding this assessment of recovery, because many challenges lie ahead. In the first half of this year alone, we suffered from a number of negative economic shocks, including the Iraqi war, rapidly rising oil prices and the SARS epidemic. Adding to the economic malaise are the imponderables of geopolitical risks, the volatility of major currencies and stock markets and continuous deflation in some Asian countries. Given such potential crises and risks on our economic horizon, it is prudent and even extremely important for us to enhance the early warning and response capabilities of our international financial systems. In particular, developing countries, China among them, must deepen their economic systems and strengthen their institutions if they are to promote long-term growth that will weather such global challenges and shocks.

Let me make a simple statement that catalyzes our own development strategy in finance: Long-term sustainable economic growth requires the development of a

sound and efficient financial system that accommodates the coordinated development of three forms of finance – budgetary finance, bank finance and securities finance. They are like the three legs of a stool – stable where they complement each another; wobbly if they are not level. Each type has its advantages and limitations and each is associated with an important set of functions and rules of the game. In a balanced economy with long-term sustained growth economy, we must develop all three in complementarity.

Budgetary finance is relatively straightforward: it realizes the government's fiscal policy objectives and helps facilitate the development of market credit, enterprise credit and social credit by capitalizing on the role of the government and the use of its sovereign credit standing; allocation of resources is through budgetary revenue and expenditure approach. Budgetary finance can be considered a rudimentary form of direct financing that requires no repayment. However, given the needs and size of our respective countries (large by any global standards), budgetary finance has very real limitations and certainly cannot be expected to achieve all desired goals.

By comparison, bank finance operates through the intermediation of banks in compliance with relevant regulations requiring asset security, capital and interest repayment. Importantly, there is a significant multiplier effect that bank finance brings to project realization. However, it is an indirect form of financing in a market economy, and its effectiveness is predicated on the premise of a well-developed credit culture and infrastructure, as there are public and market constraints within economies that are transiting towards fully developed market economies. Maximization of national economic development necessitates the strategic use of bank finance as a public policy tool as well as a commercial medium. China Development Bank is a case study for just such a banking institution that effectively intermediates between budgetary finance and commercial credit.

In contrast, securities finance or capital market finance is a direct form of financing in a market economy; it envisages widespread and direct participation by the public. However, securities finance remains significantly constrained by public sentiment and its availability and costs are susceptible to wide market fluctuations. By definition, securities investors directly assume market risks, so this form of finance relies on the existence of a relatively large number of investors with the sophistication, means and ability to shoulder such risks. Unfortunately, such a large class of citizenry with those qualities is an element generally lacking in developing countries.

Case studies of various national economies show that their economic development can be analyzed through the paradigm of the evolutionary process of these three forms of finance.

Witness the stark contrast between the developing countries of Asia and the developed countries of Europe and North America. The latter feature highly developed and modern market economies, where bank finance and securities finance are capable of more efficient resource allocation than budgetary finance. They boast a well-developed capital market, which has been fine-tuned over the course of many years and played a crucial role in their successful economic development. Underpinning such advanced securities finance and capital markets are populations that accept and rely on a social credit culture embracing complementary systems of legal discipline, market and regulatory discipline and moral discipline.

Today, most Asian countries remain largely dependent on bank finance while their securities finance remains relatively underdeveloped – China certainly falls in this category. Moreover, Asian bank finance and securities finance are burdened by historical legacies, both in attitudes and actions that result from past mistakes in budgetary finance. Our banks have necessarily shouldered financial risks that would be unacceptable in developed markets. This exposes an inherent flaw in bank finance - risks are deferred to the future, where liability only compounds. Problem loans create problematic banks and troubled banking systems. This drawback has yet to be redressed by Asian banks in general and it is not merely a Chinese problem. Indeed, non-performing loans made twenty years ago are still troubling the Japanese economy.

China is a developing economy, where, by definition, the three forms of finance are not balanced. By definition, our economy lacks the sophisticated financial institutions and educated citizens to fully appreciate their advantages. Prior to relatively recent reforms and opening our economy to world markets, China's economic development was largely the fruits of budgetary finance. In the last twenty years, China has developed a financial framework largely reliant on bank finance. The disparity between the three is striking:

1. China's current annual fiscal revenue is something in excess of one 1 trillion RMB.
2. China's bank deposits amount to 18 trillion RMB; whilst its bank loans total 14 trillion RMB.
3. The total capitalization of our stock market is valued at a mere 4 trillion RMB.

In the non-financial sectors, the ratio of financing through treasury bonds, loan, debt and stock is even more unbalanced, and the ratios of treasury bonds and bank loans present are 15 to 80, the remaining 5 percents are 1 percent corporate bonds and 4 percent stocks. This relative overweight in bank financing fails to exploit the synergistic efficiencies of the three forms of financing and has resulted in large amounts of non-performing assets given the absolute size of bank finance. Due to the weak economic foundations that underpin our financial institutions, together with our outdated and erratically enforced regulatory policies, China is now facing an arduous task in its development.

The lesson is clear: China's economic progress has been achieved in spite of our backward financial institutions when it should have occurred through the assistance of those same institutions. Going forward, we must either lose our inefficient financial infrastructure or we will lose pace in our economic development. Like three engines that seriously needs tuning and balancing, our economy will inevitably break down unless budgetary finance, bank finance and securities finance are in balance and acting in a complementary fashion. This balance will generate growth more than simply the aggregate sum of financing – it will entail a conceptual, methodological and behavioral dynamic that will enhance the power, efficiency and reputation of our financial system. We believe that budgetary finance will act as the catalyst and play a key role in transforming our economy into one driven by the market. We see bank finance and securities finance as the foundation pilings of our future socialist market economy.

Let me draw your attention to five issues:

1. We must make effective use of the dominant role of bank finance. On the one hand, it is necessary to develop securities finance through strengthening the bank system, to keep long-term capital and short-term capital in proportion and to develop a prudential risk management system aimed at mitigating long-term and short-term financial risks. On the other hand, application of the principles and methods of capital markets to the instrument of bank finance may serve to provide develop bank finance to a higher level of maturity, efficiency and security.
2. We must fully utilize the macro adjustment and regulatory function of fiscal and monetary policies, and transit from a heavy dependence on governmental finance towards a combination of governmental and market finance. The government should take advantage of market finance and adapt its financing accordingly.
3. We must provide a fertile ground for fostering capital markets and ensuring the

mutual promotion and development of the loan market, the bond market and the stock market.

4. We must establish and enhance the credit environment so as to facilitate the robust operation of the economy and its financial markets. This entails the building a framework for credit culture and risk management by providing clear rules of the game for all investment and financing activities. This remains a priority and requires the concerted effort of government, the financial sector, business enterprises and the public.
5. We must cautiously address issues concerning the utilization of foreign capital, especially considering the risk of short-term capital outflows. As you know, foreign capital is assuming an increasingly significant role in economic development of every country, given rising economic and financial globalization. Both China and India must draw from the experience of the recent Asian financial crisis and the Latin American economic crises of the 1980's and learn to cope with issues inherent to the opening up of capital markets and short-term capital flow in a global economy.

As we work to achieve these five objectives, we must never forget: **Financial institutions are the foundation and heart of modern market-based economic institutions.** Such a market system is a production and service economy integrated into a complex of elements, including corporate governance practices, financial infrastructure, the investment and financing system (including capital markets), information disclosure transparency, competition and market supervision, together with the critical roles of macro-adjustment and macro-regulation. Of all of these elements, the financial institutions are the most important; and therefore, their modernization is essential.

Modernization of financial institutions will enable clear-cut processes and procedures in response to unambiguous regulations concerning legal entities, corporate governance, ownership and property rights, while the financial infrastructure will involve accounting standards, payment systems, credit systems, performance reviews and law enforcement. To give an analogy, financial institutions are like the cells of the market organism, while infrastructure activities parallel those of the internal regulatory organs. Both elements are interdependent, essential and complementary, and they operate in a seamless environment.

The Chinese financial institutional modernization I envision calls for the joint efforts of government, the financial sector, business enterprises and the public to see the job done. In other words, it has to be the convergent work of the entire

economy. The fundamental economic and financial institutions in developed countries are the product of scores of hundreds of years of transition and improvement. China, as a latecomer, can leap frog directly from a primitive to advanced financial stage, bypassing the glitches and errors that time has lain bare. China, with its strong macroeconomic growth and abundance of resources and capacity, has at present an excellent opportunity to tackle the mission of total financial institution modernization. We have the momentum economically, so now is the time for our government to prioritize financial institution modernization at a high tier on the national agenda. Government credit should be intensively utilized within this program.

Targeted-development finance can play an important role in correcting prior market failures and institutional defects. This has proven itself on a global basis, even in developed countries. There are instances where governments can and should directly commit funds to initiate measures and create and restructure the financial institutions that will implement those measures. The United States, Germany, Japan and the Republic of Korea all have such institutions. With sovereign assistance, targeted-development finance can promote quality corporate governance, aid in restructuring the enterprise as a proper legal entity, strategize cash flow management and evolve a credit culture. In such a climate, project funding, societal improvement and institutional modernization are developed in parallel.

In practice, targeted-development finance functions in the following way: (1) it integrates sovereign credit with market performance effectively; (2) it combines quasi-treasury bonds with asset management methods; and (3) it aligns its advantages in financing with that of government in organizing and restructuring enterprise capacity to meet policy objectives.

Ladies and gentlemen, China and India are two great nations that are the inheritors of two great ancient civilizations. Today the issues of development and globalization confront us both and we face the same or similar opportunities as well as challenges. We can learn from one another in respect of reform and development and it is beneficial that we do so.

China Development Bank wishes to import from India advanced management education and technology. We wish to strengthen cooperation between our nations and advance the exchange of talent and trade. We see economic collaboration as a progenitor to increased trade and development for us both, and in so doing, contribute further to long-term economic prosperity for Asia and the world.

I would conclude by citing what a famous former leader said, “There will be no real Asia-Pacific century until both China and India are well-developed.”

Thank you.