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DEVELOPMENT PROJECT (FMD)

CHINA'S FINANCIAL SECTOR DEVELOPMENT

CHINA TODAY BEARS LITTLE RESEMBLANCE TO THE CHINA I FIRST VISITED IN 1975. IT HAS COME A LONG WAY AND WILL TRAVEL EVEN FASTER IN THE NEXT 22 YEARS.

IT IS DIFFICULT FOR FOREIGNERS TO STAY ABREAST OF THE CHANGES IN CHINA - NOTWITHSTANDING ITS "STEP BY STEP" APPROACH TO ECONOMIC REFORM - AN APPROACH WHICH CONTRASTS WITH THE "BIG BANGS" FAVORED IN THE WEST AND FOLLOWED BY RUSSIA IN ITS ROUGH TRANSITION TO A MARKET ECONOMY.

FOR CHINA ITS ASIAN APPROACH IS SENSIBLE, BUT EAST ASIA IN GENERAL HAS BEEN SLOW TO RECOGNIZE THAT FINANCE IS THE LIFE BLOOD OF AN ECONOMY - LIKE THE CARDIOVASCULAR SYSTEM IS TO THE HUMAN BODY. THE FINANCIAL SYSTEM DETERMINES THE HEALTH OF THE ECONOMY.

IN 1993 THE PACIFIC ECONOMIC COOPERATION COUNCIL (PECC) RECOGNIZED AT MY SUGGESTION THAT ALL EAST ASIAN ECONOMIES HAD UNDERDEVELOPED FINANCIAL MARKETS, AT LEAST BY WESTERN STANDARDS. THEY WERE EXCESSIVELY DEPENDENT ON COMMERCIAL BANKS AND THE CHINESE NETWORK - INEFFICIENT AND EXPENSIVE WAYS OF MOBILIZING FOREIGN, AS WELL AS DOMESTIC, SAVINGS AND ALLOCATING THEM TO THEIR MOST PRODUCTIVE USES.

SAVINGS LEVELS IN EAST ASIA ARE THE WORLD'S HIGHEST - BUT THE REGION'S FINANCIAL REQUIREMENTS ARE ENORMOUS - ESPECIALLY FOR INFRASTRUCTURE IMPROVEMENTS AND INDUSTRY WHICH IS BECOMING MORE CAPITAL INTENSIVE.

WITHOUT EFFICIENT FINANCIAL MARKETS IT IS ALSO MORE DIFFICULT TO TRANSFER OWNERSHIP OF STATE ENTERPRISES TO PRIVATE HANDS. VENTURE CAPITAL FOR THE START UP OF ENTERPRISES IS MORE DIFFICULT TO ACQUIRE BECAUSE VENTURE CAPITAL INVESTORS LOOK FOR AN EXIT FROM THEIR INVESTMENTS IN FINANCIAL MARKETS. AND CENTRAL BANKS LACK ALL THE TOOLS FOR MONETARY POLICY AND FOSTERING GROWTH IN THE MONEY SUPPLY WHILE KEEPING PRICES AND EXCHANGE RATES STABLE. THEY REQUIRE THE OPEN MARKET OPERATIONS WHICH FINANCIAL MARKETS MAKE POSSIBLE.

IT WAS NOT UNTIL 1994 THAT PECC AND APEC BEGAN TO ADDRESS THE NEED FOR MORE EFFICIENT AND LIQUID FINANCIAL MARKETS AND THE FINANCIAL

INTERMEDIARIES WHICH MAKE THEM FUNCTION. IT CREATED THE FINANCIAL MARKETS DEVELOPMENT PROJECT. CHINA JOINED THE EFFORT ENTHUSIASTICALLY AND IS ABLY LED NOW BY LIU MINGKANG OF THE STATE DEVELOPMENT BANK AND ZHANG WENZHONG. THE CATALYST INSTITUTE OF THE U.S SUPPORTED U.S. INVOLVEMENT. JAPAN'S WAS LED BY ITS FOUNDATION FOR ADVANCED INFORMATION AND INFORMATION (FAIR).

NOW ALL THE ECONOMIES OF EAST ASIA ARE MOVING TOWARD DEREGULATION OF FINANCIAL MARKETS BUT ARE FACING DIFFERENT LEVELS OF DEVELOPMENT AND CONDITIONS. SOME LIKE THE REPUBLIC OF KOREA HAVE MANY BANKS WITH BAD LOANS; KOREA MUST BE CAREFUL NOT TO EXPOSE ITS BANKS TO TOO MUCH COMPETITION TOO FAST. SO THE EAST ASIAN ECONOMIES ARE MOVING IN DIFFERENT WAYS AND AT DIFFERENT SPEEDS.

IN ADDITION TO THE NECESSITIES OF ECONOMIC DEVELOPMENT AND MONETARY POLICY, THE ECONOMIES OF THE REGION WILL BE UNDER PRESSURE FROM WITHIN APEC AND THE WORLD TRADE ORGANIZATION TO OPEN UP THEIR MARKETS TO FOREIGN FINANCIAL SERVICE COMPANIES. I HOPE AND EXPECT THAT CHINA WILL SOON BE MEMBER OF THE WTO - SO A CONVERGENCE OF PRESSURES IS BUILDING FOR DEVELOPMENT OF FINANCIAL MARKETS WHICH, TO SOME EXTENT, REQUIRES THE KNOW HOW AND CAPITAL OF FOREIGN INTERMEDIARIES - LIKE INVESTMENT BANKS AND FUND MANAGEMENT COMPANIES AND INSURANCE COMPANIES WHICH OFFER SAVINGS VEHICLES, INVESTMENT MANAGEMENT SERVICES AND CREATE MARKETS FOR THE BONDS NEEDED FOR LONG TERM FINANCING. CREDIT RATING AGENCIES ARE NEEDED.

ELECTRONIC COMMERCE IS DEVELOPING RAPIDLY ALSO; ELECTRONIC MARKETS ARE BEGINNING TO MAKE TRADES POSSIBLE WITHOUT THE INTERMEDIATION OF TRADERS. THE INTERNET IS BRINGING VAST AMOUNTS OF INFORMATION TO ANY INVESTOR OR TRADER ANYWHERE WITH A TELEPHONE AND MODEM. SOON DATA AND VOICE TRANSMISSIONS WILL BE AVAILABLE TO ANYONE WITH ACCESS TO THE DIGITAL MOBILE NETWORKS BEING DEVELOPED AND DEPLOYED IN CHINA AS WELL AS ELSEWHERE.

WHICH BRINGS ME TO CHINA. CHINA HAS MADE GREAT PROGRESS SINCE THE BEGINNING OF ITS EFFORTS IN 1994 TO DEVELOP A MODERN FINANCIAL SYSTEM WITH THE PEOPLES BANK BECOMING A TRUE CENTRAL BANK. ITS EFFORTS CONTINUE. LAWS ON FOREIGN EXCHANGE CONTROLS, COMMODITY TRADING AND BANKRUPTCY WILL SOON BE PROMULGATED. ALL BUT THE FOUR LARGEST STATE BANKS HAVE BEEN FREED OF GOVERNMENT CONTROL. STATE OWNED ENTERPRISES HAVE BEEN REFORMED, MERGED OR ALLOWED TO GO BANKRUPT. A SAFETY NET FOR DISPLACED WORKERS IS BEING DEVELOPED.

BANK DEPOSITS HAVE SOARED AND FINANCIAL INSTITUTIONS HAVE MULTIPLIED. THE PROGRESS IS COMMENDABLE AND IMPRESSIVE. NONETHELESS, TO AN OUTSIDER CHINA'S DEVELOPMENT STILL SEEMS TO BE

RETARDED BY A FINANCIAL SYSTEM MORE CONTROLLED BY GOVERNMENT THAN THE REST OF THE ECONOMY.

THE STRUCTURE OF CHINA'S FINANCIAL SYSTEM HAS CHANGED, BUT BENEATH THE MULTITUDE OF BANKS, NON BANKS, TRUST AND INVESTMENT COMPANIES, SECURITIES COMPANIES AND FINANCIAL MARKETS - NOT ENOUGH HAS CHANGED. THERE ARE MORE VEHICLES FOR INVESTMENT OF SAVINGS, BUT THE WAYS BY WHICH THE SYSTEM CREATES MONEY AND DISTRIBUTES CREDIT TO USERS OF CAPITAL SEEMS LITTLE CHANGED IN PRACTICE. IT REMAINS AN INEFFICIENT SYSTEM.

VIRTUALLY ALL THE BANKS ARE GOVERNMENT OWNED. LOANS STILL APPEAR TO BE ALLOCATED BY GOVERNMENTS; INTEREST RATES ARE CONTROLLED AT BELOW MARKET RATES; THE BANKS ARE BURDENED BY BAD LOANS AND, ACCORDING TO THE WORLD BANK, IN THE AGGREGATE HAVE A NEGATIVE NET WORTH - MORE LIABILITIES THAN ASSETS. TO GET AROUND THE CONTROLS, ALL KINDS OF INFORMAL FINANCIAL INSTITUTIONS AND MARKETS DEVELOP LIKE THE CURB MARKET. THIS IS INEFFICIENT AND OFFERS FEW SAFEGUARDS FOR INVESTORS. IMPORTANT INSTITUTIONS FOR AVERAGE INVESTORS LIKE INVESTMENT FUNDS REMAIN UNDERDEVELOPED AND UNDER REGULATED.

THIS SYSTEM INHIBITS THE DEVELOPMENT OF MONEY MARKETS AND CAPITAL MARKETS. ALL OFFERINGS IN THE CAPITAL AND MONEY MARKETS HAVE TO BE APPROVED BY THE GOVERNMENT. THIS IS PARTLY FOR PRUDENTIAL REASONS - BUT ALSO TO PROTECT THE BANKS FROM COMPETITION IN THE OPEN MARKET. APPROVALS FOR NEW OFFERINGS ARE INCREASING, BUT THE BOND MARKETS ARE STILL DOMINATED BY TREASURY ISSUES. THE STOCK MARKETS ARE MINUSCULE IN RELATION TO GROSS DOMESTIC INVESTMENT. THEY ARE ALSO HIGHLY VOLATILE WITH AN UNENFORCEABLE CLASSIFICATION OF A AND B SHARES FOR CITIZENS AND FOREIGNERS. COMPANIES SEEK LISTINGS IN HONG KONG, INSTEAD OF BEIJING OR SHENZHEN, AND SOMETIMES RECEIVE PHENOMENAL RETURNS.

SO WHAT TO DO? OBVIOUSLY A GREAT DEAL NEEDS TO BE DONE - AND IS BEING DONE- TO DEVELOP THE HUMAN INFRASTRUCTURE, THE TRAINED PERSONNEL, AND ALSO THE INSTITUTIONAL FRAMEWORK - THE ACCOUNTING PRINCIPLES AND DISCLOSURE REQUIREMENTS, ENFORCEMENT AGENCIES, NATIONWIDE FUND CLEARING AND SETTLEMENT SYSTEMS. THIS IS BASIC AND REQUIRES LITTLE ELABORATION THOUGH MUCH WORK.

THE REFORMS WHICH STARTED IN 1994 ARE AN EXCELLENT START. BUT IT SEEMS TO SOME OF US ON THE OUTSIDE THAT THE ENTIRE EFFORT TO DEVELOP A SOUND BANKING SYSTEM AND CAPITAL MARKETS IS STILL RETARDED BY THE DEPENDENCE OF LARGE STATE ENTERPRISES ON THE BANKS. THE BANKS HAVE TO BE PROTECTED FROM COMPETITION IN A FREE MARKET BECAUSE THEY ARE WEAK, AND THEY ARE WEAK BECAUSE THEY HAVE TO SUBSIDIZE STATE

ENTERPRISES. SETTING UP POLICY BANKS IS NOT SOLVING THE POLICY LOAN PROBLEM. AND, GIVEN THE FISCAL PROBLEMS OF THE GOVERNMENT, IT IS DIFFICULT TO SEE HOW THE OBJECTIVES OF THE POLICY LOANS CAN BE LIFTED OFF THE BANKS BY THE GOVERNMENT.

CONFLICT BETWEEN SECURITIES AND COMMERCIAL BANKING BUSINESSES IS PRESENT IN ALL ECONOMIES WHERE THEY ARE PREVENTED FROM ENGAGING IN EACH OTHER'S BUSINESSES, INCLUDING IN THE US. WE HAVE BEEN STRUGGLING FOR A LONG TIME TO STRENGTHEN OUR OWN BANKS SO THEY CAN BE COMPETITIVE IN THE NEW GLOBAL ECONOMY AND HELP OUR INDUSTRIAL FIRMS BE COMPETITIVE. WE STILL SEEK TO GIVE OUR BANKS BROAD POWERS TO UNDERWRITE AND DEAL IN SECURITIES, SELL INSURANCE AND OTHER FINANCIAL PRODUCTS, AS WELL AS ENGAGE IN COMMERCIAL BANKING. THEN THEY COULD MEET ALL THE FINANCIAL REQUIREMENTS OF THEIR CLIENTS, INCLUDING THE FOREIGN COMPANIES DOING BUSINESS IN THE U.S. THIS STRUGGLE CONTINUES IN THE U.S., AND IT MAY BE A STRUGGLE THAT SHOULD BE ADDRESSED BY CHINA AS IT SEEKS TO STRENGTHEN ITS BANKS.

CHINESE OFFICIALS OFTEN SAY THAT CHINA'S BANKS WILL BE STRENGTHENED WHEN THE STATE ENTERPRISES ARE REFORMED AND BECOME STRONGER CREDITORS. BUT THEY WILL BE SLOW TO REFORM AS LONG AS THEY CAN RELY ON SUBSIDIZED LOANS, MANY OF WHICH ARE IN DEFAULT AND DO NOT EARN INTEREST. SO CHINA FACES A DILEMMA. MEANWHILE STATE ENTERPRISES CONTINUE TO ABSORB CREDIT FAR OUT OF PROPORTION TO THEIR SHARE OF INDUSTRIAL OUTPUT.

THIS DILEMMA CAN ONLY BE RESOLVED BY SIMULTANEOUS REFORM OF THE FINANCIAL AND INDUSTRIAL SECTORS. BUT HOW? ONE POSSIBILITY IS TO SECURITIZE THE POLICY LOANS, REPLACE THEM WITH BONDS, GRADUALLY SHIFTING THE BURDEN OF THESE LOANS TO THE GOVERNMENTS THAT ARE RESPONSIBLE FOR THEM. GOVERNMENTS WITH TAXING POWER COULD OVER TIME ISSUE BONDS TO THE BANKS IN EXCHANGE FOR POLICY LOANS. THIS PROCESS WOULD PUT SOME RESPONSIBILITY ON THE GOVERNMENTS TO WORK WITH THE ENTERPRISES TO REFORM THEM - OR, IF THEY WISH, TO CONTINUE SUBSIDIZING THEM. FROM THIS APPROACH MANY DIFFERENT SOLUTIONS WOULD BE DEVELOPED FOR DIFFERENT SITUATIONS - WHICH IS DIFFICULT IF THE REFORM PROCESS FOR THIS VAST COUNTRY IS BEING ORCHESTRATED BY ITS CENTRAL GOVERNMENT.

THIS PROCESS COULD ALSO LEAD TO THE FURTHER DEVELOPMENT OF CHINA'S BOND MARKETS - WITH INTEREST RATES AND BOND VALUES ESTABLISHED IN THE MARKET PLACE, INSTEAD OF BY GOVERNMENT. FOR THE BOND MARKETS TO DEVELOP, THE MARKET WILL HAVE TO ESTABLISH THE INTEREST RATES. BUT THIS CAN BE A GRADUAL PROCESS. THERE ARE MANY KINDS OF INTEREST RATES. THE PROCESS MIGHT START WITH DEREGULATION OF MONEY MARKET RATES. IN ANY EVENT, ALL INTEREST RATES DO NOT HAVE TO BE

DEREGULATED AT ONCE. IT WILL HAPPEN ANYWAY SINCE BELOW MARKET RATES FORCE INVESTORS TO FIND UNREGULATED WAYS TO INVEST.

REQUIRING CHINA'S FINANCIAL INSTITUTIONS TO COMPETE IN THE MARKET ECONOMY WILL HELP THEM BECOME MORE EFFICIENT AND RESPONSIVE TO THE NEEDS OF THEIR CLIENTS AND THE ECONOMY AS A WHOLE. IF THEY NEED HELP, JOINT VENTURES COULD BE PERMITTED TO A GREATER EXTENT WITH FOREIGN INSTITUTIONS AND DIRECT FOREIGN INVESTMENT WHICH WOULD ALSO HELP TO MOVE TOWARD COMPLIANCE WITH FUTURE WTO REQUIREMENTS IN THE FINANCIAL SERVICES SECTOR.

THE CHINESE ARE BY NATURE GREAT FINANCIAL ASSET MANAGERS. AND IF CHINA IS TO BE FULLY ENGAGED IN THE GLOBAL ECONOMY, ITS COMPANIES AND FOREIGN COMPANIES IN CHINA WILL NEED THE SUPPORT OF COMPETITIVE FINANCIAL INSTITUTIONS OFFERING A WIDE RANGE OF SERVICES - FROM COMMERCIAL LENDING AND TRADE FINANCE TO FUND MANAGEMENT AND HEDGING IN FUTURES MARKETS. SHANGHAI COULD COMPETE WITH LONDON AND NEW YORK. AND CHINA'S FINANCIAL SERVICES SECTOR WOULD BECOME A MORE DYNAMIC SOURCE OF PROFIT AND EMPLOYMENT, AS WELL AS EVEN GREATER PROGRESS FOR CHINA..