

**China and the Global Economy**  
**Financial Reform and Unlocking Opportunities**  
**Painters' Hall, London 29<sup>th</sup> October 2019**  
**Remarks by Mark Yallop, Chair FMSB**

Good Morning

I first had the privilege of visiting China in October 1984. Li Xiannian was President. Beijing was a city of bicycles. And we stood on Chang'an Avenue on the first of the month to watch a huge parade marking the 35<sup>th</sup> anniversary of the foundation of the People's Republic. China's economy that day was smaller than either Canada and Italy.

35 years on, the National Day parade is still pretty impressive. But everything else has changed. There aren't many bicycles. And GDP has grown 45 times, making China the second largest economy in the world.

Today, China is the largest exporter of goods in the world, the largest importer of crude oil and the consumer of over half of many non-oil commodities globally, including steel and coal. Its businesses are the manufacturing engine of the world, accounting for 20% of all global manufacturing output and employing 130 million people in its factories; and it is a true leader in the advanced technologies of tomorrow. The heart of this engine has been the Chinese SME sector, which accounts for 90% of businesses, 50% of tax revenues, two-thirds of GDP, 70% of technology innovation and 80% of urban employment.

China's economic performance in my working lifetime has been literally staggering. So it seems impudent to say the least for me to offer advice on what policies it should, or could, follow now. There are few things more unattractive than poorly-informed foreigners handing out simplistic prescriptions masquerading as policy expertise.

Let me therefore offer a couple of observations and some suggestions relating to financial markets policy, an area that I can comment on more confidently.

First, as is well known, this exceptional growth has been fueled in large part by debt.

Private sector debt stands at about 200% of GDP, of which corporate debt is roughly three-quarters and household debt one-quarter. Debt levels have risen markedly in the past decade, with corporate debt rising from 90% to 150% of GDP and household debt from 20% to 50% of GDP. As is also well known, much of this debt is related directly or indirectly to property. Less often talked about is the dependence of the critical SME sector on non-bank finance.

Second, despite a range of new regulatory and policy changes introduced in the past 2 years to rebalance the economy, the increasing interconnectedness of China with the rest of the global economy means that spill-over risks both into and from China to the rest of the world are more material than ever before.

Necessary regulatory reforms to banking and non-bank finance are squeezing credit supply, offset to some degree by fiscal easing and monetary measures. In the past we in the rest of the world would have worried principally about the knock-on impact on Asian economies and commodity exporters. But increasing economic integration means we have to be concerned today about the knock-on impact in Europe and the US; and trade disputes mean we have to be concerned about additional pressures inside China which may not be so easily countered.

Many observers have helpful suggestions for how to grasp these pressures. Generally, they involve versions of speeding up financial sector change and further opening up financial markets in China.

It is true that China's capital markets are of broadly similar size, relative to GDP, to other countries of similar income levels, but are noticeably more closed to foreign entry. Potentially therefore, liberalising the capital and financial markets could bring a number of advantages.

More foreign capital inflows could help to finance credit at a lower cost, increase the efficiency of resource allocation, bolster competition in the domestic financial system,

aid market liquidity, and help to finance green initiatives. Foreign investors could bring with them valuable expertise in restructuring the corporate sector. Opening up the financial services sector could help to reduce pressures arising from the trade disputes. Liberalising the capital account would also allow domestic investors to diversify their portfolios and offers debtors more alternative sources of borrowing.

And it is true that there are many technical factors which could be looked at to step up internationalisation of the RMB and increase interest in the RMB asset class.

Among these might be:

- Streamlining the approval processes for Panda bonds;
- Rationalizing or consolidating some of the channels by which foreign investors access RMB fixed income markets, to make holdings more fungible across channels, standardize operational requirements between channels, improve the liquidity of off-the-run issues and make index tracking easier;
- Increasing access for international credit rating agencies to the onshore market;
- Changing arrangements in the repo market to provide for transfer of ownership of the underlying security, conforming to global standard documentation and opening up repo markets to a wider range of institutions;
- Increasing participation in onshore bond futures markets;
- Further developing the municipal bond markets.

And there are excellent positive examples of how technical changes of this sort in the past have had a beneficial effect on the markets: the inclusion this year of RMB bonds in BBG Barclays Global Aggregate Bond index, for example. All of these ideas are worth further thought.

But I would like to sound a note of caution for policy makers wrestling with the bigger strategic, structural questions of openness and liberalization and finish with three short observations from experience elsewhere.

- First, beware calls for increased flexibility in the foreign exchange regime until the institutional arrangements for managing such flexibility – whatever these need to be: inflation targeting, further-developed regulation of the financial sector and so forth – are secure; otherwise the increased volatility and unpredictable capital outflows that will likely result may do more damage than the benefits that are expected;
- Second, exercise caution about liberalizing the capital account before the domestic economy has achieved a balance and the regulatory infrastructure to oversee it - both macro-prudential and micro-prudential – are well established and fully coordinated.
- Third, remember that regulation cannot control all risks in financial markets; for markets are driven by human behavioural traits, which are not necessarily rational, as well as by the law. We have spent hundreds of billions and painful years of remediation work repairing the damage created by poor conduct and unethical behaviour in so-called developed Western markets.

Behaviour that was often inside the law and regulation, or occurred in areas where regulation and the law were silent. Behaviour, however that was outside any notion of what acceptable business practices might be. Behaviour that undermined the effectiveness of our markets and killed the trust in them that consumers, businesses and governments need to have.

Through these experiences we have learnt the hard way about the importance of Standards and clearly defined guidance on good practice where the law and regulation cannot dictate how markets operate, and the importance of engaging and educating professionals working in markets on these principles. So my final request is that policy makers learn from our experience – most recently with the FX Global Code and the FICC Markets Standards Board – how to protect financial markets and the trust in them that is essential for them to support a modern economy.

Ladies and Gentlemen, thank you for your attention.