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Our next speaker is Professor Qiao Yide, who is Vice Chairman and Secretary General of the Shanghai Development Research Foundation. He specialises in financial, economic and stock market issues. Qiao graduated from the Kennedy School of Government at Harvard and has done some great work on a number of interesting presentations on what is called the cognition gap between Shanghai and outside China.

Qiao YIDE, Vice President & Secretary General, Shanghai Development Research Foundation

Thank you, Ambassador, for your kind introduction and for organising and chairing the workshop on China. I would also like to thank Professor Cooper for setting a good foundation for me to go more deeply into talking about the Chinese economy. I will not address the Chinese issue today but rather will give an alternative perspective to address some reasons for the cognition gap between Chinese decision-makers and international economists and investors on specific issues, such as how to explain and interpret the stock market turmoil in China in June and exchange rate reform. Professor Cooper described the general trend for the Chinese economy and we have a general agreement between outside investors and economists and Chinese economists, but on specific issues there are some differences. I would like to use the case of exchange rate reform on 11 August to elaborate on the reasons behind the differences and try to explore ways of reducing these differences in the future.

The People's Bank of China (PBoC) – China's central bank – made an announcement on the reform of exchange rates on August 11. The main context of the announcement was reform of central parity fixing. Secondly, there would be a one-off depreciation of the renminbi of 3%. That was the main context of the announcement on August 11. However, these announcements received a strong reaction from the rest of the world. The entire major stock index fell immediately the next day and in some markets it fell dramatically. Why was this? It was because only in June there had been turmoil in the stock market and people were asking why the Chinese Government would do this to the exchange rate. There must be something wrong that they did not know about it.

I will quote Martin Wolf who said 'It is a good move but bad timing'. The conclusion therefore was that the Chinese Government tried desperately to prevent the collapse of the Chinese economy by introducing a big depreciation of the renminbi. Therefore was then the strong reaction from the rest of the world. Interestingly, at the same time, Chinese officials felt shock and surprise in the face of this strong reaction from outside. Behind the closed doors of an international conference that I was attending, I heard a middle-ranking Chinese official complain – as some foreign guests were also attending – saying 'We have been under great pressure to carry out market-oriented reforms. We are doing that now but at the same time we are still subject to strong criticism. Why is that? We do not understand why that is'. I suppose that that demonstrates that there was a cognition gap between Chinese decision-makers and outside observers and investors.

Why does this gap exist? First of all, I have tried to identify three major motivations behind the August 11 announcement. First, the Chinese Government tried to reform the central parity fixing mechanism. It is well known that in China we adopt what is called a managed floating rate system or mechanism, which means that it includes three components. First of all, the exchange rate of Chinese renminbi is determined by its sticking to a currency basket. However, we do not know which currencies are in it and how they are weighted in the basket. Secondly, there is central parity fixing which the Central Bank decides each day. The third component is the daily fluctuation range around central parity fixing. Originally, this range was 0.5% and later it became 1% and recently 2% along the central parity. Every day, foreign exchange could float up or down by 2%. That is therefore the whole picture.

I would now like to talk about the change to central parity fixing, which was the first motivation of the announcement. This is the interbank foreign exchange market which is based in Shanghai and is affiliated to the PBoC. The PBoC has the ability, or authority, to intervene in the market. That is that the commercial banks put in the money – the foreign exchange – and carry out transactions through the interbank exchange market. The foreign exchange is of course for residents and enterprises to give money to the commercial banks for that. That is the central parity. Previously, the Central Bank had decided central parity fixing, which determines the floating range on that day, as I described, and then the closing price on the day.

The Central Bank now tried changing that and reformed the mechanism. They severed the relationship between the Central Bank and central parity fixing and allowed the commercial banks to directly decide central parity based on the previous day's closing price. Therefore, from the Central Bank's perspective, that move is more market-oriented.

Interestingly, I would like to share an episode with you. A couple of weeks ago, I had dinner with a Board member of Cathay Pacific Airlines, which is very famous in Asia, who told me how they decided the price of an air ticket daily by using software and putting a lot of dates into calculation. For example, he said that every year the ticket for 16 December from London to Hong Kong is the most expensive because all the students want to go home for Christmas then. In the past, they had difficulty identifying the exchange rate for the renminbi for the following day. They now know what it is because they can base it on the closing price for the previous day and then put the date into their calculation. That is a very important step in a market-oriented mechanism.

However, I should point out that this is not totally marketalised because the People's Bank can still intervene in the exchange. As you will remember, they have never said that Central Bankers cannot intervene in the exchange market and that is one reason for the misconception on all sides. They will argue by saying 'Okay. You have already done that. Why is the PBoC still intervening in the market?'

The second motivation is that the Central Bank is trying to meet the request of the IMF to include the renminbi into the SDR basket. In July, the IMF issued a staff report on the review of methodology of including a currency into the SDR basket. They had been positive about the progress that the renminbi had already made in terms of being freely useable, which is the one criterion for putting a currency into the SDR basket. Another criterion is that you have to be a top export country, and China already met this criterion in 2010. However, at that time they could not meet the other criterion on being freely useable. The staff report was positive on progress made but at the same time it pointed to some operational issues that were still there. First of all, current onshore-fixed renminbi rate is not a market-based representable rate. There were also other operational issues.

After that, the Chinese Government took serious actions to meet the request, although I do not want to go into a lot of detail on this as some of these were very technical. Chinese Government decided to release data according to the Special Data Dissemination Standard (SDDS) which is a high standard of data release for meeting the request of the IMF. The Ministry of Finance started to issue three months bonds on a weekly basis, which was what the IMF was requesting. In addition, the Central Bank intends to extend the interbank foreign exchange trading time to almost midnight so that North American and European markets can still do the transition after closing time in China. It will also allow foreign central banks, sovereign wealth funds and international financial institutions to enter the interbank bond market and the foreign exchange market.

On November 13, Mme Lagarde issued a statement where she basically said that the Chinese authorities had already addressed all the remaining operational issues identified in initial staff analysis submitted to the Executive Board in July.

Therefore, when we look back, it is very clear that that is one of the motivations of the Chinese Government was to try to bring in exchange reform. You may of course argue whether it is worse for the Chinese Government to spend so many political assets on this. I think that that is a legitimate question but it is irrelevant to the issues that we are discussing.

The third reason is that it may partially offset renminbi appreciation occurred in the past. In the past one year, other currencies depreciated dramatically against the US dollar. However, the renminbi actually appreciated against other currencies, including the US dollar. Therefore, a 3% depreciation only partially offset the appreciation of the renminbi that occurred in the past. The renminbi only depreciated by 2.4% from August 2011 until last Friday. We can also see the difference between the renminbi offshore and onshore rates, where the gap has reduced. As we will remember, the IMF staff report stated that the central parity rate was not market-based, which shows that the Chinese have made a great improvement to meet the IMF's request.

Why do these cognition gaps exist and how can they be reduced or eliminated? I really like Larry Summers' article a while ago where he said that the world, including China, was unprepared for the rise of China. The article was published in The Washington Post and I strongly suggest that you read it. That was the general conclusion for the reason why the gap exists. However, I would like to go into this in a bit more detail and look at what we should do about it.

The rest of the world probably has to understand the Chinese philosophy of reform, which is gradualism. If we look at the approach that China has taken in the past 30 years, it is a gradual one, which is totally different from the shock therapy that was taken by the former Soviet Union. The Chinese are also using this philosophy in financial reform. This is very important. As I have described, the exchange reform this time is a step forward. Up until now, it is not totally floating. However, they have changed it partially by changing the central parity fixing. Central Bank intervention in the foreign exchange markets is not totally forbidden.

Secondly, we need to distinguish one policy error from the general trend of reform although this policy error is part of the reason for the turmoil in the stock market. I think that the Chinese authorities made a mistake in dealing with the stock market. At the beginning, the official media editorial said that 4,000 points was only the start for the bull market and I think that it is wrong for the Government to indicate which price level is a proper. In addition, they later dealt with a lot of things in a way that was less than perfect. However, very importantly, we have to distinguish one policy mistake from the general trend of reforms and we must also keep in mind that it is not the same people who make the decisions on the stock market and the foreign exchange reform, which is a different authority.

Another thing, we have to go beyond the data issue. I know that there is a lot of debate and argument about some data not being true, but I am not in a position to be able to say whether that is right or wrong. However, it is not a big issue. You cannot always fake the data systematically for a very long time.

Additionally, in China, decision processes must be streamlined in two ways. They have to have a clear cut between Government and the market. As a Party document says, 'let the market play a decisive role in resource allocation'. Another meaning is to reduce the heavy bureaucracy among the decision-making, and the processes also have to be transparent. If the Chinese Government really wants the renminbi to become a reserve currency, it has to move further to do that. In the right time they have to release the records of the decision-making to the public, perhaps not now, but in the future. The other thing is that they have to be more effective in communication with the outside.

I will just stop there.

PARK In-kook, President of the Korea Foundation for Advanced Studies; Co-chairman of the Beijing/Shanghai Forum

Thank you. I am not an expert on financial issues but if I were to speak on behalf of outside people, to be a reserve currency the textbooks say that there are two elements. One is free capital flows and the other is a flexible exchange rate. The focus was therefore on the second of those and how China could improve on the issue of a flexible exchange rate, and I recognise that China has made some improvement. However, there is still silence on the free capital flows issue.

People outside of China still have chronic complaints. As of now, only 3% of China's stock market is open to foreigners. Until there is an improvement on that basic problem, outsiders will still have lingering hesitations and doubts. I would therefore highly appreciate it if we could have a blueprint for further improvements on that.

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It will be fully liberalised by 2020.