

The Challenges to Payment Business in Asia

Speech by Mr. Thirachai Phuvanatanarubala

Secretary-General, Securities & Exchange Commission, Thailand

At the Asia Pacific Business Information Industry Association Conference,
Chiang Mai, Thailand, 11 November 2009

Good Morning, ladies and gentlemen

We are still right in the middle of the financial crisis that is considered the most severe in several decades. And things are still unfolding. Estimates by the IMF indicate that despite the big losses already written off, there are still more to come.

The banking system is the sector that has taken the biggest hit. Suddenly the job of bankers has become much less secure than before. Their bonuses have come under criticism. And there are various calls for tighter regulations.

But even in the banking circle, your particular segment, the payment business, has been the least affected. So today you can rest in comfort that, in your line of business, advancement and development will still have to continue.

Nevertheless, a financial crisis of this proportion **will** definitely pose both new opportunities and new challenges to all businesses, the payment business included. Therefore advance and develop as your line of business may continue to do, the impact of this crisis will still be felt by you for many more years.

Therefore, today I will try to interest you by sharing with you some of my thoughts on what challenges and opportunities lie ahead for your business.

The most important thing to look at is the unwinding of the global imbalance. By now, it is clear that global imbalance was the most important factor that brought on this financial crisis. So we should analyze this phenomena closely, its rise and its fall.

Imbalance is the word used to describe the situation when one country or one group of countries run persistent trade surplus, while

another persistent trade deficit. This is not global problem until it becomes especially big and threatens to run away without any solution.

Global imbalance is not a new thing, however. If you look back into history, the opening of a major geographical region to join in the globalization process would always create some economic ripples.

The opening of the American continent, both North and South, had strong impacts on European trade of cotton and sugar, as well as the investment flows from Europe to the new worlds to finance railroads and other infrastructure projects as never seen before those days.

The opening of the naval trade route from Europe to East Asia also caused European countries to suffer trade deficits from importing spices and other commodities. In both American and Asian examples, the European countries in a way solved the problem of global imbalance at that time by colonization.

In my opinion, perhaps the most interesting chapter is China's entries into world trade. China's first commercial contact with Europe was through the silk route which went overland through Afghanistan and Turkey.

The commercial exchanges were disrupted by the Mongol some 700 years ago. They were good warriors and looted and killed for others' possession in many European countries. I am not sure whether they did it in order to solve global imbalance at that time or not, but it certainly was a way of getting something for nothing.

After the Mongol era, the Ming Dynasty several time some 400 years ago sent out a massive trade navy led by a famous eunuch. They called on several sea ports in Asia and Africa. Unfortunately, they found no product that China particularly wanted and sadly stopped the practice after a few missions.

If China had continued opening up the sea trade route to Europe, perhaps it would have found a-----

It occurred the first time during the Qing dynasty. At that time, China's competitive advantage over the trade of tea with Britain was particularly strong.

The British widely picked up the habit of drinking tea, resulting in very high import. Unfortunately, at that time Britain could not produce anything that China particularly wanted. Therefore China ended up with a

big trade account surplus with Britain. And Britain had to settle in silver ingots.

The global imbalance problem at that time was therefore between China and Britain. Unfortunately, the imbalance got too big and there was no system of IOU at that time for China to give long term credit to Britain. Therefore Britain had to pay for its tea without any financing.

After a while, Britain of course ran out of silver ingots. Britain had to resort to opium. To correct the global imbalance and lessen its trade deficit, Britain sold opium to China.

The Chinese became addicted to opium as much as the British became addicted to tea. However, opium was detrimental to health as well as productivity. In the end, the Chinese government decided to resist the importation of opium.

Without opium, there was no other commercial way for Britain to correct the global imbalance. No other way except a tragic war. Finally Britain ganged up with France and attacked China. The extent of looting and destruction of the Imperial Palaces in Beijing was among the most awful in recent history.

Chinese Imperial ceramics and bronzes that were taken from the Palaces by British and French soldiers would today resurface in public auctions in London, Paris and Hong Kong every now and then. Each time it would cause China to protest the offer for sales, but without success.

Having said this, I have to apologize to you for being somewhat simplistic in my analysis of history. Many historians may contradict my analysis and my conclusion of the events. And I do not mean to pass any judgment on past actions, good or bad. The reason that I bring up this side of history is because of the lesson that it is in everybody's interest that global imbalances are gently and systemically wound down. If not, things could get out of hand and lead to tragedy.

Fast forward one century, and we have found that China reentered the globalization process again. It started some 25-30 years ago. This time, China simply used the very same model as the other East Asian countries that entered development after the Second World War. The model of the factory of the world!

The only exception is that China started from a very low base and that it is a very, very large country. No other previous Asian country

had such a vast supply of labor that could keep the wages low for so many years as China.

Other East Asian countries would see their wages rise after a while, and this will cut into their trade surpluses. Unless they can upgrade their technology into the goods with higher value add. The weights that they add to the global imbalance would therefore start to reduce after a short while.

But in the case of China, the competitive labor advantage continued for many years. Hence the buildup of trade surplus and the global imbalance was much bigger.

Another factor that caused the trade surplus to persist was that the model of factory of the world required wages to be kept low. Strikes and collective bargaining by workers are not allowed in China.

This kept China's labor competitive, but at the same time took away their power to consume both domestically and from abroad. Make no mistake about this. It does not mean the Chinese consumption is especially low. It is not.

In actual fact, the consumption by China of basic commodities was ferocious. It demanded more and more of everything from steel to rubber to soya beans. And because of the very high sheer head count, Chinese demand led to persistent price rises for almost all basic commodities including oil.

Importation into China covers a long list of commodities, raw materials and parts for final assembly in China for re-export. But due to the low buying power of the consumers, there has been too little importation of finished goods.

This is unlike other East Asian countries that have used market economy for much longer. I still remember many years ago, whenever Thai economy picked up after a short lull, imports would immediately rush ahead of exports because the consumption pattern of the Thai people had high import contents.

The lack of import of consumer goods into China kept the trade surplus high. It made the global imbalance worse.

Another problem that followed was that too much of China's foreign assets have been retained in the hands of the authority in the form of international reserves. China has not done enough in allowing her

citizens to invest abroad. Similar to many other East Asian countries, tight exchange control rules are still in place.

The high levels of international reserves are indeed the most important factor that turned the global imbalance into the financial crisis. Why?

When foreign cash is in the hands of the authority, they have very limited choice in their investments. A small part of the reserves can actually be used to acquire companies that own rights to natural resources in all corners of the globe.

But because the levels of the reserves are so high, the majority of the foreign investments made by the authority have to be safe. The Asian countries therefore have no choice but to invest these reserves in sovereign bonds of other big countries.

And in this global imbalance, the main counter party to China is the United State of America. On the one hand, the US is the consumer of last resort. They consume more than they can produce, and are prepared to borrow beyond their ability to repay - just to consume.

On the other hand, China, together with other East Asian countries as part of the supply chain, is the producer of last resort. And China and these Asian countries are prepared to produce more than they can consume. And they also don't mind lending money to finance over consumption.

The two sides matched perfectly. China and other Asian countries have therefore run up high trade account surpluses with the US. They ended up with high amounts of reserves. And they had nowhere to invest these reserves except in US government bonds.

Why don't these countries invest their reserves instead in bonds of European countries or Japan?

They could not. Because the US is the consumer of last resort, all these countries have to manage their currencies linked to the US dollar one way or another.

If instead they had piled their money into Euro bonds, the Euro would have strengthened, while the US dollar weakened. Not only would the European complain about the strong Euro, but the value of the reserves of Asian countries, most of which was already in US dollar, would also suddenly decline. This would have been a big dual problem.

Therefore they had no choice but to buy US government bonds. And this finally led to the biggest financial crisis in decades.

The money that flowed nonstop into the US government bond market led the US dollar long term interest rate to decline sharply over the years. The big decline in interest rate made money too freely available, at low costs. Cheap money opened the way for people to speculate in residential home en mass. And the rest is now history.

So what to do now?

Everybody is now calling for China and other Asian countries to change the development model. From factory of the world to consumer of the world, and investor of the world!

These countries should build up more domestic demand, and rely less on export. They should sell more to each other, and rely less on the United State.

And they should spread out their foreign assets more by allowing their citizens to make portfolio investments abroad by themselves, and rely less on the central banks.

Now I come to the final part. What are the opportunities and challenges for you people as a result of all this?

First, there will be much more domestic consumption in Asia. It will mean much more consumer spending, many more transactions and many more payments. This will happen both within the domestic countries in Asia and across borders, as Asian citizens become richer and travel abroad within Asia and beyond more.

China is already promoting the setting up of small retail banks to cater to the consumers and the SMEs. Over time, a large proportion of these consumption payments will have to go electronic instead of using cash.

Second, there will be much more trade of goods and services within Asia. It will mean many more large business payments across borders. More Asian companies will have operation abroad, and they will have to make many more frequent transfers of funds.

Finally, there will be much more portfolio investments across borders within Asia. It will mean many more large business payments across borders for capital market activities.

But along with the opportunities, there will also be challenges.

The first challenge that I foresee is that Asian consumers will demand excellence for their payment services. They will demand only the best.

A lot of these consumers are already internet savvy. They are already downloading music and movies in split seconds, with immediate responses to their enquiries. In payment service, I am sure the new Asian consumers will require cutting edge technology in term of speed, accuracy and convenience.

The second challenge that I foresee is that Asian companies will also demand excellence no less than the consumers.

The payment service for corporate transactions will simply have to be absolutely reliable, easily verifiable, and legally enforceable with clear finality. The old ways in which a lot of transactions go through commercial banks will change to capital markets.

Previously the payment service might have been able to rely solely on the integrity of the internal system of large commercial banks. But under the new paradigm, more and more transactions will go through the capital market. Much less reliance can be placed on the banks' internal system alone. It has to extend also to all other intermediaries.

The payment service will therefore have to ensure high integrity of capital market transactions to match the speed of transaction which keeps on increasing yearly.

Ladies and gentlemen

The best time to prepare for the future is at the point of inflection, when the trend starts to change direction. I think that moment is now, when the unwinding of the global imbalance has to begin.

It seems to me therefore that this conference is very well timed, and I have to thank you sincerely for organizing it in Chiang Mai.

Chiang Mai is the city with 700 years history and warm hospitality. This is the best environment to incubate your strategy for the future.

Thank you.