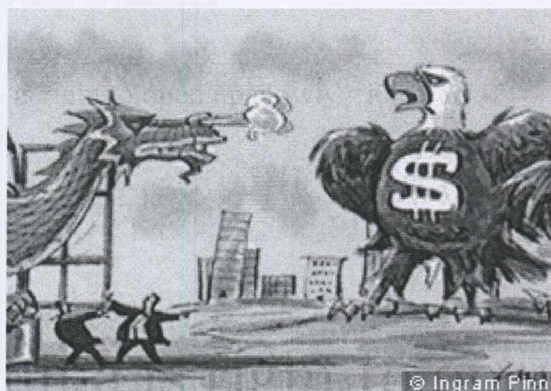
FINANCIAL TIMES

February 28, 2012 7:42 pm

China is right to open up slowly

By Martin Wolf



© Ingram Pinn

The next big global financial crisis will emanate from China. That is not a firm prediction. But few countries have avoided crises after financial liberalisation and global integration. Think of the US in the 1930s, Japan and Sweden in the early 1990s, Mexico and South Korea in the later 1990s and the US, UK and much of the eurozone now. Financial crises afflict every kind of country. As Carmen Reinhart of the Peterson Institute for International Economics and Kenneth Rogoff of Harvard have remarked, they are "an equal opportunity menace". Would China be different? Only if Chinese policymakers retain their caution.

Such caution permeated last week's report that the People's Bank of China has recommended accelerated opening up of the Chinese financial system. Given what is at stake, in both China and the world, it is essential to consider the implications. Maybe the world will then do a better job of managing this process than it has done in the past.

Click to enlarge

This plan was published by Xinhua, the state news agency, not on the PBoC's web site. Moreover, it was published under the name of Sheng Songcheng, head of the statistics department, not that of the governor or a deputy governor. This must mean that it is more an exercise in kite-flying than a policy. Nevertheless, this was published with the PBoC's approval and, quite possibly, with that of people much higher up still.

The article lays out three stages for reform. The first, to occur over the next three years, would clear the path for more Chinese investment abroad as "the shrinkage of western banks and companies has vacated space for Chinese investments" and so presented a "strategic opportunity". The second phase, in between three and five years, would accelerate foreign lending of the renminbi. In the longer term, over five to 10 years, foreigners could invest in Chinese stocks, bonds and property. Free convertibility of the renminbi would be the "last step", to be taken at an unspecified time. It would also be combined with restrictions on "speculative" capital flows and short-term foreign borrowing. In sum, full integration would be indefinitely delayed.

What are the implications of this plan? The answer is that it seems sensible. In reaching that view, one has to take into account the benefits and risks of financial "reform and opening" for China and the world.

The arguments for such opening up to the world are closely connected to those for domestic reform. Indeed, the former cannot be undertaken prior to the latter: opening up today's highly regulated financial system to the world is a recipe for disaster, as Chinese policymakers know. It is for this reason that full convertibility would come in the distant future, as this plan suggests.

Happily, arguments for domestic reform are powerful. Dynamic financial markets are an essential element in any economy that wishes both to sustain growth and to begin rivalling rich countries in productivity, as China surely aspires to do. More immediately, as Nicholas Lardy of the Peterson Institute for International Economics notes in a recent study: "Negative real deposit rates impose a high implicit tax on households, which are large net depositors in the banking system, and lead to excessive investment in residential housing. Negative real lending rates subsidise investment in capital-intensive industries, thus undermining the goal of restructuring the economy in favour of light industries and services."*

Yet, as Mr Lardy also knows, this distorted financial regime is part of a wider system for taxing savings, promoting investment and repressing consumption, which has led to huge interventions in foreign currency markets and vast accumulations of foreign currency reserves. The deeper case for reform is that this system no longer contributes to a desirable pattern of development. But it has become so deeply entrenched in the economy that reform is politically fraught and economically disruptive. The question is even whether such reform is politically feasible. It is surely likely to be a slow process.

How would the PBoC's proposed moves towards opening up then fit with such a cautious reform? Presumably, the greater freedom for capital outflows envisaged for the next five years would partly substitute for accumulations of foreign currency reserves. Yet if this went with suggested moves towards higher real interest rates, China's savings and current account surpluses might explode, worsening the external imbalances.

This point underlines just how big a stake the rest of the world has in the nature of China's reform and opening up of the financial sector.

China's gross savings are running at an annual rate of well over $3tn, which is more than 50 per cent larger than the gross savings of the US. Full integration of these vast flows is sure to have huge global effects. China's financial institutions, already enormous, are also almost certain to become the biggest in the world over the next decade. One need only think back to Japan's integration in the 1980s and subsequent financial implosion to recognise the possible dangers. We should be pleased, therefore, that China is taking a cautious approach.

The world has a huge interest in a shift of China's economy towards more balanced growth. It has a parallel interest in the way China manages its domestic reform and opening up of the financial system. A whole range of policies need to be co-ordinated, particularly over financial regulation, monetary policy and exchange rate regimes. If this is done well, today's high-income

countries' crisis will not be promptly followed by the "China crisis" of the 2020s or 2030s. If it is done badly, even the Chinese might lose control, with devastating results.

The PBoC suggests a timetable of reforms that would fit with China's and the world's needs. But if this is to happen, thorough discussion of all the implications must now occur. China's policies do not matter for the Chinese alone. That is what it means to be a superpower – as the US should note.

**Sustaining China's Economic Growth After the Global Financial Crisis, Peterson Institute for International Economics, 2012*

martin.wolf@ft.com

Others in your industry are reading

US bank dividends set to double

Academic accuses Clarke over bill of rights

US starts on long road to recovery

Clegg forced to go soft on 'tycoon tax'

Bank of England should retire QE debt

Printed from: http://www.ft.com/cms/s/0/a44d9cec-6163-11e1-94fa-00144feabdc0.html

Print a single copy of this article for personal use. Contact us if you wish to print more to distribute to others.

© THE FINANCIAL TIMES LTD 2012 FT and 'Financial Times' are trademarks of The Financial Times Ltd.