No Time for Retrenchment

By David McCormick

Why China should push ahead with financial liberalization.

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888 16th Street, N.W.
Suite 740
Washington, D.C. 20006
Phone: 202-861-0791
Fax: 202-861-0790
www.international-economy.com

The dramatic downturn in the U.S. housing market, combined with global capital market turmoil and significant losses by leading financial institutions, has presented financial regulators and policymakers with new and in some ways unprecedented challenges. As international financial authorities have responded, many important lessons have become clear. In the United States, policymakers are taking aggressive and targeted actions to stabilize financial markets, reduce the impact of market turmoil on the U.S. economy, and ensure the mistakes that led to this downturn are not repeated. As the global financial system works through the turmoil, we must continue to digest and act upon the lessons learned from these events.

Just as it is important that policymakers in the United States learn the right lessons from the recent market turmoil, it is equally important that policymakers in China do not learn the wrong ones. Some in China have mistakenly concluded that financial market liberalization should be slowed or brought to a halt to protect against "importing" complex financial products and financial market volatility.

David McCormick is U.S. Under Secretary of Treasury for International Affairs. This article is adapted from a speech he gave at the Lujiazui Financial Forum, Shanghai, May 9, 2008.

However, it is now more important than ever that China push ahead with financial sector reform—and greater opening to foreign participation—to assure continued growth, prosperity, and stability. The lessons that U.S. policymakers have learned in recent months can also be useful for China as it moves forward with establishing the underpinnings of a modern, world-class financial system. This article focuses on China, but many of the same issues, and lessons, are applicable to emerging markets more broadly.

RESPONSES TO THE FINANCIAL MARKET TURMOIL

Why did this financial turmoil occur? A long period of benign credit conditions—relatively stable asset markets, low interest rates, and low inflation—encouraged many investors to seek higher returns. Responding to this demand, the financial services sector created a variety of complicated new products that diversified risk and lowered borrowing costs. Financial innovation brought enormous benefits, helping many people to move into homes, others to start or expand businesses, and investors to diversify their risk and enhance returns. Complacency about risk, however, encouraged a loosening of credit standards and an erosion of market discipline among investors, regulators, and credit rating agencies alike.

Last summer, however, new vulnerabilities in the financial system became clear. Looser credit standards in the housing market, combined with an end to rapid home-price appreciation, led to a significant rise in delinquent mortgages. This in turn contributed to immediate and unexpected losses for investors and a greater appreciation of investment risk—first in housing, and soon after, across all asset classes. Shaken investor confidence in housing assets had a domino effect throughout world markets, ratcheting up demand for cash and liquidity, and curtailing the new lending and investment necessary for strong growth to continue. In short, those in the United States and around the world were reminded of the age-old lesson that financial innovation, for all its advantages, sometimes produces unexpected consequences to which policymakers must quickly and creatively respond.

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Policymakers in the United States have acted aggressively to stabilize markets, reduce the impact of the turmoil on the real economy, and address underlying regulatory and policy weaknesses. At the same time, policymakers also have sought to avoid overreacting with regulations or policy responses that would stifle innovation or distort the natural self-correcting forces of markets.

Treasury Secretary Henry Paulson has led the U.S. government effort to ensure a comprehensive, timely, and appropriate response to the turmoil. He and other U.S. authorities have urged banks to promptly recognize and report losses and to raise additional capital. The U.S. government has forcefully taken steps to soften the impact on the real economy, through fiscal stimulus and a series of initiatives to help families stay in their homes. The U.S. Federal Reserve and other central banks have taken focused, and sometimes coordinated, actions to protect the financial system from severe disruption by ensuring that markets have access to financing.

As the immediate remedies take effect, policymakers have also begun to focus on the weaknesses in the business practices of financial institutions that this experience has revealed, and on the needed improvements in our fragmented financial regulatory structures.

In the United States, the President's Working Group on Financial Markets recently recommended changes to mitigate systemic risk and restore investor confidence. At the same time, the Treasury Department, working closely with counterparts in major economies around the world, including China, has taken steps to address market instability. The Financial Stability Forum, which brings together the supervisors, central banks, and finance ministries of major financial centers, has been critical to this effort. The FSF has produced a series of recommendations that echo and complement efforts underway in the United States. These proposals include: strengthening prudential oversight of capital adequacy, liquidity and risk management; enhancing transparency and improving asset valuation, particularly for structured products; revising and clarifying the role and use of credit ratings; improv-

ing the responsiveness of authorities to risks; and creating robust arrangements for dealing with stress in the financial system.

There is no single measure that will place financial markets on a sound footing or prevent past excesses from recurring, but each of these specific proposals represents an important step toward addressing the challenges we face.

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While the first priority is working through the current capital market turmoil and the housing downturn, the United States is also considering longer-term changes to our financial regulatory system to maintain efficient, safe, and sound U.S. capital markets. This dynamic process requires balancing appropriate regulation with the need for an environment that fosters innovation.

Specifically, Treasury has considered how to modernize the U.S. financial regulatory structure, which is a patchwork of overlapping agency responsibilities cobbled together over the past seventy-five years. Secretary Paulson's recently released Blueprint for a Modernized Financial Regulatory Structure proposes a financial regulatory model that ensures market stability, safety, and soundness for federal guarantees, and consumer and investor protection through the creation of regulators for market stability, prudential financial oversight, and business conduct. This approach is designed to foster innovation, mitigate risk, and enhance the competitiveness of America's capital markets.

WHAT ABOUT CHINA?

China has weathered the recent turmoil relatively well, despite severe snowstorms in January and a devastating earthquake in May. Stronger growth in domestic consumption has offset much of the impact of weaker external demand on China's economy. Moreover, a slowing of overall Chinese economic growth from last year's pace may in fact be welcome in addressing concerns about excessive growth in investment and rising domestic inflation. Although Chinese equity prices have fallen sharply since last October, this was due more to domestic factors than to linkages with global stock markets.

But despite its relatively benign impact thus far, some in China view the recent bout of turbulence in global financial markets as a reason to slow or halt financial sector reform. This would be a mistake. China needs to pursue financial sector reform with renewed vigor in order to realize gains for China's citizenry and set the nation on a path of sustainable, stable growth.

China has made great progress in financial sector reform in the past decade, from the banking sector to the stock, foreign exchange, and bond markets. Key challenges now in China's financial sector development include increasing access to direct financing through the equity and bond markets; developing a yield curve for government bonds that can be used as the baseline for pricing other financial products; introducing a variety of financial products to hedge risk; and fostering the growth of institutional investors.

These are the basic building blocks of financial sector development, not exotic products on the cutting edge of financial innovation. There are risks, to be sure, in carrying out these reforms. Financial regulation and supervision must be developed in tandem. But China's policymakers must also recognize that there will be significant costs if China slows the development and reform of its financial sector. Important gains for China and its people would be left unrealized.

An ambitious financial sector reform agenda will advance China's economic goals in four important ways. First, reform will help to rebalance the sources of China's growth to ensure that it is more harmonious, more energy and environmentally efficient, and that it provides greater welfare for Chinese households. A more developed financial sector is essential in shifting to a growth model that can be sustained in the future, one less dependent on industrial activity and exports, and one more oriented towards services and household demand. Key to this is reducing the need for very high saving rates. A greater diversity of financial instruments for saving, risk diversification, and consumer borrowing would relieve much of the need for precautionary saving, immediately raising the welfare of Chinese households.

A higher risk-adjusted return from a broader array of financial assets and greater access to consumer credit would allow Chinese households to achieve their financial goals—such as buying a house, educating their children, or achieving a secure retirement—without having to set aside large portions of their current income. A more developed financial sector will also provide Chinese enterprises with options beyond reinvesting earnings in expanding their own capacity.

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Second, more developed financial markets will help bring greater stability to China's economy by giving the authorities the macroeconomic tools—flexible and more powerful monetary policy in particular—to assure stable growth and prices. Deeper and more interconnected bond markets would give the central bank greater ability to guide market interest rates and credit throughout the economy. In addition, greater efficiency of capital allocation will help to dampen the volatility of investment cycles.

Third, an efficient, well-developed financial sector will support China's transition to a market-driven and innovation-based economy by channeling capital to the new ideas, businesses, and entrepreneurs that will power future growth. As China's economy becomes more complex, so too will its need for financial services. A more developed financial sector is necessary to fund the industries of tomorrow.

Fourth, a robust financial sector will help China deal with the demographic challenges that lie ahead, including population aging and the provision of healthcare. A deep and sophisticated financial sector will be critical to strengthening the social safety net and providing tools such as health care insurance and retirement investment vehicles necessary to cope with growing demographic pressures.

Greater foreign participation will contribute substantially to financial sector reform, and for that reason, it has been a top priority for the U.S.-China Strategic Economic Dialogue launched by Presidents Hu and Bush.

Some in China fear that opening the doors to foreign financial firms could jeopardize the position of domestic firms. On the contrary, financial sector reform and increased foreign participation expands the opportunities for all firms in the market, including domestic Chinese firms. This is not a zero-sum game. Clearly, foreign firms will benefit from expanded opportunities in China. But they will also enhance the diversity of financial products in China, improve allocation of capital, and spur innovation—all of which will benefit China's economy and its people.

Foreign investment in Chinese financial institutions has, in fact, turned institutions that were a drain on fiscal resources into engines of growth—creating jobs and strengthening financial sector soundness. Take for example Shenzhen Development Bank, one of the first banks to be controlled by a foreign investor. Over the past several years, profitability and capital adequacy at the bank have increased significantly, while non-performing loans have declined sharply. The bank is lending more to finance households and medium-sized enterprises.

Financial institutions across China are also struggling to meet the exploding demand for experienced personnel in this period of rapid expansion. Increased foreign participation in the financial sector will hasten the creation of financial sector talent within China, benefiting Chinese workers, businesses, and the development of financial centers like Shanghai.

The current approach of offering limited ownership shares for foreign investment in Chinese financial firms hinders the growth opportunities of China's entire financial sector. It leads to unwieldy managerial and ownership arrangements that reduce operational flexibility and the limit the transfer of financial technology. Higher ownership restrictions for foreign firms would benefit the financial sector overall and the Chinese businesses that depend on it to grow their companies and create jobs. China achieved great success by opening its manufacturing sector to foreign investment. This has fostered—not inhibited—growth of Chinese manufacturers. Greater opening in financial services will do the same.

There are many reasons to believe that the appetite for financial services liberalization in China may be waning, after years of demanding reforms. From China's perspective, each successful reform must appear to bring calls from around the world for yet more. Moreover, global volatility in financial markets may give China's leaders pause as they chart the course ahead. However, China's leaders should carefully and dispassionately evaluate the current turmoil and the lessons learned in the United States and other advanced financial markets to sharpen their focus and strengthen their commitment to the bold path of financial sector reform on which they have embarked. It is critical to China's future economic growth and stability. ◆