CHAPTER 6

The Significance of Chinese Financial Market Liberalisation

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Introduction

The expression "new era" carries particular magnitude. Whenever a development comes along which promises to permanently alter the lives of many people, we speak of a new era. This is why there was good reason to prick our ears when the president of China, Xi Jinping, spoke of a new era recently. According to President Xi, one major element of this new era is that China is opening up—and he expressly included the financial markets. So it's no surprise, then, that China's central bank and finance ministry have been emitting clear signals in favour of more bidirectional financial flows. As a case in point, the foreign ownership limits in Chinese financial institutions have recently been relaxed, and the schemes to liberalise the cross-border capital flows have received further push by raised quotas.

From a European vantage point, one might initially wonder what is so pioneering about the opening-up of financial markets. After all, as some will note, open financial markets are one of the salient features of the EU single market, and have been so for a quarter of a century. But open

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financial markets in Europe have not always been a cut-and-dried affair. We conveniently overlook the fact that only since 1993, with the Treaty of Maastricht, all restrictions on the movement of capital between Member States and between Member states and third countries were prohibited. But a quarter of a century after this, the European financial markets are still fragmented in some segments. That is why a capital markets union [—a project dating back to 2015—], which the Bundesbank also supports, is intended to realign these markets more closely by 2019.

So it's worth taking a fresh, unprejudiced look at the following questions: What are the pros and cons for China of opening up its financial markets? Why is this country seeking to open up further? To answer these questions, we will shed light on some findings from the literature first and then contrast them with experience from the Asian crisis, which left its mark on China, amongst other countries. We will continue by discussing how the potential future role of China's currency, the renminbi, could be an engine of further financial market liberalisation.

Main Part

Advantages of Open Financial Markets in the Literature

The advantages of open financial markets in the traditional textbook literature appear intuitive. Let us list three of these theoretical foundations. First: economies are rewarded for opening themselves up to cross-border capital flows with better growth opportunities. Open financial markets, in principle, support economic growth by enabling resources to be directed to their most productive uses. In saving rich countries—like China—they create broader investment opportunities for savers, thereby increasing aggregate yields (and possibly allowing to save less and free some resources for consumption). Capital inflows can reduce firms' funding costs and thus spur investment. The result is higher, and more productive, investment, and more dynamic growth, than absent the free movement of capital.

Second: open financial markets encourage greater market discipline. At the microeconomic level, increased competition with non-residents forces domestic financial institutions to be more efficient, more transparent, and better governed. In macroeconomic terms, open financial markets and the attendant competition for global funding provide incentives for institutional reforms, such as to legal systems and legal certainty, accounting and

disclosure standards. Domestic financial supervisors can benefit from knowledge transfer by obtaining a deeper insight into foreign institutions' risk management practices. Anyone who takes a little time to read up on the Chinese financial system will soon realise that this is another angle from which China stands to benefit both microeconomically and macroeconomically from a further opening-up of financial markets.

Third: open financial markets open the door to stability gains through cross-border risk-sharing. Investors have more options for diversifying their portfolios across multiple countries, giving them an insurance of sorts against a shock striking their own country. This is because, if their home country falls into recession, the lower income from domestic assets can be compensated for by returns on foreign investments not affected by the recession. Consumption fluctuations can thus be dampened to a certain degree. China's avowed goal of "rebalancing" its economy from one that tends to be investment- and export-driven to one that is more strongly consumption- and services-oriented represents an additional incentive to take larger, more dynamic steps towards financial market liberalisation.

Practical Experience of Open Financial Markets During the Asian Crisis

In practice, however, experience of open financial markets has not always been quite as positive as in theory. The suffering endured by Tiger Cubs and Asian Tigers (Indonesia, Malaysia, the Philippines, Thailand and South Korea) during the Asian crisis of 1997–1998 is representative of the downside of open financial markets. At that time, macroeconomic deficiencies such as external imbalances, high external, often USD-denominated debt coupled with insufficient reserve assets, but also inadequate financial supervision, caused foreign investors to lose confidence in large swathes of the region. They quickly and massively withdrew their funds, which had in many cases been invested for short-term speculative purposes. The result was a sharp drop in economic activity and a considerable surge in unemployment in the affected countries.

China, on the other hand, was relatively immune to the direct impact of the Asian crisis, given its lower external debt, lower budget deficit and in particular its higher stocks of reserve assets compared to the most affected countries. Many countries, including China, learned from the later that building up a high stock of reserve assets can be an effective protective shield. A more decisive factor for the much smaller impact of

the Asian crisis on China, however, is likely to have been the fact that its financial account was much less open than that of its neighbours in the region at that time.

What the Asian crisis appears to have shown is that, in a setting of open financial markets, access to foreign capital could be assured if monetary policy is oriented to stability and an effective financial oversight regime is in place. If, however, poorly regulated short-term lending from abroad leads to a situation in which financial institutions can use excessive short-term funding to finance long-term assets, this would create illiquidity risks on balance sheets. Sudden capital flight could then quickly overwhelm and destabilise the entire domestic financial system. Moreover, borrowing in foreign currency which is not hedged against exchange rate risks harbours additional potential for destabilisation. A sharp currency depreciation would drive up the debt burden dramatically, force borrowers into insolvency and impede further funding from abroad, creating a vicious circle.

Renminbi's Reserve Status a Strong Motivation for Further Financial Market Opening

Seen in this context, the Asian crisis gave China good reason to tread carefully when opening up its financial markets. The salient feature of its journey so far has been a prudent and the process of lifting of its capital controls was gradually albeit not in straight line. Investor programmes for individual market segments with limited and rising investment ratios have been designed to ensure that China retains control of cross-border capital flows. As for opening itself up to investor groups, China again took a gradual approach, with a distinct preference for long-term investors.

However, the liberalisation process has not always gone smoothly. For instance, China fought a bout of downward pressure on the renminbi which persisted since the summer of 2015 by using considerable reserve assets and restrictions on capital outflows. Effective though these measures were in the short term, one may wonder why China now wants to push ahead even more quickly with efforts to open its financial markets and why the topic is high up the political agenda, despite the aforementioned risks and problems. To approach the answer, it pays to look at some key figures which are important for the country's self-image. China accounts for 18% of the world's aggregate GDP. It is the world's leader in merchandise exports, with a share of 13%, and is the number 2 merchandise importer at 11%. In the financial sector, China likewise occupies many of the top spots—even if the

different stages of developments make it more difficult to compare cross-national. Its domestic bond market has the third-largest stock of outstanding bonds, behind Japan (number 2) and the United States (number 1), and the Chinese banking system is the world leader in terms of total assets, ahead of the euro area and the USA. In these categories, then, China has been in Champions League territory for quite some time already, and often with the prospect of having a lock on the title.

But there is another category, one that is important for China's self-perception, where it is currently still far removed from such echelons: its currency's status as a reserve currency. In 2016, the renminbi was included into the exclusive group of the now five key currencies which form the basis for the special drawing rights (SDRs) of the International Monetary Fund (IMF). Celebrated as a "historical milestone", the practical impact, however, has been, to put it charitably, modest, as China's currency accounts for a mere 1.8% of allocated global reserve assets. That is little more than the Australian dollar (1%) and less than the Canadian dollar (2%), neither of which is contained in the SDR basket, and virtually negligible compared to the share of the world's leading reserve currencies, the US dollar (62%) and the euro (20%).

But it is precisely the title of leading reserve currency which is arguably the most coveted accolade. Back in the 1960s, Valéry Giscard d'Estaing, then France's finance minister, said that the US dollar's status as the key currency in the Bretton Woods regime was an "exorbitant privilege" for the United States. But this status of a key currency still stands to this day, as the United States continues to enjoy relatively low interest rates because the government debt issued in its own currency is regarded as extremely safe, and is therefore sought after and held globally by reserve investors such as central banks and sovereign funds. This, for its part, generates additional downward pressure on yields and, according to conventional wisdom, helps the USA to fund both its foreign trade deficit and also its new borrowing less expensively than other countries.

The US dollar's status as a reserve currency is, moreover, associated with a certain shock absorbency capacity, since, in a crisis, investors will choose this currency as a safe haven for their investments in the absence of liquid alternatives—and thereby stabilise the US financial markets, though at the cost of an appreciating currency. For the domestic banking system, this is just as much of an advantage as the lower relative costs of hedging foreign currency exposures, given the global proliferation of the US dollar in the markets as a transaction currency. The money creation gains gener-

ated by the difference between the costs of printing money and its face value (seigniorage) are also considerable. The often large quantities of cash denominated in a reserve currency which are in circulation abroad make this seigniorage that much higher.

Against this background, from the Chinese point of view there seem to be particular benefits to the privilege of reserve currency status, which would outweigh the imponderables and problems of opening its financial markets. High global demand for the renminbi would significantly bolster and even expand China's stature on the world stage once it was able to capitalise in full on the advantages of bona fide reserve currency status.

However, reserve status would appear to be beyond reach without open financial markets. The economic history books, at least, tell us that even the USA was first and foremost an economic and trade powerhouse to begin with at the start of the past century, much as China is today. It wasn't until the mid-1920s that the US dollar achieved supremacy over its main competitor at the time, the pound sterling. The literature credits the more highly developed, deeper US financial markets with being the decisive factor.

Outlook

Story of Opening Up China's Financial Markets to Be Continued

So if China wishes to model its trajectory on the historical example of the US dollar, it will have to press ahead more vigorously and decisively than before with its current policy of gradual opening its financial markets. This more lasting desire to liberalise its financial markets might also be the essence of the new era President Xi referred to. For the story of China's opening-up is not really new. It already began under Deng Xiaoping in the late 1970s but, since then, has progressed more in waves, sometimes with large gaps or even setbacks in-between.

Another relevant factor is that the actual proclaimed concept for opening-up relates to "socialism with Chinese characteristics" marking a new chapter in China's rejuvenation. It would therefore be inaccurate to equate the opening of Chinese financial markets with a move towards Western-style democracy. Rather, these efforts towards liberalisation are—besides exploiting the general economic advantages—far more about eliminating once and for all the discrepancy between China's status as a real economic

superpower and the marginal status of its currency as a reserve currency in the financial markets.

According to market participants, the outlook for this is encouraging, notably, as central banks are well-known slow movers with regards to new markets. According to a survey conducted by HSBC for 2018, global reserve managers expect the share of the renminbi as a global reserve currency to increase to 8.5% by 2020 and 15% by 2030.

If we expand our view, we see another project, one that is actually directed entirely elsewhere, as being complementary to China's monetary interests: the Belt and Road Initiative (BRI), also known as "new Silk Road". This flagship project which China is dynamically pursuing is intended, in future, to create the infrastructure for several routes along which trade with Europe will be intensified. Chinese banks are eagerly providing funding for this project in renminbi. This means that the Belt and Road Initiative would not only have a real economic effect of intensifying trade but could also jump-start demand for renminbi among borrowers based in countries located along these new trade routes. Those countries, however, would have to keep a watch on the sustainability of their debts denominated in foreign currencies.

Finally, a factor which will be of particular importance from a central bank perspective is how China treats one element which has always been seen as a decisive precondition for a leading reserve currency to reap its dividends: the confidence of global investors. Only if they have faith in the renminbi as an asset which is readily available, stable in value, and can be redeemed in goods and services without major frictions will its status as a leading reserve currency be cemented in the long term. For this to happen, will it be necessary to adapt additional properties of current reserve currencies? Will China introduce more elements of the rule of law? Will China be able to continue the stability-oriented economic, fiscal and monetary policy—well aware of the in traditional textbooks described trilemma between free capital movement, fixed exchange rate and independent central bank? Or will there ultimately be another way, one with Chinese characteristics? The jury is still out.