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Tempest in a Teacup: Containing China's Financial Turbulence

Introduction

The following are recent headlines about China's economy, whose GDP is US$10 trillion.

1. In August, 2015 there was a "significant" devaluation of China's currency.

2. Since then, China's foreign exchange reserves have fallen by over $1 trillion.

3. China's stocks lost $1.8 trillion in value in January 2016.

These headlines depict an economy in crisis. This picture has taken hold in global mass media, helping to roil global financial markets already worried by the financial implications of the collapse in oil prices and the limited effectiveness of successive rounds of liquidity injections by leading central banks.[1] China has made matters worse by failing to explain abrupt shifts in financial policy and personnel.

The negative impact has been excessive because foreigners mistakenly project onto China their models of the connection between financial and real variables. As the impact of China on the world financial system is bound to increase, we seek to explain the misunderstanding in terms of how the Chinese economy actually works and to propose ways to alleviate damaging financial feedbacks between China and the rest of the world.

Some basic misconceptions are as follows:

Devaluation of the RMB?

The People's Bank of China (PBOC) has changed its benchmark for the RMB exchange rate from the US$ to a trade-weighted basket of major currencies. This was to allow market forces a greater role in determining the value of the RMB, as would be required if it were to join the IMF's SDR basket. Knowledgeable commentators have explained this, but most still speak loosely of a "devaluation". Retail investors interpreted the "devaluation" as a desperate attempt to stimulate China's economy. In fact, the RMB has depreciated relative to the US$ only by 4.33 percent over the last 12 months (from 6.26 in February 2015 to 6.53 in February 2016). This cannot improve China's international competiveness by much. With a current account surplus of US$600 billion in 2015, China has little reason to devalue its currency for this purpose.

[1] *Economist* February 20, 2016 p.60 "Liquid Risk" argued that the market turmoil may have been driven by recent developments in market liquidity rather than fears of slowdowns in the US and China.

China's Reserves have Fallen by US$1 Trillion

Only a small proportion of the $1 trillion reduction constitutes classic capital flight, i.e., the exit of personal wealth out of China for fear of a massive devaluation or an internal collapse. In a recent interview[2] the head of the PBOC, Zhou Xiaochuan noted other components:

(a) Downward valuation of reserves held in other currencies which have depreciated relative to the US$.

(b) Chinese corporations repaying US dollar loans, for fear that further depreciation of the RMB will inflict a capital loss. The large volume of Chinese corporate borrowings abroad reflected an expectation of continued RMB appreciation and low US interest rates. Once these expectations reversed, Chinese corporations hastened to pay off these borrowings, which increases the demand for US dollars. The high US$ borrowings reflect the difficulty that private Chinese companies have of securing loans from China's state banks.

(c) Chinese entities are switching RMB holdings in China into US$ holdings in China. This is exchange rate speculation rather than capital flight.

(d) Less inward FDI. This has happened even though China's trade balance on a value-added basis has performed much better than its gross trade balance. This shows that China now has much greater capacity for internal processing, instead of merely serving as a platform for assembling imported components. This increase in capacity must have been built up from internal investment, which must have been largely by Chinese entities, given that FDI into China has been falling. So this large block of investment has NOT gone into low-return activities like infrastructure and real estate.

(e) More outward FDI. This reflects China's desire to use its trade surpluses to invest in real assets abroad, especially in infrastructure, which would help use up the excess capacity in China's heavy industries.

Collapse in China's Stock Market?

A major collapse in a Western stock market would have serious economic implications because (A) the wealth effect would reduce consumer demand, hence GDP growth, and (B) the collapse would reflect deep pessimism by stock market investors about business prospects. But neither is true in China. The wealth effect of the stock market collapse would reduce consumer demand only if a substantial part of private wealth were correlated with stock market indices, whereas in China only one person in 30 owns stocks [3] and only 5% of personal assets are stocks[4]. Moreover, China's stock market has gone through several cycles of boom and bust, even as GDP growth continued at a high rate; there has been little

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[2] *Caixin Online* 16/2/2016

[3] Andrew Walker BBC news 7/1/2016

[4] https://next.ft.com/content/9062c7da-c379-11e5-808f-8231cd71622e

correlation between the two time series.[5] This is because the stock market contributes only 5% of corporate financing and plays no role in financing pensions or as collateral for corporate loans. The major impact of the stock market collapse is likely to be political.

Communication Problem Between China and the West

The above comments illustrate a severe communication problem between China and the Western press. Two direct examples are as follows:

The interview by the head of the PBOC cited above could have been extremely helpful in calming world financial markets, for he enunciated a rational approach to financial policy, showed a sophisticated understanding of how global markets worked, and was firm but moderate in tone. But none of this was effectively conveyed in the brief summaries of this interview in the Western press like the *Wall Street Journal* or the *Financial Times*. Moreover, his comments would have been much more helpful had they been made in August 2015, when commentators were focusing on China's "devaluation".

A few days ago[6], the PBOC's data on "position for forex purchase" were merged into the "other items category". This left the market unable to form a clear picture of capital flows, which had been estimated from the gap between positions on the yuan in the financial system and at the central bank. The PBOC did not explain the reasons for the change, which some commentators were bound to interpret as an attempt to conceal a deteriorating situation.

The Broader Picture of China to be Communicated

The communication problem is salient because China has cobbled together a successful market economy within a political economy whose premises are murky and difficult to enunciate, but are certainly different from those of the West. In organizing the production and allocation of goods, China's system has proved just as successful as the Western system, but it is performing less well in guiding financial transactions. Why the Chinese system works in the case of goods but not in the case of finance cannot be explained in a sound bite, so Western commentators fall back on familiar tropes about Communist dictatorship, corruption and China's inevitable collapse from a failure to embrace Enlightenment values. This misunderstanding is having real economic consequences, since China's political economy has grown to the point that it has become a key player in a global financial system built on Western premises.

All market economies must secure property rights and transfer and enforce contracts. A Western-style political economy does so via a constitutional democracy and an independent legal system; China distributes the task down the Party's hierarchical network to provincial and local governments whose top officials are evaluated and rewarded for generating

[5] This was also true of Japan, which enjoyed a growth rate of -1.4% last quarter on an annualized basis, yet its stock market boomed.

[6] *South China Morning Post*, 20/2/2016 "Sensitive Figures Absent in PBOC Data"

economic growth and social stability, which legitimizes the Party. Officials achieve this partly by providing an attractive environment for private business, partly by supervising state-linked firms within their jurisdiction.

China's approach precludes a clear segregation of politics and economics, so the playing field for business is far from level. Government units at all levels routinely interfere in markets to favor cronies, uphold employment and social stability, or to earn political credit from their administrative superiors. This system has ensured spectacular growth by funding infrastructure and investment in heavy industry via sales of use rights to state-owned assets, especially land, and monopoly rights, like the right to operate a bank.

China is quite open in terms of commodity trade and direct investment. Here, its interaction with Western economies that operate on very different premises has been smooth and successful because the qualities of traded goods are determined mainly through use. This leaves little scope for destabilizing interactions across different commodity markets in different countries. However, financial assets are claims on money. To enable their definition, secure ownership, rational valuation and trade on fair terms in markets requires a highly-developed legal system and regulation that is independent of those with political power – which China does not have. Therefore, asset price movements in China are driven by different factors from those driving price movements in the West; Western commentators do not recognize this and arrive at invalid inferences about China's economy, as discussed earlier.

Financial assets are claims on the future, so current perceptions about the quality of the claims affect their price immediately. In turn, changes in the price of one asset affect that of related assets, enabling booms and busts and contagion across financial markets. Therefore, the rising financial openness of China has brought severe misunderstandings which have had real consequences

Interaction Between Domestic and International Financial Issues

The recent instability in China's foreign exchange reserves is closely connected to distortions in domestic financial markets. They are why Chinese citizens are so keen to shift money abroad; although there are good investment opportunities at home, the typical citizen cannot capture the high returns because of financial rigidities. Moreover, private corporations borrow abroad because they cannot access finance at home.[7] But doing so creates foreign exchange exposure, which recent events have shown to be destabilizing. Such exposure is gratuitous, since China has high domestic savings and a current account surplus.

The central government is always talking about financial reform but the political will has been weak because of vested interests. Recent events have brought home that financial

[7] As of mid-2015, US Dollar-denominated Foreign Bank Claims on China Non-banks totaled US$192 billion. See http://www.rba.gov.au/publications/bulletin/2015/dec/pdf/bu-1215-6.pdf

turmoil damages the central government's legitimacy and international credibility. Urgent financial reform would not only dampen international financial instability but would strengthen the current drive against corruption since financial rigidities create rents, hence opportunities for corruption.

Reform of China's Financial Markets

Western critics of China's financial markets tend to recommend more "rule of law". But there is no prospect that China will upend its political economy to install an independent legal system anytime soon. Moreover, the West took millennia to achieve the requisite personal attitudes, institutional development and checks and balances; it took centuries to evolve the requisite professional bodies and professional standards of conduct in accountancy, law and finance. Given the urgency of financial reform, it would be more realistic and useful for China to reform its financial system by taking advantage of its institutional strengths, in particular, the way that its economy has succeeded by checks and balances within its political hierarchy, such as competition between power centers at the same hierarchical level.

For example, the only effective supervision of China's state corporate managers is via the political system; government units have every incentive to extract revenue from the state enterprises in which they own shares. Therefore, the share portfolios owned by various government units could be organized as exchange-traded funds; citizens could be given the opportunity to buy shares in these funds, on the basis that they will receive payouts at the same rate as the controlling government unit. State-linked units are already in the business of buying stocks to support the market; they could secure more funds to do so by issuing shares in their exchange-traded funds to private citizens. Speculative trading of these shares could be discouraged by requiring immediate settlement of all trades and/or by a substantial tax on short-term capital gains.

The result would be a more stable stock market where corporate governance merges with political governance. As this merger is here to stay in China and has performed well in respect of goods markets, it should be extended to financial markets via innovations like that suggested above. This would serve China — and the rest of the world — better than the pursuit of Western financial models which are built on quite different political and legal premises which China is neither able nor willing to replicate.

Recommendations

China should make regular and timely efforts to convey its financial analysis and policies to the Western press, taking advice from experts in Western public relations who can get help it get its message out effectively to relevant audiences, especially business commentators in the mass media.

In reforming its financial system, China need not take Western financial systems as the benchmark, but should consider what instruments and rules would work best given its unique institutional structure.