Three Reasons Why China Must Liberalize the Financial Sector – and 3 Reasons Why Not

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The past two years have intensified the need for China to develop the RMB into a strong and global currency. With high levels of reserves and exports, several recent events in the international financial markets have pushed China's RMB policy to the edge of a financial precipice.

On the one hand, several factors are compelling China to position the RMB as a world currency. The massive foreign currency reserves held by the country have been hard earned over the last 30 years of economic acceleration. This amassing of national wealth risks losing value if it is not invested wisely.

The two key currencies with the size to absorb such placements are the dollar, a historical refuge, and the Euro, a more recent and welcome alternative to the dollar. But both currencies are fraught with dangers for China, even more than for other investors.

The fight over debt ceiling in Congress during the past weeks confirms that the US government has a completely inward looking monetary and fiscal policy, its priorities are clearly internal politics, nearly ignoring the impacts its actions could have on the dollar's role as an international refuge for investment and as a measure of value. The concerns for employment and partisan politics in the USA have led to massive government debt and budget deficits, artificially inflated money supply, and blackmail-like tactics to garner political advantage in government processes – all with very damaging implications for those who hold dollars. In the past few years, US policies have severely neglected the international fall-out of the weakening dollar and the loss of credit worthiness of the US government.

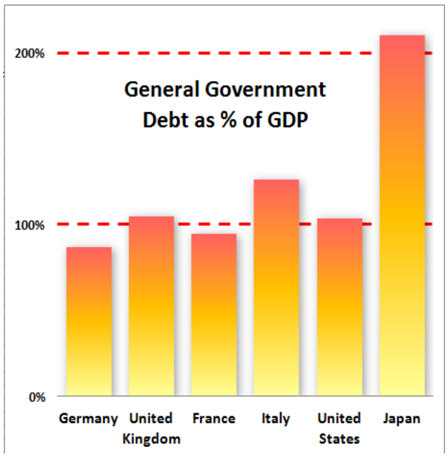
Yet everyone must hold dollars for trade of oil, airplanes- even the food we eat is priced on the international markets in dollars. The situation is even worse for China than for other countries to the extent that a) it needs to find a financial market large enough to absorb its massive foreign currency reserves, and b) the competitiveness of its exports, still the main motor of its economic miracle, is precariously dependent on dollar's value as the main currency of global exchange.

The Euro also suffers from political weaknesses but not the same ones as in the USA. The fragmented political landscape in Europe is a major handicap to the credibility of a single currency. Every crisis or risk explodes into an analysis of 17 individual national cases, and even the smallest of these can have magnified economic implications, as we saw in the Greek sovereign debt crisis.

This is without pointing out that the governments behind both currencies are indebted at historically unsustainable levels – leading to worries about the denouement of this burden and its consequences on their monies.

The other choices in Europe – the Pound Sterling or the Swiss Franc – are supported by economies whose scope is far too small today to offer a realistic alternative to the Big Two.

The Japanese Yen also suffers from a declining economy in terms relative to the world, and to China. Persistent deflation now into its third decade makes this a currency without attractiveness to investors, given the structurally low returns. Yet the yen remains paradoxically strong in spite of astronomic government debt and weak economic performance, a strength that seems to perpetuate the vicious cycle of deflation and slow growth.



Source: OECD Statistics 2013; Data 2010 & 2011

At the same time the declining economic fortunes of the dollar and euro based economies has forced China to turn to faster growing markets as privileged trade and investment partners, many of which are located in geographical proximity. This trading region can presume to look within its own boundaries for a medium of exchange, the major economic player offering its currency as the metric and basis for trade. China's position as a major trading partner makes its currency the natural basis for pricing, at least in this region.

So China would have every right to imagine the RMB as a more attractive world financial repository than the dollar, euro or yen. With the second largest economy and still one of the fastest growing compared to those currencies, it can reasonably claim a position in the rank of world currencies. But the pre-requisite to play in this game is financial liberalization – convertibility, market based pricing, off shore lending and borrowing.

We could summarize the 3 Compelling Forces that would drive China to liberalize:

1. The traditional currencies of international scope are no longer sound, and their future is unstable. A vacuum exists that should be filled.

2. The size and strength of China's economy both domestically and relative to the region make it a qualified candidate that can be seriously considered to fill this vacuum.

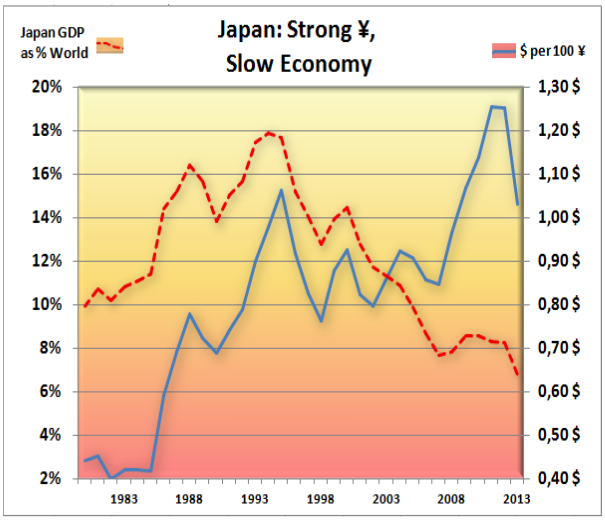
3. Both for trade and for preservation of accumulated wealth as measured among other things by the foreign reserves, China cannot afford to be passive - it must act in order to avoid losing trillions in value.

On the other hand,there are serious risks. If freely traded, a rush to the RMB as a refuge currency, due to the relatively stronger economic fundamentals of China and other reasons given above, risks creating an appreciation of value that could choke exports and further dampen economic growth. A free convertibility could also take an important part of domestic economic policy outside of the government's control, and force it into fiscal and monetary policies that could be at odds with domestic needs.

For instance, reducing interest rates could temper foreign enthusiasm for the RMB, but would at the same time fuel property and financial bubbles that are already so difficult to regulate. You may say that convertibility would also bring with it greater access to foreign investment opportunities for the Chinese, relieving local assets from artificial run-ups in prices. Perhaps. I would argue that a much stronger RMB with free convertibility could result in a crisis similar to what the Japanese experienced in the early 90's, from which they have not recovered.

Following decades of export driven economic growth in Japan not dissimilar to China's, Japanese GDP reached two thirds the size of US GDP in early 1990's. At that time, eight of the top ten largest banks by assets were Japanese. Sony, Toyota and others used high value added innovation to their industrial miracle, and as a result dominated many markets around the world. Deliberate government policies kept general inflation low, and interest rates followed. And the Yen doubled in value in about a decade, from 1980 to the early 90's.

Armed with a very strong freely convertible yen, high profits, foreign reserves from exports, and cheap borrowing, Japanese corporations and wealthy individuals went on an international shopping spree in a world, relative to the yen at 100¥ per $, that seemed temptingly cheap. These foreign investments included Paramount Studios and castles with vineyards in France. Unfortunately, the same forces that made this situation attractive became the forces that led to economic downfall. The yen continued to climb as the mascot of an economy with one of the highest per capita GDP's in the world, the lowest inflation rate, and a size that put it at nearly one fifth of the world's total economic activity.



Sources: World Bank GDP data; fxtop.com $/Yen

Exports dried up in the face of exorbitant pricing of the yen, slowing down the domestic economy. Foreign based profits, and assets that were purchased so cheaply in other countries, lost value when converted to yen, making it difficult to service yen denominated debt. Japanese banks, so strong just a few years earlier, suffered a major crisis of defaulting loans, and the economy came to a grinding slowdown that was totally unimaginable even a few years earlier.

As Chinese banks climb the ranks of the world's top 20, the Renminbi continues its ascent versus the dollar, and wealthy companies and individuals increase purchases of foreign assets , it is time to take stock of strong lessons from history.

Poorly executed liberalization could expose China to risks that give ample reasons to hesitate :

1. The same market forces that would justify China positioning the RMB as a world currency are the forces that could lead to an overly strong RMB, with serious negative consequences to growth. Even without free convertibility, the RMB has already appreciated against major trading partners, and not without incidence on the competitiveness of exports.

2. It can also drive excessive speculation, not only domestically with foreign inflows, but also with regard to domestic demand for international assets financed with high leverage. The Japanese experience is a significant example of this risk.

3. As the USA demonstrates, the whole world will then expect Chinese monetary and fiscal policies to take their needs into account, every action that nudges the RMB in a direction unfavorable to other currencies will be met with criticism and resentment, if not retaliation.

Like the hero in so many action films, China faces opportunities and dangers whether it tries to move forward or to move back.

On the side of going forward, and taking steps to make the Renminbi a world class currency, is the need for a reserve currency to compensate for the dollar's lost luster in the aftermath of the financial crisis, and the weak economic policy and ineffective political practices that have tarnished the Euro. The need to recognize the weight of the RMB in international, and especially regional, trade. And the need to preserve the value of its reserves and its trade without being dependent on another country.

Rank	Bank	Country	Mkt cap, $B (15/08/2013)
1	Wells Fargo & Co	US	228.74B
2	Industrial & Commercial bank of China (ICBC)	China	225.81B
3	HSBC Holdings	UK	206.76B
4	JP Morgan Chase & Co	US	200.64B
5	China Construction Bank	China	178.36B
6	Citigroup Inc	US	154.67B
7	Bank of America	US	153.84B
8	Agricultural Bank of China	China	132.87B
9	Bank of China	China	123.33B
10	Commonwealth Bank of Australia	Australia	107.70B

Source: www.relbanks.com

Yet the liberalization required to reach this position would leave the currency open to market forces that could result in financial risks, so dangerous to economic and social stability, that it is quite logical to hold back. Of course, China now is in many ways different from Japan then – with a much larger population giving it a potential for a large domestic economy, higher inflation and interest rates, and a more highly regulated economy.

But the importance of maintaining a stable and predictable currency that behaves in ways that support national economic and social policy, within an international role, cannot be overestimated.

In the end, we are certain that China must go forward. The impetus of financial self reliance will win over the risks associated.

But this can only happen with a very well designed implementation plan that mitigates some of the risks before they materialize. The top priorities of that plan should also be three:

1 - ensure a healthy and robust banking sector,

2 - careful monitoring of national and private debt, and

3 – establish clear and transparent economic processes through well-defined regulation.

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