Capital Market Liberalization in China: Opportunities and Dangers

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Capital market liberalization\(^4\), or financial globalization, is one of the most controversial aspects of globalization. On one hand, financial globalization makes it easier for funds to flow in and out of a country’s borders, allows transfers of technological and managerial expertise, and lowers the cost of capital. Capital account liberalization also provides an opportunity for a country’s currency to be accepted outside its borders, making trade transactions easier and less costly. On the other hand, however, capital market liberalization, especially that of short-term capital flows, can add to instability within the financial system. Historically, capital market liberalization has been associated with crises in industrial as well as emerging economies. According to the Bank of International Settlement, in many countries in Scandinavia, Latin America, and Asia over the past few decades, financial globalization has given rise to capital inflows that were too large for the countries’ financial systems to absorb safely (Icard, 2002). When these capital inflows stopped or reversed, the result was an impaired financial system. However, when studying capital market liberalization, one should distinguish between the two types of capital flows, foreign direct investments (FDI) and short-term speculative capital flows. While FDI has proved to be largely beneficial to emerging markets, short-term capital flows have posed somewhat of a challenge to many economies. In liberalizing its capital markets, China should continue to reap the benefits of FDI while paying close attention to the risks associated with short-term capital flows, and should minimize these risks through

\(^4\) See Appendix: glossary
fiscal and monetary policies.

In the first section of the paper, I explore the history of capital market liberalization, and the arguments for and against it. Advocates of financial globalization turn to the neoclassical model that predicts higher output and greater efficiency in a flat financial world, whereas those who caution against capital market liberalization point to the numerous economic crises that were in part caused by financial globalization, most notably the 1997 Asian economic crisis.

The next part of the paper distinguishes between two types of capital flows, foreign direct investments (FDIs) and short-term capital flows that are speculative in nature. I argue that FDIs are more consistent with the neoclassical model, and are usually channeled into real investment activities that improve the total factor productivity of an economy. The most remarkable example of this is China, a country that has benefited tremendously from FDIs in the past few decades. At the same time, I agree with many economists that short-term speculative capital flows are volatile and bring considerable instability to the financial system. Without a sound macroeconomic environment and an effective regulatory framework, liberalization of short-term speculative capital flows can lead to large-scale economic crisis with irrevocable consequences. I looked further into the Asian economic crisis, its background and impacts, and how capital market liberalization precipitated the crisis.

The last section of the paper is dedicated to China, a country with a sizable economy but relatively primitive capital markets. Historically, China has welcomed foreign direct investments while remaining closed to other types of capital flows. Following its entry into the WTO in 2001, China entered a new phase in its financial liberalization. In this section of the paper, I explore the progress China has made towards capital market liberalization, the risks associated with it, and how the Chinese government can establish a regulatory framework that maximizes the benefits of financial globalization.
The history of capital market liberalization reflects the recurring difficulties faced by policymakers and the different approaches they adopt to confront these difficulties. Since the mid-1980s, the most recent wave of financial globalization has been characterized by an increasing level of capital flows among industrial as well as emerging economies.

Among the most ardent supporters of capital market liberalization are the IMF and the U.S Treasury (Stiglitz, 2004). The argument for financial globalization, comparable to that for globalization in general, is largely based on a conventional neoclassical model, which predicts that capital market liberalization leads to higher output and greater efficiency. In addition, the neoclassical model predicts extensive risk sharing across countries in a flat world for finance (Stulz, 2005). In other words, financial globalization enables investors worldwide to share and dilute risks across different countries, and allows capital to relocate to where productivity is highest. Therefore, countries have the opportunity to access the international capital markets and reap the benefits of their respective comparative advantages such as advanced technology or cheap labor.

For example, capital inflows play an important role in the economy by bridging the gap between demand and supply of capital. It is hard to imagine an U.S economy without these foreign capital injections into U.S corporations, not to mention the trillions of U.S Treasury Bills held by foreign investors.

In addition to the neoclassical theory, those in favor of financial globalization argue that it will lead to economic growth through maximizing GNP, creating a macroeconomic environment that is attractive to business, providing an additional source of funding, and stabilizing the economy through diversification (Stiglitz, 2000).

First, the argument for financial globalization states that countries should be
concerned with their Gross National Product (GNP) rather than their Gross Domestic Product (GDP). GNP measures the income produced by the citizens (within and outside the border) of a country whereas GDP measures the income produced by individuals and corporations (regardless of nationality) within a country’s border. Thus, income produced by an American in France would be considered a part of U.S’s GNP, but not GDP (it is considered a part of France’s GDP). Therefore, citizens as well as corporations should relocate capital to where the rate of return is highest. In other words, by allowing funds to enter and leave foreign capital markets, GNP is maximized by financial globalization. Secondly, because capital market liberalization allows funds to flow freely in and out of a country, international competition for funds requires governments to create an economic environment that is more attractive to business. This benefits a country directly through attracting more foreign investment and indirectly through providing a more business-friendly platform for domestic corporations to grow and prosper. Additionally, open capital markets can serve as an additional source of funding for investment projects. For example, as mentioned before, foreign investment (in the form of stock and bond securities) serves as a crucial source of funding for U.S corporations. Finally, advocates of this theory claim that capital market liberalization is self-stabilizing through diversification. In other words, if a country’s economy is in a downturn, wages and cost of production decrease due to falling prices. Moreover, if the government tries to stimulate the economy by lowering interest rate, the cost of capital declines as well. A lowered cost of production, along with the cheap cost of capital, will attract foreign funds into the country and help stabilize the economy.

Bekaert, Harvey and Lundblad (2003) found that on average, equity market liberalization lead to a 1% increase in annual real economic growth. However, despite the strong theoretical suggestions, evidence demonstrating that capital market liberalization promotes economic growth, especially
growth in developing countries, is relatively limited. In fact, it was the IMF, among all, that stated in a 2003 research paper that “it is difficult to detect a strong and robust casual relationship between financial integration and growth” and that “Contrary to theoretical predictions, financial integration sometimes appears to be associated with increases in consumption volatility in some developing countries, at least in the short run” (Prasad et. al., 2003). This statement by the IMF was applauded by many policy makers who had held reservations about capital market liberalization, as well as economists who were less enamored with the idea of financial globalization. By then, most had come to the conclusion that the economic crises of 1990s and early 2000s were largely attributable to capital market liberalization.

At the core of the 1997 Asian economic crisis was large-scale foreign capital inflows that left the financial system vulnerable to panic. These capital inflows, or so-called “hot money” driven by short-term profits, created an economic bubble by fueling up asset prices. Prior to the crisis, noted economist Paul Krugman (1994) had warned against the idea of “hot money” and argued that only an increase in total factor productivity will lead to long-term prosperity, which was not the case during the “Asian Economic Miracle”. Instead, the growth witnessed by many Asian countries in the late 1980s and early 1990s was a result of increasing capital inflows that had little to do with total factor productivity. In hindsight, most agreed with Krugman and saw the fact that the two large countries who survived the crisis, China and India, both implemented strong controls on capital flows.

Joseph Stiglitz (2000) was among the skeptics of capital market liberalization, especially when done without first putting into place an effective regulatory framework. He distinguished between two types of capital flows, foreign direct investment (FDI) and short-term capital flows, speculative hot capital that can come into and out of a country. Stiglitz believed that FDI is more consistent with the neoclassical
theory and beneficial to economic growth, and focused mainly on short-term speculative capital flows. He also suggested that these two types of capital flows are not mutually exclusive. In other words, a government can intervene in short-term flows while still providing a hospitable environment for foreign direct investment, as it has been the case in China. I will return to the difference between these two types of capital flows in further detail later in the paper, and will focus on the argument against short-term capital flows now.

One of the biggest fallacies of the argument in favor of financial globalization is that capital market liberalization stabilizes the economy through diversification. According to the argument, when a country is in recession, falling wages and prices will result in lower cost of production, attracting foreign investments which help stimulate the economy. However, the problem with this theory is that unlike the labor market, capital markets are pro-cyclical, which, instead of stabilizing an economic downturn, usually worsens it. This is because capital markets are largely built on expectations, and in the event that a country is heading towards an economic downturn, foreign investors will usually pull out their investments instead of injecting more capital. This pro-cyclical nature is most obvious in the stock market. Theoretically, when the stock market dips, investors should see it as an opportunity for higher return and therefore buy more stocks, pushing the market back up. This, however, is not the case in reality. When the stock market declines, people sell their stocks in the fear of not being able to get their money back, causing the market to further decline. Similarly, in the event of an economic recession, it is unlikely that foreign capital will flow into the country to help stabilize the economy.

In addition, Stiglitz argued that short-term capital flows create instability. The reason why capital market liberalization does not lead to growth, according to Stiglitz, is that “firms are unlikely to engage in productive long term investments on the basis of short-term funds” (Stiglitz, 2000, pg. 1080). As
mentioned before, the only way through which a country can generate sustainable growth is improvements in total factor productivity, whereas short-term capital flows, more often than not, will only increase asset prices and create economic bubbles.

**Foreign Direct Investment: the Path of China**

It has long been presumed that FDI has a positive effect on growth. Historically, foreign direct investments have brought resources, technology, easier access to markets, and valuable training, as well as an improvement in human capital, to many developing countries.

Among the biggest beneficiaries of FDI is China. Historically, China’s inflows have generally been dominated by FDIs, which, compared to other short-term capital flows such as offshore lending, appear to be a preferred form of inflow as a result of its stability and the transfers of technological and managerial expertise that come along with it. Since the market reform in 1978, the Chinese government has gradually adopted policies favorable to foreign investors, promising tax reduction and higher rates of return to attract FDI. In early 1980s, the government established “special economic zones” and opened up coastal cities for overseas investments. In the 1990s, the government offered generous tax treatment to foreign firms. For example, a foreign-invested firm is exempt from corporate income tax in the first two years it makes a profit. In subsequent years, foreign companies are only subject to an average corporate income of 15%, much less than the 33% paid by Chinese companies (Prasad et. al., 2005).

The selective opening of capital markets, coupled with rapid trade expansion as well as China’s seemingly unlimited supply of cheap labor, created vast opportunities for foreign investors. Meanwhile, according to Lemoine (2000), there was a worldwide trend that directed large amounts of FDIs towards developing countries, among which China was a main
destination. Capital inflows soared throughout the 1990s, despite the Asian economic crisis, and have remained strong ever since. In 2003, China overtook the U.S as the number one destination for FDI.

By almost all accounts, the economic growth China has witnessed has been a major success story of the past decade. During the same period of time, foreign direct investments in China have risen tremendously as well. The commonly told story about FDI in China is that foreign investments have generated much economic growth, especially in coastal regions, that would not have been realized in the absence of such investments. Did FDI contributed to economic growth in China through providing an external source of financing and improving the productivity of industrial output.

FDI has been particularly effective in China for three reasons. First of all, FDI has been a major source of external funding for China since 1990s, far more so than foreign loans and portfolio investments, the other two forms of capital flows. Unlike many other Asian countries, the share of FDI in external financing is much larger, and the importance of foreign loans and portfolio investments is much lower. This structure of external financing, dominated by FDI, explains why China was able to avoid the 1997 economic crisis that hit most Asian countries.

In addition, FDI contributed to the improvement of productivity and efficiency of industrial output in China. During the 1990s, state-owned enterprises’ (SOE) share of output dropped while foreign-invested enterprises’ (FIE) share of output increased. At the same time, the capital intensity at FIEs was much higher than that at domestic firms. Since higher capital intensity is usually associated with more advanced technology and higher labor productivity, FIEs at the time outperformed their domestic counterparts in efficiency of industrial output. Not surprisingly, FIEs strengthened their industry position as they recorded above average growth during the late 1990s. Two forces worked together to contribute to the

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increasing efficiency of industrial production: FIEs proved to have a positive effect on capital and technology transfer through the presence of multi-national corporations, as they invested in large projects oriented towards relatively capital-intensive and technology-intensive sectors. At the same time, FIEs also boasted much better financial metrics, demonstrating greater profitability than domestic firms. This also put pressure on domestic firms to reform their cost structure and improve their existing technology, therefore cutting costs and resulting in greater profitability. Furthermore, foreign direct investment also strengthened China’s comparative advantage in manufacturing, as FDI were concentrated in a limited number of manufacturing industries.

FDI, in the form of foreign-invested enterprises, has also benefitted China through job creation. Although many criticize the fact that some multinational corporations reap the benefits of cheap labor while paying minimal wages and providing poor working conditions, workers at FIEs are usually better paid and have better working conditions than their counterparts at domestic manufacturing factories. More significantly, many FIEs have set an example for company-wide regulation within their respective industry sectors. Before the introduction of foreign investments, China had just emerged from a 10-year cultural revolution that caused the country’s industrialization to come to a halt. As a result, many industries were under-developed, unregulated and deeply corrupted. FIEs set an example for many Chinese SOEs of how to manage and regulate the company to reach maximum efficiency; among the techniques demonstrated were the establishment of a human resource management system and a compensation system based on labor productivity.

Short-term Speculative Capital Flows: the Asian Economic Crisis

The case of short-term speculative capital flows is a
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quite different story. As the name suggests, this type of capital flow is speculative in nature and can create instability within the financial system. Many economic crises in the 1990s, such as the 1995 Mexican economic crisis and the 1997 Asian economic crisis, can be attributed in part to short-term speculative capital flows.

In hindsight, while the 1997 Asian economic crisis was partially caused by a combination of risky macroeconomic policies, lack of government regulation, and the ineffectiveness of IMF programs to help restore confidence in the area, the single most dramatic factor that led to the crisis was the reversal of private capital inflows into Asia (Radelet & Sachs, 1998). During the booming years of 1990s until the crisis, countries like the “MIT” economies (Malaysia, Indonesia and Thailand) had witnessed a credit boom fueled by private net capital inflows. Although real GDP was growing rapidly in these countries, the growth rate of bank and non-bank credit to the private sector still managed to exceed GDP growth by a wide margin. This was because the capital market liberalization facilitated a greater flow of funds to emerging markets around the globe, particularly to Asia. Among the ASEAN countries, capital inflows increased from an average of 1.4 percent of GDP between 1986-90 to 6.7 percent between 1990-96, according to IMF (Presad et al., 2003).

However, the composition of these net capital inflows was quite different from that of China. While China was mainly dominated by foreign direct investments, capital flows to Thailand, Indonesia, Malaysia or the Philippines came mainly from offshore borrowing by banks and the private sector. In the most extreme case of Thailand, between 1990-96, capital inflows averaged an extraordinary 10.3 percent of national GDP, and offshore borrowing by banks and private sector alone amounted to 7.6 percent of GDP (Presad el al., 2003). Foreign direct investments were minimal compared to short-term capital flows. These short-term capital flows were mostly directed towards real estate and equities, and rather than
being channeled to productive investment activities, most of these capital flows became “hot money” that pushed prices up and created asset bubbles.

The asset bubbles were bound to explode when they became too big. This was when the pro-cyclical nature of capital flows came into play: when the market is anticipating or heading towards an economic downturn, investors withdraw their capital, fearing they would lose their money. As a result, capital outflow increases while inflow decreases, leading to a substantial decline in net capital inflows, which then causes the exchange rate to depreciate and the interest rate to increase, exacerbating the economic recession.

by The effect of such an economic downturn creates a downward spiral: the economies of these Asian countries suffered severely when foreign investors withdrew their funds and net capital inflows halted. As a result of the worsened economic conditions in these countries, rating agencies like S&P and Moody’s had little choice but to downgrade their sovereign ratings. The lowered sovereign ratings subsequently affected the private sector, as corporate ratings cannot surpass the sovereign rating of the country where the company is located. The result is a lowered rating for the private sector, making it even harder to raise foreign capital and attract the funding needed to stimulate the economy.

Ultimately, short-term capital flows, when channeled into investment activities that increase the productivity of the economy, can be quite beneficial. However, foreign capital flows on a large scale are volatile, and when poorly utilized, can leave the economy vulnerable to panic. One of the lessons learned from the Asian economic crisis was that, when exposed to the international capital markets, a weakly regulated financial system with tremendous amounts of capital inflows can generate serious instability. Moreover, there was a lesson for China: policy makers in Beijing recognized that the non-FDI part of the international capital flows had been a crucial part of the crisis, and they had reservations about the idea of
capital market liberalization. Although China was only marginally affected during the Asian economic crisis, the crisis itself was an important wake up call for the Chinese to reconsider their approach to financial globalization.

**China: the Road Ahead**

“...one might compare capital account liberalization to putting a race car engine into an old car and setting off without checking the tires or training the driver. Perhaps with appropriate tires and training, the car might perform better; but without such equipment and training, it is almost inevitable that an accident will occur. One might actually have done far better with the older, more reliable engine...”

-- Joseph Stiglitz, 2000 pg. 1075

There is much truth in Stiglitz’ words. Thailand and Indonesia were like the old car with new engines and tires during the 1990s, and the Asian economic crisis proved Stiglitz’ point: financial integration, done hurriedly without first putting into place an effective regulatory framework, will inevitably steer the economy into “an accident”.

It has also been widely accepted that the secret to why China was only marginally affected by the crisis lies in the Chinese government’s control of short-term capital. In many ways China is a prototypical country that can be best served by FDIs. With a vast population, seemingly unlimited cheap labor and relatively low levels of human capital and technological expertise, China benefited considerably from the transfer of technological and managerial expertise, as well as the employment opportunities created by foreign direct investments. Compared to short-term speculative capital flows, FDIs are less volatile, and the majority of FDIs are channeled into investments that increase the productivity of the economy.

Therefore, there is no surprise that the Chinese government is hesitant to relax capital controls and diversify the composition of China’s net capital flows. However, the
sustainability of an economy depends on a healthy and sizable capital market system. Over the past few years, China’s capital markets have grown substantially in size and complexity. For example, in 2007, the combined market capitalization of the Shanghai and Shenzhen stock exchange surpassed China’s GDP for the first time (KPMG, 2007). However, the size of capital markets in China remains a fraction of those in some of the more advanced economies, and China’s capital markets are relatively primitive. For instance, while the stock market has significantly increased in value over the past 20 years, the bond market is taking a back seat to equities, with government issues continuing to play the dominant role and corporate bonds comparatively small in size. The lack of an active corporate bond market has in the past fueled speculation in the equity market and forced companies to rely heavily on bank loans to finance their operations. In addition, bond trading is hindered by the lack of a structured secondary market and a mature rating system.

Realizing the importance of establishing a more structured financial sector, the Chinese government has gradually relaxed its capital controls, especially in the equity markets. In 2002, China launched the Qualified Foreign Institutional Investor (QFII) program, which gave foreign investors access to the previously closed-off mainland stock exchanges in Shanghai and Shenzhen. The QFII system allowed licensed foreign institutional investors to buy and sell Yuan-denominated “A” shares, treasuries, convertible debt, and other financial instruments for less speculative investments. To participate, a QFII needs to appoint a Chinese commercial bank to act as custodian of its assets, and name a domestic securities company to handle its trading activities. China expanded the quota for the QFII system from $10 billion to $30 billion in May 2007 at the second round of the China-U.S Strategic Economic Dialogue.

In addition to the QFII system, the Chinese government has allowed qualified corporations to raise capital overseas
since 1993. At the same time, Chinese companies are permitted to obtain a credit rating with foreign rating agencies and issue corporate bonds overseas.

Not only has the Chinese government relaxed controls on capital inflows in various securities markets, it has also given domestic institutions and individuals the opportunity to invest offshore, through the Qualified Domestic Institutional Investor (QDII) system. Launched in April 2006, the QDII system paved the way for domestic investors to make investments overseas in both equity and fixed income markets. The system allowed China to drain some of its excess liquidity from domestic savings and its vast foreign reserves, and also provided an opportunity for potentially higher returns in the more mature and complex capital markets overseas.

Apart from broader choices in the securities markets, China has also gradually opened up the market for bank credit. According to Reuters, since China opened its retail banking market to foreign competition, foreign financial institutions, including HSBC and Citibank, have expanded rapidly in the past several years. As a result, Chinese companies with overseas operations can borrow from foreign banks, while commercial banks like HSBC and Citibank can lend to Chinese companies as long as they meet the rules set by China Banking Regulatory Commission (CBRC). According to CBRC data, in Shanghai, the commercial capital of China, outstanding loans by foreign banks reached $57 billion in 2008, up 4.5 percent from the year before (China Bank Regulatory Commission, 2008).

Over the past few years, more and more capital has also flown in and out of China in the form of mergers and acquisition. It is not uncommon for foreign investors to hold stakes in Chinese companies. For example, China Mobile, the country’s largest cell phone service provider, is partially owned by technology giant Vodafone. In the financial sector, for instance, Citigroup holds equities in the Pudong Development Bank, a large commercial bank headquartered in Shanghai, and
China International Capital Corporation, the country’s most prestigious investment bank, is partially held by Morgan Stanley. Recently, many Chinese corporations have been seeking to expand their operations abroad by taking over or acquiring partial ownership of foreign companies.

China has benefitted greatly from these attempts at capital market liberalization, as they have provided alternative ways of financing for many Chinese companies and have allowed China to invest its excess liquidity in foreign markets. However, along with the benefits came the risks that are associated with capital account liberalization. One of the main risks is the increased market volatility caused by the sudden entry or withdrawal of foreign funds, as it was the case in 1997 Asian economic crisis. If the domestic capital markets are relatively small in size without sufficient liquidity, a sizable entry/withdrawal of funds could substantially affect market prices, making the markets extremely volatile and vulnerable to panic.

In addition, by opening up its capital markets, China is exposed to currency risks. As capital flows in and out of the country, the demand for the yuan also fluctuates. A surge in capital inflows causes the value of the yuan to appreciate due to a higher demand for the currency. If the Chinese government allows room for the value of the currency to fluctuate, a stronger yuan can potentially be very harmful to the export sector, as China has in the past relied on an under-valued yuan to increase the competitiveness of its exports. On the other hand, if large amounts of capital flow out of the country in a short period of time, the value of the yuan will decline sharply. In the case of the Asian economic crisis, the sudden reversal of capital inflows to Asia caused the collapse of Thai baht.

Moreover, deeper levels of capital market liberalization often mean more complicated financial products. As mentioned before, despite its sizable economy and incredible growth, China has a relatively primitive capital market system. This is
especially true in the fixed income markets. The bond market is dominated by government treasury bills, and volume of corporate bonds is almost negligible. China also has relatively limited experience with derivatives trading. The financial derivatives market consists mainly of commodities trading, as well as futures and options. Only recently has the Chinese government launched currency forwards and swaps trading through banks (KPMG, 2007). With the liberalization of capital markets, more and more financial products (such as asset backed securities and collateralized debt obligations) will be introduced to Chinese investors. These derivatives often mean greater leverage and a more integrated financial sector, and they come with higher risks. Without an effective regulatory system, a small problem in the highly complicated and integrated financial sector might endanger the economy as a whole.

Therefore, it has become increasingly clear that successful capital liberalization cannot be realized without first establishing a strong regulatory framework. The Asian financial crisis has led the Chinese government to rethink the issue of financial integration. Although the importance of sound macroeconomic policies had been well understood even before the crisis, the critical role played by a well-capitalized, well-managed and well-regulated financial system in minimizing risks associated with capital account liberalization really came into the spotlight.

In his 2000 paper, Stiglitz made a brilliant analogy between government intervention in capital markets and dams used to prevent flood (Stigliz, 2000, pg. 1083). Without dams to stop the flow of water from the mountain top the ocean, such powerful flows can only cause death and destruction; with the dam in place, power generated from the flows can be channeled into constructive uses. Sometimes, even the most advanced economies with strong financial institutions are faced with the failure of its regulatory framework, as the subprime crisis in the U.S has by now demonstrated. Thus, the dilemma
faced by Chinese policy makers is how to design an effective intervention system that does not generate too great a cost to the economy.

One way the government can control short-term capital flows is through banking regulations. The Chinese government is already regulating banks to some degree; according to a news report by Reuters, when foreign lending fell at the beginning of January, the China Banking Regulatory Commission issued a statement that strongly urged foreign banks to “maintain their level of loans” and “strengthen their support of economic growth with a mentality of service”. In addition to the statement, the government also provided incentives for foreign banks to continue lending by considering allowing qualified foreign banks to issue financial bonds and securitize their loans in China. Given the importance of relationships with the local government when doing business in China, the government could use such incentives to counter the pro-cyclical nature of foreign capital flows and to steer bank lending in the desired direction.

In addition, the Chinese government limits the amount of inflows allowed in the QFII system. In the future, as the Chinese capital markets mature, the government can potentially increase the limit placed on foreign institutional investors.

Given the relatively primitive nature of China’s capital markets, the government should place strict rules on financial institutions in terms of leverage and market capitalization to asset ratio. This action will to some degree prevent the domino effect of financial derivatives during the current subprime crisis; that is, a small failure of the financial market (in this case, default on subprime loans) will lead to the collapse of the economy as a whole. As China develops more capacity for complicated financial products, these restrictions can be gradually relaxed.
Conclusion

“Freedom has its risks.” – Michel Camdessus, Managing Director of IMF (Camdessus, 1997)

The series of crises in the 1990s, especially the 1997 Asian economic crisis, has led many people to rethink the cause of financial globalization. Once an ardent advocate, the IMF has now come to realize that the costs of capital market liberalization might indeed overweigh the benefits. For emerging economies with less developed financial systems, it has become increasingly clear that some form of intervention is needed to ensure the soundness of the economy in the event of financial liberalization.

One country that has benefitted from such interventions is China. Historically, China has placed relatively strict controls on short-term capital flows while remaining hospitable to long-term foreign direct investments. This allowed China to channel capital inflows to constructive uses that improved its total factor productivity, while avoiding exposure to greater volatility as a result of short-term speculative capital flows.

Whereas this form of intervention has worked in the past, gradual financial integration seems inevitable for China in the future. Over the past few years, China has allowed qualified foreign investors to invest in China’s capital markets, and qualified domestic investors to buy and sell abroad. In addition, China has also loosened controls on bank lending, and foreign loans have become an important alternative for many companies to finance their operations.

More than ever, the Chinese government is now faced with the dilemma of establishing an effective regulatory framework that maximizes the benefits of capital market liberalization without generating too great a cost to the economy. Possible interventions include providing incentives for foreign banks to steer bank lending in desired direction, limiting the value of foreign investments in equity and fixed-income markets,
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placing restrictions on leverage and other key financial metrics of financial institution, as well as some form of currency control. As Michael Camdessus said, freedom comes with risks, and the path ahead for China is promising, yet difficult.
References


Appendix: Glossary

Capital market liberalization: government restriction relaxation in the capital market. Also referred to as “financial globalization”

Foreign direct investment: a direct investment by a corporation in a commercial lventure in another country

Capital flows: the movement of money for the purpose of investment, trade, or business production

WTO: the World Trade Organization, a global organization dealing with the rules of trade between nations

IMF: the International Monetary Fund, an intergovernmental organization that oversees the global financial system

Diversification: the act of investing in a variety of assets to reduce risk

Financial integration: level of capital flows between different countries

Offshore lending: the act of funding investment, trade and business operations using money from foreign countries

QFII: Qualified Foreign Institutional Investor, a Chinese program launched in 2002 to allow licensed foreign investors to buy yuan-denominated securities traded in China’s mainland stock exchanges

Asset backed securities (ABS): a security whose value and income payments are backed by a specified pool of underlying assets

Collateralized debt obligation (CDO): a type of structured asset backed security