Pierre-Olivier Gourinchas
Comments at the "Panel RMB Exchange Rate, Capital Market Openness and Financial"
Tsinghua University, June 24, 2014

Ten points on China's financial account liberalization:

1. We should start by taking stock of what has been accomplished. What do I mean? I think I am right when I say that very few people back in 1978-1980 expected that China would (a) follow the transition path it chose to follow, and (b) would be successful at it. Obviously, it has worked well for China, so far.

2. Before we embark on policy recommendations for the future, this suggests that it is essential to understand the reasons for the success of China's transition policy to date. There have been many candidates, but I think a reasonable argument is that a policy of (a) financial repression (supported by a closed capital account); (b) fueling high levels of domestic investment, in partnership with foreign direct investment (technology transfer); (c) export-led growth —supported by reserve accumulation-- has worked very well for China.

3. If we agree on points 1 & 2, we can venture to ask what is different now. One possibility is that a model based on domestic financial repression has reached its limits and cannot sustain growth much longer. Is that the case? Let me try to argue it is: There are (a) limits to growth potential driven solely by the manufacturing sector and exports; (b) state-driven investment policies were quite easy to implement when it was a simple matter of catch-up but things become more complicated as China approaches the technological frontier; (c) a debt-fueled development strategy reaches its limits too as corporate balance sheets weaken; (d) Economic development requires financial development. This may be particularly true in an environment where both SOEs and private sector firms co-exist but SOEs are both less productive and have easier access to credit. So financial repression may hamper the speed of convergence of the economy (on this precise point, see Song, Storesletten and Zilibotti, 2014, "Growing (with capital controls) like China" http://www.econ.uzh.ch/faculty/zilibotti/publications/IMF_140606_final.pdf). Low interest rate policy may misallocate resources towards the SOE sector. The points above indicate that domestic financial reforms are probably desirable: removal of financial repression (removal of floor on lending rate and ceiling on deposit rates); increased competition in domestic banking sector; regulation of `shadow banking system'.

4. Note however that these policies have redistributive consequences (in favor of future workers but hurting current ones). Same is true of policies to maintain an undervalued currency. But the interesting aspect is that interest rate liberalization and opening the financial account may go in opposite direction. Interest rate liberalization may depress real wages. Opening the financial account may increase real wages. (Again on this see the paper by Song et al).

5. This does not imply that capital account liberalization is desirable per se, at least in the short run. The empirical literature on the benefits of financial account liberalization has a hard time finding

substantial effects (see Gourinchas Jeanne, Restud, 2006). There may be indirect effects (e.g. competition effects) but in general, it is a risky proposition to think of financial account openness as a substitute for good domestic institutions. All kinds of things can go wrong along the way: capital can withdraw suddenly; it might be difficult to manage surges and reversals in capital flows; capital flow surges can distort the local economy, creating the conditions for a reversal with large economic costs (and therefore validating the beliefs that sustain a sudden reversal…). History is littered with the experience of countries that liberalized their capital account too quickly and lived to regret it!

6. It is fashionable these days to argue that surges in capital flows can be contained with capital controls. This is far from established. As Michael Klein and Jay Shambaugh 2013 observed, Walls are better than Gates! China has a Great Wall!

7. Timing. This suggests that the focus should be on the domestic side of financial reforms, less so on the external side. Eventually, China's capital account will be fully open. But "eventually" can be in a long time.

8. When this happens, and assuming that China maintains a good macroeconomic policy mix, it is to be expected that China's currency will play a major role, both regionally -as it already does- and globally, as a key reserve currency and safe asset, alongside the US, and perhaps the Euro.

9. Research indicate that a key benefit of issuing one of the reserve currency is a low funding cost, including (or perhaps especially) in times of global stress. This funding advantage can be quite significant, but it has global implications. Much like the US now, if China is short safe assets, it will need to be long risky assets. So its external balance sheet will experience a major adjustment towards risky securities.

10. The corollary of that is that China will experience major valuation losses during times of global stress. The country has to be ready to accept this `risk sharing' pattern before it fully liberalizes its capital account.

To conclude, while the benefits of domestic financial reforms are quite clearly established, those of external financial liberalization are not. China should proceed cautiously.