China's financial floodgates

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As China's economy starts to slow, following decades of spectacular growth, the government will increasingly be exposed to the siren song of capital-account liberalization. This option might initially appear attractive, particularly given the Chinese government's desire to internationalize the renminbi. But appearances can deceive.

A new report argues that the Chinese authorities should be skeptical about capital-account liberalization. Drawing lessons from the recent experiences of other emerging countries, the report concludes that China should adopt a carefully sequenced and cautious approach when exposing its economy to the caprices of global capital flows.

The common thread to be found in the recent history of emerging economies – beginning in Latin America and running through East Asia and Central and Eastern Europe – is that capital flows are strongly pro-cyclical, and are the biggest single cause of financial instability. Domestic financial instability, associated with liberalization, also has a large impact on economic performance, as does the lack of control over non-bank financial intermediaries – an issue that China is now starting to face as the shadow banking sector's contribution to credit growth becomes more pronounced.

Most academic research also supports the view that financial and capital-account liberalization should be undertaken warily, and that it should be accompanied by stronger domestic financial regulation. In the case of capital flows, this means retaining capital-account regulations as an essential tool of macroeconomic policy.

Indeed, during the 1990s, China – and also India – taught the rest of the developing world the importance of gradual liberalization. It was a lesson that many countries fully learned only in the wake of the economic and financial crises that began in East Asia in 1997, spread to Russia in 1998, and affected most of the emerging world. By maintaining strong capital-account regulation, China avoided the contagion.

Even the International Monetary Fund, in late 2012, adopted a cautious approach. The IMF now recognizes that capital-account liberalization comes with risks as well as benefits, and that "liberalization needs to be well planned, timed, and sequenced in order to ensure that its benefits outweigh the costs." Moreover, the Fund now regards capital-account regulations as part of the broader menu of macro-prudential measures that countries should be free to use to prevent economic and financial instability.

To the extent that capital-account volatility is the major pro-cyclical financial shock in emerging economies, regulation should be the major macro-prudential instrument used to counter it. These regulations should complement, not substitute for, other countercyclical macroeconomic policies. The IMF recommends giving higher priority to those other policies, whereas we have previously recommended using them and capital-account regulations simultaneously.

It is not just emerging markets that have had to pay heed to the dangers of rapid liberalization. Japan's experiences also offer valuable lessons about the importance of prudence in capital-account liberalization for a currency in increasingly high demand internationally. For an extended period, Japan allowed only strongly regulated financial intermediaries to manage capital flows, effectively discouraging the international use of its currency. And when a tsunami of capital looked set to flood the

economy, policymakers did not shy away from trying to contain the inflows.

In a sense, Western Europe was once in the same boat. Its capital-account liberalization was also a long-term process, beginning with current-account convertibility in 1958 and ending with capital-account convertibility in 1990. And it faced a crisis of its payments system two years later that led to significant depreciation for some countries' currencies.

None of this is intended to suggest that the internationalization of the renminbi should not take place in the foreseeable future. Given the importance of China in the global economy, the denomination of an increasing share of trade and investment in renminbi seems inevitable. But China's authorities should manage that process gradually, choosing the specific channels through which it should take place.

Indeed, China is perhaps the most successful example in history of gradual and pragmatic economic transformation. It should not allow itself to be tempted from its tried and tested course by calls for a policy that has led too many emerging economies onto the rocks.

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