Will financial liberalization trigger an economic crisis in China?

Financial liberalization is typically associated with bringing benefits to emerging economies—cutting red tape, boosting growth, expanding trade, and creating jobs and opportunity. Is it just what China needs as the country's leaders grapple with how to guide it to the next level?

Or would it bring with it added risks to China's economy? And could those risks trigger a crisis?

Those are questions asked by Qin Gou of the Central University of Finance and Economics in Beijing and Huang Yiping of the Institute of Digital Finance of Peking University.

In research supported by the Asian Development Bank Institute, they investigated a wide body of work done on other emerging economies, contrasting the results with China's current status.

An early conclusion was that almost all successful emerging market economies have more open and liberalized financial systems, suggesting that liberalization is important for development.

Yet, it also became clear that there is no consensus that liberalization is some sort of magic policy elixir. When, how, and under what conditions to liberalize could be more critical to avoid spikes in financial risks such as banking failures and sharp currency fluctuations.

Many emerging market economies, including Indonesia, Thailand, and Mexico, have suffered major financial crises after drastic financial liberalization. Today, they are still stuck in the so-called middle-income trap.

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So, what are the conditions of China's financial and economic system?

China achieved extraordinary economic growth starting from 1978 under highly controlled financial policies, or what the two researchers call "repressive" governance conditions. These included the strict regulation of interest rates and mandatory allocation of financial resources.

In remaking the economy, China's leaders built a new financial system, described as "strong in establishing institutions and growing assets, but weak in liberalizing markets and improving governance."

These repressive financial policies in fact helped the economy grow rapidly, at least during the early years of economic reform in the 1980s and 1990s. This was by maintaining financial stability and encouraging conversion of savings into investments.

Such repressive polices dragged growth down in the 2000s and, if allowed to continue, will further slow the economy and potentially push China into the middle-income trap.

This suggests that China's economy is between the proverbial rock and the hard place. That is, leave policies as is and perhaps wander into the middle-income trap, or liberalize and face the threat of new risks.

This dilemma is nothing new, and how to juggle the benefits and costs of financial liberalization has been studied and debated in recent decades.

Some studies have found that financial liberalization lowers risk, helps growth and transparency, and boosts efficiency. Others have been inconclusive, while some suggest that premature financial liberalization raises the likelihood of boom–bust cycles and banking and currency crises.

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What does seem probable is that emerging market economies are more prone to excessive cycles, bubbles, and instability than mature financial markets.

Other studies have explored the specific pace of financial reform. Again, though, conclusions differ, favouring either a gradual targeted approach or rapid simultaneous action or "bigbang" method.

With the literature throwing up such a variety of conclusions, the researchers compiled a financial liberalization index, a financial crisis index, and a financial fragility index to help form a picture of China's economic scenarios.

Using those yard sticks, reams of data, and investigations of other countries' experiences, the researchers concluded that financial liberalization reduces rather than increases financial instability. Liberalization therefore offers the better opportunity for China to avoid financial crises.

But too rapid a pace of financial liberalization, or the big-bang approach, may increase financial risks, suggesting a key role for the central bank in moderating and controlling the pace of reform.

The quality of institutions such as investor protection and law and order also matters. The experience of other countries indicates that investor protection can significantly reduce the probabilities of financial crises.

These findings offer important policy guidance for China. Financial liberalization and greater use of market forces is necessary to sustain economic growth and reduce financial risk. Without further financial liberalization, it would be almost impossible for China to avoid the middle-income trap.

The most important institution the economy lacks is market discipline. Existing bankruptcy laws must be used to deal with zombie companies that suck up financial resources.

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The researchers also see a key, expanded role for China's central bank in financial regulation. But they stress that the bank needs greater independence and that its role should shift from regulating institutions to regulating financial market functions.

This episode was based on research done for the Asian Development Bank Institute by Qin Gou, an associate professor at the School of Finance, Central University of Finance and Economics, and Huang Yiping, Jin Guang chair professor of economics and deputy dean of the National School of Development and director of the Institute of Digital Finance of Peking University. Both universities are in Beijing, the People's Republic of China.

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