

INTRODUCTION

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In 2005, as part of a new set of initiatives designed to foster greater and deeper communication between academics and practitioners, the Jerome A. Chazen Institute of International Business at Columbia Business School decided to sponsor a major project exploring current prospects for financial policy reforms in China. The goals of this project were (1) to provide a treatment of the trajectory of financial reform at this time—its recent past, current status, and likely future; (2) to undertake both a deep and comprehensive effort by including detailed, empirical analysis of each major area of recent reform (domestic banking sector reform, securities market listings of Chinese firms, capital inflows from abroad, and foreign exchange policy); (3) to include a variety of perspectives and techniques in that analysis—that is, those of academics, practitioners and policymakers—all of whom have unique and important perspectives on financial reform, and all of whom can benefit from a collective effort to take stock of China's financial policies and prospects and to promote further communication among them; and (4) to ensure that, while preserving the authentic voices and techniques of these various participants, we would also produce a written volume of essays that would be accessible to someone with an MBA level of training in finance and a basic knowledge of the Chinese economy.

This volume is the result of that effort. The chapters are designed to be used either as part of a comprehensive investigation of China's current reforms or as stand-alone contributions to specific areas of investigation. Unlike a monograph, this volume brings together the perspectives of many authors and commentators. Unlike the typical "conference volume," it does not merely collect existing papers, but rather is designed to address important related questions. The chapters taken as a whole provide an integrated vision of China's financial reforms and prospects.

In a fundamental sense, the subject of this book is the future of Chinese economic modernization. Without question, financial policy choices have become the primary areas of focus in the current debates about Chinese growth prospects. Those financial policy choices include the structure of laws and regulations affecting financial intermediaries (including commercial banks and investment banks), rules governing firms' access to public markets for funds, rules governing international capital flows, and foreign exchange policy. Up to this point, with respect to its financial and foreign exchange systems, China has made a great deal of progress in real growth despite its underdeveloped financial and foreign exchange systems. The growing consensus is that this is no longer possible. This consensus is fueling an ambitious and wide-ranging effort to reform the financial system, as well as the rules and policies governing capital flows and exchange rate determination.

With respect to the domestic financial system's role as an effective resource allocator, self-finance has been the primary engine of growth for Chinese entrepreneurs. Savings channeled through retained earnings or the savings of individual entrepreneurs and their associates have been the engine of private sector growth, not bank or securities market-intermediated finance. The banking system has yet to enter an era in which banks perform true arms-length credit transactions, based on the analysis of credit risk, subject to enforceable laws that define and protect the rights of creditors and debtors. Securities markets have begun to develop, but entry into these markets is restricted and performance has sometimes been lackluster.

Foreign investment has been largely confined to foreign direct investment (FDI) because of capital controls limiting the ability of firms to use other forms of foreign capital. The foreign exchange system had been founded on a long-maintained fixed exchange rate, and strict controls of foreign exchange transactions, which at least ostensibly limit transactions to those involving foreign trade or the expatriation of profits to foreign owners.

This system is beginning to change. When China joined the World Trade Organization (WTO), it agreed to a dramatic and rapid opening of its financial markets to foreign entrants. Significant portions of the state's stakes in the largest ("big four") banks are being sold to private holders. Banks' balance sheets have been improved by the state's absorption of loan losses. A host of new financial laws and regulations are now being promulgated and debated. The previously fixed exchange rate is being allowed to

fluctuate within a narrowly defined band, the currency has appreciated slightly, and a gradual, long-term continuing appreciation is widely expected. Limits on the ownership of foreign assets by domestic residents have been relaxed somewhat, and forms of capital other than FDI have been growing in importance over time.

China has reached an important crossroads in the development of its financial and foreign exchange systems, in six important respects at once:

1. A crossroads for determining the future path of capital allocation, with important implications for growth and stability.
2. A crossroads for China's foreign exchange rate policy, which will be defined in terms of both the pace of any near-term currency appreciation and the new long-term regime that will be established for determining the extent of currency variability.
3. A crossroads for deciding how much and what type of international capital market transactions will be allowed, which is also closely related to the question of how changes in the foreign exchange rate will be managed.
4. A crossroads for the developing relationships between the Chinese government and foreign financial institutions, which will now play an increasing role in Chinese financial markets.
5. A crossroads for the political relationships between China and the United States, which could pose significant shocks to trade relationships, trade flows, and global capital inflows, given the political heat that has been generated in the United States regarding China's alleged "currency manipulation."
6. A crossroads for China's own internal political evolution, which may be more closely linked to financial reform than is immediately apparent.

A CROSSROADS FOR CAPITAL ALLOCATION, INVESTMENT, AND GROWTH

Among the various determinants of China's continuing economic growth, current efforts at banking sector reform stand alone in importance. Chinese growth rates have been impressive thus far, but we need to be cautious about the future. Future growth will be more dependent than ever on the success of financial sector reform, especially banking sector reform. Two cautionary notes are particularly relevant.

First, despite China's rapid growth in the past, statistics on gross domestic product (GDP) have exaggerated the true growth in value added

in the Chinese economy (as compared to, say, growth rates for the United States) because GDP statistics mask the large amount of intentional value destruction inherent in investments in state-owned enterprises (SOEs), which are mainly financed by loans from state-owned banks. Loans are made to SOEs often with little or no hope of repayment. The SOEs' investments financed by the state-owned banks are a clear case of value-destroying expenditures—that is, capital investments that are worth less as productive capital (in terms of the expected cash flows that those investments will generate) than the amount invested in that capital.

The amount of value destruction from such investments occurs at the time the loans are made and the capital is purchased, but the net destruction of value is not reflected in GDP growth at that time. Rather, the increase in GDP is measured as the amount *spent* on investments, not the amount that the investments are worth. In the United States, a reasonable presumption prevails that because investment is part of a competitive market process, capital purchases are an accurate, reasonable indicator of value added from investment, and thus there is no need to adjust U.S. GDP statistics to better capture true value creation from investment. But that is not true for China's investments in SOEs. The amounts spent for these investments are substantially greater than the amount they are worth. If GDP were adjusted for this effect, the actual level of GDP would be lower in China than the measured level.

The value destruction from China's SOE investments does eventually show itself, though not in the form of a downward GDP adjustment. When the government ultimately provides the taxpayer funds necessary to absorb the loan losses in the state-owned banks that result from value-destroying investments, that amount reflects *ex ante* value destruction. The cost of the partial cleanup of bank balance sheets undertaken by the Chinese government in recent years has already been enormous.

These losses did not just represent bad luck, and they were not a surprise. Rather, one of the primary functions of the Chinese banks in the economy has been to purposely and predictably lose money on their loans by making loans to finance value-destroying investments.

Branstetter (note 71 of chapter 1) estimates the eventual cost of cleaning up past NPLs from SOE loans at roughly \$500 billion. Continuing losses on new SOE loans could remain large. Brandt and Zhu's data in chapter 2 shows that more than half of the loans made to SOEs in the 1990s became nonperforming. Loss rates on those loans reached 90 percent. Annual lending to SOEs remains at roughly 15 percent of GNP. If half of

those loans became nonperforming, and if loss rates on those NPLs reach two-thirds, the continuing annual value destruction from new loans to SOEs would be 5 percent of GNP.

If China is unable to reform its banking sector, and transform it into a vehicle for efficient allocation of capital, the potential implications for China are far-reaching. Those implications include major risks of (1) a reduction of growth; (2) a financial crisis; and (3) a fiscal crisis. The risk of a growth slowdown in the absence of financial reform follows from the law of diminishing returns and was evident in the 1990s for several other high-growth countries in East Asia (e.g., Korea). As development proceeds, “low-hanging” fruit is picked first. Cheap labor, together with unexploited obvious production opportunities, make the efficiency of capital allocation less relevant for the earliest wave of investments. As an economy becomes more developed, maintaining growth becomes more challenging, and the importance of efficient capital market allocation for maintaining growth consequently rises over time.

As the Asian crises of the 1990s illustrate, the poor-capital market allocation that results in a growing stock of bad bank loans does not just result in diminishing productivity growth, but also in a bankrupt financial system. The rising risk of bank insolvency can itself create an incentive for deposit and foreign capital flight, as was evident in the Asian financial crises. The cost of resolving bank insolvency, preventing or mitigating depositors’ losses and subsidizing government-favored lending institutions, can be enormous. The fiscal consequences of absorbing losses in Korea, Thailand, and Indonesia were greater than 20 percent of GDP in each of the three economies. These fiscal shocks, and the need to “monetize” them, go a long way toward explaining the large depreciations of the currencies that attended those crises. For China, such a fiscal cost would be especially unwelcome, given the large anticipated fiscal burden that Chinese taxpayers will already have to bear to support retirees, which will grow significantly in the coming decades as the result of China’s low birthrate.

Continuing the growth experience and avoiding a major financial crisis like the one that plagued other Asian countries in 1997 will depend crucially on improvements in the financial sector. China’s growth over the past three decades has been driven by vast amounts of savings, which have financed massive capital accumulation. China’s stunningly high savings rate has reached nearly half of GDP in recent years, which is high even for high-saving Asia. Savings are channeled to investment either through the

reinvestment of earnings outside the formal financial sector (entrepreneurial savings, the pooling of funds among business associates) or through the intermediation of the banking sector, and to a much lesser extent, via securities markets. The large quantities of savings and investment have produced remarkable growth in China, but because the efficiency of capital investments has been low and declining over time, high savings is no longer enough to sustain rapid growth. In the long run China's high savings rate is not desirable; after all, consumption, not production, is the ultimate purpose of economic activity.

Looking forward, the most important question about banking reform is whether the banks will be able to stop making value-destroying loans to SOEs in the future. An optimistic view would emphasize the enlightened self-interest of the government and the big four banks (and their investors), who recognize the substantial social and private costs of failing to reform. The pessimists, however, point to the extreme difficulty from a domestic political perspective of eliminating the implied loan subsidies received by favored bank borrowers, including influential SOEs. Bank loan losses are the lifeblood of political patronage, as Minxin Pei (2006) cogently argues in his recent book, *China's Trapped Transition*. Eliminating loan losses means eliminating the existing system on which politicians and their constituents rely. Pei contends that, absent a political revolution, lending reform is not feasible as a matter of simple arithmetic. That pessimistic view of reform is buttressed by the lack of existing legal infrastructure and the lack of experience with the management of credit risk within the financial sector, both of which are important for developing an arms-length system of efficient intermediation.

If the risk of failure in banking reform is great, then the need for successful reform of securities markets is all the greater. In order to create a captive market for favored securities offerings, the Chinese government has rationed access to securities market offerings by "de-statizing" enterprises. But returns performance has been weak for those offerings, particularly for the less desirable offerings, which tend to be placed in the Shanghai and Shenzhen exchanges rather than in Hong Kong or other foreign markets. Many firms that offer shares in the Shanghai and Shenzhen exchanges have not resolved internal corporate governance problems, which are often related to the continuing large stakes in those firms owned by the government. This limits the ability of firms to pursue value maximization and makes those firms less attractive to investors.

Thus, from the standpoint of both successful banking sector reform and securities market reform it is crucial that the government come to grips with the problem of inefficient SOEs. These SOEs impose a fiscal burden, sap resources from capital markets, and limit the government's willingness to liberalize financial markets in order to give private sector firms a chance to raise funds competitively.

A CROSSROADS FOR FOREIGN EXCHANGE AND INTERNATIONAL CAPITAL FLOWS POLICIES

After many years of maintaining a fixed yuan-dollar exchange rate, the Chinese government is facing intense pressure to allow its exchange rate to appreciate and to let the exchange rate float (that is, allow its value to be determined by market supply and demand, with minimal government currency "interventions" involving government buying or selling of foreign currency). China has accumulated a vast reserve of over \$1 trillion in U.S. Treasury securities and currency as the result of its persistent current account surplus, which is closely related to its undervalued exchange rate. Although an undervalued currency boosts exports, it raises the cost of imports. It also presents political problems for China to the extent that political leaders and interest groups in the United States and elsewhere use undervaluation of the yuan to justify attempts to roll back free trade agreements or place punitive tariffs on China.

China's leadership has also signaled that it sees a need to reform its exchange rate regime. The government seeks to reduce the country's reliance on exports as an engine of growth and sees an increasing future reliance on internal demand as another motor of growth. China's government also is beginning to reduce some restrictions on Chinese capital market inflows and outflows. All of these trends would be consistent with both an appreciation of the yuan and a movement toward a flexible exchange rate. A flexible exchange rate would facilitate the emergence of an autonomous domestic monetary policy regime (which may be desirable to manage domestic aggregate demand in an economy less reliant on export growth). As international financial economists have long recognized, a "trilemma" characterizes monetary, exchange rate, and capital markets policies. A government can choose any two of the following policies, but not all three: a fixed exchange rate, open capital markets, and a domestic monetary policy. Given China's movement over time toward more reliance on domestic demand as the engine of growth, and toward greater

openness in international capital markets, greater currency flexibility may be a desirable evolution.

A CROSSROADS FOR CHINA'S RELATIONS WITH WALL STREET AND THE U.S. GOVERNMENT

Financial and exchange rate policy changes have important consequences for China's evolving relationship with the West, with respect to both important Wall Street firms and the U.S. government. Wall Street is making significant investments in China's big four banks. This is best seen as a "pay to play" move; Wall Street is willing to make very risky investments in China's big banks in return for the ability to partner with those banks and others to deliver a growing range of financial services to China's expanding domestic financial market. Wall Street has not always found China a hospitable location for new opportunities, as Morgan Stanley's unpleasant experience in the 1990s bears witness. The stakes are much higher this time. If, on the one hand, financial reform succeeds, and if Wall Street firms are permitted to enter profitable new areas (credit cards, insurance, asset management), the potential for mutually beneficial growth and the transfer of technology in the financial sector is enormous. On the other hand, a financial crisis, large losses for investors, and the failure to realize new opportunities in China could have a lasting negative effect on Wall Street's interest in investing in China.

The stakes are also high for U.S.-China government relations. If China continues to maintain an overvalued exchange rate, which seems likely for the near term, the rising chorus of protectionism in the United States may someday succeed in restricting trade. And if, either in reaction to that threat or due to China's own political exigencies, China fails to deliver on its WTO obligations, including the promised opening in financial services, an international political backlash in trade and finance could be significant. Given the size of China's current account surplus, any sudden change in trade flows could have important repercussions for global exchange rates, interest rates, and stock markets.

A CROSSROADS FOR CHINA'S POLITICAL EVOLUTION

Finally, returning to Pei's (2006) view of China's "trapped transition," financial sector reform could have important consequences for China's political development. Pei is pessimistic about successful financial reform

because he sees the need to preserve political patronage as too strong a force to overcome. But he may be wrong. Another possibility is that the economic, and therefore, political forces favoring reform are so strong that they will result in a major transformation of Chinese politics. At the moment, this possibility seems a remote one, but the world is full of surprises. Revolutions are not always predicted.

THE CONTRIBUTIONS IN THIS VOLUME

With these important stakes in mind, this volume examines the phenomenon of Chinese financial and foreign exchange systems reform from a variety of important perspectives, and addresses the following important questions.

1. What has been the history of China's progress in the development of its financial system?
2. Why has China now reached a "decision point" regarding financial and exchange rate reform?
3. Why are these financial, exchange rate, and international capital market reforms important to the future of China's growth?
4. What specific reforms are necessary, and which of those necessary reforms are likely to be successful?

To address these questions, with the intention of producing a volume of authoritative contributions on Chinese financial policies and prospects, Columbia Business School's Jerome A. Chazen Institute of International Business invited top scholars and practitioners concerned with financial and foreign exchange reforms to participate in a research project, consisting of two conferences—one in the summer of 2005 at Tsinghua University in Beijing, and one at Columbia Business School in the spring of 2006. Their efforts culminated in this book. The contributors come from diverse backgrounds and include professors, Wall Street economists, a Goldman Sachs director based in China, IMF officials, and a rating agency analyst.

The first six chapters of the book contain detailed scholarly reviews, followed by commentaries by the Columbia conference discussants. Chapter 1 (by Lee Branstetter) begins with a broad overview of the history of financial sector development, regulation, and performance over the past three decades. Chapter 2 (by Loren Brandt and Xiaodong Zhu) focuses on the banking sector and discusses the progress, challenges, and

prospects relating to current banking sector reform. Chapter 3 (by Eswar Prasad and Shang-Jin Wei) describes the role of foreign capital in China's development and describes and analyzes the changes in capital flows and controls over time. Prasad and Wei explore various explanations for China's composition of foreign capital and foreign exchange policies, particularly the factors shaping China's reliance on FDI as the primary form of foreign investment. Chapter 4 (by Geert Bekaert, Campbell R. Harvey, and Christian Lundblad) provides an international comparative perspective on the remarkable growth experience of China, and the contribution of its institutional environment to that experience. Chapter 5 (by Fred Hu) examines the experience of foreign-listed initial public offerings (IPOs) of Chinese SOEs, and derives implications from that experience for the desirability of further privatization and further stock market liberalization. Chapter 6 (by Barry Eichengreen) examines the question of exchange rate regime choice for China, focusing on the long-run desirability of flexibility, as well as the appropriate sequencing of reforms in foreign exchange policy, domestic banking reform, and capital market openness.

Chapter 7 presents a roundtable discussion by prominent economists, including some of the top China analysts on Wall Street, at the IMF, and in the academy. Here the focus is on the questions of how much China will appreciate its currency, and what the likely consequences of that policy will be within and outside China. Participants include Peter Garber, Robert Hodrick, John Makin, David Malpass, Frederic Mishkin, and Eswar Prasad.

CHAPTER 1: THE EVOLUTION OF CAPITAL MARKET POLICIES TO DATE

Lee Branstetter ("China's Financial Markets: An Overview") provides a brief history of the breathtaking evolution of Chinese financial markets since the onset of the reform period. He lays out the principal remaining shortcomings and economic challenges the Chinese financial system is likely to face over the next five years. The primary role of this chapter is to provide an integrated historical perspective on the co-evolution of the various parts of the Chinese financial system and policies, and their relationship to Chinese macroeconomic cycles and political developments.

Several themes emerge: the fast pace of reform; the substantial remaining unresolved problems, primarily related to the remaining dominance of state-owned banks, state ownership of bank borrowers and securities issuers,

and limitations on private market competition for funding by banks and securities markets; the uneven progress over time; encouraging recent improvements in the institutional regulatory apparatus; the close relationship between investment and growth over the business cycle; and the fiscal costs of bank losses produced by boom-and-bust cycles in which loose credit to SOEs during booms produces large losses during contractions. This latter observation provides a cautionary perspective on the prospects for continuing losses in state-owned banks in the future.

Xiaobo Lü's discussion properly broadens the perspective on financial reform to consider the political context of Chinese economic reform. Lü stresses the important distinguishing features of the Chinese reform strategy: gradualism, state leadership in transforming the function and nature of institutions, and "de-statization" (rather than true privatization) as a means of controlling the transition process of reform. He argues that Chinese reforms, including those in the financial sector, must be judged as part of a comprehensive strategy of reform, which appears to have served China well, despite its inherent weaknesses. The financial sector is a weak spot in the reform process, but those weaknesses are part and parcel of an overall strategy that has been successful, since, thus far, financial sector weakness has not been an obstacle to growth. Lü concludes, however, that the time has come for financial reform to take center stage, since the success of the past may not hold true in the future: "Old approaches such as gradualism and de-statization have worked in the past, but they have also left behind unintended consequences and may not work any more."

CHAPTER 2: THE PROSPECTS FOR BANKING SECTOR REFORM

Brandt and Zhu's review of banking sector reform ("China's Banking Sector and Economic Growth") begins by emphasizing the crucial historical role of value-destroying loans to SOEs in redistributing income and maintaining the political and economic equilibrium during the economic reform process. They examine the recent clean-up in banks' balance sheets, which has been far-reaching, but they point to a substantial new risk of new nonperforming loans emerging, especially if growth slows.

Brandt and Zhu analyze the changing composition of bank loans, based on their unique data collection effort, which allows them to track the characteristics of bank borrowers over time. Brandt and Zhu note that an important process of "recentralization" of the banking system has occurred in the past decade, along with an increased concentration of

lending to large firms in a few sectors, which they argue heightens the risk of loss because of less diversification in lending.

Michael DeStefano's commentary echoes and amplifies the reasons for skepticism about the prospects for successful banking sector reform. He sees bright spots in some lending niches, especially in consumer lending, but expresses doubt about the ability of Western bank investors to transform or effectively govern the Chinese banks in which they have invested. He places little confidence in regulators to change bank practices. He also sees continuing impediments to market processes that would otherwise encourage reform—namely, little competition, continuing links to SOEs, sectoral concentration in lending, and little involvement of banks in lending to the export sector or small businesses. DeStefano notes that the increasing maturity of loans (which Brandt and Zhu identify in their data) can present problems for credit quality by masking credit quality problems for long periods of time.

CHAPTER 3: CAPITAL FLOWS AND CAPITAL CONTROLS

Prasad and Wei ("Understanding the Structure of Cross-Border Capital Flows") offer an exhaustive survey of the evolution of capital controls in China. (Their appendix alone—see appendix 2—should be of great value to scholars and practitioners trying to navigate the complexities and changes over time in Chinese capital controls.) FDI has dominated Chinese capital inflows, a phenomenon that the authors point out has occurred *despite* many aspects of the Chinese economic environment that are normally inhospitable to FDI investors in comparative international studies (e.g., a high level of corruption). Most of China's FDI comes from other Asian economies. Prasad and Wei hypothesize that some of China's apparently surprising success in attracting FDI may be related to its relative stability during the Asian financial crises, as well as to the widespread perception that its high level of foreign reserves and capital controls policies made it less susceptible to a financial crisis.

Prasad and Wei point to limitations in the Dooley, Folkerts-Landau, and Garber (2004) model (see the further discussion of this model by Garber, Hodrick, and Malpass in chapter 7) that purports to explain high FDI, high exports, and currency undervaluation as part of a political-economic strategy to use undervaluation to attract FDI and to use reserve accumulation as a form of "collateralization" for repatriation by FDI investors. Prasad and Wei point out that this "mercantilist" story for the

high levels of FDI investment “cannot be the entire story” since most of FDI inflows into China are from Asian countries that export to China.

Prasad and Wei offer an alternative view. They emphasize that China’s weaknesses in its domestic financial system, the government’s desire to attract foreign technology, and other factors probably work together to promote FDI investing as the most desirable means of external finance.

Prasad and Wei identify growth over time in the importance of non-FDI sources of capital inflows into China, especially the category “errors and omissions,” which has switched in sign from a net capital outflow to a net inflow. They hypothesize that this change may reflect “hot money flows” that circumvent capital market controls, and reflect the capital importers’ desire to take advantage of the yuan’s undervaluation.

Daniel Rosen’s commentary offers additional facts and interpretations regarding the changing patterns of FDI into China. He notes that a major change has been the growth of FDI into regions other than Guangdong Province, which reflects an increasing focus by FDI firms on production for the domestic Chinese market rather than production for export.

Rosen also points out that repatriations by FDI investors have been rising over time. Part of the motive for repatriation may relate to another point he emphasizes: the recent push to permit Chinese nationals to invest abroad. In April 2006, the People’s Bank of China permitted limited access to foreign exchange for the purpose of making foreign investments. This is an important observation: despite the motivation for capital inflows as the result of undervaluation, there is also a diversification motive that results in outflows of currency.

This observation leads Rosen to another interesting conclusion: to the extent that China would increase permissible foreign investments by its nationals, this could act to reduce the undervaluation problem by increasing the domestic demand for dollars. And higher returns to savers from access to foreign investments could also reduce the level of domestic savings and increase import demand, further buttressing demand for dollars. Rosen makes the important point that undervaluation of the yuan is itself partly a consequence of foreign exchange policies, capital controls, and low returns to saving in the domestic financial system. Reforms that buttress opportunities for savers could have far-reaching effects on consumption and the equilibrium exchange rate. The extent of presumed yuan undervaluation is subject to change depending on the path of financial sector and capital markets reforms.

CHAPTER 4: THE IMPACT OF INSTITUTIONAL FACTORS ON CHINA'S GROWTH

Bekaert, Harvey, and Lundblad ("Financial Openness and the Chinese Growth Experience") reflect on China's economic performance from the perspective of the experiences of a broad panel of countries. They formulate an econometric framework, using standard growth regressions to measure the impact of various factors on a country's growth and the volatility of that growth. In essence, they examine China's experience through the statistical mirror of what its characteristics would predict about its growth and growth variability based on a regression derived from other countries' experiences.

Interestingly, they find that China is a highly exceptional country, providing evidence to back up the often-heard statement that "China is different." According to Bekaert, Harvey, and Lundblad, China clearly is different from the observed regression mapping that relate country characteristics to growth experience derived from the data for other countries. China's extraordinary average growth and low-growth volatility cannot be explained by patterns observed from other countries.

But Bekaert, Harvey, and Lundblad also uncover some surprising aspects of the Chinese growth experience, which are likely to puzzle many "China hands." Consistent with Branstetter's discussion and conventional wisdom about China, they find that the large size of investment has been an important and predictable contributor to growth, but according to their model, trade and FDI per se have not been very important in explaining China's growth.

It is important to emphasize what these findings do *not* mean. Bekaert and his co-authors find that China's trade and FDI cannot explain China's growth if one assumes a relationship between trade and FDI, on the one hand, and growth, on the other hand, that is derived from the experiences of *other* countries. That does not mean that FDI and trade were not important for China's growth; it simply means that if they were important, they were important for reasons that were particular to the Chinese experience and that could not have been predicted based on the experiences of other countries. Other countries' experiences would lead one to underpredict Chinese growth, based on the amounts of trade and FDI observed in China. Indeed, Bekaert, Harvey, and Lundblad point out that "it is conceivable that [as a peculiar feature of the Chinese development experience] trade and FDI indirectly provided significant contributions to factor productivity."

There is a possible connection between the previous chapters in this volume and this interesting conclusion. Because of weaknesses in China's economic and financial system, and its comparatively low level of development and per capita GDP—which are reflected in weaknesses of the domestic financial system, the low level of domestic consumption demand, and the absence of alternative means to promote foreign investment or technology transfer in China—it may be that the impact of trade and FDI on Chinese growth was unusually high.

Bekaert and his co-authors note that China remains a poor country in terms of GDP per capita and that future progress is likely to be more dependent on efficient capital allocations than it has been in the past. They suggest that this likely implies a greater future reliance on capital market reforms and broader access to foreign capital. In several of their prior studies, they have shown a significant positive effect on emerging market countries from connecting to global capital markets.¹ In this chapter they suggest the existence of “threshold effects” relating domestic institutional quality to the ability to reap the advantages of access to foreign capital. This, in turn, suggests that “full capital account convertibility should probably be preceded by a sound institutional framework.” This conclusion reinforces the view that now is the crucial moment to push forward financial reforms in China, to clear the way for increasingly necessary improvements in capital allocation and greater reliance on international capital markets in the future.

Mary Darby's commentary emphasizes the perception that she and other practitioners have shared that China's exceptionally high growth does reflect, in large part, its trade policies and its ability to access FDI. She notes that a standard practice in China, which is visible in its policies encouraging joint ventures between foreigners and domestic firms in the financial services sector, is to encourage joint ventures as a means of importing best practices. “Recently when China wanted to allow its banks, which have long been subject to a Glass-Steagall like separation of banking and securities, to enter the mutual fund distribution business, how did it do it?—by requiring that the banks partner with large foreign mutual fund complexes with improved investment management technology.”

Darby also points to an encouraging development in the Chinese financial landscape that has not been addressed by other authors, namely, the prospects for the growth of institutional investors. She notes the recent emergence of many new initiatives in China to encourage the growth

of institutional investors, which she believes “will add depth and liquidity to the equity markets and will improve prospects for the market to better absorb increased share supply resulting from the sale of state shares.” She also states that China has recently announced that it will permit foreign institutional investors to purchase strategic stakes in listed companies. Darby argues that such concentrated block holdings could encourage improvements in the corporate governance of listed firms.

CHAPTER 5: THE EFFECTS OF STOCK MARKET LISTING ON THE FINANCIAL PERFORMANCE OF CHINESE FIRMS

Fred Hu begins this chapter by recognizing that most commentaries on partial privatizations of Chinese SOEs through IPOs have expressed disappointment with that experience. As he points out, however, much of that pessimistic analysis reflects the poor performance of the firms listed on the local Chinese stock exchanges (Shanghai and Shenzhen), rather than those that listed on Hong Kong and other foreign exchanges. Some of the largest and most important (partial) privatizations of SOEs occurred in Hong Kong and other foreign markets, and these firms are the subject of Hu’s analysis.

Hu finds that the post-IPO earnings growth, efficiency, profitability, and dividend payout of SOEs listing on the Hong Kong and other foreign markets has been quite positive. Improved profitability, he adds, is all the more remarkable in light of the significant de-leveraging that has accompanied public listing. Improved performance is visible for all sectors with the exception of airlines. His sample of firms represents more than 90 percent of the market value of the Morgan Stanley Capital International (MSCI) China Index as of 2005.

Hu concludes that a combination of factors explain how IPOs contribute to improvements in firms’ performance. First, privatization changes the ownership structure of the firm and gives managers greater control and stronger incentives to improve performance. Second, prior to the IPO, important restructuring occurs, which carves out the most valuable parts of the firm for the IPO. This process of streamlining businesses, cutting costs, and cleaning up balance sheets helps to boost the performance of the firm relative to its past. Third, Chinese firms that are listed on international markets have to face strict disclosure standards and the discipline of market scrutiny, which further encourages good performance.

Hu states that “the widely held view that firms listed in China’s domestic stock market have failed to live up to expectations should not be generalized to include overseas listed Chinese firms. . . . It also highlights the importance of reforming China’s nascent domestic stock market so that it can play the role of efficiently allocating capital and fostering world class Chinese companies.” This last comment is especially relevant because it appears that the Chinese government will focus primarily on the domestic market as the outlet for future IPOs.

Ailsa Röell’s commentary raises some reservations about how much the performance improvements of the firms analyzed by Hu can tell us about either the actual improvements that have taken place to date for foreign-listed firms as a whole, or the likely improvements that would come from a more widespread use of IPOs as a privatization device. She makes five criticisms. First, the best SOEs in China tend to be selected for IPOs in foreign markets. Lower-quality firms are directed to the local markets where valuation multiples tend to be much higher, owing to the scarcity of offerings. This alleged selectivity bias implies that foreign-listed firms may not be representative of Chinese SOEs generally, thus implying that greater use of foreign listings for other firms might not deliver the same positive results measured by Hu.

Second, Hu does not control for potential survivorship bias, including in his analysis only those firms that survived until 2005. Firms that were delisted or that fell in value so much that they were no longer covered by Goldman Sachs are excluded from his sample. Thus, the average performance results of the sample will tend to exaggerate the performance improvements of all firms listing abroad.

Third, Hu sometimes uses forecasts of accounting information when the actual accounting data are not available. Although his Goldman Sachs forecasts tend to be more conservative than the average consensus forecasts, it is possible that they are still overly optimistic.

Fourth, Röell worries that earnings may be manipulated by management.

Fifth, Röell argues that dividend payments may reflect flows of profits from sources other than the cash flows of the privatized SOE.

These criticisms point to the need for further research to measure the importance of these potential distortions before one can be sure either that the entire sample of foreign IPOs have performed well on average or that prospective IPOs would also be likely to perform well. Nevertheless, Hu’s chapter provides an important set of facts about the performance improvements that have occurred in an important segment of the Chinese

IPO market. He shows that, at least for a large fraction of foreign-listed Chinese IPOs, performance improvements have been large.

CHAPTER 6: THE DESIRABILITY OF EXCHANGE RATE FLEXIBILITY AND REFORM SEQUENCING

Barry Eichengreen (“China’s Exchange Rate Regime”) considers Chinese foreign exchange policy options from a long-term perspective. He analyzes the desirability of moving toward a more flexible foreign exchange rate and examines the necessary accompanying reforms to such a policy and their sequencing. He focuses primarily on the question of the desirability of a flexible exchange rate *regime* rather than on the appropriate level of the exchange rate or the appropriate near-term pace of revaluation.

Eichengreen summarizes his view of the received wisdom of the theoretical and empirical economics literature on the question of the desirability of exchange rate flexibility: “countries subject to distinctive business-cycle conditions (‘asymmetric shocks’) will want a more flexible exchange rate, since they can both afford and will wish to tailor monetary policy to domestic conditions. In contrast, relatively open economies with weak financial systems will want a less flexible [exchange] rate.” From this perspective, China’s exchange rate regime choice does not appear clear cut. Eichengreen notes that, on the one hand, China’s large size and rapid development and transformation subject it to distinctive business cycle conditions. On the other hand, it has a large export sector and a weak banking system. But Eichengreen argues that these considerations point in an unambiguous direction for future reform: over time, exchange rate flexibility will likely become increasingly desirable for China.

Given that judgment, Eichengreen also considers the importance of adopting the proper sequence of complementary reforms. He argues that there should be a co-evolution of capital account opening and increasing exchange rate flexibility. The increased flexibility of the exchange rate should not await the development of deep markets for hedging exchange rate risk, since those markets will only develop over time in response to the needs created by greater flexibility.

Eichengreen recognizes that moving to a regime of greater exchange rate flexibility may complicate the job of prudential bank regulators, which

he says makes it necessary for bank regulators to “issue guidelines for strengthening the banks’ internal risk policies and procedures,” and establish adequate procedures to monitor foreign exchange exposure.

From the perspective of these arguments for the desirability of greater flexibility, Eichengreen finds that policy actions thus far have not allowed greater flexibility; rather, they have simply set the exchange rate at a different level, with an expectation of continuing appreciation. Eichengreen also constructs a model to estimate the composition of the currency basket on which the managed exchange rate is based. He finds that it is still, in essence, a dollar peg. Eichengreen also contends that the maintenance of a narrow band for the exchange rate is a missed opportunity. Now is the time to widen the band, before market developments and changes in policy make the band a binding constraint.

As a lesson for China, Eichengreen considers Japan’s exchange rate policy in the 1970s, when it faced a similar situation to China’s present-day situation (an undervalued currency and an economy with a substantial dependency on exports). One significant lesson of the Japanese experience was that the appreciation of the yen in the years 1971 through 1973 did not result in significant adverse macroeconomic consequences. Japan successfully managed domestic demand during the revaluation to mitigate the macroeconomic consequences of revaluation.

Jialin Yu’s commentary on Eichengreen’s chapter considers one of the arguments sometimes made by proponents of China’s more rapid movement toward exchange rate flexibility. Some economists argue that a regime characterized by undervaluation may invite short-term, “hot money” capital inflows, which some regard as undesirable and destabilizing influences. Hot money flows are possible in China, despite capital controls, because companies are able to circumvent controls through under- or over-invoicing of imports or exports (see also chapter 3’s discussion of “errors and omissions” in the balance of payments).

Yu points out, however, that if the government’s commitment to maintaining undervaluation over time is credible, as is arguably the case in China today, then there is no motivation for short-term hot money flows, since there is no opportunity for short-term profit. Yu analyzes market expectations of exchange rate policy using evidence from forward exchange markets in China, and finds that a one-way bet against the gradually appreciating exchange rate peg maintained by the government is not an attractive speculative opportunity.

CHAPTER 7: ROUNDTABLE ON FOREIGN EXCHANGE POLICY
AND ITS CONSEQUENCES IN THE NEAR TERM

Peter Garber begins chapter 7's roundtable discussion ("China's Foreign Exchange Policy") with a summary of the Dooley, Folkerts-Landau, and Garber (2004) view of China's foreign exchange, FDI, and reserves strategy, which Prasad and Wei discussed in their chapter. Garber regards China's policy choice as a natural one for an excess-labor-supply economy, which sees export-led growth as the means to successfully transition from poverty to prosperity. He argues, therefore, that China will choose to change course only once excess labor is absorbed, allowing its currency to appreciate substantially and reversing its reliance on export-led growth and reserve accumulation.

Robert Hodrick reviews the historical Bretton Woods system as a way to cast light on the Dooley, Folkerts-Landau, and Garber (2004) model of China's foreign exchange policy. Under the Bretton Woods system, there was a similar long-term undervaluation of currencies relative to the dollar. The key difference, he argues, is that China's undervaluation is a voluntary action, whereas dollar overvaluation under Bretton Woods was the result of U.S. policy.

Hodrick agrees with Garber's explanation of the logic behind Chinese foreign exchange policy. He also notes that the acquisition of reserves, which are held in the form of U.S. Treasury securities, appears to have had a significant negative effect on long-term rates, which implies a benefit for the United States.

John Makin agrees that there is likely to be a protracted period of undervaluation, and he, like Hodrick, draws attention to the consequences for asset markets. Makin considers what consequences a sustained period of undervaluation of Asian currencies will have for the global economy. Makin, like Hodrick, points to important effects in the treasury market. Makin also argues that the effects on treasuries and other asset prices are likely to fuel inflation, which will, in turn, spur a monetary policy tightening that will eventually result in a substantial decline of asset prices.

David Malpass reinforces the view, shared by other roundtable participants, that China will maintain its policy of gradual appreciation, and he, like Jialin Yu, points to the evidence from forward markets showing that market participants share that view. He takes exception, however, to the view that China's foreign exchange policy is designed to subsidize exports. Like Prasad and Wei, in chapter 3, he notes that this story does not fit all

the facts. In particular, China maintained its currency peg in 1998 when its currency was *overvalued*. A better explanation of Chinese policy, he argues, is that China has been maintaining a stable long-run exchange rate as a means of achieving exchange rate stability for reasons other than export subsidization, a policy that he regards as quite successful.

Frederic Mishkin approaches China's undervaluation from the perspective of U.S. policymakers. He concurs with Dooley, Folkerts-Landau, and Garber (2004) that China may be pursuing a sensible development strategy. Furthermore, he argues that successful Chinese development is important as a means of alleviating world poverty and should therefore be welcomed by U.S. policymakers. He continues that China's policy has other tangible benefits for the United States, including the low prices of imported goods in the United States.

Eswar Prasad agrees that China is likely to maintain its gradually appreciating peg for some time, but he points to the important costs of this policy from the standpoint of the Chinese financial system's development, which commentators that favor undervaluation often ignore. The accumulation of foreign reserves in the Chinese financial system encourages the continuation of regulations that maintain artificially low lending and deposit interest rates in China, which limit depositors' returns and subsidize inefficient borrowers.

Prasad also worries that, as capital controls become increasingly ineffectual over time, they may become increasingly risky. He proposes that China should consider a movement toward exchange rate flexibility, combined with an inflation targeting policy to guide its monetary authority. He recommends that the Chinese government consider adopting this policy sooner rather than later; the best time to make such a policy change, he says, is in an environment of relative stability and growth rather than in reaction to a crisis.

CONCLUSION

These seven chapters taken together provide unique, timely, and detailed perspectives on one of the most important questions of the next decade: Will China succeed in implementing the crucial financial sector and foreign exchange reforms that financial service providers, practitioners, academics, and its government recognize as likely to be important ingredients for continuing rapid growth? The answer to this question is important in determining China's ability to transform itself from an immature economy characterized by extremely high savings, export-led growth, limited

access to foreign capital, and an allocatively inefficient capital market to a mature economy characterized by higher consumption, efficient capital allocation, a globally integrated financial system, and an autonomous monetary policy. But the stakes are high not just for China, but for the growth and stability of the global economy, whose prospects have become increasingly intertwined with China's.

The perspectives of the participants in this volume are balanced and point to potential pitfalls at least as much as arguments for optimism. Reform, after all, is a political process, which makes it inherently difficult to predict, and China's remarkable recent history is a special case of development, whose path is hard to predict based on the experience of other countries. Our project will be deemed a success if we have helped practitioners and policymakers understand and manage some of the risks that await them as they travel the path of reform.

NOTE

1. This perspective disagrees with the more skeptical findings of Prasad et al. (2003), which is mentioned in chapter 3. This apparent disagreement seems to be largely attributable to the way liberalization is defined. When the definition of financial openness focuses on equity market liberalizations (as in the studies by Bekaert, Harvey, and Lundblad, and others), or specific removals of barriers to bank entry, there is little ambiguity about the positive effects of liberalization. For relevant reviews, see Calomiris (2005) and Forbes (2007).

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