

COMMENT: China should show some trust in capital markets

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At the most recent International Monetary Fund meeting in Washington, Chinese officials again resisted suggestions of setting a timetable for opening up China's nascent capital markets and floating the currency. The notion seemed to be: the economy is doing well, so why take action? History is often cited to support this assessment. China, with its pegged currency, was largely able to sidestep the Asian crisis of the late 1990s.

We believe China would benefit from moving faster to modernize its financial system. Well functioning capital markets play an important role in lifting economic growth and spurring job creation. China needs only to look to the US economy for strong empirical evidence of the power of the capital markets - the proof is an annual gross domestic product of \$11,000bn (£6,500bn).

Countries with the most well-developed capital markets, such as the US and Britain, have outperformed countries in which banking-based systems dominate, such as some other European countries and Japan. The economic performances of the US and UK have improved over time as their capital markets have become more developed. This is evident in a number of metrics: higher productivity growth, higher real wage growth, greater employment opportunities and improved macroeconomic stability. Why is this? In terms of productivity, capital markets raise the growth rate in two ways.

First, by providing nearly instantaneous price signals, capital markets help direct funds to projects with the highest anticipated returns. Second, derivatives markets enable the transfer of risk to those who are best placed to bear it from those who are not as well-placed. This risk transfer helps facilitate the type of entrepreneurial activity that generates new technologies and ways of doing business. It is no accident that the US is the global headquarters for venture capital investment and start-up companies.

By ensuring the best projects are undertaken, a better allocation of capital raises the return on capital. By improving the transfer of risk, higher risk projects with higher expected returns are undertaken. Higher productivity growth, in turn, leads to higher real wages and better employment prospects. Ultimately, workers' living standards are linked directly to their efficiency in terms of what they can produce for each hour of labor.

The capital markets also enhance job growth. By raising productivity, they enable better wages for workers. And by creating a bigger wedge between wage and price inflation, this higher productivity lowers the level of unemployment at which inflation pressures start building. Job creation is also improved by the positive effect capital markets can have on the quality of economic policymaking. Unlike a banking-based financial system, a capital markets-based system provides nearly instantaneous feedback to policymakers; when they are considering bad policies, for example, prices of stocks and bonds decline. By anticipating future developments, capital markets reduce the incentives for politicians to opt for short-term political gains that might improve their

prospects at the polls but at the expense of long-term costs that will ultimately hurt national economic performance.

Finally, capital markets enhance employment prospects by contributing to economic stability. This happens in a number of ways, first through development of a securitized mortgage finance system which, in the US, has helped halve the volatility of housing activity and stabilize the pace of growth. Second, the use of credit derivatives obligations has enabled commercial banks to reduce and diversify credit exposures. In 2001-03, only 16 US banks failed. This compares with 412 bank failures at a comparable point in the business cycle in 1990-92, when there was no credit derivatives market. Other factors, namely a property bust, contributed to these failures. But it is no accident that as US capital markets have become more developed, recessions have become milder and business expansions longer.

The last two periods of US business expansion were the longest and third longest in US history. The UK, also characterized by a well-developed capital market, is experiencing its longest economic expansion and the unemployment rate has not risen by one percentage point in more than 10 years.

The capital markets path does have bumps along the way. Sometimes these even include financial market spasms that can be frightening. Flaws that are identified must be remedied. Accounting standards must be upheld; financial reports must be transparent. But what should not be underestimated are the benefits that flow from such a system. The benefits are not abstractions - they include more and better jobs and more stable employment prospects. And a better return on the very large savings (as much as 40 per cent of gross domestic product) for households in China.

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