KEVIN P. GALLAGHER

Cons of deregulating finance

It is speculated that China is set to accelerate the deregulation of its financial system. For years, China has restricted the ability of its residents and foreign investors to pull and push their money in and out of the country.

While that may be illiberal, there was a sound reason for this restriction: Every emerging market that has scrapped these regulations has had a major financial crisis and subsequent trouble with growth.

The world can't afford that to happen in China. China is too big to fail.

This issue came to the fore last year when the People's Bank of China announced that it might "liberalize" its financial system in five to 10 years. The move was in stark contrast to a National Development and Reform Commission-World Bank report that put such a plan much further into the future.

That study cited the overwhelming evidence that shows, first, that dismantling cross-border financial regulations is not associated with growth and, second, that it tends to cause banking crises in economies with fledgling financial systems.

But now, Guan Tao, a State Administration of Foreign Exchange director-general has announced that "capital account convertibility" — as wonks call financial globalization — should happen in just a few years' time.

Indeed, China has already started raising the ceiling on the amount of foreign speculation in China.

Why rush this issue? Guan says this is about making the yuan a global currency. No doubt, in the long run it sure would be good to have more than US dollars on offer in the world economy. The US dollar is increasingly becoming a risky bet. Moreover, trading in the yuan would reduce exchange-rate risk for one of the world's largest trading countries (and all its trading partners). It would also reduce global risk by alleviating the world's over-reliance on the US dollar.

But China should not put the cart before the horse. To get where it wants to be and deserves to be, China will need to carefully reform its interest rate, exchange rate and financial regulatory regimes first.

Managing these reforms successfully will be close to impossible to achieve with a deregulated capital account. Financial stability is essential for China to move on with necessary reforms and maintain growth — as well as to maintain political stability.

The PBOC has kept interest rates low to provide cheaper loans for industry. This has been very beneficial, playing a key role in China's industrial policy that spawned the world's manufacturing export powerhouse. However, at this point China's investment rates are too high and China needs to consume more. Low rates moved households to over-invest in real estate, and have caused a real estate bubble in the country.

If China deregulated cross-border financial regulations before reforming its interest rate policy, there could be an enormous capital flight out of China. Low interest rates in China, juxtaposed with higher rates available abroad, would provide an attractive rate of return for many wealthy Chinese. While China has taken small steps in interest rate reform, it still has a long way to go.

Capital flight would also jeopardize China's exchange rate reform, which has deepened over the past two years. Exchange rate reform has made the yuan appreciate significantly, with estimates of yuan appreciation now at 35-50 percent.

Capital flight could cause a major depreciation of the yuan, which, in turn, could hurt consumers by further weakening their purchasing power, and stall reform.

China will also need to continue financial regulatory reform. The country's big banks are still indirectly responsible for large amounts of non-performing loans and are increasingly intertwined with a shadow banking system that is not properly regulated.

These banks need serious reform — or they will not be able to compete with international financial companies on liberalization.

The global record is clear: When Latin America prematurely opened its doors to foreign finance in the 1990s domestic banks got wiped out. Next, the new dominant players in the market — foreign banks — didn't lend to domestic enterprises with innovative new ideas. That undermined growth and economic transformation. The result has been anemic investment rates, de-industrialization and very little inclusive growth.

The International Monetary Fund's own (and other) studies show that capital flows are susceptible to massive surges and sudden stops. These trends have only intensified since the global financial crisis.

For a while, there was a surge in capital flows into emerging markets because of low interest rates in the industrialized world, which made things look good. But now that the US Federal Reserve has hinted that its bond buying programs would slow down, capital is fleeing from emerging market economies.

But even before that change in trend occurred, things were more bubbly than rosy. During the 2009-2013 period, when capital flowed in, exchange rates appreciated. That hurt export prospects and created asset bubbles. Now that exchange rates are falling, all those loans from the credit bubble are more expensive because they are denominated in US dollars.

China's ambitions aside, the fundamental economic lesson is clear: Regulating capital flows is essential for the exchange rate to fluctuate relative to economic fundamentals — rather than the irrational whims of speculative finance.

Indeed, there is now a consensus among economists and international financial institutions that capital account liberalization is not associated with economic growth in emerging markets, and that it causes banking crises (especially in countries with fixed exchange rates).

Such evidence has even prompted the IMF — the very institution that once saw rapid capital account liberalization as top priority — to change its tune. It now officially recommends the cautious sequencing of capital account liberalization.

China should remember with pride that it was not as severely hit by the financial crises of the 1980s and 1990s in Latin America and East Asia. These were crises where capital account liberalization played a big role. Large countries such as Indonesia were set back by as much as a decade. Why did China not suffer as much? Because it prudently regulated cross-border capital flows.

If China does not proceed with great caution now, few countries can weather a financial crisis that hits China. Across the world, we are reliant on China for trade, investment and finance. Simply put, China is too big to fail.

Thus, it is in the interests of the US and the rest of the world to urge China not to deregulate its financial system — but most of all, it is in China's own interest.

The author is a professor of international relations at Boston University and a regular contributor to The Globalist.

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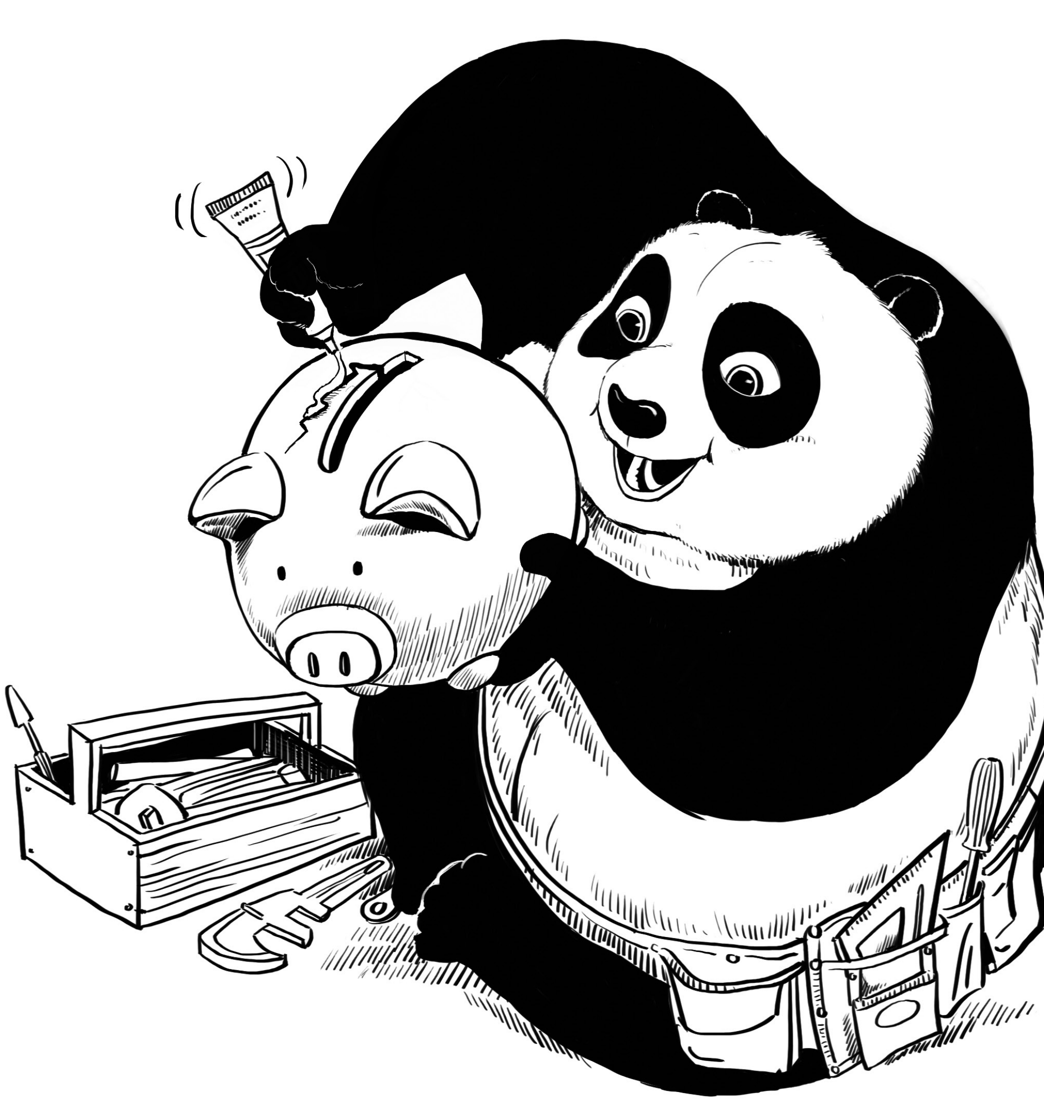

SONG CHEN / CHINA DAILY

WILLIAM DANIEL GARST

Give Chinese overseas tourists a break

If China's media is to be believed, Chinese tourists visiting foreign countries have become the new "ugly Americans". Hardly a day goes by without some report of boorish and culturally insensitive behavior on the part of Chinese traveling overseas.

For example, some "rude Chinese tourist" stories published online go straight to most read articles. And this summer, photos of middle-aged Chinese-looking females dipping their feet in the Louvre fountain were splashed all over the Chinese media. Two of the accompanying headlines screamed "Foreigners dumbfounded as Chinese turn Louvre fountain into feet-washing basin" and "Chinese feet-washing army takes over Louvre".

However, bloggers in China noted that the matronly ladies in the Louvre photographs could have been from other Asian countries. And other shots taken that day at Louvre showed many Western visitors dipping their feet into the museum's fountain. Given the terrible heat wave gripping Europe this summer, these people can hardly be blamed for wanting to cool off a bit.

To be sure, many Chinese going overseas do behave as stereotypical "tourons", which stands for "tourist plus moron". They typically take package group tours which are crammed with lightening fast visits in out and of "famous" places, mainly so those making the trip can snap a quick photo and say to friends and family, "I was there."

Moreover, large numbers of the tourists visit foreign countries mainly to shop. According to Jiang Yiyi, a researcher at the Chinese Tourism Academy, cited in an Aug 17, 2012 Guardian article, some Chinese tourists spend 100,000 yuan (about $16,000) on shopping alone. And Global Blue, a shopping tourism company, notes that 20 percent of all duty-free shopping is by Chinese customers.

However, Chinese tourists are hardly unique in being dedicated shopaholics, nor do they have any monopoly when it comes to buying kitsch. In fact, an American friend who worked as New York City tour guide while attending Columbia University — this was before masses of Chinese tourists began visiting the Big Apple — once said he was "appalled at all the kitsch purchased by foreign tourists."

When instructing English at a no-name university during my first year in China, I saw a similar behavior pattern among the older American teacher colleagues. As we pulled into the Terra Cotta Warriors Museum parking lot on a group trip to Xi'an of Shaanxi province, our Chinese guide warned us not to buy the miniature soldiers hawked by local farmers, saying that they were shoddy and overpriced. But an older instructor, a 60-something lady, said not once, but twice, "Can't we just bargain them down!"

It was as if our main purpose in going there was to haggle with farmers over tacky souvenirs rather than seeing Emperor Qinshihuang's terra cotta army. For this teacher and the other older instructors, all of whom made no effort to study Mandarin or learn about Chinese culture, the big country was one big flea market for buying things on the cheap.

Despite my strong dislike for tourists, I am willing to cut Chinese tourists some slack in both the group tour and shopping areas. Unlike Western Europeans, Chinese people do not have long vacations, so seeing a lot in one short go is often done out of necessity. And thanks to import duties and high taxes, luxury goods are much less expensive to buy overseas than in China.

Thus the number of serious travelers, vs. tourists, is on the rise in China. This could not come soon enough, as Chinese tourists are creating a serious image problem for their country.

But as much as people in other places heavily visited by Chinese tourist might kvetch about the latter's conduct, they are also surely quite happy to see these visitors part with their money. Before complaining about Chinese behavior, foreigners should remember who is helping to butter their bread.

The author is an American corporate trainer in China.

LETTERS

Prayers are with people of Gansu

Living in China for the last 10 years and being married to a wonderful Chinese woman, I consider China to be my second home. I have established many wonderful friendships with Chinese people. That's why any tragedy that befalls this land of glorious history moves me deeply.

I was saddened to read about the 6.6 magnitude earthquake that hit Gansu province recently. I got a greater shock when I read that the area struck by the quake was just beginning to recover from weeks of torrential rain and flooding. The Chinese government rose to the occasion by sending troops and heavy machinery to help the rescue and relief efforts.

As a foreigner living in China I am aware of my limited resources, but I shall do everything possible to help the earthquake victims. The Chinese people have the grit and determination to triumph over this tragedy, just like they have done over many tragedies in the past. My prayers are with the distinguished people of Gansu.

SAVA HASSAN, *via e-mail*

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FROM THE CHINESE PRESS

The mentally ill need proper care

Many violent attacks by mentally challenged people have been reported recently. In the latest incident, a knife-wielding man killed three people and left five injured. These tragedies have again raised concern over public security. To prevent such incidents, we need to strengthen the management of the mentally challenged as well as treat them with love and better understanding, says an article in People's Daily. Excerpts:

Unfortunately, we think of mentally challenged people only after a tragedy occurs. In normal times, we tend to forget even about their existence, let alone providing them with proper medical treatment and counseling.

Center for Disease Control and Prevention data show that more than 16 million people in China suffer from severe mental disorders, while medical resources for their treatment are inadequate. By the end of 2010, China could only accommodate 228,000 patients in psychiatric wards of hospitals.

In the absence of hospital beds and proper medical treatment and counseling, many mentally challenged people have to be kept under lock and key at home. Apart from more psychiatric treatment centers, well-established rehabilitation centers near communities are also urgently needed. When patients are discharged from hospitals, they need to be attended to at the community level by counselors and physicians. Plus, we should also arrange for them to get training in vocational skills so that they can lead a normal life afterward.

Many mental illnesses can be cured, but patients need a long time to fully recover from them, for which they need proper care by families and communities.

The Mental Health Law came into force on May 1, but more efforts are needed to increase medical resources for the treatment of the mentally ill and to ensure that their rights are protected.

Fighting corruption the right way

The Hunan Party commission for discipline inspection's new draft regulation that bans officials from accepting gifts (read bribes) at birthday parties and family members' weddings and funerals shows the department's determination to eliminate corruption. About 90 percent of the 7,361 people who responded to an online survey supported the move, although some considered it an infringement upon privacy rights, says an article on gmw.cn. Excerpts:

Party officials should abide by the law and Party discipline. Even though the draft regulation has wide public support, corruption cannot be eradicated by just passing it.

Besides, the ban imposed by the draft regulation is not all encompassing. For example, the regulation makes some exception for special occasions. If local authorities want the regulation to be really effective, it should be devoid of any loopholes.

The Hunan Party commission for discipline inspection should enforce the ban, because officials have been using all sorts of excuses to organize banquets in recent years, which not only goes against social values, but also is a drain on precious public funds. The ban should, however, be accompanied with strict supervision.

To expect local officials to gradually adapt to and accept the new regulation is easy. But corruption is more deep rooted that we can imagine. Since discipline inspection departments cannot impose a ban on all banquets that can be used as an opportunity by officials to take bribes, a simple but effective way to root out corruption is to strictly enforce the law without having too many supplementary regulations.