China should rethink deregulation

It has to reform interest rate, exchange rate, financial regulatory regimes first before deregulating its financial system

By **KEVIN P GALLAGHER**

RUMOUR has it 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 for 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 (PBOC) announced that it might "liberalise" its financial system in 5-10 years.

This move stood in stark contrast to a Chinese National Development and Reform Commission (NDRC) 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 director-general in the State Administration of Foreign Exchange has announced that "capital account convertibility" – as wonks call financial globalisation – should happen in just a few years' time.

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

One wonders: Why rush this issue? Guan Tao says this is about making the yuan, China's currency, a global currency.

No doubt, in the long run it sure would be good to have more than US dollar on offer in the world economy.

The US dollar is increasingly a risky bet. Moreover, trading in yuan would reduce exchange-rate risk for one of the world's largest trading nations (and all its trading partners). And it would also reduce global risk by alleviating the world's over-reliance on the US dollar.

That said, 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 in order to move on with necessary reforms and maintain growth – let alone to maintain political stability.

Interest rates in China have been kept low to provide cheaper loans for industry. This has been very beneficial, playing a key role in a Chinese 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 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 jeopardise China's exchange rate reform, which has made great strides over the past two years.

Exchange rate reform has made the yuan appreciate significantly, with estimates of yuan appreciation now at 35-50 per cent.

Capital flight could cause a major depreciation of the currency that could hurt consumers by further weakening their purchasing power, and stall reform.

China will also need to continue financial regulatory reform. China'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 firms upon liberalisation.

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 firms with innovative new ideas.

That undermined growth and economic transformation. The result has been anaemic investment rates, de-industrialisation and very little inclusive growth.

The IMF's own (and other) research shows 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 to emerging markets due to low interest rates in the industrialised world, which made things look good.

But now that the US Federal Reserve hinted its bond buying programmes would slow, capital is fleeing from emerging market countries.

But even before that trend change occurred, things were more bubbly than rosy. In the 2009-2013 period, when capital flowed in, exchange rates appreciated. That hurt export prospects and caused asset bubbles.

Now that exchange rates are depreciating, 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 liberalisation is not associated with economic growth in emerging markets, and that it causes banking crises (especially in nations with fixed exchange rates).

Such evidence has even prompted the International Monetary Fund – the very institution that once saw rapid capital account liberalisation as a number one priority – to change its tune.

The IMF now officially recommends the cautious sequencing of capital account liberalisation.

China should remember with pride that it was not as severely effected by the financial crises of the 1980s and 1990s in Latin America and East Asia. These were crises where capital account liberalisation played a big role.

Large countries such as Indonesia were set back by as much as a decade. Why did China not experiences the same disaster? Because it prudently regulated cross-border capital flows.

If China does not now proceed with great caution, few countries will weather a financial crisis when it hits China. All around the globe, we are reliant on China for trade, investment and finance. Simply put, China is too big too fail.

Thus, it is in the interests of the United States and the rest of the world to urge China not to deregulate its financial system. But most of all, it's in China's very own interest.

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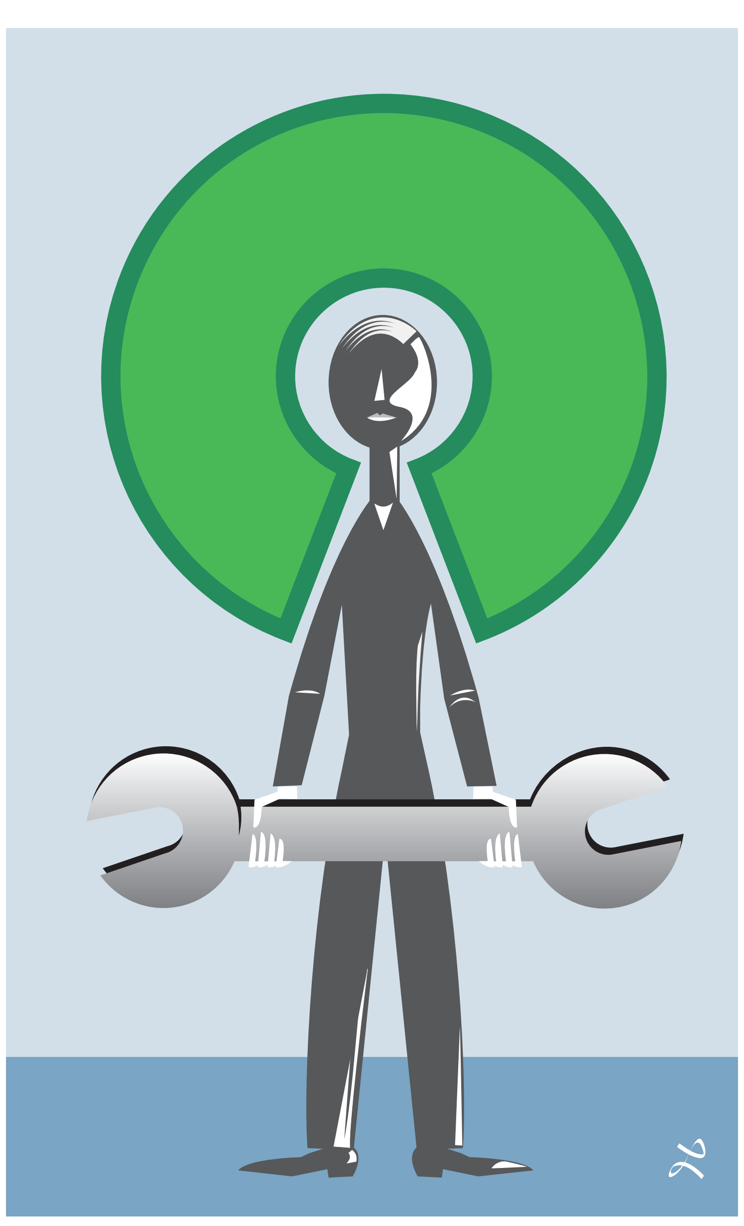
Taking a risk? *If China does not now proceed with great caution, few countries will weather a financial crisis when it hits China. All around the globe, we are reliant on China for trade, investment and finance. Simply put, China is too big too fail.* PHOTO: REUTERS

How S'pore govt could benefit from Toyota's kaizen approach



By **DAMIEN WONG**

AUTOMOBILE giant Toyota has long been regarded for their efficient manufacturing and business practices. Having pioneered the use of *kaizen* principles of "continuous improvement", Toyota has been lauded as the paragon of efficient production and quality control.

This is also applied to its software for its cars, with the understanding that the know-how does not reside in an individual alone, but the "accumulation of small improvements" from other team members. Indeed, Toyota was one of the first companies to understand the correlation between quality and participatory systems.

In the IT world, the equivalent of *kaizen* is open source software. Open source has been one of the most disruptive forces in the last decade, with many large IT companies leveraging open source software to address growing business demands.

Essentially, open source encourages participation in developing and enhancing software source code – understanding it, finding flaws, fixing it and adding functionality. It advocates continuous improvement, similar to *kaizen* manufacturing principles, where it encapsulates the power of participation to solve complex problems.

How appropriate is this model for IT systems used in the public sector? Very much so, if we look at the number of countries that are already on board. Estonia, awarded by the United Nations for having "Best of the Best" e-government applications, use open source for many of their national projects. Similar initiatives have also been announced by the governments of Australia, Germany and the United States.

Just a few hundred kilometres up north, the Melaka State Government chose open source solutions when it embarked on a journey to consolidate its IT assets, while making their datacentres cloud-ready. Compared to proprietary software, open source technology offers choice and avoids vendor lock-in. Open source addresses key concerns which keep organisations from reaping the full benefits of cloud.

The value of open source for governments is best expressed by the chief technology officer of the World Economic Forum, Brian Behlendorf. He said in an interview: "Because open source is based on common platforms, you can switch vendors without changing the underlying technology. Governments and NGOs think things have to be done by particular vendors and if they want to change, they have to change the entire stack."

Behlendorf further explained that there is a need to get public agencies "out of that thinking and understand about common platforms and code reuse and redevelopment. This is all rather new to them, but it is starting to take hold," he adds.

In a nutshell, this means that with open source, governments now have the ability to move more quickly, innovate faster and with fewer constraints from either budget or vendor choices.

This concept is embraced in the US by the Office of Management and Budget, when it announced the Federal IT Shared Services Strategy. It seeks to increase return on investment, eliminate waste and duplication, and improve the effectiveness of IT solutions.

One of the key ways to achieve this is all 300 organisations under them must adopt the Common Approach to Federal Enterprise Architecture, which provides agile, standardised methods and tools for designing the next generation of IT resources and shared services in the face of tight resources and rising customer needs.

It is no surprise that the public sector is being singled out, especially as many governments strive to adopt practices that have a high degree of accountability. That is why the benefits of open source are too compelling to ignore. Unsurprisingly, the past few years have seen a significant shift in the perception in the public sector space worldwide.

In fact, the conversation on open source has now moved from "is it safe and secure to use" to "how we can get the maximum value for every tax dollar".

The Singapore government has always been one of the most progressive in introducing technologies to help citizens and businesses live and work easier. Given the value of open source in driving greater IT cost-efficiency and agility, coupled with the Singapore government's desire to continuously improve, we expect that it could only be a matter of time before open source becomes mainstream in local government agencies.

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Open source is one of the best platforms that can enable these local agencies to not only maximise taxpayers' dollars, but also maintain agility and continue introducing innovative e-services to Singaporeans. In essence, embracing open source in government could be akin to adopting a *kaizen* approach towards public sector IT systems.

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