UP & DOWN ASIA

China’s Flawed Plan to Be a Financial Superpower

Beijing’s stock and currency markets plans are leapfrogging conventional wisdom on market development.

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Photographer: SeongJoon Cho/Bloomberg

Stocks and currencies tend to be viewed as completely different asset classes with dissimilar dynamics and world views. That is, unless we’re talking about China.

This thought kept leaping to mind while reading Eswar Prasad’s new book, “Gaining Currency.” Ostensibly a look at the rise of the yuan, it’s also a timely exploration of how Beijing puts the cart before the proverbial horse in ways the Communist Party may regret. The Cornell University monetary-policy expert is no China-meltdown hysteric. Rather, he’s a concerned observer of Beijing’s penchant for punting on many of the vital building blocks necessary to minting one of the top-five currencies.

“There something remarkable about the yuan,” Prasad writes. “Even before it met many of the technical criteria considered necessary for a reserve currency, it has already ascended to the status of one in practice.”

Modern economics holds no other examples of global institutions and investors giving a government a pass on liberalizing its capital account, allowing convertibility, increasing transparency and central-bank independence. The reason, of course, is size. China’s role as the No. 2 economy and its boundless potential led the world to make some huge allowances for the lack of progress President Xi Jinping has made in building a modern and trusted financial system.

It’s striking to see Beijing pursuing a similarly hasty strategy to make its stock markets world class. Many Chinese shares are on a bull run amid rumors the Shenzhen-Hong Kong stock market link will soon launch (last night Beijing confirmed it, without specifying when). It would complement the Shanghai-Hong Kong link that opened in November 2014. Investors are understandably giddy about the specter of increased cross-boundary capital flows, and exponentially giant ones at that. So giddy that few punters are stopping to consider the dark side of this moment.

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Traders seem to view (wrongly) that capital liberalization is a reform all its own. What matters more is the plumbing supporting those flows - fundamentals, in other words. It’s great that Beijing is loosening barriers to capital and integrating itself more deeply into international markets. That’s only a plus if accompanied by increased transparency, tightened corporate governance, fewer shadow-bank excesses, greater legal certainty and efforts to get the government’s not-so-invisible hands off valuing share prices. The more China prioritizes attracting foreign cash over fixing internal vulnerabilities, the more it’s just sharing its bubbles and volatility with an already jittery world.

Heavy lifting also matters on the currency front. Beijing has done a skillful job maintaining rapid growth and confounding China-crisis predictions. Even so, China “stands out as an anomaly in the context of the voluminous academic literature that a well-developed institutional framework - typically characterized by independent legal institutions, the rule of law, an open and transparent democratic system of government, and good public and corporate governance - are important determinants of growth,” Prasad argues. “But, when it comes to earning the trust of foreign investors, a key characteristic of a safe-haven economy, strong institutions are indispensable.”

China does have formidable institutions, but their current objectives run counter to pledges to let “market forces” play a leading role. Trouble is, Xi’s government remains even more opaque than recent predecessors, while media censorship efforts have exploded. Nor is Xi doing enough to curb China’s worst excesses in credit, borrowing and state-owned- enterprise overcapacity. That’s why, ultimately, Prasad concludes that hype over the yuan steadily rising to global dominance are overblown.

Might the same be true of Shanghai and Shenzhen shares? Just as with its currency, Beijing has pursued a size-matters-most strategy on equity-bourse development. Financial brawn matters, of course, be it the number of transactions denominated in yuan, mainland stock-trading volumes and giant initial public offerings. But Chinese officials are mistaken in thinking they can leapfrog over entire levels of financial development and that investors will just play along.

As Prasad warns, “there are legitimate reasons to be concerned about the brittleness of China’s economy. Moreover, the political structure appears to have become even more rigid under Xi Jinping, raising the risk that political and social stability might unravel suddenly and dramatically if adverse shocks to the economy or other events were to break the party’s tight control of society and the state.”

These concerns are among the reasons decision makers at MSCI keep rejecting China’s inclusion in their premier indexes. They’re also why, even though the International Monetary Fund accepted the yuan into its basket of top-five currencies, officials in Washington remain wary. China does itself no favors upgrading its economy in ways contrary to the conventionally expected order. It makes China the one place where the currency and stocks risk moving in the same direction: down.

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