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Capital controls will not cure China's ills

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The government should make a real commitment to supply-side reforms, writes Eswar Prasad



In yet another sign of the strange times we live in, Japan is calling for China to impose controls to stem capital outflows that are eroding the value of the renminbi. Authoritative voices have endorsed this view. This fast-developing orthodoxy that capital controls could give China some breathing room is wrong. Controls would make things worse, not better.

China certainly has a problem on its hands. In August 2015, the People's Bank of China

ostensibly freed the renminbi's value to be more freely determined by market forces. Unfortunately, it got off on the wrong foot, combining a well-intentioned move towards greater exchange rate flexibility with a 2 per cent devaluation relative to the dollar. Financial markets focused on the devaluation, interpreting it as a desperate measure to shore up a stalling economy. The problem was compounded by botched communications.

Since August, China has lost about \$320bn of foreign exchange reserves in trying to prevent its currency from falling too fast. This has intensified a trend of reserve losses since mid-2015 as restrictions on outflows have been eased, allowing households, corporations and institutional investors to seek portfolio diversification through investments abroad.

Japan has good reason to worry about a falling renminbi. The success of the Bank of Japan's monetary stimulus in raising inflation and boosting growth depends on a weaker yen stimulating exports. A falling renminbi vitiates that goal and the ensuing investor concerns are driving safe haven inflows to Japan, pushing up the yen. But the suggested remedy for the renminbi could end up worsening these problems.

Japan's experience with capital account liberalisation (easing restrictions on capital flows) holds some positive lessons and a few cautionary ones for China. Opening up the capital account facilitated Japan's integration into global trade and finance, and also helped in developing and deepening domestic financial markets. But it also made exchange rate management harder. An open capital account without a flexible, market-determined exchange rate complicates monetary policy.

In an ideal world, the correct sequence is clear — fix financial markets, free up the exchange rate, then open up the capital account. In a less than ideal world, an opportunistic approach to reforms may be the best available option.

The PBoC wisely used the goal of elevating the renminbi into the IMF's basket of reserve currencies by the end of 2015 as a tool for opening up the capital account, freeing up the exchange rate and undertaking a number of financial sector reforms. But the timing was less than propitious as capital outflows for the right reasons (portfolio diversification) got mixed in with outflows fuelled by concerns about the economy and Beijing's anti-corruption drive.

The endgame is clear. The PBoC will eventually have to free up the exchange rate rather than maintaining substantial and costly intervention to keep its value stable. In its own inimitable and oblique way, the PBoC signalled in December that markets ought to focus on the renminbi's value relative to a trade-weighted basket of currencies of China's major trading partners.

Despite its best intentions, however, the PBoC has painted itself into a corner. It faces a

challenge in allowing for more currency flexibility in practice without triggering substantial capital outflows and a sharp currency depreciation. Reversing the progress on capital account opening through measures designed to hinder outflows risks signalling that the government is back to its inconsistent approach to reforms.

There is a better exit strategy from the PBoC's current dilemma, however. It will take a number of self-reinforcing elements to stabilise market expectations and rebuild investor confidence.

First, a balanced mix of macroeconomic policies to support growth. With monetary policy constrained, fiscal policy could be used to boost growth in the short run and help in longer-term economic rebalancing. This requires judicious tax cuts and increases in social spending. Second, a redoubled commitment to reforms. This would be an excellent time for the government to make a real commitment to some of the supply-side reforms it has long talked about. Third, a transparent communications strategy that makes clear what the government's short-term and long-term plans are for currency market and other financial sector reforms.

Capital controls are a seductive but dangerous substitute for what China really needs — strong and concerted action to build confidence rather than measures that sow more panic.

The writer is a professor at Cornell University and a senior fellow at the Brookings Institution

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