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China Should Trust in Capital Markets

By R. Glenn Hubbard and William Dudley

A critical factor in China's long-term economic growth is the development of its capital markets, which if properly organized could foster greater productivity, increased wages, and employment growth.

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. 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 U.S. economy for strong empirical evidence of the power of the capital markets—the proof is an annual gross domestic product of $11 trillion.

Investment Productivity

Countries with the best developed capital markets, such as the United States and Britain, have outperformed countries in which banking-based systems dominate, such as some other European countries and Japan. The economic performances of the United States and the United Kingdom 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 United States 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.

Employment Growth

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

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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.

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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 United States, 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 2001–2003, only sixteen U.S. banks failed. This compares with 412 bank failures at a comparable point in the business cycle in 1990–1992, when there was no credit derivatives market. Other factors, namely a property bust, contributed to these failures. But it is no accident that as U.S. capital markets have become more developed, recessions have become milder and business expansions longer.

The last two periods of U.S. business expansion were the longest and third longest in U.S. 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 ten 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 the benefits that flow from such a system should not be underestimated. The benefits are not abstractions—they include more and better jobs and more stable employment prospects, as well as a better return on the very large savings (as much as 40 percent of gross domestic product) for households in China.