

# China's financial market rise – the foundation of global power

By Eric Hall, Reuters Editorial Business Manager, Asia

The commitment of China's established government to create strong, stable financial markets is not in doubt.

How fast and how smoothly that will happen is a matter for deep policy debate and direction inside China, and presents enormous challenge and opportunity to the international financial community.

But the long-term global implications of China's success in achieving its financial market goals are not so often discussed, yet it will be successful financial markets which are the prerequisite to the country's emergence as a true World power.

It will simply not be possible to reach China's economic, social, political and security objectives in the next decade and beyond without the ability to price capital properly and transparently and therefore raise it competitively on a global scale and allocate it efficiently to the tasks ahead.

If this does not happen, then China will be unable to develop its manufacturing, health and pensions, and military and global security networks in a way which avoids social decay and instability, environmental disaster, resource scarcity, and continued waste and misdirection through local and regional corruption.

It is in this deep sense that I believe that financial market reform and change is absolutely at the foundation of what is emerging as the third great stage of China's economic AND political development.

President Hu Jintao's struggle for a harmonious and stable society and a China that feels secure in the World will not be won without financial market maturity in the context of the global financial systems that we now have.

## THE THREE STEPS TO A GLOBAL SCALE ECONOMY

It is important therefore to understand the three stages of China's economic rise to predict the dynamics that will drive financial market and economic liberalization, and to see that this development may be based on many of the mechanics of the western model but remains firmly rooted in the Chinese experience.

Let's start with a definition of what China is in the World.

China is a single-party state run by the world's last, classically organized communist party, which rules one fifth of the global population.

It's the World's fastest growing major economy with a continental structure and scale that makes it the only realistic, potential challenger to the United States for economic dominance by one nation.

China is one of the most culturally and racially homogeneous countries, where individuals retain a deep and conscious sense of national being and pride which is connected to but also independent of government achievements.

China's political, social, economic and resource policies are not aligned and are in many cases contradictory to the Western models and objectives we have become used to since the end of World War Two.

In fact, under current global economic structures and with no miracle new energy technology, in the key areas of resources, consumption of available global capital, and geo-political power broking and influence, China's long-term economic graph may seriously conflict with the western world's own aspirations to sustain its lifestyles.

At the same time, the globalisation of currency and capital markets and trade has allowed China to integrate and leverage opportunities for growth, at a pace and with a success rate that was never before possible.

Arguably, the Soviet Union during a short window in the 1950s was in a similar economic development position vis a vis the West. But nuclear confrontation, inflexible policies based exclusively on the communist canon, and the absence of a globalised economy swiftly undermined any potential it had.

In short, China represents the first time since 1945 that the Western democratic-economic model has had to deal with an emerging economic equal that is not its ally. That alone represents the biggest political as well as economic change in our lifetimes.

So what does China's ruling Party want? The Party's two core objectives are its own survival and the creation of a wealthy and powerful Chinese state with secure borders and the ability to project power globally to achieve its current and future objectives.

China's leaders themselves state these two objectives as completely compatible. They believe it can be done peacefully.

For the Party to survive and achieve its objectives, it must do two things. It must sustain internal social stability while it creates sustainable, balanced growth to bring as many people as possible into the new wealth spheres that are being created.

Second, it must keep its own house in order and tackle the corruption that is the main threat to its mandate to rule.

So why has China's ruling communist party been so successful when various communist systems elsewhere have not. The answer is, of course, as complex as you would like but I think there are some clear reasons.

China's entire written history has been an experience of either strong, centralised authoritarian rule, or internal chaos and collapse.

The overwhelming relationship of the rulers to the ruled has been a mandate for governance in exchange for stability, harmony and the right to prosper individually without excessive interference in exchange for the individual's respect and obedience to authority.

I add this last point because it's the one crucial social deal of the most successful periods of previous Chinese history that tends to be forgotten and it is the exact same deal which is expressed through policy now by the rulers to the ruled.

China did step close to the brink at least twice after the founding of the People's Republic in 1949. Once in the massive famines of the 1950s and then in the cultural revolution of the 1960, both triggered by Mao Zedong's policies.

But since the death of Mao, China has gone through two main phases, and is now entering the third stage. Each represents a clear positive political and economic step, without which China almost certainly would not have advanced to the next stage along.

## POLITICAL CHANGE THROUGH ECONOMIC FREEDOM

First, in the 1980s, Deng Xiaoping freed the productive resources of agriculture and launched the first wave of price liberalization.

It is essential still to see China's economic reform is built on a market price economy and not a full-blown free market economy on the Anglo-Saxon model. The excesses of the most recent laissez faire industrial phase created the illusion of a free market state. Mass unemployment is not government policy!

But Deng's political insight was to understand that at a certain level of human poverty, the ability to take control over even a part of your economic destiny is in itself a political freedom. If today you can sell an egg to a private citizen at more than you were forced to sell it yesterday to the state, you have been politically as well as economically empowered.

The popular support and seeds of national pride which started to grow from this helped the Communist Party live off a fund of popular goodwill well into the next, much more stressful phase.

## THE IMPERATIVE OF INDUSTRIALISATION

So in the 1990s, President Jiang Zemin triggered the country's hell-for-leather industrialization, loosening investment and risk controls, and devolving policy and spending control to the provinces almost carelessly, for a time threatening to throw the country into a cycle of boom-bust and generating corruption of a size which the state security system could not and would not control.

But the need to industrialise was paramount, if China's ultimate economic goals were to be attained. Arguably, it was not Chinese genius at work this time but the greatest global creation of liquidity

ever seen, courtesy of the Federal Reserve and the Bank of Japan, which saved the day. That largesse, of course, may now have a limited life.

China's industrial revolution was at the same time pushed by the developed world's increasingly excitable search for new investment returns, and its corporate search to sustain profitability, which started the massive global labour market shifts. Both played to China's strong suits.

This not only saved the day but has now put China into such a powerful position as the global arbiter of low-cost manufacturing capacity, the swing consumer and producer of almost every natural resource, and the biggest single holder of dollar-assets in the World that it has probably achieved a global, and most certainly a regional influence a decade before it might otherwise have done.

The third phase is now beginning and it remains a mistake for western analysts to think that democracy is the next priority of either government or people. The next step, led by President Hu Jintao, is to try to create accountability in society, without which there is no harmony.

## POLITICAL AND ECONOMIC STABILITY THROUGH ACCOUNTABILITY

Now, in a society where personal freedoms under the law are routinely disrespected, the main social demand is that officialdom, the security forces and the Party are accountable under the law.

Achieving accountability is going to be tough.

President Hu with his Premier Wen Jiabao are committed to regaining policy control of the economy, to mend the social rifts which emerged in the industrializing phase, and to build the global alliances, trade and resource and capital supply connections which the government hopes will secure China's future position.

Their work will be marked by increasing policy controls to blow the froth off the economy, limit the sway of the corrupt and the speculative, and create sustainable financial markets based on a robust currency and the opening of the capital account.

It will also be marked by a political offensive against factions or groups which threaten these policies, to either destroy them as disruptive political forces, or to co-opt them. The result of the latest Party Congress and the new leadership lineup suggests President Hu is succeeding in both these objectives.

It is important to remember that single party politics tends to work on an opposite timetable to democratic politics. In democracies, the ruling party or coalition typically starts from a position of strength, and then declines as the honeymoon with voters fades.

In a single-party state, the new leader tends to start weak as previous factions try to retain power, but ends strong, if they can purge the past and entrench their own teams. In other words, if Hu is succeeding, we have not seen the height of his power yet.

Let's look a bit more at the economics of China. To achieve its objectives, the Party must continue liberalization of the economic and financial system.

The government knows that they offer it the only realistic tools to fund and control the seven percent or so trend growth it will need in the next 20 years, and to disentangle itself from impossibly high future costs of state-provided pensions and healthcare.

The big question is whether an economy this size can achieve broad individual wealth without drastic political change, due to the poor being left behind, or to growing demands from the newly rich for those economic powers they will require to realize the full benefits of owning that new wealth.

This dilemma, as we discussed, is well understood by the leadership.

It is therefore well within the possible that China will be able to continue its current path without overwhelming popular demand for change, but only if it can sustain the flow of citizens into the wealth-owning class, reduce the wealth gap, and show its citizens that personal security and freedoms are protected under the law.

China has already reached a stage of industrial revolution that has historically defined a country on the road to major global economic power. Britain, Germany, Japan, and the United States all had similar experiences at different periods.

## THE MODEL OF CHINA'S FUTURE

The question is: what final economic model will China take? I believe it will be on the American model -- a dispersed and resilient economy and financial markets on a continental scale with enormous reserves of productivity, and capital accumulation.

Although China is a centralized state, it is not centralized in economic ambition and power. China, unlike European countries and Japan, has not one or two, but many industrial and financial centres, separate from the political centre in Beijing.

Shanghai Guangzhou, the Southwest, the Northeast are already hubs.

China's most successful periods have always balanced the need for national unity with local economic ambition.

Meanwhile, the government's attempts to cool the economy need to be well understood in line with its social and national security objectives. There will be no compunction in sacrificing some private sector gains and ambitions, if stability is at risk.

Also, there is an understanding at the top levels that controlled busts can be a useful tool, not only in clearing out bad debt but also in clearing out bad management. Whether they deploy this tool, (or are forced into it), before or after the Olympics is a moot question, but at some point they must take this route.

There are two potentially serious obstacles to China's ability to stay the course: its access to resources, and a threatening environmental Armageddon .

China is already the second biggest importer of crude, and biggest consumer of almost every other global commodity. Yet its per capita consumption is still a fraction of the average American.

For all China to consume at an American level is not possible under current technologies.

There are three future options: others lower consumption as China rises, China accepts a limit to its consumption, or the World faces commodity shortages.

The last option looks most likely but even then it will be hard for China to avoid either economic or military confrontation to secure the resources it will need.

The environment could be one of the most interesting futures in China. The leadership has put it as a high priority because it is clearly one of the greatest threats to medium term social stability.

It is possible that in the next decade, China could become one of the leading exponents and markets for environmental technology, if only for reasons of political survival.

To sum up: what I am confident of is that China's solutions to these problems as the days tick away will fail without robust and continued financial market reform, but they will continue to be rooted in China's historical, political and cultural experience and that western models of analysis will not tell you all that may come.

Miss that, and you may miss the shape of the Chinese future.



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Over the years, Eric has worked as a foreign correspondent in Hong Kong, Beijing, Tokyo, and Pakistan, reporting political, military, and financial news from China and Japan, and covering the Soviet withdrawal from Afghanistan. From 1988, he was Chief Correspondent for the Gulf and Iran during the period of the first Gulf War. In the 1990s, he went to London as Deputy Financial News Editor for Europe, and then returned to Tokyo to create Reuters' new financial television network in Asia. In 1998, he went to Singapore as Chief News Editor for Reuters in Asia, and was North Asia Editor until this year. Eric is a graduate of Oxford University, where he took Chinese studies.