China's Ascent

The rise of China in the coming decades will have far-reaching consequences—the world should get ready

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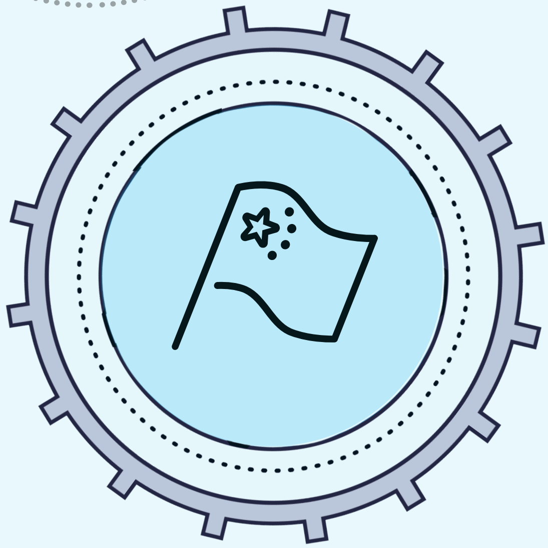
AS IT TRANSFORMS from an economic backwater to the most connected hub in the global economy, China is driving seismic changes, within its own borders and beyond. It is the second time in recent history that a developing economy is on the fast track to becoming the world's largest, but it is the first time this has happened in such an interconnected world.

How China—a unique country in transition—designs its financial liberalization and opening-up policies will be of paramount importance to all. So will the mantle the country is bound to assume in the realm of global economic cooperation. Contemporary thinking on the future of the international financial order does not yet focus on the new paradigm created by China—but it should.

China in 2040 will look on the face of things to be a mighty economic power. Under plausible projections, it will have firmly established itself as the largest economy in the world, with 60 to 70 percent of the US income level. But in 20 years, China will still be a developing economy by many measures—its financial development will lag its economic development, and many economic and policy distortions may still persist.

In that scenario, the world must be prepared for China to be its first *systemic* emerging market economy. It should brace for greater volatility and uncertainty as China becomes more intermeshed with global financial markets. It should prepare for a China that emits shocks distinctive to developing economies—but on a much larger scale and with greater thrust and impetus.

Every significant policy move, stock market panic, and cyclical upswing or downswing in China can plausibly diffuse and propagate through the web of financial networks that links nations. In China today, 70 percent of investors in capital markets are retail investors, quick to react to noise and changes in sentiment. Mercurial stock markets and volatile exchange rates may become the rule, not the exception.



Currently, China is already inadvertently sending shocks to the rest of the world, despite its small international financial exposure. My own research with Yi Huang shows that it is not only policy shocks (monetary and fiscal) that spill over to the rest of the world but also the shocks of policy *uncertainty.*

In a country where reforms big and small happen on a regular basis, where policy moves often instigate cyclical fluctuations rather than subdue them, where policy direction and strategy are based on experimentation rather than experience, uncertainty can be a first-order menace to overly sensitized financial markets.

Our research shows that during 2000–18, Chinese policy uncertainty shocks significantly affected not only economic variables, such as world industrial production and commodity prices, but also key financial variables, including global stock prices and bond yields, the MSCI World Index, and financial volatility.

Now imagine China in 2040, more consequential and with a greater number of channels open to the rest of the world—whether cross-border bank lending, portfolio holdings, capital flows, or a more dominant renminbi. In that scenario, shocks emanating from China would not only propagate more swiftly and potently, they would also be amplified and expanded through its increasing and diverse financial channels.

The rise of China today bears much similarity to the ascent of the United States in the late 19th century. Although it was growing rapidly and catching up with European countries, it had the developing economy malaise of unsophisticated capital markets. Corporate governance was riddled with problems and banking crises occurred regularly; weak financial intermediaries and a shortage of financial assets, along with the absence of a lender of last resort, prevented the efficient mobilization of capital. The vagaries of the US economy and the financial panic in 1873 were fully transmitted to Europe and Great Britain, which had significant exposure to the US economy.

This raises three questions for the future of China and international global cooperation.

The first is the desirability of China's rapid financial liberalization and opening up. From China's point of view, financial liberalization and integration may lead to better allocation of financial capital. It will also constrain policy. When a country is subject to the harsh scrutiny of global investors, there is less room for opaque, erratic, or irresponsible policies—all of which are more acceptable behind closed doors.

The second question concerns what the world wants, and to what extent it should say what it wants. The world is still wrestling with the tension between domestic policies and international imperatives, and sometimes there is a double standard. The Federal Reserve asserts that it bases its policies on US interests not on world interests, but US monetary policy substantially affects the rest of the world. Is it realistic to ask China to base its financial policies on the world's interests rather than its own?

The third question relates to international cooperation, which will be imperative in the future if the Federal Reserve and the People's Bank of China, each with its own mandate and objective, embrace two different and potentially conflicting views of the world. Cooperation was very much the aspiration of the Bretton Woods system, the earlier parts of the flexible exchange rate regime, the Group of Seven, and the 1985 Plaza Accord. It has largely disappeared from discussion but crucially needs to return.

On the positive side, China will be an anchor for demand in the world, particularly since aggregate demand deficits in advanced economies may be a perennial affliction. It can also serve as an additional source of diversification for global portfolios and currencies—and the renminbi could even be an alternative reserve currency. We live in a world of shifting paradigms. "Is China ready to open up?" is a question often posed. The real question may be: "Is the world ready?" FD

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