IMF Chases Wrong Targets in China

By James A Dorn

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The International Monetary Fund (IMF) has recommended that China institute deposit insurance before embarking on interest rate liberalization and opening its capital markets. Higher rates on deposits may encourage more risk taking by banks and some of the lending/investments may go sour. The IMF sees deposit insurance as a way to prevent bank runs.

That logic may be true, but deposit insurance also encourages banks to take more risk, because ultimately taxpayers will have to make depositors whole if a bank fails. Most banks in China are already state owned and have an implicit guarantee that the government will not let them go bankrupt. Deposit insurance may help smaller private banks compete against the giant state banks. But the real problem is not the lack of deposit insurance; it is the lack of private ownership and responsibility that permeates China's financial sector.

Federal deposit insurance was not introduced into the United States until 1934. Previously, banks used liability rules to prevent excessive risk taking and protect depositors. Instead of today's limited liability rules, bank owners and managers faced double, triple, and, in some cases, unlimited liability. Because shareholders could lose more than their investment in a bank, they tended to be responsible risk takers and imposed conservative lending practices on managers.

From 1865 to 1934, US national banks were subject to double liability, and depositor losses as a percentage of total liabilities in the national banking system were relatively low, as legal scholars Jonathan Macey and Geoffrey Miller have documented. When liability rules are sound, banks will also tend to be sound.

Deposit insurance treats symptoms, not causes, of unsound banking practices. China's banks are by definition "too big to fail" because state ownership naturally means the politicization of investment/lending decisions. There is a strong incentive for state-owned banks to lend to state-owned enterprises rather than to private firms, which the government will not bail out.

The absence of widespread private ownership in the financial sector and the influence of the Chinese Communist Party mean the threat of bankruptcy for state-owned banks and state-owned enterprises is slim. The result has been a very inefficient use of capital and the rise of "shadow banking".

China needs to restructure its ownership system in order to fully liberalize its price system, including deposit and lending rates. Piecemeal reforms cannot create free private capital markets - unless reformers ultimately create a system in which individuals have the right to own and sell capital assets without state interference. Such reforms, however, would clash with the CCP's monopoly on power.

So long as capital freedom is hindered, China can never become a world-class financial center. Economic freedom to invest domestically and internationally coincides with personal freedom of ownership and contract, which characterize a true market system. China has moved a long way toward a market economy, but the legacy of central planning still haunts the financial sector.

Introducing deposit insurance is a double-edged sword: it may help protect depositors but it also increases risk taking and could be costly to taxpayers. China's move toward liberalizing interest rates does not require government deposit insurance; it requires a genuine rule of law that safeguards personal and economic freedom, and holds those who make unwise investment/lending decisions responsible.

Focusing on property rights rather than government deposit insurance is important because it moves liability and responsibility to the center of the discussion about how best to achieve financial harmony.

Financial reform in both China and the United States would benefit by thinking in terms of contingent liability standards rather than assuming that global capital standards coming out of Basel, Switzerland, will save the world from future financial crises. (On the case for contingent liability rules, see Joshua R Hendrickson's article in the Winter 2014 Cato Journal.)

Privatizing China's banks and enterprises, or at least allowing the private sector to grow and foreigners to compete, would improve incentives and efficiency. Increasing capital freedom by making the yuan fully convertible would expand people's choices among investments and currencies, China would gain wealth and stability - not from the top down but from the bottom up.

The challenge will be to limit the power of government and increase the rights of individuals. Economic reform cannot be divorced from political reform. China's leaders have paid lip service to the rule of law, but they want a legal system that does not permit a free market in ideas. In such a system, China's "dream" could become a nightmare.

Financial repression has strictly limited depositors from earning positive real interest rates. Lifting restrictions on deposit rates, as proposed by Zhou Xiaochuan, governor of the People's Bank of China, would help savers earn higher returns and also help normalize the balance of payments by fostering domestic consumption.

The IMF's call for deposit insurance, supported by Premier Li Keqiang, is a siren song. It distracts attention from a more fundamental reform - namely, the shift from state-led to market-led capital allocation.

Hong Kong is the world's freest economy; it is characterized by capital and personal freedom. The lack of full-fledged democracy should not detract from the strong sense of limited government and adherence to the classical liberal rule of law founded on British tradition. China is fortunate to have this haven of freedom to learn from and to help internationalize the yuan. But it cannot fully do so until it adopts similar institutions.

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