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China Takes Another Step toward Capital Freedom

The linking of the Hong Kong and Shanghai stock markets marks progress, but real liberalization can only come if the mainland ensures property rights under the rule of law

By James A. Dorn
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The launch of the Shanghai-Hong Kong Stock Connect takes China a step closer to capital freedom. Before the new trading link, officially known as the Mutual Market Access (MMA) program, investment opportunities for foreign investors have been limited to a select group of fund managers. Now all foreign investors can directly buy shares listed in Shanghai via the Hong Kong Stock Exchange. Likewise, capital is now freer to move southward into Hong Kong.

By giving global investors a wider choice of mainland stocks, President Xi Jinping hopes to pave the way for rebalancing China's lopsided economy. Injecting new capital into consumption-oriented firms will help grow the nonstate sector and improve the allocation of resources. Meanwhile, by allowing Chinese investors direct access to the Hong Kong exchange, the MMA will help diversify portfolios, mitigate risk and increase pressure for even greater capital freedom.

The new property rights structure, however, is limited by quotas placed on daily trading volumes. Foreign investors have the right to buy stocks of 568 firms listed on the Shanghai Stock Exchange but are subject to a daily quota of US$ 2.1 billion on a net basis – that is, on the difference between the value of shares bought minus shares sold. The daily quota for investment in Hong Kong is US$ 1.7 billion.

One significant restriction of the MMA program is that offshore investors in the Shanghai market must enter buy/sell orders before the market opening, which limits rapid responses to new information. Unless trading can take place continuously, capital markets will be less robust.

Hong Kong, as the freest economy in the world, is an ideal place for global capital to enter the mainland. With the further opening of China's capital account, Shanghai could one day outshine Hong Kong, but only if property rights are protected under the rule of law understood as a meta-legal principle whereby all individuals are guided by what F. A Hayek called "rules of just conduct."

A system that limits the power of the state and enhances individual freedom under the law is one in which no one is above the law. Individuals are free to choose provided they do not infringe on the equal rights of others. That system has served Hong Kong well and would do so for China.

Economic reform in China has been characterized by local experiments, not top-down planning. Once authorities recognized the benefits of innovation and market-led development, the experiments were legally sanctioned and widely adopted. Paramount leader Deng Xiaoping was brilliant in that regard. If Xi embraces Deng's legacy of spontaneous institutional change, China has a bright future.

At this juncture in the reform process, it is essential to gain credibility by fulfilling promises to further liberalize capital markets and move closer toward a fully convertible currency. To do so, China needs to recognize the importance of an independent judiciary and constitutional guarantees of fundamental rights, including freedom of the press. Shanghai cannot become a bright star in the global capital market without the free flow of information protected by law and a transparent accounting system that gives a true picture of listed companies.

When the state owns enterprises and financial institutions it has the power to control economic life and thus politicize the allocation of capital. The challenge for China is to build a Great Wall to protect, not denigrate, fundamental rights.

China's capital controls have been porous. Wealthy, well-connected individuals have been able to find ways to circumvent government roadblocks and to move capital offshore. This shadow capital outflow is not surprising given the leading role of the Communist Party in handing out favors and overseeing a large part of the economy, especially the financial sector. If government power were limited, as in Hong Kong, there would be much less corruption and more wealth creation.

The stock market has performed poorly in China even though there have been decades of economic growth. That disconnect has been due to the factors already mentioned, namely uncertainty of property rights, lack of transparency in accounting statements and standards, and corruption. Moreover, capital controls and the limited range of investment choices open to Chinese households have given stock exchanges the reputation of casinos.

Establishing credible capital markets in China will require more openness and more trust. Beijing must address the problem of political risk as well as ensure the clearing and settlement of complex financial transactions. Hong Kong has prospered because it has a well-developed financial architecture based on a legal system traders trust.

One of the key benefits of the launch of the Hong Kong-Shanghai Stock Connect is that China will learn the importance of the rule of law in creating private free markets. Institutional arbitrage and a freer flow of ideas will help the mainland move closer toward capital freedom.

The next steps would be to bring the Shenzhen Stock Exchange into the MMA program, increase quotas, liberalize interest rates and further loosen capital controls – eventually eliminating them and making the yuan fully convertible.

Opening capital markets means more capital can flow into China and more can flow out. If Beijing pursues sound policies that expand economic and personal freedom, capital will flow into the private sector and increase pressure for further liberalization. The question is whether the ruling class will embrace markets or cling to power.

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