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Special report: China's economy

In this special report

Homeric wisdom

Easier cross-border capital flows may help liberalise interest rates

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SPEECHMAKERS LIKE TO claim that the Chinese word for crisis (*weiji*) contains the characters for both danger and opportunity. Most linguists dispute this. Either way, China's economic policymakers don't seem to believe it. For them, a crisis is a reason to batten down the hatches.

In 1996 China's government told the IMF that it intended to remove its controls on international capital flows within five to ten years. But when the Asian financial crisis struck a year later, China's government retreated into its shell.

Sixteen years later the timing looks better. Fear of capital outflows has been assuaged by China's vast foreign-exchange reserves. The opposite danger—excessive capital inflows—has also eased. Indeed, the yuan has come under downward pressure at several points in the past year.

Reformers in the government are testing the waters. In April regulators raised the amount that "qualified" foreign investors can venture in the country's securities markets to $80 billion, and eased the limit that similarly qualified Chinese investors can whisk out of the country. The central bank also loosened its grip on the currency a little, widening the yuan's daily band from 0.5% either way to 1%.

China has no obvious need for foreign capital: its own saving is more than enough to meet its investment needs. So liberalisers may have ulterior motives in mind, calculating that external liberalisation will force the pace of domestic financial reform. If capital could move more freely across borders, the authorities would struggle to keep interest rates artificially low—unless they were prepared to let capital flee and the currency fall.

By opening the capital account soon, China could claim several prizes, reformers argue. Its investors could acquire foreign firms at low prices, thanks to European turmoil and American caution. The country could also take advantage of the world's disillusion with the dollar to promote the yuan as an international store of value and medium of exchange.

Eswar Prasad of the Brookings Institution calls this a "Trojan horse" strategy, after the gift horse described by Homer that tricked the Trojans into opening their gates. The reformers' ploy poses some risks. If China opens the capital account before it reforms its SOEs, foreign lending may help feed their investment hunger. An open border would also make it harder to contain a domestic banking crisis. A different Homer put it best. Told that Chinese uses the same word for crisis and opportunity, Homer Simpson exclaimed: "Yes! Crisa-tunity!" A premature opening of the capital account would be just that.

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