

## **China Shuns Paulson's Free Market Push as Meltdown Burns U.S.**

September 24, 2008

Eighteen months ago, U.S. Treasury Secretary Henry Paulson told an audience at the Shanghai Futures Exchange that China risked trillions of dollars in lost economic potential unless it freed up its capital markets.

"An open, competitive, and liberalized financial market can effectively allocate scarce resources in a manner that promotes stability and prosperity far better than governmental intervention," Paulson said.

That advice rings hollow in China as Paulson plans a \$700 billion rescue for U.S. financial institutions and the Securities and Exchange Commission bans short sales of insurers, banks and securities firms. Regulators in the fastest-growing major economy say they may ditch plans to introduce derivatives, and some company bosses are rethinking U.S. business models.

"The U.S. financial system was regarded as a model, and we tried our best to copy whatever we could," said Yu Yongding, a former adviser to China's central bank. "Suddenly we find our teacher is not that excellent, so the next time when we're designing our financial system we will use our own mind more."

The recent moves by Paulson, the former chief executive officer of Goldman Sachs Group Inc., contradict what the U.S. told Asian governments over the past decade. Thailand, South Korea and Indonesia were urged to let unviable banks fail during the 1997-98 Asian financial crisis.

'Turning Left'

"It's the end of an era," said Shanghai-based Andy Xie, a independent analyst who was formerly Morgan Stanley's chief Asia economist. "In 1989, when the Berlin Wall fell, socialism was discredited and the whole world turned right. Now financial capital has been discredited and the whole world, including the U.S., is turning left."

China's economy has grown an average of 9.9 percent a year since former leader Deng Xiaoping ditched hard-line Communist policies and began moving toward a free market in 1978.

Since joining the World Trade Organization in 2001, China has gradually opened its markets to foreign competition, allowing international investment banks to form joint ventures with local partners and permitting the biggest state banks to sell shares on overseas stock exchanges. In the past three years, China dropped a decade-old currency peg to the dollar, introduced foreign-exchange swaps and forwards that allow investors to hedge or bet on currency fluctuations, and expanded the bond market.

China has yet to allow margin trading -- where investors borrow money to buy shares -- or futures contracts based on equity indexes.

'It's Ironic'

Since China permitted securities backed by assets such as mortgages in 2005, only 14 such instruments have been approved for sale, according to the Web site run by China Government Securities Depository Trust and Clearing Co., the country's biggest debt clearing house.

China's financial institutions were slow to buy the mortgage-related securities that triggered the U.S. meltdown, incurring just \$4.3 billion in losses and writedowns, according to data compiled Bloomberg.

Globally, banks have written down more than \$520 billion as the credit crisis led to the demise or makeover of Wall Street's five biggest investment banks. In response, the U.S. government nationalized insurer American International Group Inc., as well as mortgage giants Fannie Mae and Freddie Mac.

"It's ironic Paulson has become the manager of many large financial institutions," said Wang Jun, a finance specialist at the World Bank in Beijing. "He will have to ask the Chinese leaders about their experience of managing state-owned assets."

## 'Double-Edged Sword'

Plans to introduce many financial products, including derivatives, may be shelved as China focuses on improving risk- management, said Fan Wenzhong, deputy head of research at the China Banking Regulatory Commission, at an industry conference Sept. 18 in Beijing.

"Financial innovation is a double-edged sword," Fan said. "We can't just concentrate on product innovation and overlook the need to build the financial system."

Derivatives are contracts whose value is derived from stocks, bonds, loans, currencies and commodities, or linked to specific events such as changes in interest rates or the weather.

Eventually, China's leaders will have to take a cue from the U.S. and western Europe by allowing more competition to provide cheaper funding for companies and consumers, said Fraser Howie, co-author of "Privatizing China: The Stock Markets and Their Role in Corporate Reform" (Wiley 2003).

## Rethinking Strategies

"China doesn't have any choice except to continue with the U.S. model because there is no competing system," he said. "More people die in cars than they did on horses, but are people going to say we should stick with horses?"

Even so, company bosses are rethinking their strategies.

China Life Insurance (Group) Co., parent of the country's biggest insurer, once planned to emulate New York-based AIG, which offers annuities, holds real estate assets and leases aircraft, in addition to selling insurance.

"We used to look at AIG as our model and think, 'That's where we want to go,'" said Zhang Fengming, vice president of the firm's asset management arm. "Now it's got restructured," so China Life will focus on its main business.

The China Insurance Regulatory Commission will create a "new road" for insurers, Li Kemu, the agency's vice chairman, said at the Sept. 18 conference, without elaborating.

That road may be different from the one Paulson proposed 18 months ago, according to Arthur Kroeber at economic research company Dragonomics Advisory Services Ltd. in Beijing.

"China's made it clear it won't listen to these snake-oil salesmen who come from Wall Street, even if they're wearing suits issued by the Treasury Department," he said. "It's strengthened the hands of all the people who are very skeptical about financial liberalization in China."

**Source: Bloomberg**