

## CREATING FINANCIAL HARMONY: LESSONS FOR CHINA

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The current turmoil in global financial markets, which began with the U.S. subprime crisis in 2007, has shed a bad light on market liberalism. But it was the socialization of risk—not private free markets—that precipitated the crisis. Government sponsored enterprises (GSEs), not private enterprises, politicized investment decisions and overextended credit to high-risk households by buying up and guaranteeing subprime and Alt-A mortgages.<sup>1</sup>

Financial innovation and the information revolution allowed greater specialization and diversification of risk, but government backing of GSE debt created a moral hazard problem and, together with loose monetary policy and flawed regulations, led to excessive risk taking and overinvestment in housing. When housing prices began to decline in 2007, defaults spread and banks failed. Toxic assets rapidly mounted and the housing crisis morphed into a general credit crisis.

The central issue this article addresses is how to structure institutions and incentives to promote financial harmony. The notion that the subprime/credit crisis stemmed from “market failure” diverts attention from “government failure.” To remedy that diversion, this article examines the sources of the present financial crisis and finds

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<sup>1</sup>Alt-A mortgages require virtually no credit check. They are sometime called “liar loans.”

that the free market is more the victim than the culprit.<sup>2</sup> The lessons learned from the U.S. subprime/credit crisis can help China confront the challenges it faces in creating a “harmonious society.”

### Sources of the Present Crisis

History has taught that sound money and financial stability go hand in hand. Today we have a pure fiat money standard and fractional reserve banking. There is no convertibility principle at play, as under the gold standard, and central bankers prefer discretion to a hard monetary rule. In such a world, the long-run value of money is uncertain, and there is always the threat that the fiscal hand of government will reach out and pull the monetary lever to stimulate economic growth. Yet, the first lesson of economics is “There is no free lunch.” If printing money created prosperity, we could all be rich in an instant. One need only look at the chaos in Zimbabwe to reveal the reality of what happens when sound money is debased and government profligacy reigns.

In a world of pure fiat money, there must be effective limits to its creation. China was the first to discover the benefits of paper money, but also learned that excessive money creation is ruinous to the economic and social fabric of a nation. Today, the challenge is to achieve monetary and financial stability so that money can retain its purchasing power and people can regain trust in financial institutions. Without such trust, liquidity will diminish and market transactions will be constrained. Economic prosperity will suffer as a result.

A safe and sound financial system depends on trust. In a small private setting, with only a few borrowers and lenders, where everyone knows each other and reputation effects are strong, transparency will be high and default risk low. Yet, such a small-scale financial system does not allow for innovation and specialization in risk taking, and thus limits liquidity. The ability to diversify and globalize risk is beneficial so long as the network of contracts is anchored in trust. Once that trust is lost, crisis can set in.

Financial contracts have become so complex that computer models are needed to price risk. Face-to-face dealings in small capital markets have given way to millions of computer screens in trading rooms around the world, and to trust in abstract risk-assessment models for derivative instruments based on the underlying assets. Those models appeared to price risk prudently when housing prices

<sup>2</sup> Roberts (2008) provides a useful summary of how Congress helped create the subprime crisis.

were rising, but in the summer of 2007 the boom in housing peaked and the models failed.

In his recent congressional testimony, former Federal Reserve chairman Alan Greenspan (2008) admitted that the risk-assessment models were flawed: “The whole intellectual edifice collapsed . . . because the data inputted into the risk management models generally covered only the past two decades, a period of euphoria.”<sup>3</sup> Indeed, he recognized that flaw as early as March 1999, when he recommended “stress testing” of risk-assessment models (Greenspan 1999).

Forecasting is not a science, and markets are not omniscient. Yet no one has improved upon the spontaneous feedback mechanism of competitive markets based on private property rights and individual responsibility. The failure of the models to correctly price risk associated with mortgage-backed securities (MBSs) could be called a “market failure,” but only in the sense that the model-builders ignored the possibility of widespread declines in U.S. housing prices. What Greenspan did not admit was that the Fed erred in creating too much liquidity and kept interest rates too low for too long beginning in 2001. According to monetary historian Anna J. Schwartz (2008), “If you investigate individually the manias that the market has so dubbed over the years, in every case, it was expansive monetary policy that generated the boom in an asset.” The present crisis is no exception (see White 2008). Market pricing and risk assessment work best when monetary stability is the primary objective of central bank policy.

The huge leveraged positions of many investment banks holding MBSs and other collateralized debt obligations (CDOs) came under fire as housing prices fell and defaults increased. A small change in the value of the underlying—now rotten—assets (houses) could easily wipe out the capital of a highly leveraged financial firm, as it did to Bear Stearns, Lehman Brothers, and others.

Those who bought credit default swaps (CDSs) to insure against default risk placed a low probability on such risk, and firms like AIG were willing to sell contracts to insure against that risk because management thought it would be profitable. What happened?

<sup>3</sup>Paul Mizen (2008: 564), a visiting scholar at the St. Louis Fed, notes, “No one anticipated that house prices would fall nationwide in the United States—these conditions were not built into the models used to assess risk—but house prices did fall and when they did so defaults increased in the subprime sector, which proved a trigger for the crisis as investors reappraised the risks associated with the high-yielding residential MBSs and CDOs composed of these assets.”

*The Role of Fannie and Freddie*

The story really begins with the distortions in the U.S. housing market created by Fannie Mae and Freddie Mac, the two giant housing finance firms.<sup>4</sup> With an implicit (now explicit) promise that the federal government would guarantee their debt, those two GSEs were able to borrow at low interest rates and crowd out competitors. In the process, Fannie and Freddie became “too big to fail.” As creatures of Congress, they poured millions of dollars into lobbying to protect their privileged positions, and Congress used them to pursue the goal of “affordable housing,” as expressed in the Community Reinvestment Act (CRA).<sup>5</sup>

After the accounting scandals at Fannie and Freddie in 2003 and 2004, Congress and shareholders (seeking higher returns) put increasing pressure on management to expand purchases of subprime and Alt-A mortgages. Fannie nearly tripled its guarantees of risky Alt-A loans during 2005–06 relative to all previous years (Figure 1). Moreover, little attention was paid to risk. One former loan officer remarked, “We didn’t really know what we were buying” (Duhigg 2008: 1).

Meanwhile, in 2004, Henry M. Paulson, then head of Goldman Sachs, along with other top investment bankers went to Washington to lobby for relaxing the net capital rule, which required large trading firms to hold reserves against their investments. That rule limited leverage and, hence, profits. Paulson’s lobbying efforts succeeded in having the Securities and Exchange Commission (SEC) revoke the net capital rule (Labaton 2008). As a result, the door was open for further increases in the market for MBSs, CDOs, and CDSs, which helped funnel even more money into the already overheated housing sector.

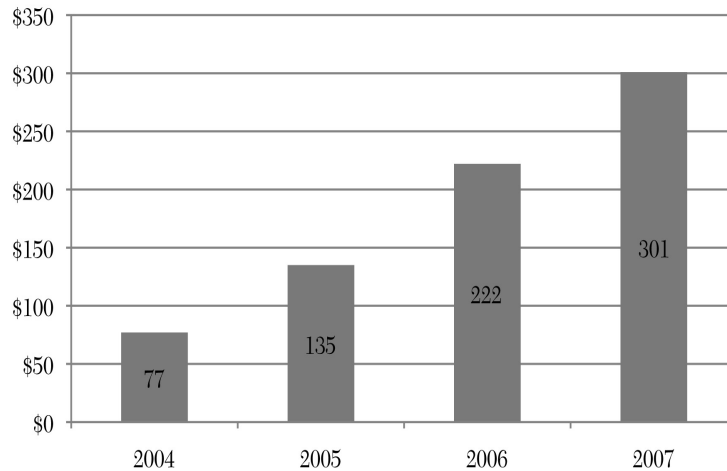
Compounding the problem was that Standard & Poor’s and other rating agencies relied on Wall Street models to assess risk, just as the SEC did, and made large profits by rating the risky securities at investment-grade level. When defaults started to increase, the charade ended and the deleveraging process began.

The absence of a clearinghouse for over-the-counter (OTC) derivatives linked to the housing market meant that trust was absent, and trading virtually came to a standstill. Balance sheets were affected as

<sup>4</sup>For a detailed treatment of the rise and fall of Fannie and Freddie, see Wallison and Calomiris (2008).

<sup>5</sup>Congress passed the CRA in 1977 and amended it in 1995. The Act is designed to induce community banks to grant mortgages to low-income households.

FIGURE 1  
 CUMULATIVE ALT-A LOANS GUARANTEED  
 BY FANNIE MAE (\$ BILLIONS)



NOTE: The 2004 figure includes all previous Alt-A guarantees. Since the data are cumulative, the additional guarantees in 2006 were valued at \$87 billion.

SOURCE: Duhigg (2008: 30).

ratings fell, calls for collateral increased under mark-to-market accounting rules, and losses mounted. Bank failures and the disappearance of long-established financial giants revealed the depth and breadth of the toxic assets and the overborrowing that had occurred. Actuarial trust was therefore tarnished, just as it was during the failure of Long-Term Capital Management.

When the Treasury took over Fannie and Freddie in September 2008, the implicit guarantee on GSE debt became explicit. The crisis spread and a few weeks later Congress passed the \$700 billion bailout plan—the so-called Troubled Assets Relief Program (TARP). That legislation substitutes a government guarantee to buy up distressed assets (at taxpayers' expense) for a constitutional duty to protect the sanctity of private property rights. The danger is that such legislation, along with a broad-based guarantee of bank deposits and money-market funds, will increase moral hazard, thus increasing risk taking, and lead to more government debt and higher taxes.

U.S. debt has more than doubled since 2000, and now is approaching \$11 trillion. That figure does not include the more than \$43 trillion of unfunded liabilities in Social Security and Medicare. The likelihood of breaking those promises on the implicit debt is considerable. Indeed, if U.S. debt continues to increase relative to GDP growth, global investors will downgrade that debt, just as they did in the case of Argentina.

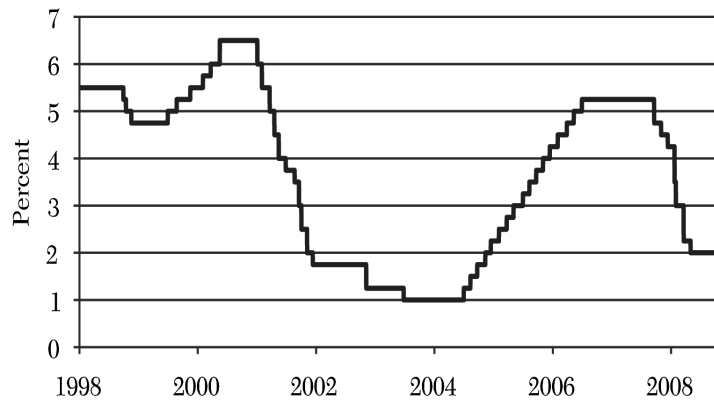
In sum, much of the blame for the subprime/credit crisis can be laid at the doorstep of Congress for creating GSEs with the primary duty of supporting the housing sector, and for passing the CRA, which ultimately compelled Fannie and Freddie to pollute their portfolios with toxic assets and to spread those assets around the larger financial system by guaranteeing the MBSs they sold. That flawed system of market socialism, however, was only part of the financial crisis puzzle; the Federal Reserve also deserves some blame (Buiter 2008; Calomiris 2008a: 1; White 2008).

### *The Role of the Fed*

The Federal Reserve, which has a monopoly power on the creation of fiat money, lowered the federal funds target from 6.50 percent in January 2001 to 1 percent by July 2003, and kept it there for a year (Figure 2). The Fed then slowly increased the funds rate to 5.25 percent by July 2006, but the damage had been done. The artificially low rate increased the demand for liquidity and helped promote the housing and credit boom. Accordingly, Anna Schwartz, an eminent monetary historian, concluded, “Among the consequences of the policy of maintaining interest rates at an inappropriate low level were credit and mortgage market distortions, discouragement of personal savings, incipient inflation, and depreciation of the dollar foreign exchange rate” (Schwartz 2007: 158).

While it is true that the glut of savings in China and other countries with large current account surpluses helped keep U.S. interest rates lower than otherwise and encouraged U.S. consumption—both private and public—the low Fed funds rate helped fuel the housing boom. If the Fed had been bound to a monetary rule, such as an inflation targeting rule or a nominal final demand rule designed to achieve long-run price stability, real interest rates would not have been as distorted, and capital would have been more efficiently allocated.

FIGURE 2  
FEDERAL FUNDS TARGET RATE



SOURCE: St. Louis Federal Reserve Bank.

### *The Role of Regulation*

There are numerous risks associated with financial contracts, including credit risk, interest rate risk, and exchange rate risk. Private markets do a good job of hedging against those risks when contracts are transparent and credible—and when investors bear the full costs of their decisions. Unlike the OTC market for certain derivatives (e.g., CDSs), the market for exchange-traded contracts (e.g., futures contracts) has standardized contracts and a highly successful settlement and clearing process. Indeed, according to Walter Lukken, acting chairman of the Commodity Futures Trading Commission, “No U.S. futures clearinghouse has ever defaulted on its guarantee” (Lukken 2008).

The lack of transparency in the OTC market is most likely the result of too much faith in the implicit guarantee on GSE debt, too much reliance on Fannie and Freddie’s guarantees on the MBSs they issue, too much trust in the rating agencies’ evaluation of complex securities, and too much confidence in the regulatory agencies that are supposed to ensure the safety and soundness of the financial system. The SEC’s decision to bow to Wall Street in April 2004 and revoke the net capital

rule freed billions of dollars for investing in high-yielding MBSs and CDSs. Bear Stearns, Morgan Stanley, Lehman Brothers, Merrill Lynch, and Goldman Sachs all increased their borrowing and exposure to risky assets to turn a significant profit as the housing boom continued (fueled by easy money and Fannie and Freddie's incentive to buy up mortgages and guarantee MBSs). Debt-to-equity ratios soared for the big investment firms, reaching more than 30 to 1 by 2008, except for Goldman Sachs, which had a ratio of around 20 to 1 (still relatively high compared to commercial banks). The quid pro quo for the relaxation of capital requirements was that the SEC would, for the first time, have access to information on the firms' investments in MBAs and other complex securities. Yet, the SEC did not have the staff or expertise to monitor those securities and had to rely on Wall Street's risk-assessment models. Moreover, the perception that the SEC was now overseeing the big investment banks' risky assets allowed those banks to take on even more risk (Labaton 2008).

The removal of the net capital rule in return for greater SEC oversight of large investment banks, based on complex risk-assessment models using flawed historical data, was not a case of deregulation; it was a case of "failed regulation" stemming from the ill-conceived Basel II capital rules, which require the use of an internal ratings-based (IRB) approach to measuring credit risk (Calomiris 2008b). Both Basel I and the New Basel Accord were designed to increase financial stability but, in fact, by increasing complexity and weakening market discipline, the Basel capital rules have increased risk and decreased stability (Rodriguez 2002).<sup>6</sup>

Oversight by regulatory agencies is almost always going to be less efficient than market discipline. Regulation can impose large costs on private parties while yielding few benefits; regulators are seldom penalized for reducing market values and not rewarded for increasing them. Also, regulators have less information than market participants who stake their livelihoods on being right. Those weaknesses are why it is important to rely on market discipline. Private markets allow experimentation with innovative risk-management practices and permit firms to fail. In contrast, regulations often put unrealistic trust in government and rely on political promises and "guarantees" that create a dangerous moral hazard problem.

<sup>6</sup>On the shortcomings of the IRB approach for assessing risk and regulating banks, see Tarullo (2008).



In testimony before the House Committee on Oversight and Government Reform, former Treasury official Peter J. Wallison (2008) hit the nail on the head when he said, “Bad or weak regulation is often worse than no regulation at all.” He pointed to the failure of the FDICIA, which was enacted in 1991, and concluded: “Calling for more regulation as a solution to the financial crisis is simplistic.”

In the case of Fannie and Freddie’s overseer, the Office of Federal Housing Enterprise Oversight, there was little incentive to limit risk taking, and OFHEO even encouraged risk to meet Congress’s quest for affordable housing.<sup>7</sup>

Rating agencies also deserve some blame for ignoring warning signals as leverage increased. If the agencies had downgraded housing-related securities earlier, the housing boom would have been weaker and default rates lower.

Finally, the Basel capital adequacy standards, adopted by OECD countries to improve the safety and soundness of banks, used simplistic risk categories to devise minimum capital requirements, and fostered a demand for structured investment vehicles to improve balance sheets while taking on more risk. “Harmonization” of regulation, in fact, led to financial innovations and regulatory capital arbitrage that increased overall risk. Rather than top-down harmonization, a strong case can be made for market-based risk management and national treatment.<sup>8</sup>

## Lessons from the Financial Crisis

What have we learned thus far from the subprime—and now global financial—crisis? Four lessons come to mind.

### *Market Socialism Breeds Moral Hazard*

When government guarantees debt, even implicitly, it lays the groundwork for excessive borrowing and risk taking. In a global financial market, risk can spread as foreign central banks and investors gobble up GSE debt. Ultimately, however, the risk is thrust back onto taxpayers in the home country. By privatizing profits and

<sup>7</sup>See Wallison and Calomiris (2008) for a discussion of the failure of OFHEO to effectively monitor and discipline Fannie and Freddie.

<sup>8</sup>For an extensive critique of the Basel approach to financial regulation, see Rodriguez (2002).

socializing risks, the U.S. government created market socialist enterprises, not private free-market firms. Capital markets were polluted and the moral hazard problem emerged in full force.

If capital markets are to be transparent and contracts credible, there must be well-defined private property rights, and losses, as well as profits, must be concentrated on owners.

### *Monetary Stability Promotes Financial Stability*

Financial stability requires monetary stability so that people have confidence in the long-run value of money. Under a government fiat money regime, trust is essential. Limiting the central bank to a single target—long-run price stability (zero inflation)—would anchor expectations about the future value of money. Policymakers should recognize that excessive growth of money and credit harms, not helps, economic growth (Figure 3).

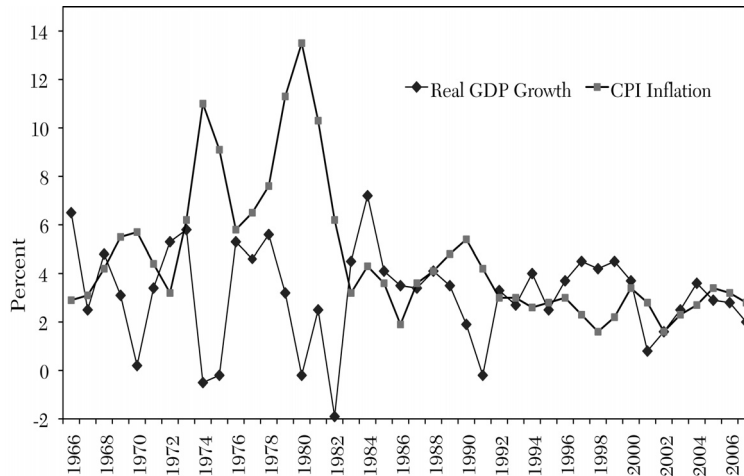
The idea that price stability promotes financial stability is not new, but it is critical in setting a framework for monetary policy. Otmar Issing, a former member of European Central Bank's executive board, advises, "As long as money and credit remain broadly controlled, the scope for financing unsustainable runs in asset prices should remain limited" (Issing 2008: 5–6). The Federal Reserve and other central banks cannot afford to ignore asset prices, which are forward-looking indicators that can help monetary authorities avoid ruinous injections of liquidity during periods when core inflation does not appear to be a problem. Housing prices, stock prices, foreign exchanges rates, commodity prices, and other asset prices can help guide central bankers in pursuing price stability over the medium to long term.

Adopting a monetary rule, in place of discretion, does not mean that central banks should not provide liquidity during a banking panic. However, central banks should do so only on the basis of good collateral and at a penalty rate—Bagehot's rule. Insolvent firms should be allowed to fail, and private bankruptcy law should be followed to ensure that capital flows to its highest-valued uses. In that regard, U.S. bankruptcy law needs to be reformed to allow for a swift redeployment of assets. Relying on bankruptcy law rather than on government bailouts would help ensure that the "too big to fail" mantra is never acted upon.

### *Regulation Should Be Market Friendly*

Market-friendly regulation and national treatment are more apt to encourage safe and sound banking than top-down regulation intend-

FIGURE 3  
U.S. INFLATION AND ECONOMIC GROWTH



SOURCES: U.S. Bureau of Economic Analysis; U.S. Bureau of Labor Statistics.

ed to “harmonize” regulations across countries. Competition among regulatory regimes—and among rating agencies—would allow those that work best to dominate. Bad regulations and inaccurate rating agencies would disappear. Legal restrictions have often prevented the very competition that is needed to ensure the efficient use of capital.

Conventional wisdom holds that markets are inherently unstable and that unregulated banking would lead to chaos. Historical evidence on U.S. free banking and the Scottish free-banking system before 1844, however, indicates that market discipline can work to bring about socially beneficial outcomes (Capie and Wood 1991). Policymakers should try to learn from those episodes and think about alternatives to discretionary government fiat money (Dorn and Schwartz 1987, Dorn 1997).

Financial crises typically lead to more, not less regulation. The abuse of regulatory powers and the incentive to engage in rent seeking—that is, to buy political favors—wastes resources. Getting incentives and institutions right requires letting competition work and allowing the free flow of information, as revealed in market prices. The first rule of regulation should be “Do no harm.”

*Keeping Promises to Protect Property Rights and Economic Freedom*

Rather than trusting government to guarantee GSE debt and buy up toxic assets, the focus should be on keeping promises to safeguard private property rights and economic liberties. Government officials do not have either the information or the incentive to allocate capital efficiently—that is, to those uses valued most highly by consumers. Placing assets in the hands of government is risky because it politicizes investment decisions, attenuates economic freedom, and enhances the power of government.

Long ago Adam Smith recognized the futility of government-directed investment. In *The Wealth of Nations*, he argued: “No human wisdom or knowledge could ever be sufficient [to carry out] the duty of superintending the industry of private people, and of directing it towards the employments most suitable to the interest of the society.” Consequently, he favored a “system of natural liberty,” in which “every man, as long as he does not violate the laws of justice, is left perfectly free to pursue his own interest his own way, and to bring both his industry and capital into competition with those of any other man, or order of men.” His policy prescription was simple and transparent: Government should remove “all systems of preference or of restraint” and allow the “system of natural liberty” to spontaneously emerge (Smith [1776] 1937: 651).

The \$700 billion bailout of U.S. financial institutions sets a dangerous precedent by placing government officials in charge of valuing distressed assets, bypassing the normal market process of bankruptcy, and reinforcing the “too big to fail” mentality—making future bailouts more likely (Smith 2008, Zingales 2008). Most important, the bailout violates the laws of justice—that is, the sanctity of private property and contracts—that are at the heart of a market-liberal order.<sup>9</sup> Increasing the size and scope of government must necessarily reduce economic freedom, thwart the market feedback mechanism, and distort the allocation of capital.

<sup>9</sup>On the relation between “just rules of conduct” and market liberalism, see Hayek (1967). According to Hayek, “Under the enforcement of universal rules of just conduct, protecting a recognizable private domain of individuals, a spontaneous order of human activities of much greater complexity will form itself than could ever be produced by deliberate arrangement, and in consequence the coercive activities of government should be limited to the enforcement of such rules” (p. 162).

## Risks and Opportunities for China

The U.S. subprime crisis has become a global credit crisis that China cannot escape. Fortunately, 30 years of economic liberalization and opening up to the outside world have made China stronger and more resilient to outside shocks. China's leaders are to be congratulated for allowing greater economic freedom, which has helped millions of people escape poverty. Trade has expanded individual choices and given people new opportunities to improve their lives. It has also increased personal freedom. Those are important advances compared to the chaos of the "Cultural Revolution" and the "Great Leap Forward," when capitalism was a crime and private property outlawed.

While central planning has largely disappeared, it is still present to some degree in the financial sector. Macroeconomic prices—interest rates and the exchange rate—are heavily influenced by government policy, and the yuan is not fully convertible. Capital controls allow the central bank to peg the exchange rate and at the same time sterilize capital inflows to prevent inflation. Nearly all banks and nonbank financial institutions are state owned and controlled, though the large banks have been turned into shareholding firms in which private investors can take minority positions.<sup>10</sup>

China's "financial repression" means that the financial system is characterized primarily by market socialism, not market liberalism, which poses a risk for future development.<sup>11</sup> Just as the socialization of risk and the privatization of profit in America's GSEs helped precipitate the credit crisis, the same could happen in China. Although the large state-owned banks have been recapitalized and marketized to a degree, they remain creatures of the state. If they become insolvent, taxpayers will be the victims.

China will be able to have an independent monetary policy aimed at long-run price stability, which fosters financial stability, only if it floats the yuan and eventually allows full convertibility. Under the present regime, in which the yuan is undervalued, the People's Bank of China (PBC) must buy dollars by increasing the supply of domestic currency. Firms are limited in the amount of foreign exchange they can hold, so the opportunity to increase domestic consumption through imports is restricted while expansion of the PBC's balance sheet crowds

<sup>10</sup>See Anderson (2008) for an overview of China's banking system.

<sup>11</sup>For a comprehensive analysis of financial repression in China, see Lardy (2008) and Dorn (2006).

out private investment. To prevent inflation, which would occur under a fixed exchange rate regime, the PBC must withdraw liquidity by selling central bank bills or increasing reserve requirements. Sterilization, however, distorts interest rates and delays the appreciation of the real exchange rate by suppressing inflation, which is the only route adjustment can take if the nominal rate is pegged.<sup>12</sup> In addition, sterilization prevents banks from lending to the private sector since they must accumulate reserves and hold central bank bills.

A final distortion is that financial repression has led China to hold massive amounts of U.S. Treasury and agency debt, which has kept U.S. interest rates lower than they would have been, thus helping to bring about the housing boom.

John Greenwood (2008), chief economist at INVESCO, considers each of these distortions and warns that suppressed inflation, the bottling up of liquidity by the central bank, eventually will surface. When it does, capital could flee China and the boom could turn into a crisis. The 1997–98 Asian financial crisis was preceded by excessive growth of money and credit, which led to overheating. China can buy time with capital and exchange controls, and by using credit quotas and price controls, but only by distorting the real economy.

According to Greenwood (2008: 213),

In China's case, the controls on capital flows may for a time prevent such a sudden reversal of capital flows and drastic adjustment as occurred in the Asian financial crisis of 1997–98, but the key point remains. Allowing an extended period of overinvestment in one or two sectors that ultimately produces unacceptably low returns can shift a currency from being perceived as undervalued (as with the RMB today) or appropriately valued (as in the case of Asian currencies in 1996–97) to being suddenly overvalued.

Although consumer price inflation has slowed and China's asset bubble in the stock market has most likely been deflated, housing prices in major cities have skyrocketed over the last several years and the growth of money and credit continues to be strong. With pressure to lower interest rates and reserve requirements to "stimulate" the economy, the PBC will face some difficult choices.

<sup>12</sup>In China's case, it would be much easier to adjust the real exchange rate by changing one price—the nominal exchange rate—than by inflating the average price level via changes in expenditures and incomes.

Because of the PBC's commitment to defend the foreign exchange value of the yuan and prevent it from appreciating at a politically unacceptable rate, the monetary authorities are limited in their ability to use the bank interest rate to control inflation. Raising the rate would simply attract more capital that would have to be sterilized to control money growth—so reserve requirements and direct controls are used to limit bank lending.

Although the yuan has appreciated more than 20 percent against the dollar since July 2005, the rapid increase in foreign exchange reserves, which now total more than \$1.8 trillion, imply that the yuan is still undervalued. For a capital-poor country like China to invest billions of dollars in low-yielding U.S. government debt is wasteful and risky, especially if the U.S. financial crisis becomes a fiscal crisis and inflation is used to reduce the real burden of the debt.

The longer China delays creating real capital markets and allowing relative prices—especially interest rates and the exchange rate—to be freely determined, the more costly the final adjustment will be. As Greenwood (2008: 216) emphasizes, “[Sterilization] is no more than a temporary palliative, buying financial stability at the cost of real distortions.” Fortunately, China's leaders appear to recognize that danger and are gradually relaxing capital controls, liberalizing interest rates, allowing greater flexibility in the exchange-rate regime, and lifting price controls. The most difficult, but essential, task will be to privatize state-owned banks and allow owners, not taxpayers, to bear the risk of loss. In this regard, the United States is not setting a very good example.

The present trend in the United States is to move toward market socialism and away from market liberalism. That departure from free-market principles could present China with a novel opportunity to become the world's largest capital market. To do so, however, would mean getting rid of “all systems of preference or of restraint” and allowing the “system of natural liberty” to emerge.

## Conclusion

Long before Adam Smith wrote *The Wealth of Nations*, China's great historian Sima Qian wrote “The Biographies of the Money Markets,” an essay that advocated a laissez-faire approach to organizing economic life. Drawing on Taoist thought, he wrote, “When all work willingly at their trade, just as water flows ceaselessly downhill

day and night, things will appear unsought and people will produce them without being asked. For clearly this accords with the Way and is in keeping with nature” (Chow 2007: 13).

The question of financial stability is ultimately one of balancing state and market (see Minton-Beddoes 2008). Government is necessary to protect persons and property and to enforce contracts. But if the state socializes risk while privatizing profits, the delicate balance of risk and responsibility will be upset. Instead of creating harmony, government intervention will negate the spontaneous market order and destroy the Tao of the market—undermining freedom and prosperity.

The global financial crisis that began in the U.S. housing market is not a failure of market liberalism, but of market socialism. Prior to central banks, the international gold standard worked spontaneously to bring about a balance between the demand for and supply of money. That system was not perfect, but it did help generate sound money, limit the size of government, and expand trade.

In theory, central banks can control the supply of paper money and prevent inflation, but will they have the political will to do so? Without effective constraints on central bank discretion, there is no guarantee that fiscal pressures will not lead to an abuse of the monetary authority’s power.

One should recognize that there are limits to monetary policy (Dorn 2009, forthcoming) and to regulation. Policymakers need to recognize those limits and learn from the current crisis as well as past crises. Financial harmony requires a system based on private property in which owners, not taxpayers, bear the losses and capture the gains from investment decisions. All individuals seek to improve their lives. When that natural instinct is harnessed by a rule of law protecting persons and property, free trade will lead to mutual gain. China’s quest for “social harmony” will be furthered by following the Tao of the market and adhering to the rule of law, not by rigidly embracing a “socialist market economy.”

Many great economists from Adam Smith to Vernon Smith have expounded on the spontaneous market order and its benefits for freedom and prosperity. The failure of central planning in the Soviet Union and elsewhere led China and other nations to make the transition from plan to market.

The challenge will be for China and other emerging market coun-



tries not to succumb to greater central planning of financial markets, but to structure incentives and institutions so that individuals can coordinate their saving and investment decisions efficiently through private free markets.

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