Will the China crisis be a trigger for financial innovation?

| BY PATRICK LECOMTE |

Once again, investors were caught by surprise when the Chinese stock market crash this summer. There are two ways to make sense of investors' apparent surprise. First, one can find comfort in common investing wisdom. As the Wall Street adage goes, "Sell in May and go away." Alternatively, one can look at what could have been done to prevent investors' knee-jerk reactions and panic, and lay the groundwork for more sustainable global financial markets.

The Chinese economy's rise to prominence over the last 30 years has been both a tremendous opportunity for the world and a source of increased risk for the global economy. Three years ago, economists at the International Monetary Fund became concerned about the systemic risk posed by China's ability to keep growing at the levels it had enjoyed since joining the World Trade Organization while shifting its focus from fixed asset investments to domestic consumption. They ran sophisticated models based on former US Federal Reserve chairman Ben Bernanke's academic research, and estimated that a 1% decline in China's investment would mean a reduction of 0.1% in global growth.

When suddenly confronted with this risk over the summer, investors were at a loss. Admittedly, they have no easy way to allocate China-related risk, let alone to effectively hedge it, and little transparency to fully grasp it. Uncertainties stemming from a relative lack of disclosure related to the People's Bank of China's monetary policy have made the matter worse. China's perceived vulnerability has become the world's vulnerability. Whether you are an institutional investor, a corporate treasurer in an MNC, or an individual investor managing an equity portfolio, how do you hedge China?

In a series of articles published in Asia and Europe in spring 2013, I suggested that financial instruments be designed to capture the new economic reality embodied by the fast emergence of China and her growing importance, both in scope and intensity, in the global economy. In particular, I advocated the launch of economic derivatives on the Chinese economy as a way to easily hedge China-induced risks.

Arguably, what has been happening in China over the last few months reveals the financial sector's shortcoming at being forward-looking and innovative. Thanks to past landmark innovations such as derivatives pricing models, financial markets globally serve a useful purpose in our economies by enabling optimal risk allocation. The problem is that there are no incentives for actors in the financial sector, be they investment banks or standardised derivatives exchanges, to foster innovation that would benefit greater society in the long term. Launching new derivative instruments such as China's economic derivatives are a costly and risky venture inasmuch as most new derivatives markets fail within a few years of their openings.

With the proper incentives in place, the financial sector could become an important engine in promoting sustainable and efficient capitalism. Derivatives aimed at managing risks stemming from large economies, including the Chinese economy, are long overdue. Their relevance has been proven during the global financial crisis of 2008, and more recently over the summer. These types of derivatives would be part of what Nobel Prize laureate Robert Shiller calls "Macro Markets", that is, markets to manage society's largest economic risk. After an eventful summer, the time is ripe for some financial innovation, and China might be the trigger for it. E

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