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's fast-evolving financial industry, like the country itself, defies the type of easy, sound bite-friendly synopses that foreign investors might like. It's often unclear exactly what factors are stoking China's remarkable economic growth engine. "The Chinese financial industry is a very complex story," said Winston Wenyan Ma, an investment banker who most recently worked for J.P. Morgan in New York and is author of *Investing in China – New Opportunities in a Transforming Stock Market*.

Speaking at the recent Wharton China Business Forum in Philadelphia, Ma moderated a panel on financial reform – a key ingredient in China's plans for economic expansion. Complicating matters in China are the country's size (3.7 million square miles), diversity and the tricky relationship with its island neighbor to the southeast, Taiwan.

So what's the good news for Chinese citizens, outside investors and would-be investors? It's that the communist government shows no signs of slowing reforms that look a lot like, well, capitalism: privatizing state-owned enterprises, permitting citizens and foreigners alike to participate in the stock market and allowing foreign-owned firms to set up operations and employ locals. Such ideas were unthinkable during the Cold War reign of Mao and his successors.

"Regulatory reform brings liquidity into the system," and "opens up foreign direct investment into the markets," said Ma. While such foreign infusions of capital dipped slightly in 2006 to $69.5 billion, the figure jumped considerably in January of this year – to $5.18 billion, or a 13.9% increase over the previous January, according to China's Commerce Ministry.

Panelist Lawrence Goodman, head of emerging market strategy for Bank of America, sounded a cautious note in an otherwise rosy assessment: "China is doing extremely well" in its transition from a developing, or "emerging" economy to an "advanced" one. But, he said, "That transition is not necessarily going to be seamless."

He lauded the transfer of certain state-owned enterprises into private hands as a move that has "unleashed productivity." At the same time, he said, the country's monetary policy poses a potential threat to growth. Goodman criticized the People's Bank of China for raising "not one, but six interest rates at once" in what he described as a blunt-instrument approach aimed at controlling inflation. The bank increased several key landing and savings rates by a combined .27% in mid-March, a move it said was necessary to stabilize prices and balance growth.

According to Andrew Busch, global foreign currency strategist for BMO Capital Markets in Chicago, China's growth over the past nearly two decades has "been a miracle, really, that I don't think we're going to see again." In the 1990s, under then-President Jiang Zemin and Premier Zhu Rongji, China "created a middle class, nearly out of thin air," that numbers 200 million today, he noted. Consequently, Chinese leaders have a strong incentive to proceed with economic reforms that allow an increasingly wider swath of the populace to improve their standard of living. "The last thing Chinese politicians want is people unemployed, people unhappy, people massing in Tiananmen Square."

A "Wild West" Stock Market

Like Goodman, Busch foresees hiccups ahead: "Every emerging market at some point has stumbled." He compared China's nearly $1 trillion stock market to the "Wild West" -- rife with speculators and amateur investors apt to act on emotion rather than the underlying fundamentals of a security, an industry or the market as a whole.

Furthermore, Busch said, cultural differences between East and West bear close watching. Misunderstandings have the great potential to be misconstrued as outright hostility, he adds, nothing that they "can be political or they can be financial." Two recent moves, on both sides, raised alarms:

The United States' proposed sale last month of more than 400 air-to-air and air-to-ground missiles to Taiwan. China regards Taiwan as a breakaway republic that it will one day reclaim. According to the Associated Press, the Chinese Foreign Ministry called the sale a "rude interference into China's internal affairs."

China's decision to shoot down one of its aging satellites in January to test the capability of a missile system. International observers worried that Beijing is trying to develop the power to knock out adversaries' satellites and thus blind those opponents' military forces. Beijing has provided little in the way of explaining its intent.

"China now has $1 trillion of U.S. dollar reserves," Busch said, noting that an ambiguously worded statement about monetary policy – whether it is about currency valuation or the balance of trade – from either side, could have severe impacts for both.

So where does the "reform" come into play in all this?

According to Ma, the Chinese government is receptive to adopting and allowing the tools of capitalism – gradually. "For 15 years, the only instrument you could trade was common stock." But Ma said that more sophisticated financial products, tools and services are now becoming available. One such innovation is the expanding use of financial derivatives, which proponents say allows for more efficient allocation of capital and increases market liquidity.

As China makes the gradual transition from am "emerging" to an "advanced" economy, the panelists agreed that everyday Chinese citizens could expect greater access to consumer credit, which, for better or worse, has become a hallmark of Western economies.

They also emphasized – again – that while the long-term trend slopes upward, some pain inevitably lies ahead. One need search no further than the "advanced economy" of the United States for evidence. "You just have to look at Enron when you talk about 'immature investors,'" Goodman said. Countless people who should have known better, he stated, bet the farm on the doomed, scandal-plagued company -- in many cases wiping out their retirement funds.

Even more recently in the United States, the subprime lending crisis has added further proof that advanced economies do not equal perfect ones. Subprime loans allow access to homeownership for individuals whose credit ratings are otherwise too low to qualify for loans. But this easy availability also tempted lenders to take extreme, imprudent credit risks on applicants. At the seamier end of the spectrum, lenders have been accused of pushing borrowers into expensive and inappropriate loans that they could not afford.

The Chinese government finds itself performing a delicate high-wire act with its economy – encouraging foreign investment, but also rationing it so as not to stoke inflation; and still wrestling with the idea of individual ownership, access to capital and free enterprise.

Goodman said China can do more to incubate its economic expansion by letting go of some of the reins and allowing its markets behave more like markets. "There should be capital market liberalization," he noted, "but ever so gingerly."

Worldclass Consumers

In a separate interview with Knowledge@Wharton, Ma noted that members of China's burgeoning middle class are happy with their status, which has been made possible through sweeping economic reforms that lifted millions from poverty in the 1990s. At the same time, Ma adds, the middle class is also quite nervous. Even as stock market fever grips China's masses, there is a collective fear that the affluence could be gone in an instant, he notes.

"Competition is extremely fierce for jobs," specifically the skilled, professional jobs that are fueling the middle class's growth, he said. There are many smart, hard-working poor people who are qualified to replace those who are already successful. Thus, those who have made it in, some cases, "have just been in the right place at the right time,"

He also cited "the higher supply of people comfortable in two languages." In addition to China natives who understand English, companies doing business in China have a growing pool of employees born in the United States in whose households both English and Mandarin were spoken. These candidates possess the added advantage of understanding the nuanced, crucial differences between Western and Chinese cultures.

Also weighing heavily on the minds of the middle class are their own increasingly consumption-oriented ways. "They wonder if they even can maintain this type of lifestyle," Ma said. Xinhua News Agency reported at the end of March that China will become the second-largest purchaser of consumer goods by 2015, second only to the United States. That means Chinese consumers would account for 14.1% of the total consumption among major economies, up from 5.4% in 2006, and that they will have surpassed Japan, Germany, Britain and Italy, Xinhua said, citing a report by investment bank Credit Suisse.

There is much discussion also of increasing Chinese consumers' and private businesses' access to credit as one of several means to ensure continued economic growth. For other than state-owned enterprises, borrowing money from the bank is extremely difficult at best, according to the panelists and other experts.

Yet people have found a way around this by turning to the thriving gray market for loans, the panelists add. Where the state-run People's Bank of China (PBOC) has yet to serve the credit needs of small borrowers, informal and sometimes very personal networks of lenders have set up a shadow economy that funds consumer purchases, real estate transactions and business development, a phenomenon that has been well-documented in the media and in academic research.

That gray market also offers higher interest rates than the PBOC, up to 20% in some cases. McKinsey reported last year that this market held about $100 billion in assets. PBOC has been steadily raising interest rates in an attempt to keep economic growth manageable, while observers say the moves are also an attempt to hang on to depositors, who have been moving their money to the lending gray market and even, Ma said, the stock market in hopes of getting better returns. "We go back to the theme of more effective use of capital," he noted.

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