

## Managing Capital Flows: the Case of China

### Introduction

China's growth since 1979 has been export-led and FDI-driven. At the same time the Chinese government has adopted a cautious attitude towards capital account liberalization. Owing to capital controls during the Asian financial crisis, although China's financial system was as fragile as those crisis-affected countries in the region, if not worse, the Chinese currency (the RMB) escaped attacks by international speculators. In the wake of the Asian financial crisis, the pace of capital account liberalization in China slowed down, if not grind to a complete halt. Most of planned liberalization actions were shelved. However, since 2002, capital account liberalization has returned to policy agenda because of China's commitment to open the financial services sector as a part of WTO entry commitments. Since 2003, the management of cross-border capital flows began to intertwine with Chinese monetary authorities' efforts for reducing the appreciation pressure on the RMB. Currently, how to manage cross-border capital flows has become one of the most controversial issues in China. The author believes that the adequate management of cross-border capital flows holds the key for China's success in the maintenance of a stable growth path. The paper is aimed at providing a comprehensive account of the evolution of

China's management of capital flows and analyzing possible trajectories of the management of capital flows in the future. The main theme of the paper is that liberalization of capital controls should be treated as part of the long term program of China's economic reform and opening up, and should not be subject to the need for reducing pressure on RMB appreciation. There is still long way to go for the complete convertibility of the RMB, due to the insufficiency of China's institutional reform. The stabilization of the RMB should not be achieved at the expense of losing control on capital flows. The first section of the paper is a short introduction of the evolution of China's management of capital flows. The second section discusses China's imbalances of international balance of payments and China's exchange rate policy. The third section discusses the interaction between macroeconomic stability and the management of capital flows under the given exchange rate policy. The fourth section is devoted to future direction of China's management of capital flows. The last section is a short conclusion.

## **1 The Evolving of China's Capital Controls**

The literature on capital account liberalization comprises mainly two parts: the costs and benefits of capital account liberalization and the sequencing of capital flow liberalization. The two components basically are answers two questions: why capital flows should be liberalized (or not liberalized) and how capital flows should be liberalized.

### **1-1 Arguments for and against Capital Controls**

According to Eichengreen (1998), "Before World War I, controls on international financial transactions were absent and international capital flows reached high levels. The interwar period saw the collapse of this system, the widespread imposition of capital controls, and the decline of international

capital movements. The quarter-century following World War II was then marked by the progressive relaxation of controls and the gradual recovery of international financial flows. The latest period, starting with the 1970s, is again one of high capital mobility.”<sup>1</sup> The benefits of capital mobility seem unquestionable. In literature, the main arguments for free movement of capital include:

- Free flows of capital provide more international investment opportunities
- Free flows of capital increase opportunities for portfolio diversification and thereby enable investors to achieve higher risk-adjusted rates of return
- Capital controls do not work any way. In modern financial markets, financial instruments are highly fungible and investors are able to evade capital controls when they have strong incentive to do so. Capital controls only lead to increase in transaction cost
- Capital controls give rise to corruption and favoritism.
- Individuals should be allowed to dispose their own wealth and income as they see fit.

Then why the Chinese government still imposes capital controls? First, capital controls are necessary for the maintenance of dependence of monetary policy, while China is still not ready for free floating. According to Eichengreen, capital controls “loosened the link between domestic and foreign economic policies, providing governments room to pursue other objectives like the maintenance of full employment. Governments may no longer have been able to take whatever steps were needed to defend a currency peg, but capital controls limited the extremity the steps that were required. By limiting the resources that the markets could bring to bear against an exchange rate peg, controls limited the steps that governments had to take in its defense.”<sup>2</sup> Second, China’s financial system is fragile and its economic structure rigid. Therefore, shocks created by sudden changes in the direction of cross-border capital flows can destabilize its

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<sup>1</sup> Eichengreen, B.1996. *Globalizing Capital*. Princeton: Princeton University Press.

<sup>2</sup> Ditto, p5.

economy severely. With a more flexible exchange rate, capital inflows will cause large appreciation. Due to lack of financial instruments for hedging, Chinese enterprises cannot protect themselves from the risks created by sudden changes in exchange rates. Also due to structural rigidity, they cannot make quick adjustment to the changes in exchange rates. Third, China's economic reform has not completed and property rights still need to be more clearly defined. When the issue of who owns what has not been solved, free flows of capital across borders encourage money laundry and asset stripping, which in turn will cause social tension.

Fourth, by means of capital controls, the government wished that wrong type of capital can be prevented from being introduced. Last but not least, with more than 1.6 trillion US dollar foreign exchange reserves, China is an attractive target of predatory attacks by international speculators, the under-development of its financial system and the inefficiency of its capital market means that with an open capital account, China will not be able to withstand a major attack like what we saw during the Asian Financial crisis. A fire wall of capital controls is needed to protect China from such an attack.

### **1-2 Current Capital Control Regime**

First, all inward FDI must be approved by and registered with both planning departments and foreign trade departments of the government. After having been registered and approved, investors may then open special accounts — foreign exchange capital accounts at designated banks. There were no restrictions on the remitting of foreign exchange into China by those approved investors. However, the conversion of foreign exchange into Chinese currency, the RMB must obtain advanced approval from the State Administration of Foreign Exchange (SAFE) or its provincial branches. Self-balancing of foreign exchanges was required for virtually all foreign funded enterprises. As for outward FDI, after having obtained approvals, the investors must register their investment with foreign exchange authorities, and then proceed to remit foreign

exchanges to the host country of investment.

Second, foreign investors were prohibited from using the RMB to invest in the stock exchanges inside China. Foreign investors were allowed only to use foreign exchanges to invest in so-called B shares. Any floatation of B shares more than US \$ 30 million must be subject to approval of the China Securities Regulatory Commission of the State Council (CSRC). The total amount of B shares floated each year must be within the quotas set by the government. Only a small number of Chinese companies were allowed to list in New York and Hong Kong (The shares they sell are called N shares and H shares, respectively).

Third, the issuers of bonds abroad were limited to 10 authorized window institutions in addition to the Ministry of Finance, and state policy banks. Generally speaking, other borrowers could ask those 10 window institutions to issue bonds on their behalf. Except for authorized financial institutions that were engaged in foreign borrowing and large-size enterprise groups, Chinese residents were not allowed to buy foreign securities of any kind.

Fourth, entities eligible for borrowing from foreign banks and other foreign financial institutions were financial institutions authorized by the State Administration of Foreign Exchange and industrial and commercial enterprises or groups of enterprises approved by the SAFE. Chinese residents were not allowed to borrow from foreign banks and other foreign financial institutions without prior approval by the government. The State Development Planning Commission was in charge of compiling annual plans of foreign borrowing. It was authorized to determine the total amount and the allocation of the borrowing after reconciling the borrowing applications from different departments and provincial governments. All borrowing and lending agreements without prior approvals by the authorized government

organizations were not legally binding. The SAFE would refuse to recognize the agreements and register the loans as foreign debt.

### **1-3 Cross-Border Capital Flows in China**

Owing to China's preferential policy towards FDI supplemented with capital controls, cross-border capital flows in China have been dominated by FDI inflows. The cross-border capital flows in China can be divided into three stages: 1979 to 1991, 1992 to 2000, and 2001, the year of China's entry into the World Trade Organization (WTO), to the present. In 1979, when the policy of reform and liberalization began, FDI inflows into China were of a negligible amount of US\$0.08 million. Following the establishment of the four Special Economic Zones, and the opening up of more regions and cities to foreign investors, FDI inflows into China began to pick up. From 1984 to 1991, they grew annually at a rate of 20 percent (Chen 2002).

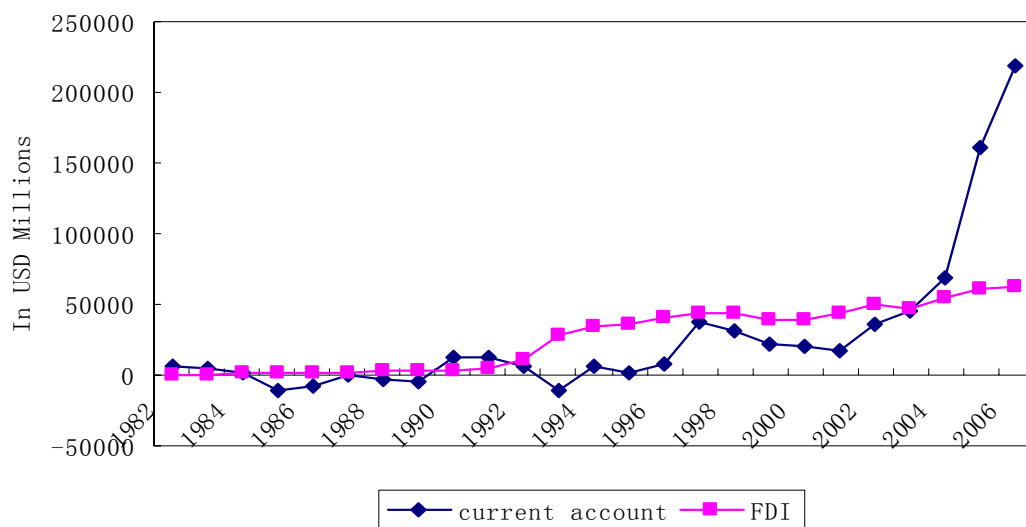
In 1992, after Deng Xiaoping's tours of South China, China's reform and opening up process intensified, and FDI inflows increased by leaps and bounds. From US\$4.4 billion in 1991, they increased dramatically to US\$11 billion in 1992, a jump of more than 150 percent. After that the increase in FDI inflows was rapid and steady until the Asian financial crisis struck in 1997. The economic turmoil caused the increase in FDI inflows to stall from 1998 to 2000.

The momentum of FDI inflows into China picked up in 2001, when FDI inflows increased 12 percent over 2000, and the share of FDI in China's total fixed investment reached 10.5 percent. By the end of 2001, China's cumulative utilization of FDI had reached US\$395.4 billion, and cumulative contracted FDI had reached US\$745.1 billion. In later 2002, one year after the entry into the WTO, and seven years after the adoption of expansionary monetary and fiscal policy to fight against deflation, the Chinese economy finally broke loose the spell of deflation. At the same time, both China's current account and capital

account surpluses, increased significantly, due to the strong recovery of the world economy and WTO entry effect. Since 2005, China's trade surplus increased significantly and replaced capital account surplus as the most important contributing factor to the increase in foreign exchange reserves (Figures 1). The cause for the sudden drastic increase in trade surplus seems to be attributable both to cyclical and structural reasons. In the early 2005, the economy was slowed due to government's tightening of the economy. On the other hand, by the time, the domination of processing trade in China's trade structure was finally established. China has become the export platform of Multinationals.

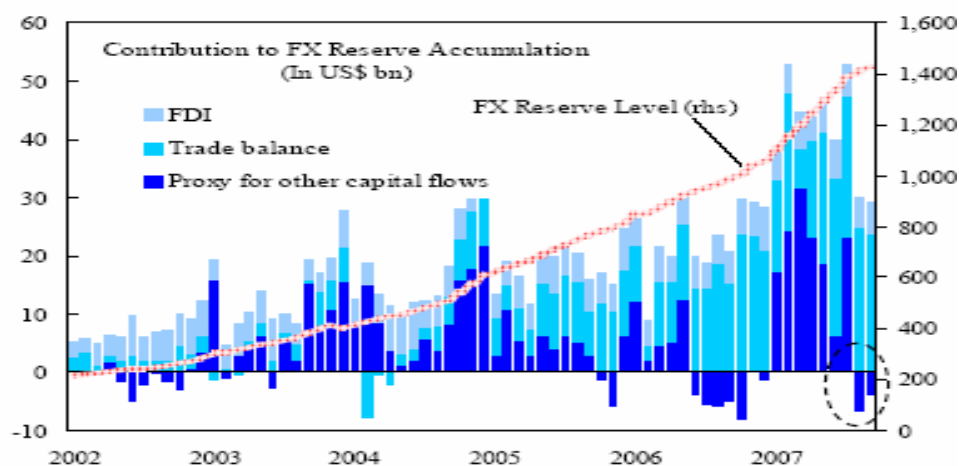
Because of China's strict capital controls, indirect capital inflows in China have been limited in relative terms. By the end of 2006, the total amount of short term foreign debts was just 1690 USD. However, it is worth mentioning that since 2004 situation has become more complicated, which will be discussed in details in section four.

**Figure 1 China's international balance of payments since the early 1990s**



Until the second half of 2001, China had always worried about capital flights since the 1980s, which was mainly reflected in the negative number of in the account of errors and omissions. However, since 2003 capital flights stopped to be an issue. Instead, hot money started to flow in. Besides the large twin surpluses, the inflow of unofficial or unexplained capital flows, which may or may not be hot money has also become a contributing factor to the accumulation of foreign exchange reserves. During this period of time, expectations for RMB exchange rate appreciation have played or assumed to have played an important role in attracting capital inflows (Figure 2). But the question of how important the expectations were needs further investigation. A more detailed analysis of cross-border capital flows since 2002 will be given in the third section. Hopefully, more lights will be shed on the unexplained capital flows.

**Figure 2 FDI, trade balance and unexplained capital flows**



Source: Wang Qing, Morgan Stanley, October 2007.

Despite their contributions to China's financial stability, capital controls are very costly and becoming increasingly difficult to implement due to China's opening of its financial service sector and its extremely liberalized and

globalized trade regime. Capital control placed unbearable workload on the government, especially on the staff members of the State Administration of Foreign Exchange Reserves (SAEF). It caused great inconvenience to enterprises as well as banks. The smooth flows of capital were hampered. The WTO adds a new dimension to the urgency for capital liberalization. Without doubt, China needs to liberalize its capital account. A once-for-all liberalization is out of question. Therefore, the question is what should be the sequencing of the liberalization. The basic problem the sequencing should solve is to strike a balance between finally liberalizing capital account and maintain financial stability to minimize the welfare losses of the country during the transition.<sup>3</sup>

According to McKinnon and others, the capital liberalization should be well sequenced and should follow certain order. The commonly accepted “right order” is something like the following: liberalizing current account before liberalizing capital account, liberalizing FDI before liberalizing indirect investment, liberalizing long term capital before liberalizing short-term capital, liberalizing portfolio before liberalizing borrowing, liberalizing capital inflows before liberalizing capital outflows and so on. Theoretically speaking, the maximization of a multi-period utility function with exchange rate stability and properly measured benefits of capital mobility as explanatory variables can define a dynamic path of capital flow liberalization. Country experience in capital account liberalization is very rich. However, a theoretical framework guiding the sequencing of capital account liberalization is still unavailable. The lack of theory in the area of capital liberalization may be due to the fact “capital controls” is a label for a bundle of events and not a single variable and is highly country-specific. Therefore, it is difficult to model the dynamic process of capital liberalization and derive general rules on the sequencing of capital

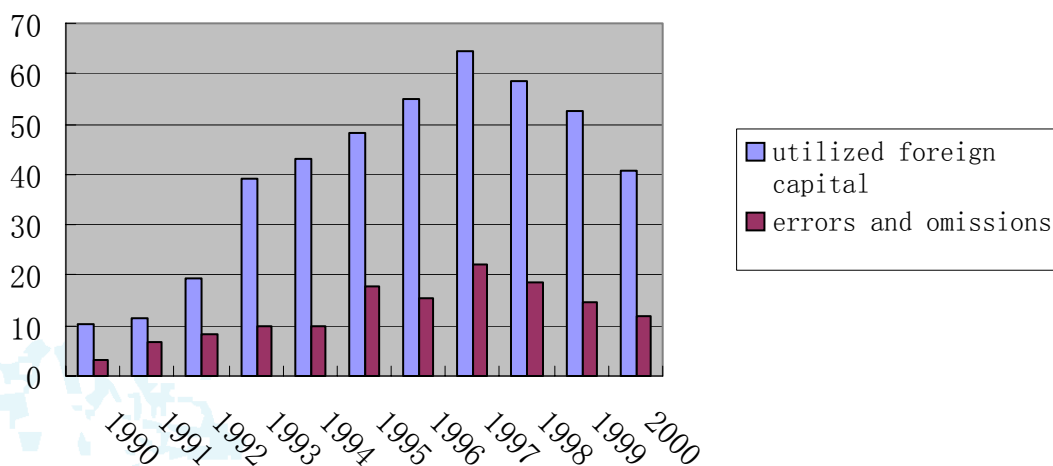
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<sup>3</sup> Yu Yongding, Global Finance and China

liberalization.

China's liberalization of capital account has followed roughly the sequence depicted by the figure 3. The first important step of liberalization happened in 1986, when foreign exchange control was relaxed for foreign funded enterprises. FDI firms were allowed to use their RMB earnings to finance local production of exports or to convert the earnings into foreign exchanges at swap markets that were opened in 1985. Foreign swap markets became the main channels for FDI firms to balance their foreign exchange accounts. The most significant development in liberalization of capital flows was the realization of the currency convertibility for current account transactions in 1996, which significantly increased China's attraction to FDI. After having merged China's official foreign exchange market where official foreign exchange rates were used with the swap market where exchange rates were determined by demand for and supply of foreign exchanges at the end of 1994 and achieved an unified but significantly depreciated RMB exchange rate vis-à-vis the US dollar, China proceeded to carry out further liberalization for its capital account. However, the Asian Financial Crisis brought China's liberalization process to a sudden halt in 1997. The Chinese government stopped implementing planned capital account liberalization and tightened controls drastically on the current account as well as the capital account to prevent international balance of payments from worsening by capital flight (Figure 3).

**Figure 3 Utilized foreign capital and errors and omissions (billion USD)**



Source: SAFE.

In October 1998, China's Supreme Court carried out crackdown on illegal foreign exchange transactions. With the deadline set by the SAFE for offenders to turn themselves in so as to get a more benevolent treatment, hundreds of cases were brought to the courts, and a large number of defendants who refused to surrender were severely punished according to the law. The government sent tens of thousands of auditors to enterprises and financial institutions to track down and recover illegally transferred money. Consequently, the capital flight was brought under control. Growth of China's official foreign exchange reserves return to the normal level since the fourth quarter of 1998.

Initially, encouraged by the successful accession into the WTO and then faced with RMB appreciation pressure the Chinese government re-launched the process of capital account liberalization with the aim of reducing appreciation pressure. The new guiding principle is to encourage capital outflows and tighten controls over capital inflows. However, due to China's WTO commitments and

its long-term plan for capital account liberalization, some inflow controls are loosened too.

The following are the main new features of China's capital control regime since 2003.

- Initially, the thresholds for Chinese enterprises to open foreign exchange accounts with banks were lowered. Chinese enterprises and commercial banks were allowed to keep a higher proportion of foreign exchanges originated from current account transaction with their foreign exchange bank accounts. In a later stage, in fact, enterprises are allowed to hold as much foreign exchanges as they want.
- Restriction on domestic institutions' issuance of bonds abroad has been loosened. By the end of 2006, a total of 27 domestic institutions (including the Ministry of Finance) had been approved to issue 141 foreign bonds in major capital markets such as Japan, the United States, Europe, Singapore and Hong Kong SAR of China, with USD 30.8 billion of funds being raised.
- The procedure for verification of eligibility of using trade financing was simplified.
- Residents are allowed to convert RMB to foreign exchanges up to 50,000 US dollar per annum. The range of qualified students who are allowed to bring out large quantity of foreign exchanges for studying abroad has been widened.
- Chinese enterprises' overseas investment becomes much easier.
- Residents are free to open foreign exchange accounts.
- Residents are allowed to buy foreign equities via the qualified domestic institutional investors (QDII). The QDII scheme was introduced in June 2006, which allowed qualified domestic banks to conduct overseas wealth management for their clients and qualified securities brokers (such as fund management companies and securities companies) to do overseas portfolio

investment. By the end of October 2007, a total of USD 26.782 billion of funds had been remitted outward under the QDII scheme.

- Non-residents are allowed to open RMB accounts in China.
- Non-residents are allowed to buy A shares via the qualified foreign institutional investors (QFII). The QFII scheme is a transitional institutional arrangement introducing foreign capital into China's capital markets while there are controls and RMB is not convertible. By October 30 of 2007, a total of 52 foreign institutions have obtained QFII status by the China Securities Regulatory Commission (CSRC), of which 49 QFIIs had been granted an aggregate investment quota of USD 9.995 billion by the SAFE. At this moment, the total quota of OFIIs is 30 billion US dollars.
- International development institutions were allowed to issue RMB bonds domestically. On October 12, 2005, the International Finance Corporation (IFC) was approved to issue 1.13 billion yuan of RMB bonds within China. On October 14, 2005, the Asian Development Bank (ADB) was allowed to issue 1 billion yuan of RMB bonds domestically.
- By the end of October, 2007, the China Development Bank, the Export-Import Bank of China and Bank of China had issued 5 billion yuan, 2 billion yuan and 3 billion yuan of RMB bonds in Hong Kong SAR respectively.
- Non-residents are allowed to buy houses in China as long as buyer have stayed in China for work or study for more than one year.

On the other hand, in contrast to the past practice, controls over capital inflows have been tightened. Measures aimed at reducing capital inflows include:

- The “extra-national treatment” given to foreign banks, which allowed foreign banks to borrow abroad with fewer restrictions than what domestic banks must subject to was eliminated.
- A new foreign exchange settlement system was established. Under this system, capital inflows are under stricter scrutiny. It is assumed that all

inflows should be based on real transactions. Inflows of foreign exchanges originated from “foreign investment” must be paid to the designated recipients and are not allowed to enter into and stay at the RMB accounts of enterprises to wait for the RMB to reevaluate.

The main features of China’s current capital control regime, after more than two decades’ evolution, China’s capital controls can be summarized as follows.

**Table 1 A summary—China’s current capital control regime**

		Inflows	Outflows
Money market	Non-residents	No permission	No permission
	Residents	Prior approval by the PBC and the SAFE is required	No permission for residents, except authorized entities
Stock market	Non-residents	B shares and QFII	Sell B shares, repatriate of QFII
	Residents	Sell H (or N or S) share abroad, repatriate of QDII	QDII
Bonds and other debt	Non-residents	QFII	No permission, except for some international finance entity, repatriate of QFII
	Residents	Prior approval by the PBC and the SAFE is required. Issuing bonds abroad must be incorporated into the State external debt plan.	No permission for residents, except authorized entities
Derivatives	Non-residents	No permission	No permission

and other instruments	Residents	Operations in such instruments by financial institutions are subject to prior review of qualifications and to limit on open foreign exchange position.	Operations in such instruments by financial institutions are subject to prior review of qualifications and to limit on open foreign exchange position.
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According to SAFE, among 43 items of transactions under capital account, 8 items are completely liberalized; 11 items are under loose restriction; 18 items are under certain restriction; convertibility is strictly prohibited only for 6 items. Calculation, based on the IMF formula, shows that so far 80% of China's capital account has been liberalized.

## **2 China's imbalances of international balance of payments and its exchange rate policy**

It is assumed in economics of development that developing countries should run current account deficits and capital account surpluses, so as to utilize foreign savings to obtain an investment rate higher than what their domestic saving rate can support. Therefore, a developing country should run trade account and current account deficits, and capital account surplus. However, China has a very different pattern of international balance of payments. Although China has been running capital account surplus almost every year since the early 1980s<sup>4</sup>, China started running a current account surplus consistently since the early 1990s (Figure 1). The persistent "twin surpluses" has resulted in the continuous increase in foreign exchange reserves. By the end of 2007, China's foreign exchange reserves will surpass 1.5 USD trillion.

<sup>4</sup> As an aftermath of the Asian Financial Crisis, China ran capital account deficit in 1998, due to capital flight.

It is worth repeating that in the past, the main contributor to China's accumulation of foreign exchange reserves was the capital account surplus, more precisely, FDI inflows. However, since 2005, the current account surplus has superseded FDI to become a more important contributor to the increase in the foreign exchange reserves.

### **2-1 Why China as a developing country runs large current account surplus and why China with excess savings attracts so much FDI**

The most popular explanation for China's current account surplus is the saving-investment gap. In contrast to the US, while China's investment rate is very high, its saving rate is even higher. Especially, after the middle of the 1990s, China's saving rate has become persistently higher than its investment rate. It seems that there is strong correlation or co-movement<sup>5</sup> between current account surpluses and the saving-investment gap. However, it is still not that easy to decide whether the saving-investment gap is the cause for or effect of current account surplus in China. In my view, until recent years, the most important factor contributing to China's current account surplus is government's export promotion policy, which includes the so-called self-balancing regulation, exchange rate policy and tax rebate. One of the most important features of China's export promotion policy was the very tight capital controls aimed at preventing any possible crisis of balance of payments from happening. Not only does the government not allow international balance of payment to suffer from running into deficit so that foreign exchange reserves would be used, but also the current account deficit. The only result the government fees comfortable is current account surplus as well as capital account surplus. Therefore, the government demanded foreign investors guarantee the self-balancing of foreign exchanges for important foreign investment projects. In other words, FDI must be export-oriented. As a result, while FDI was introduced, corresponding trade

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<sup>5</sup> Feldstein, Martin, 1983

deficits were minimized.<sup>6</sup> China even went as far as to create an economic structure that by definition has to run trade surplus. As a result, processing trade dominates China's trade sector.

China's export promotion policy aimed at achieving trade surplus coincided with the formation of international production networks, and its trade pattern was shaped to a large extent by FDI that flowed in as vehicles of the formation of international production networks (IPN). The pattern of FDI inflows into China was in turn facilitated by Chinese government's policy in favor of processing trade, which was motivated by Chinese government's fear of current account deficit and its desire to allow China's comparative advantage in labor intensive products to have full play. Because of the increasingly important role played by multinationals from developed countries, and Taiwanese OEM firms (Original Equipment Manufacturer), the bulk of FDI flow into manufacturing sectors, such as electronics, automobile, family appliances, office machines, measuring and checking instruments, telecommunications equipment, pharmaceuticals and chemicals. These products were more closely related to international production networks. As a result of changes in regional and sectoral distribution of FDI, China was more and more deeply locked into the international production networks and became processor and assembler in the IPN. While China's trade expended with accelerating speed, it is increasingly being dominated by processing trade. The domination of processing trade in China's trade means that China must run current account surplus.

According to Corden (2006), "(i)t seems perfectly rational to invest some of the extra savings abroad given the inefficiency so far of the financial system in allocating funds- as reflected in the high volume of non-performing loans held by the banks. The public sector also, has yet to improve the efficiency of public investment. It seems extremely reasonable therefore to 'park' a proportion of

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<sup>6</sup> This policy was abolished as part of China's commitments for WTO entry in 2001.

funds abroad until efficiency in domestic investment allocation improves.” Besides this “parking theory”, another explanation offered by Corden is “the deliberate pursuit of export-led growth.”<sup>7</sup> In my view, both explanations are relevant to China’s reality and interrelated. Put it simply, “the deliberate pursuit of export-led growth” is the cause of China’s current account surplus and the “parking” “extremely reasonable” or not, is a reflection of the inefficiency and hence unsustainability of export led growth. If China runs only current account surplus, “parking” can be regarded as a second best solution, because China does not have ability either to translate its current account surplus as capital account deficit or to use the funds for domestic investment. In other words, China has to settle down with low- yield but safe treasury bills. However, China’s situation is worse than that, because China not only runs current account surplus but also capital account surplus.<sup>8</sup>

Capital inflows into China can be attributed both to push factors in developed countries and pull factors in China. The push factors for China are more or less the same as for other East Asian countries. However, the pull factors in China perhaps are quite different from the rest of East Asia. The biggest difference lies in the fact that while China is the third largest FDI attracting country in the world, it is the third largest net capital exporting country in the world. In other words, China’s domestic saving is more than enough to finance China’s domestic investment. However, due to the under-development of the financial markets, though there may be excess savings for the economy as a whole, it is very difficult for many potential importers of capital goods to raise funds domestically for imports. On the other hand, due to the preferential policy

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<sup>7</sup> Corden, W. Max. (2006) Those Current Account Imbalances: A Skeptical View. Working Paper No.13/06, Melbourne Institute Working Paper Series, Melbourne University, August, 2006. pp.6-7.

<sup>8</sup> Yu Yongding. (2006) Global Imbalances and China, The Australian Economic Review, vol. 40. no. 1, pp1-21.

towards FDI, to attract FDI as a way to raise funds is much easier. Some times enterprises simply sold their foreign exchanges obtained via FDI inflows to the PBOC, and use RMB to buy capital goods produced locally. As a result, there are increases in FDI and foreign exchange reserves, but that there are no changes in current account. Essentially, China's domestic savings have often to be intermediated by foreign capital markets for domestic investment.

To run twin surpluses persistently for more than one and a half decade is a reflection of gross misallocation of resources. First, as the 100th poorest country in per capita terms should not be the third largest capital exporting country in the world. Second, as third largest FDI hosting country, China should translate capital inflows into trade deficits. Otherwise, how can China really utilize attracted foreign capital? To be a current account surplus country means that China not only fails to utilize foreign resources but also fails to utilize part of domestic savings for domestic investment. Third, as a net creditor for more than one and a half decade, China has been running negative investment incomes for most of time until 2005 when China's foreign exchange reserves has already surpassed 800 billion USD. Fourth, faced with continued devaluation and defaults of US securities, US assets are no longer good place for China to park its savings. The hard earned foreign exchange reserves are losing values quickly. All in all, the irrational structure of international balance of payments should be corrected as soon as possible.

## **2-2 The Adjustment of Growth Strategy and Exchange Rate Policy**

The irrationality of China's structure of international balance of payments has been widely recognized in China. In its 11<sup>th</sup> five year program formulated in 2005, the Chinese government called for achieving a basically balanced trade account by the end of 2010. To achieve this objective, the government decided to scrap the favorable treatments towards export industries. One of the most important policy measures is to reduce the tax rebate for most categories of

export products. At the same time the government decided to eliminate preferential policy towards foreign funded enterprises in terms of taxes, access to bank loans, use of lands and so on. However, due to the fear of the negative impact on employment in exporting industries, the government is very reluctant to allow RMB exchange rate to appreciate. Since the de-peg in July 2005, though so far RMB has appreciated by some 10% against US dollar, its nominal effective exchange rate has barely moved because of the huge appreciation of Euro against the UD dollar. At the same time, China has gone a long way in participation in the international production networks and in the establishment of an economy with trade/GDP ratio surpassing 75% and processing trade accounting for more than 60% of total trade. As a result, after the de-peg in July 2005, rather than having slowed down as feared by the government, China's trade surplus has surged dramatically. At the same time, FDI inflows are also unabated. The rapid increase in twin surpluses resulted in a further ballooning of foreign exchange reserves.

How to deal with trade surplus is a very controversial issue in China. The most popular argument against appreciation is that because of its structural nature, exchange rate policy is not useful in reducing trade surplus. The second important argument is that because of its negative impact on unemployment, there should be no appreciation or, if have to, then the pace of appreciation should be kept at a speed of 3% a year. Of course, these two arguments not only lack theoretical and empirical bases but also self-contradictory. If appreciation will have no impact on trade surplus, how it can cause unemployment and why fear of appreciation. However, the idea is still prevalent. Faced with the ever-increasing twin surpluses and the appreciation pressure, to reduce the pressure has become the single most important guiding principle for the management of capital flows. The twin surpluses and the slow pace of appreciation complicated greatly China's macroeconomic management and the management of cross-border capital flows.

### **3 Macroeconomic Stability and Management of Cross-border Capital Flows**

In 2003 when the debate on the need for RMB appreciation just started in China, the most important argument against appreciation was the possible deflationary effect of appreciation on the economy, which just bottom out from a long-drawn deflation of 6 years. However, as early as in 2004 signs of overheating have surfaced, and in 2007 it has become very clear that the Chinese economy is entering a delicate stage of overheating.

#### **3-1 The Signs of Overheating**

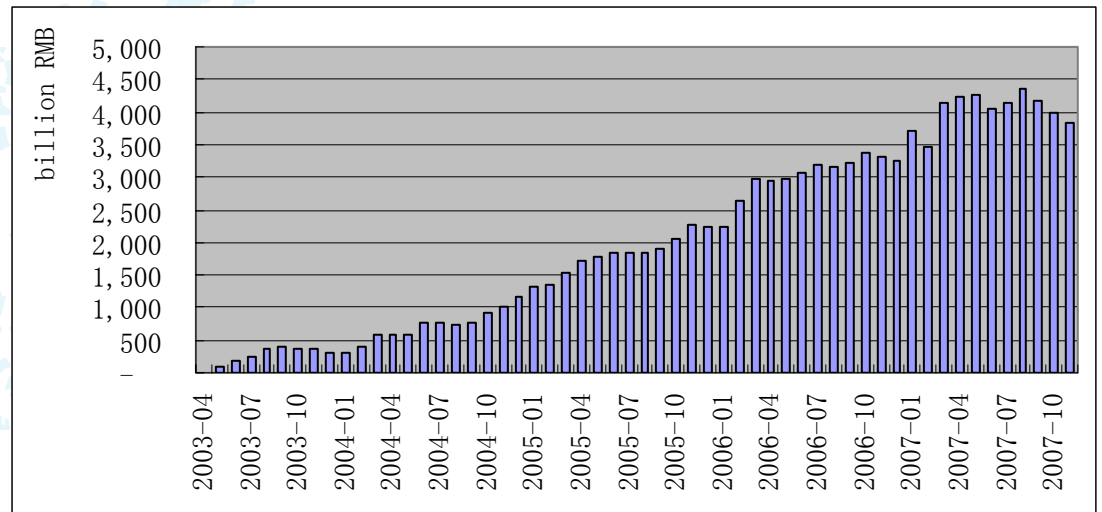
Current overheating is reflected in following important indicators:

- a very high annual growth rate of 11.5% vis-à-vis the commonly accepted potential growth rate of 9%
- an annualized inflation of 6.7% in November
- soaring price of equity index
- persistent high growth rate of housing prices
- high annual growth rate of investment of more than 20% in nominal terms and a high investment rate of more than 45% of GDP

There is no doubt whatsoever that the priority of China's macroeconomic policy should be the control of inflation. The main cause of overheating is attributable to "excess liquidity". Over the past several years, the main source of liquidity came from the PBOC's intervention in the foreign exchange market aimed at controlling the pace of the RMB revaluation in the face of increasingly large current account and capital account surpluses. To maintain the price stability and contain asset bubbles, the PBOC has carried out large-scale sterilization operation to mop-up the excessive liquidity. The first and foremost instrument

for the sterilization is the issuance of central bank bills (CBB) (Figure 4) .There is no net issuance figures available. Our calculation shows the balance of the CBBs has been increasing steadily, but in the third quarter of 2007 the balance decreased. At this moment we still do not know why it was the case. Taking into consideration commercial banks' total assets of 50.6 trillion RMB, the share of low yield CBBs in the total bank assets is just below 10%.

**Figure 4 Central bank bills balance in China**



Sources: [www.chinabond.com.cn](http://www.chinabond.com.cn).

Notes: Our assumption is that the balance of central bank notes is zero at the end of 2002. The highest balance till now is 4.3 trillion RMB in August 2007.

Another important policy of sterilization is reserve requirements. Since September 2003, the PBOC has increased the reserve requirements for 15 times. The reserve requirements have increased from 7% in 2003 to 14.5% at the end of 2007 (table 2).

**Table 2 Reserve requirements**

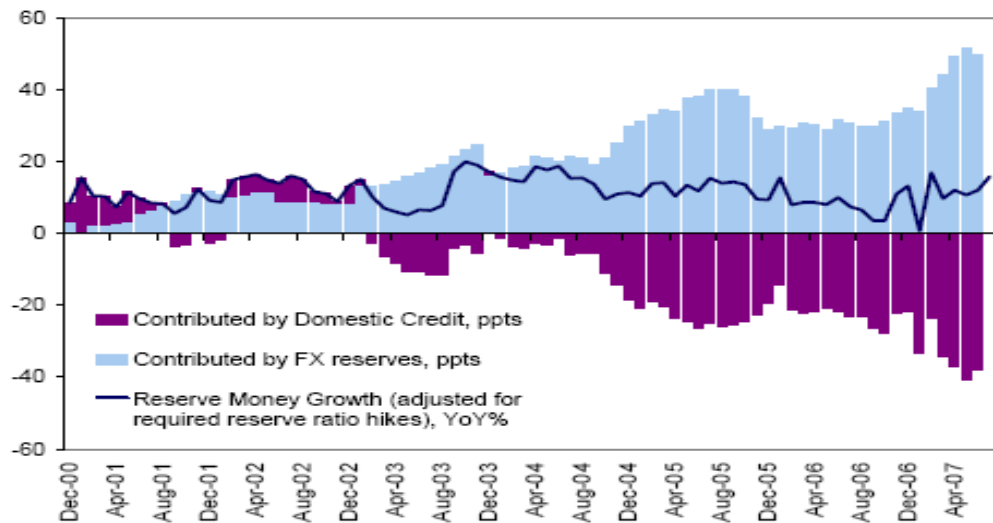
time	adjustment
2003(09/21)	7%

2004 (04/21)	7.5%
2006 (07/05)	8%
2006 (08/15)	8.5%
2006 (11/15)	9%
2007 (01/15)	9.5%
2007 (02/25)	10%
2007 (04/16)	10.5%
2007 (05/15)	11%
2007 (06/05)	11.5%
2007(08/15)	12%
2007(09/25)	12.5%
2007 (10/15)	13%
2007(11/26)	13.5%
2007(12/25)	14.5%

As a result of selling CBBs and raising reserve requirements, the share of low yield assets already accounts for more than 20% of banks' total assets. Although the sterilization policy has created serious problems for commercial banks, which have to buy an ever larger amount of low yield central bank bills and deposit an increasingly higher proportion of their cash with the central bank, sterilization operations are largely successful in mopping-up excessive liquidity. According to

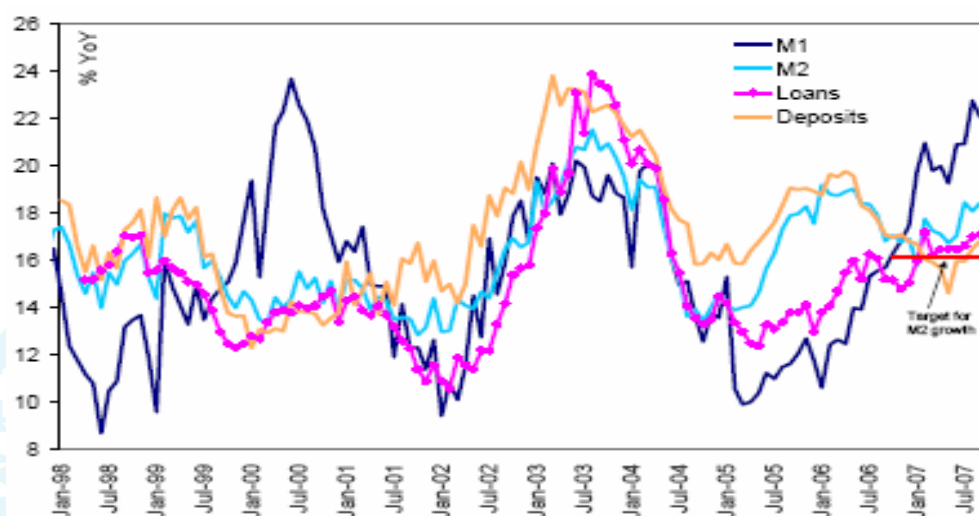
the PBOC resources, as of October 2007, high-powered money created by PBOC intervention is 11 trillion RMB. By selling central bank bills (CBBs) of 5 trillion RMB and raising reserve requirements by 3 trillion RMB, a total amount of 8 trillion was sterilized. The rest of 3 trillion spread over 5 years was just enough for the need to support the growth of broad money. In other words, the growth of monetary base has been more or less in line with historical experience (Figure 5). Because China's nominal economic growth rate was more than 16-17%, and the growth rate of M2 was 17-18%, the growth rate of broad money M2 (Figure 6) was neither widely off the mark, although with benefit of hindsight the growth rate should be lower.

**Figure 5 Growth of the monetary base**



Source: Wang Qing, Morgan Stanley.

Figure 6 Growth rates of monetary aggregates



Source: Wang Qing, Morgan Stanley.

Despite the relative success of sterilization, China's financial system is still flooded with excess liquidity. Otherwise, asset prices would not soar and inflation should be tamed. Then where the excess liquidity comes from? The answer lies in the fact that excess liquidity is not only a money supply issue, but also a money demand one. Under special circumstances, demand for money can be the driving force behind excess liquidity. Financial innovation can also introduce new liquidity into the banking system by influencing the demand for money. New products can provide investors with higher returns at low risk. Potential investors in such instruments will change their demand for money, and be more willing to convert cash into assets such as mortgage backed securities. Greedy, ignorance and "irrational exuberance" can also create excess liquidity by enticing the public to exchange their money for risky financial assets. Hence, when money supply remains constant, excess liquidity comes in the form of lower demand for money. Since Q4, 2006, market exuberance has encouraged a greater fall in money demand and a flight from bank deposits to stock exchanges. China's M2 to GDP ratio stands at 160%, the highest in the world. According to monetary theory, if M2

growth is consistently greater than GDP, inflation should rise sharply. In the past this has not materialized because of China's savings rate, but saving deposits itself is a caged tiger in periods during which the public left no choice by to park their money as saving deposits with banks.

Now the past excess money supply has come back to haunt the economy and the tiger is out roaring. The lack of demand for money is the key challenge presented to policymakers. There are two fundamental reasons behind the drastic decline in the demand for money. First, predilection to hold household savings deposits has been weakening. Developments in capital markets have given normal savers the opportunity to diversify their assets. Stocks, bonds and fixed assets are now within the reach of many. Reforms in the stock market in the period of 2004-2006 along with foreign inflows played an important role in igniting the rise of stock price. Regardless of its provenance, the realization that higher returns can be obtained through the stock market encourages households to shift their deposit away from banks into stock exchanges. The increase in share prices in turn encourages further flight and asset price inflation, ultimately creating a vicious cycle. Second, even if citizens' preference for savings deposits has not changed, interest rate gains are being outpaced by price increases, hurting intentions to save in the form of savings deposits.

### **3-2 Interest Rate Hikes and Capital inflows**

To mop-up excess liquidity, the PBOC needs to encourage households to hold their money stocks as well as to slow the growth rate of money supply. There are only two feasible methods: hiking interest rates or lowering inflation. Naturally, hiking rates is another way to control inflation so this will be the key policy instrument in the near future. Balancing returns in different asset classes is the only way to strengthen demand for money, easing the effects of disintermediation. However, the PBOC is inhibited by its lack of freedom in setting rates. It is fear that higher rates increase the chances of greater capital

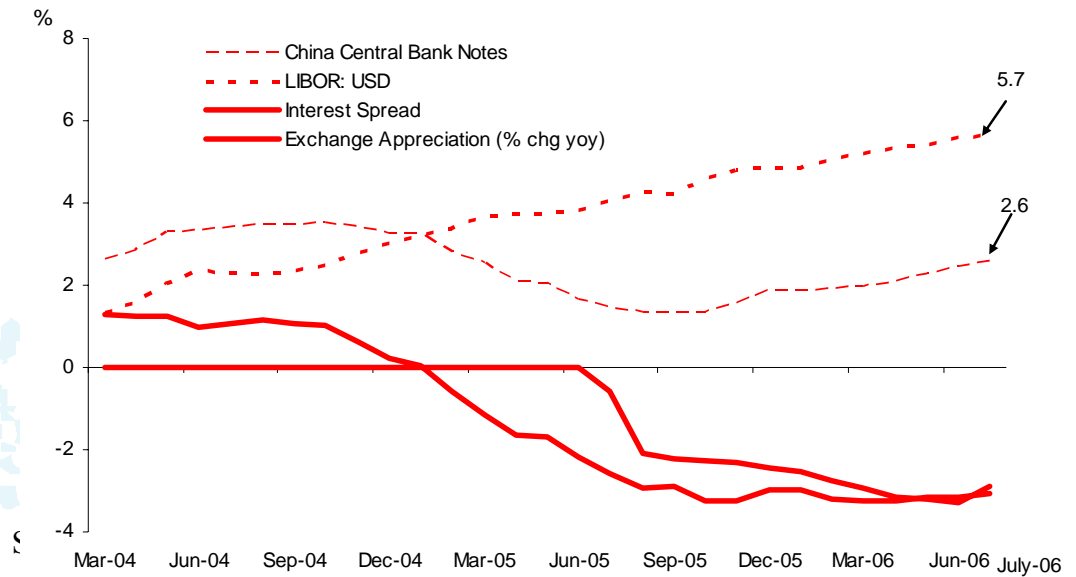
inflows and bring in new liquidity from the supply side. As such, the central bank will be forced to step up sterilization. This is a classic “Mundell Impossible Trinity” problem. What sets the current situation apart from the classical Trinity problem is China’s fall in demand for money. Therefore, the PBOC must fight in two fronts: hiking interest rates to stabilize the demand for money and using open market operations to sterilize inflows and hiking the required reserve ratio to mop-up excess liquidity created by “impossible trinity”. However, fundamentally, without capital controls, this policy is ineffective because higher interest rates will only attract more inflows to neutralize the effect of interest rate hike. The logical solution is to strengthen capital controls or allow the RMB to be determined by the market.

But how high interest rates can be raised, when significant increases are necessary for encourage the public to hold more money (household savings deposits)? The main concern of the PBOC has been carry trade. Interest rate policy since 2005 has been carried out under the shadow of carry trade. The Chinese government’s intention was to allow RMB to appreciate at an annual rate of 3%, so that enterprises could have enough time to make adjustment. To realize this goal, the government encouraged the formation of appreciation expectations of 3% in markets by repeatedly rejecting any suggestions of faster appreciation. Given US interest rate, the PBOC tried hard to adjust Chinese interest rate so as to maintain a 3% spread vis-à-vis LIBOR USD (Figure 7). As McKinnon noticed, “Investors in renminbi assets were willing to accept a lower return because they expected the renminbi to appreciate a little over 3%. This interest differential of 3% or so will continue as long as investors project that the renminbi will continue to appreciate by that amount”<sup>9</sup>

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<sup>9</sup> Ronald McKinnon: Why China Should Keep its Exchange Rate Pegged to the Dollar: A Historical Perspective from Japan, October, 2006, p9.

**Figure 7. Interest rate spread and appreciation expectations**



However, experience in the past several years seems to show that the significance of the interest rate differential for capital inflows into China is not that important. There are ample reasons to believe that those bringing in funds are looking for more than 1.5-2.5% (expected appreciation minus interest spread). One would most likely be interested in getting hold of an asset which added another 10-20% a year to his return. In other words, Uncovered Interest Parity (UIP) does not necessary apply in China. This is because the fact that cross-border capital movements are not free, capital markets are not efficient in China, and there is home bias for foreign investors. Hence China may not need to worry too much about carry trade at this moment, when deciding whether interest rates should be raised. In fact, currently, the PBOC is raising the reference interest rates<sup>10</sup> on commercial bank loans and household savings deposits, despite the fact that the interest rate spreads between China and the US have been narrowing in recent months. However, if the interest rate spreads between Chinese assets and American assets will narrow further, which is very likely in 2008, carry-trade is likely to become more active and other forms of

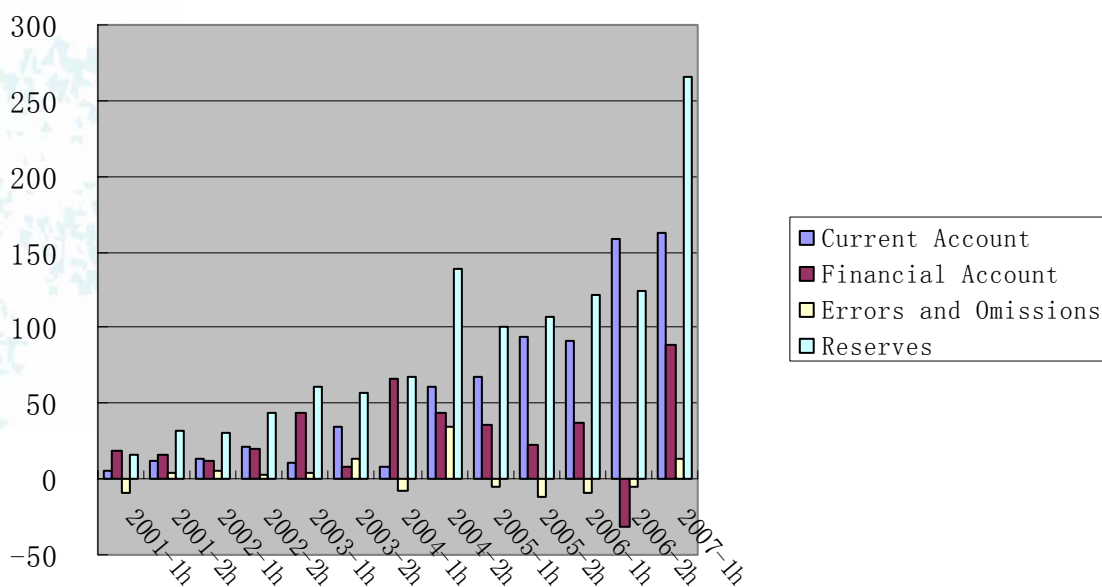
<sup>10</sup> Commercial banks are allowed to have certain leeway in deciding the rates around the reference rates.

capital inflows as well. As a result, the freedom for the PBOC to raise interest rates will be increasingly constrained. To maintain the independence of monetary policy, there are two alternatives: to allow the exchange rate to float more freely or to strengthen the control over cross-border capital flows. It seems that the Chinese government in no mood to allow the RMB to appreciate significantly in a one-off fashion. Then the Chinese government must strengthen capital controls to prevent excess capital inflows. To achieve this objective, we must first know how unwanted capitals have flown cross-border into China. Then we also must answer the question of whether capital control is effective. If capital control is ineffective, then we really do not need to bother how to strengthen the control.

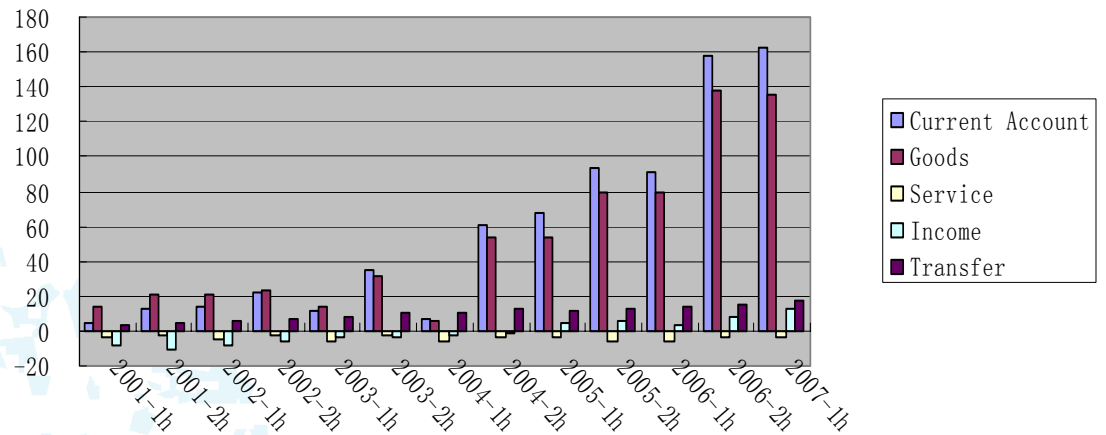
### 3-3 Cross-border capital flows in recent years

Now let us first examine what actually has happened to capital flows into and out of China in recent years (Figures 8, 9 and 10).

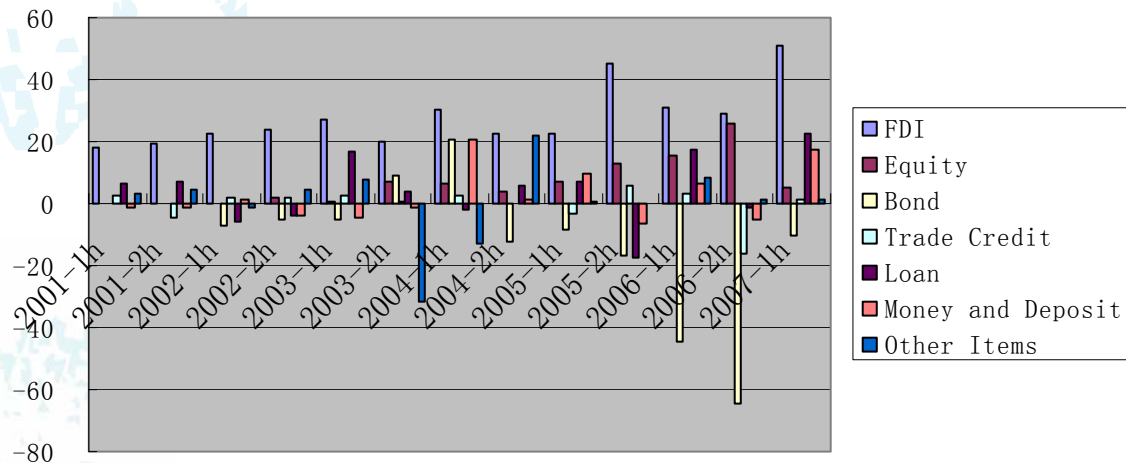
**Figure 8 China's balance of payments since 2001**



**Figure 9 China's Current Account**



**Figure 10 China's financial account**



Based on the above three figures, three observations can be drawn. First, FDI inflows have been relative stable (Figure 10). Second, trade balance has been increased dramatically since 2005 (Figure 9). Third, there are large variations in capital account and many items in the capital account (Figures 8, 9 and 10). These variations should be explained. The question of how and where unwanted capitals have flown in needs to be examined more carefully.

Table 3 is a summary of the most important forms of evading capital controls of the government. The table was drawn some ten years ago when the Asian Financial Crisis was still unfolding. In recent years, the direction of flows of unwanted money has changed, but the ways of evading capital controls are more or less the same. Anecdotal evidences show that the most common practice for unwanted capitals (not necessary hot money) to slip in via in trade account is over-invoice. But how much is the exact amount of unwanted capital inflows that disguised as export revenues is anybody's guess. The former head of National Administration of Statistics claimed that about one third of trade surplus in 2006 was hot money. I think the true amount of hot money of this sort should be much smaller. Among the export revenues there must be a certain proportion attributable to enterprises' efforts to minimize the possible losses caused by RMB appreciation, which cannot be called hot money. Due to China's relatively effective regulations, trade account is a costly route for hot money to get into China.

**Table 3. The major forms of capital control evading**

<b>Inflow</b>	<b>FDI</b>	Fixed high return without participating in management
		Selling the rights of using infrastructure and fixed assets
	<b>International borrowing</b>	Borrowing without government approval
		Borrowing with high interest rates
		Using domestic collateral to borrow by foreign ventures or joint ventures
		Forging documents to disguise borrowing as export earning so as to get tax rebate
<b>Trade Credit</b>	Forging import documents to get trade credit though T/T and L/C	
<b>Equity Investment</b>	Using residents as agents to buy shares prohibitive to nonresidents	
<b>Outflow</b>	Early remittances of profits by foreign ventures	
	Unauthorized investment abroad by Chinese enterprises	
	Moving debt repayments forward in time by Chinese borrowers	
	Delaying the remittance of dividends and profits by Chinese foreign investors	
	Delaying the repatriation of export earnings	
	Capital flight under the disguise of payment for patents, commissions, travel expense, transportation insurance	
	Invoicing imports with higher than actual value and remitting the difference abroad	
	Multinational transfer price	
	Forging documents to obtain foreign exchanges to pay for faked imported intangible assets	
	Forging documents to obtain foreign exchanges as advances for faked imports	

Source: Zhao Linghua: An Analysis of the forms of Irregular Capital Flows in China, *International Economic Review*, No.3-4, 1999.

Investment incomes have the potential to become another important channel for capital flows. Since 2005, China's investment account has changed from negative to positive. This is an important new phenomenon (Figure 8). According to SAFE officials, the change from negative to positive should be attributed to the accumulation of foreign exchange reserves. SAFE's investment revenues have increased significantly, due to the significant increase in foreign exchange reserves. Probably, it is the case. Field studies also show that some enterprises are using this channel to do bet on RMB exchange rate appreciation. Another important change is the increase in transfer account. Surveys show that transfer account have been used by overseas Chinese to channel unwanted money cross-border into China to buy assets. However, the precise amount of these inflows is unknown.

The figure 10 shows some important changes in China's capital account in recent years. First, equity investment increased significantly in 2006, especially in the second half of 2006, which coincided with the formation and development of China's equity market. This flow subsided in the first quarter of 2007, because most foreign investment considered that China's equity prices were already too high and hence unwinded their long position. Second, foreign loans and trade credits have increased significantly since 2003 (table 4). It is difficult to understand why there was such a surge while China has more than enough domestic savings. One possible reason is that due to RMB exchange rate appreciation expectations, short-term borrowings are serving the purposes of locking in of exchange rate risks for enterprises and arbitraging for speculators. The PBOC was worried about the sudden increase in the increase and measures were taken to tighten the control of the short-term borrowing. Third, the large increase in the purchasing of foreign bonds in 2006 may be related to the measures taken by the PBOC to encourage outflows of funds. The

negative sign of other items in 2004 may related to the PBOC's capital injection to the commercial banks, which were not allowed to convert their newly required foreign exchanges into RMB. They had to keep these foreign exchanges in overseas accounts. Commercial banks were requested to do currency swaps. The increase in the inflows of money and deposits account may be related to the unwinding previous positions.

**Table 4 China's debts in recent years**

	Gross External Debt		Short-term External Debt			Trade credits		
	Balance	Growth	Balance	Growth	Share	Balance	Ratio to ST debt	Ratio to gross debt
2001	1848	_*	653	_*	35.3%	363	55.6%	19.6%
2002	1863	0.8%	708	8.4%	38%	413	58.3%	22.2%
2003	2088	12.1%	922	30.2%	44.2%	517	56.1%	24.8%
2004	2475	18.5%	1232	33.7%	49.8%	654	53.1%	26.4%
2005	2811	13.6%	1561	26.7%	55.6%	908	58.2%	32.3%
2006	3230	14.9%	1836	17.6%	56.9%	1040	56.6%	32.2%
2007Jun	3278	10.0%	1849	11.2%	56.4%	1111	60.1%	33.9%

Source: Zha, SAFE, Oct. 2007.

According to Stone and McCarthy report, large proportion unexplained capital flows, which were not recorded as FDI and trade surplus, but contributed to the changes in Foreign exchange reserves, were related to unwinding currency swaps, IPO repatriations, options with Central Huijin, and speculative inflows to China's foreign exchange reserves. It concludes that "speculative capital was not a major contributor to capital outflows in the latter half of 2006, and hot money has likely continued to flow into China throughout the past three quarters (Q1-Q3 in 2007). According to it, a large portion of Q1 and Q2 foreign

exchange reserves remain unexplained by the trade surplus, foreign direct investment, interest income, unwinding swap, IPO repatriations, and the exercise of options with Central Hijing. Hence, speculative capital betting on the rise in China's currency, or property and equity markets seems likely suspect. There are no reliable statistics available. However, my sense is that the main driver of the unexplained portion of foreign exchange reserve growth in the first half of 2007 still should be attributed mainly to the unwinding of previous positions by commercial banks, which had conducted operations to reduce RMB exchange rate appreciation in 2006 when policy-led capital outflows were large.

### **3-4 The effectiveness of capital controls in China**

The most commonly used criteria for examining the effectiveness of capital controls is to compare covered interest rate differentials between different countries. It is assumed that if China's capital controls are effective, the covered interest rate differentials between China and Euro-zone or between China and the US should be significant. In fact, the differentials of lending rates, say, between China and the US are significant indeed. Furthermore, the Chinese monetary authorities have been succeeded in maintaining significantly different benchmark interest rate vis-à-vis the Fed funds rate.

It seems that empirical evidences have verified the effectiveness of China's capital controls, because China can maintain both a significantly higher or lower interest rate than that of the US. However, due to the fact that there is still lack of well-functioned money and capital markets in China. Interest rate spread is not that a meaningful measurement of the effectiveness of capital controls.

A more meaningful measurement is the magnitude of errors and omissions in China's international balance of payments and the inconsistency between items of China's international balance of payments and their foreign counterparts. The

clearest indication of the ineffectiveness of China's capital controls was reflected in the fact that in 1998, while China's current and capital accounts had surplus of several hundred billion USD, China's official foreign exchange reserves increased by only some 6 billion USD. Where has the missing money gone? It was estimated that 20-40 billion USD has left the country. According to a study made by the State Administration of Foreign Exchanges, from 1997 to 1999, the magnitude of capital flight amounted to 48.3 to 58.8 USD. According to other studies, the amount could be much higher.

The author must confess that there are few solid research results that can either verify or falsify the proposition that capital controls in China is effective. My intuition based on experience is that capital controls in China still work and have played important roles, even decisive roles in the maintenance of financial stability. Without capital controls the Chinese economy would have fallen during the Asian financial crisis. Without capital controls, the Chinese economy might be falling in certain point of time in the future. In other words, despite all leaks and loopholes, capital controls have contributed to China's financial stability by adding the transaction cost for destabilizing capital flows. Until recently, official short-term capital flows, especially those speculation-oriented short-term capital flows, are relatively small and have no way to affect the exchange rate in foreign exchange market significantly. The Chinese monetary authorities still enjoy comfortable room in deciding monetary policy without having to pay too much attention to what Bernanke says.

However, on the other hand, the controls are not that effective either. More importantly, the cost to make capital controls effective has become increasingly high. The increased cost for capital controls is reflected mainly in the following aspects. Firstly, some legitimate transactions are obstructed (American Chamber of Commerce filed complains during and after the Asian financial crisis). Secondly, due to the fact that China has liberalized its current account and has

become the third largest trading nation in the world, it becomes increasingly difficult to block illegal capital movements that are disguised as legitimate current account transactions. In some cases, the distinction between current account and capital account transactions per se is obfuscated to say the least. Thirdly, as a member of the WTO, China has committed to open its financial service sector. It will be impossible for the Chinese monetary authorities to supervise foreign financial institutions' internal allocation of funds, which may involve cross-border capital movements. This is also true of multinationals' internal transactions. Fourthly, due to the development of China's economic reform and IT revolution, institutional and technological innovations in China have been burgeoning rapidly in response to any newly introduced measures of capital controls and more often than not these innovations outwit the latter easily. Finally, as a result of the increase in China's economic size, and the scale of capital flows, the welfare losses due to market distortion that in turn is created by capital controls are increasing. Costs to correct the distortion are increasing correspondingly. Capital controls create rent-seeking opportunities. Under a worsening moral environment, corruption tempted by the abundant rent-seeking opportunities has become more prevalent, with ominous political implications to the country.

In short, as a result of trade liberalization, globalization, progress in financial techniques, IT revolution and so on, the maintenance of capital controls become increasingly difficult and the cost for the maintenance of such controls has become increasingly expensive. Eventually, the cost of capital controls will outweigh their benefit and force the government to give up capital controls. However, capital controls increase the transaction cost of capital flight and slow the speed of cross border flows of capital. At the expense of efficiency, China's capital controls were and still are the key for preventing a currency crisis caused by a sudden change of direction in cross-borders capital flows from happening.

## 4 China's Capital Account Liberalization in the Near Future

The maintenance of price stability should always be the priority of the central banks. Under normal market conditions, prices act as a signaling mechanism for resource allocation. Sharp rises in prices tend to erode this ability, causing economic agents to misinterpret market supply and demand. Another concern for the country is that high levels of inflation tend to be followed by a rise in the Gini coefficient and further undermine the fight against inequality. Those hurt the most by inflation are low income groups. Rise in staple food prices are pernicious to those struggling on low wages or social security. This population does not possess fixed assets as a form of wealth preservation. Even if they are forced into the stock market as a way of maintaining the value of their savings, the burden of risk is immense. A widening wealth gap caused by inflation poses threats to social stability. Controlling inflation is not just for the sake of economic stability, but as Keynes once noted, also a matter of social justice.

We have tried countless methods to avoid CNY appreciation: bloc purchases in the US, cutting export tax rebates, encouraging domestic enterprises to invest overseas, opening up the financial services industry, easing capital controls etc. The measures above are all necessary and have significant side-effects as well. Some are even dangerous. Take increasing capital outflows for example. Since 2003 the PBoC's policy has been "easy out, difficult in". The problem is under perfectly rational expectations of CNY appreciation, such policies are ineffective. The unattractiveness of QDII is clear evidence of lack of demand for outflows. Using easier capital controls to solve the Mundell Trinity, without making exchange rate regime more flexible first is putting the cart before the horse. Capital controls is China's last line of defense and cannot be eased until China's financial reforms are complete. Growth is cyclical and sudden change in China's situation could prompt massive capital flight. If there are no restrictions to ease the blow at that point, the effects on China's economy will

be disastrous. Capital account liberalization should be treated as a segment of China's structural reform and not a stop-gap measure to solve China's short-term imbalances.

Despite its extremely good economic performance in terms of growth rate and inflation, China has been confronted with increasingly serious structural problems. First, China's environment has been deteriorating. Second, its energy consumption has been soaring. Third, the gap of income distribution in China has been widening. Last but not least, China's current account imbalance has been worsening. Decision makers have realized that China cannot carry on with its old growth strategy characterized by Investment and export-driven, no matter how successful it was.

However, the adjustment of growth strategy aimed at achieving a more balanced growth pattern cannot be completed in a short period of time. Personally, I think it at least will take 5 years. Because the twin surpluses and other imbalances will persist for quite long time and the government has set to achieve the three contradictory objectives simultaneously, China's financial stability is likely to be compromised somewhat during the period of adjustment. Although it is entirely possible that China will muddle through again this time, it definitely will not be plain sailing. The Chinese government has to be extremely careful about excessive liquidity- led asset bubbles and/or inflation. If China succeeds in maintaining the financial stability for another five years, the Chinese economy may eventually enter into a sustainable growth path.

The Chinese government does not wish to allow the RMB to appreciate rapidly and hence the process of appreciation of the RMB may last for many years. During this period of time, cross-border capital will continue to flow in to push up the RMB exchange rate and flood the economy with liquidity. Under this circumstance, the last defense line left for the government in its effort for

preventing a balance of payment crisis and currency crisis is to improve the management of capital flows so as to reduce speculative capital inflows and encourage orderly capital outflows, especially in the outflows in the form of outbound FDI.

I have strong reservation on China's policy of "yanjin kuanchu" ("easy in, strict out"). Stricter control over capital inflows is correct. However, loosening control over capital outflows will not be very helpful for relieving the pressure on the RMB exchange rate. On the contrary, in my view, loosening control over capital outflows will encourage rather than discourage capital inflows, especially, speculative capital inflows. If it is so easy to run away in case, which means lowering the risk premium, why not come and have a go first. Temptation for buying Chinese assets is too great to resist. First, China's real estates and financial assets are cheap in terms of foreign currencies. Even without RMB appreciation, they are worth to buy.<sup>11</sup> Second, the RMB is expected to appreciate by at least 25 percent in years to come by international investors. Third, the potential for the prices of Chinese assets to rise is great. For example, until in later 2005, China's share price was less than 1300 points and now it has broken the threshold of 3000 points. Though the share price is not longer cheap now, the potential for China's other financial and real assets to rise is still great. Fourth, Chinese interest rates are higher than corresponding international interest rates, especially higher than those of Japanese interest rates. Why not carry trade? Fifth, the Chinese government's repeated injections of capital into troubled commercial banks makes foreign as well as domestic investors believe that the Chinese assets are not risky at all because of the implicit guarantees by the government. Sixth, China's huge foreign exchange reserves are the ultimate collaterals for all foreign investment. What can be more assuring? Under this circumstance, probably, only two kinds of capital

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<sup>11</sup> Due to the relative cheap prices as well as RMB appreciation expectations, Hong Kong residents' investment in Mainland's real estates totaled 15 billion Yuan, an increase by 11 percent over 2005., Lianhe Zao Bao, Singapore, February 20 2007, p 19.

will be eager to utilize opportunities provided by the “loosening control over capital outflows” to flow out of China: the unwinding speculative capital and money needs to be bled. Legitimate outbound investment and remittance of investment incomes have already had channels to move out the borders without undue difficulties. However, even this legitimate outbound investment should be carefully monitored and supervised. China should not repeat Japan’s painful experience since Plaza accord. Without careful monitoring and supervising, the results of the disorder outflows of Chinese capital will fare much worse than the Japanese who went on buying spree two decades ago. Prasad pointed out that, “many of the emerging markets with closed capital accounts have underlying fragilities like a huge fiscal deficit, a banking sector with significant nonperforming loans, or an opaque corporate or financial sector, which make full capital account convertibility risk”. On top of the usual problems with developing countries’ capital outflows, China is a country without clearly defined property rights. A great portion of public assets has been stolen quietly by the so-called stealth privatization. To channel the stolen money to Virgin Island and/or Carmen Island is the best ending for the thievery. For some state-owned enterprises, managers can be very careless about whether other people’s money will be down the drain, because of lack appropriate incentive mechanisms and low morality. In short, before further institutional reform has accomplished, and right corporate governance is put in place, to encourage capital outflows for the purpose of relieving the pressure on RMB appreciation is indeed “put cart before horse”.

To allow residents of mainland to invest on H shares in Hong Kong stock exchange without constraints is a dangerous idea. On top of the fact that this is a further transfer of wealth from mainland to Hong Kong and the rest of the world at the expense of mainland, the outflows of capital means exporting asset bubbles from mainland to Hong Kong and may cause a crash first in the A share market and then in Hong Kong. It is hard to understand why we have to take so

many risks and go such a lengthy way to reduce appreciation pressure on RENMINBI, rather than to give RENMINBI exchange rate more leeway.

Some in China argue that capital control is ineffective anyway and hence why bother? I agree that China's capital control is extremely leaky. However, it is not right to underestimate the effectiveness of capital control all together, when the authorities are determined to make it effective. At least, the government can do something to increase the transaction cost to the illegitimate cross-border capital flows. Though Thai government was criticized universally for its bungled efforts in managing capital flows, the episode shows that how to manage capital flows again has become the priority of macroeconomic policy. Thai monetary authorities' recent actions aimed at stopping speculative capital inflows are understandable, though mistakes have been made in terms of tactics and technicalities. The Thai experience shows that after the fire wall has been torn down, it is extremely difficult to be re-erected. Efforts in restoring some control over capital movement will cause strong reactions by foreign investors. The reactions can be so strong that the government would give up the attempt to reintroduce some forms of capital control. Therefore, China should not be in a hurry to dismantle capital control. Rather it should improve its management of capital flows.

China's household saving deposits amount to 17 trillion Yuan (= \$ 2.3 trillion) and account for 85 percent of GDP in 2006. We cannot rule out the possibility that Chinese households suddenly decided that they should hold certain proportion, say, 20 percent of their savings in the form of foreign assets. If it is the case, the total amount capital outflows will amount to \$ 400 billion. Furthermore, China's FDI stock must be greater than \$500 billion and the corresponding investment income outflows can be as high as \$50 billion--\$100 billion. Finally, China's balance of foreign borrowing is \$305 billion, among which short-term borrowing is \$169 billion. If capital flows reverse, due to

failure in macroeconomic management. The total amount of capital outflow in a short span can be as high as half trillion US dollars. If it happens, the consequences will be very grave indeed. Therefore, in my view, if China will make a fatal mistake in the next 5 years, the mistake will be the premature abandon of capital control aimed at reducing RMB appreciation pressure, before it has completed its economic reform.

## **5 Concluding Remarks**

China is faced with three colossal tasks in the area of open macroeconomic reform: reform of exchange rate regime, capital movement liberalization and financial system reform. China is making preparations for a transfer from a de facto exchange rate regime to the managed floating in its true sense. China has gone a long way in capital account liberalization and financial system reform. China should speed up the process of financial reform. However, it will be a long-term process and the completion of reform cannot be expected for many years to come. A complete liberalization of capital account will be dangerous, if the fragility of the financial system has not been removed. China needs to adjust its growth strategy to make its growth more efficient and sustainable. To achieve this objective, a well-functioned foreign exchange market should be established so that exchange rates can be determined on the basis of the fundamental internal and external equilibrium. To facilitate the regime change, partial capital account liberalization, namely, the liberalization of some items of capital account is necessary. In short, the liberalization of capital account and changes in exchange rate regime should go in tandem. All in all, China has entered a new stage of growth; and it has to adjust its growth strategy to make growth sustainable. Current reform of the mechanisms of exchange rate determination and a gradual revaluation of the RMB exchange rate will provide extra impetus to China's overall economic reform and adjustment.

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