Capital account management and its outlook in China

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1. Current status of capital account management in China

Since the introduction of the reform and opening-up policy, China has made eye-catching progress in developing its economy, including great advancements in transforming its foreign exchange control regime into a market-oriented arrangement. In 1994, substantial reform measures were introduced to restructure China's foreign exchange control system, which resulted in the establishment of the system of "purchasing and surrendering foreign exchange through designated banks", the nationwide foreign exchange interbank market, the unification of dual exchange rates and the managed floating exchange rate regime. In December 1996, China made its currency, the renminbi (RMB), convertible for current account transactions, removing both quantitative and regulatory restrictions on the use of foreign exchange for current account transactions.

Despite the fact that China continues to maintain a certain control over transactions and currency exchanges on the capital account, including restrictions applied to cross-border capital flows as well as quantitative and regulatory controls on exchange between the RMB and foreign currencies, a limited and selective liberalisation has been pioneered in capital account management since 1979, when the reform policy was first adopted. In terms of transaction items, current restrictions on the capital account are mainly reflected in the following three aspects:

1.1 Restrictions on access by foreign investors to domestic financial markets and by Chinese investors to foreign financial markets

In opening the securities market to foreign investors, the Chinese government is pursuing a strategy of "fragmenting the market with separate investors", which means foreign investors are only allowed to buy foreign currency denominated shares and debt instruments in either the domestic or the overseas market, including B shares onshore, as well as H shares and Red Chips offshore, and overseas foreign currency bonds, but not RMB-denominated A shares, bonds or other money market instruments. Meanwhile, Chinese residents are largely prohibited from buying, selling or issuing capital or money market instruments in the overseas market.

1.2 Restrictions on external borrowing

While foreign-funded enterprises are free from any restrictions on raising short- or long-term debts in the overseas market, other domestic entities need to obtain the required qualifications as the main borrowers and to have the proposed borrowing amount certified by the relevant authorities, with the terms of the borrowing reviewed and approved by the SAFE. In addition, domestic financial institutions can only issue external loans in line with certain provisions set in the rules on foreign exchange liability/asset ratio management upon prior approval by the relevant authorities while domestic non-financial enterprises are strictly prohibited from extending any external loans.

1.3 Restrictions on direct investment

For foreign investors, no restrictions are imposed on their direct investment in China except that they are required to follow the industrial policy guidance given by the Chinese government. However, outward direct investment by domestic entities needs to be approved by the relevant government departments; the necessary foreign exchange sources and the associated risks of such outward direct investment need to be assessed and verified by the SAFE.

Government restrictions on the capital account in China mainly involve the following two forms of management:

- Controls imposed on cross-border capital transactions by relevant government departments such as the State Development and Planning Commission (SDPC), The People's Bank of China (PBC), the China Securities Regulatory Commission (CSRC) and the Ministry of Foreign Trade and Economic Cooperation (MOFTEC). For example, if a financial institution intends to borrow from overseas markets, its qualification as the main borrower has to be approved by its regulatory authority, the PBC, with the borrowing amount to be allocated by the SDPC.
- Controls imposed on certain phases of foreign exchange transactions related to cross-border capital transactions by the SAFE, including restrictions on cross-border fund remittance and repatriation and RMB/foreign currency exchange related to capital account transactions. For example, the SAFE requires all foreign exchange proceeds from capital account transactions overseas to be repatriated to China on a timely basis.

In sum, China's control over the capital account is a direct restriction based mainly on administrative approval and quantitative limitation. However, different entities and capital account transactions are subjected to different degrees of control. For example, fewer restrictions are imposed on foreign-funded enterprises and domestic financial institutions, but more on domestic enterprises, especially non-financial institutions.

As a matter of fact, China has been largely benefiting from economic and financial globalisation thanks to its cautious approach to capital account liberalisation. Since reform and the opening-up to the outside world, foreign investment in China has become increasingly diversified, with China's level of actually utilised foreign investment ranking among the top levels in the world and first among developing countries. By the end of 2001, China had altogether licensed 390,484 foreign-funded enterprises, with total direct investment amounting to USD 395.47 billion. The cumulative drawdown of external debts has reached USD 409.16 billion. The outstanding balance of China's external debts stood at USD 170.11 billion at end-2001, and capital funds raised through overseas listing and B share issue in the domestic market topped USD 58.6 billion and USD 4.63 billion, respectively.

Foreign investment has made a significant contribution to China's economic development by meeting financing requirements, introducing into China advanced technology and management know-how from abroad, promoting a more open and market-based economy, and supporting industrial upgrading. As past experience shows, a regional economy or an industry is likely to be more advanced and competitive if it is more broadly liberalised or deregulated at an earlier stage. Economic development in China's coastal regions and the growth of its electronics industry both serve as a good example in this regard. While China is becoming more attractive to foreign investors, some Chinese enterprises have also started to explore investment opportunities in the overseas market. According to the MOFTEC statistics, by end-2001, contracted Chinese direct investment in overseas markets had reached USD 8.4 billion, involving a total of 6,610 overseas investment projects. At the same time, foreign assets maintained by Chinese financial institutions are also growing rapidly in addition to the central bank's holding of more than USD 240 billion in foreign exchange reserves.

2. The need to gradually achieve capital account convertibility

In terms of liberalising the capital account, neither the IMF nor the WTO mandates its members to have currency convertibility on the capital account, and actually the Chinese government has made no such commitments when negotiating its accession to the WTO. That said, we realise that liberalisation of the capital account and full convertibility of the RMB always stand as the ultimate goal for China's foreign exchange administration. With the deepening of economic reform and greater market opening, opening up the domestic capital market and relaxing controls on capital account transactions in a gradual and orderly way will eventually become a necessity and trend for China. Such a necessity is mainly reflected in the following five aspects:

2.1 The need to restructure the economy

The 10th five-year plan mapped out by the Chinese government has already put economic restructuring as the top priority in the coming years, when industrial and ownership structures will be improved along with a reduction of disparities across regions and between urban and rural areas. Attraction of foreign investment into China to promote capital account liberalisation could be taken as an active approach to benefit the great course of strategic restructuring of the Chinese economy. Considering the present adequacy of financial resources in both foreign and domestic currency, utilisation of foreign capital to a great extent serves to introduce into China advanced technology, skilful professionals and management know-how to promote economic restructuring and industrial upgrading.

2.2 The need to develop domestic financial markets

The Chinese government deems nurturing and developing the financial markets as the core of the financial reform, as the financial markets constitute an important platform for effecting financial transactions. Following years of effort, China has preliminarily put into place a financial market system commensurate with the development of its socialist market economy, which mainly consists of a money market dominated by transactions in the interbank bond, interbank lending and commercial paper markets, a nationwide foreign exchange trading market and a capital market characterised by rapid growth of stock trading. However, these markets, in particular the capital market, are still in the nascent stages of development and beset with problems such as a lack of investment instruments, poor corporate governance in listed companies and irrational investment cultures. Such problems have greatly impaired the efficiency of resource allocation in the financial market and could further slow down the reform process in other fields. In such a case, opening the capital market in an appropriate way could provide a good window for China to acquire relevant and useful experience from foreign countries so as to enhance the quality of the listed companies and build a regulatory framework up to international standards to guide and supervise the healthy development of the capital market.

2.3 Improving the international competitiveness of Chinese enterprises

The Chinese government has already identified a broad multilayer strategy to open its economy up to the outside world. On the one hand, foreign investments are welcomed by China; on the other, Chinese enterprises are encouraged to go abroad and compete internationally. Liberalising the capital account appropriately is an effective way to encourage Chinese enterprises to invest overseas and strengthen cooperation with their foreign counterparts in technological and economic fields, through which a fleet of China’s own transnational companies will be gradually nurtured. To make China a real economic power in the world, we urgently need to adopt such a strategy to improve China’s overall economic strength and international competitiveness. However, the pursuit of the “go abroad” strategy would naturally pose a stern challenge to the current regime of capital account management that restricts capital outflows. In fact, there are many weaknesses in China’s capital account management with regard to both capital inflows and capital outflows, which could no longer accommodate the changed economic environment and business development of Chinese enterprises. Therefore, it has become necessary to accelerate the capital account convertibility of the RMB.

2.4 The need to reduce the cost of capital account control

First of all, ever since RMB convertibility for current account transactions was achieved in 1996, a distinction has had to be made between transactions on current and capital account so as to exercise effective control over the latter. However, certain balance of payments transactions share the characteristics of both current and capital account transactions and are thus sometimes hard to clearly distinguish between, thus leaving loopholes for some capital account transactions to escape regulatory control. Second, controls on some capital account transactions have already been lifted in China. Given the potential substitutability between different regulated and liberalised financial instruments, capital flows are more likely to move in and out through the more liberalised instruments. This will tend to create a regulatory vacuum or loopholes in capital account control and thus undermine its effectiveness. Third, international experience has proved that no capital control is completely effective if incentives or motivation for capital flight remain. Capital control can only provide a temporary shelter but not long-lasting protection for the stable development of China's economy and financial system.

2.5 Post-WTO environment

With wider opening of the market after China's accession to the WTO, service industries, including banking and insurance, are expected to grow more rapidly, which will generate substantial capital flows and intensify the pressure to further liberalise capital account transactions. In addition, more liberalised and growing trade activities are likely to increase the level of cross-border capital flows. As a result, market players such as trading companies and banks will increasingly demand the removal of restrictions on cross-border investment and capital flows.

3. Principles for pushing forward capital account convertibility

Full convertibility of the RMB is a necessary condition for China to be adequately integrated into the global economy. However, convertibility for capital account transactions has been proved by both empirical studies and country experience to be a double-edged sword for the developing countries. In general, certain preconditions must be met before a country makes its currency convertible for capital account transactions, and premature liberalisation of the capital account would produce a negative impact on economic development. Recent crises in many emerging market economies serve as examples in this regard. In pursuing capital account convertibility in China, we need to observe the following principles:

3.1 Liberalisation of capital account transactions and the related exchange control could be conducted separately

Liberalising the capital account does not necessarily mean a complete removal of exchange control. Furthermore, the IMF only requires its member countries to achieve convertibility for current account transactions, not for capital account transactions. Therefore, in practice, liberalisation of capital account transactions and the removal of the related exchange controls could be conducted in a separate and sequenced manner, which means that, taking into consideration a country's balance of payments position and economic stability, certain restrictions may remain in place on exchange transactions even after the liberalisation of some capital account transactions.

3.2 Policy stance must be clarified in the process of exercising exchange controls related to capital account transactions

Exchange controls should be flexibly implemented to reflect policy concerns in different time periods on different transaction items or the need to maintain the balance of payments. At present, appropriate action should be taken to encourage inflow of long-term capital while short-term capital inflows and capital flight need to be restricted. Moreover, attention should be paid to improving the quality, not only increasing the quantity, of capital inflows.

3.3 Capital account convertibility should go hand in hand with the following conditions:

– *Macroeconomic stability,* eg in the form of appropriate economic growth, stable price levels, a sound fiscal position and a basic balance of the current account.

– *Microeconomic fundamentals* need to be established and improved. A modern corporate system should be set up in the corporate sector to make enterprises responsible for their business operations and losses/profits, to improve corporate governance and to strengthen market transparency.

– *Sound and healthy development of the financial system*. Non-performing bank assets must be dealt with first. Financial institutions should be encouraged to learn advanced financial techniques from foreign countries with a view to improving financial services and cleaning up balance sheets. Domestic financial markets should be expanded and deepened to cultivate an efficient money market and capital market. Meanwhile, financial supervision needs to be strengthened to guide sound development of the financial system.

– *Improvement of the exchange rate and interest rate regime.* Once capital account transactions are liberalised, China's external balance will rely more on timely adjustments of the exchange rate and interest rate. To accommodate such a development, the flexibility of the RMB exchange rate should be gradually increased while at the same time interest rate liberalisation is steadily nurtured.

4. Policy considerations in pushing forward RMB capital account convertibility

4.1 China will further liberalise its financial industry and increase capital account convertibility through more active participation in economic and financial globalisation

RMB convertibility for capital account transactions has always been regarded as an important target of overall economic reform by the Chinese government, which will continue to make steady efforts to accelerate its realisation. Meanwhile, reform in other fields, including reform of the financial, trade and corporate systems, will be speeded up to accommodate the progress being made in liberalising capital account transactions.

4.2 Efforts will be intensified to attract more foreign investment to expand capital account liberalisation

In the foreseeable future, China should and will be able to attract more foreign investment. More sectors are expected to open up for foreign investors and the investment quality is also likely to be improved with enhanced management of capital inflows. Meanwhile, the involvement of foreign investors in merging with, acquiring and restructuring Chinese enterprises as well as in disposing of non-performing banking sector assets will be encouraged and standardised. Qualified institutional investors will be introduced on a pilot basis and the securities market will be liberalised to attract good-quality main issuers from foreign countries. In addition, the investment culture will be rationalised by improving the quality of the listed companies and developing the domestic capital market.

4.3 Capital account management will be enhanced through improved legal and policy transparency

The existing differences between capital account management in China and international practice are yet to be bridged. For example, China maintains different approaches to Chinese- versus foreign-funded enterprises, corporate entities versus natural persons, and state-owned versus privately owned enterprises in controlling capital account transactions, and these have to be gradually brought into line with international practice. Moreover, legal and policy transparency needs to be consistently improved through timely disclosure of relevant rules and regulations to enhance overall capital account management.

4.4 Monitoring of short-term capital flows will be strengthened

As a developing country, China should always stand vigilant against possible attacks from the more risky short-term capital flows. Precautions will be taken to carry out monitoring of cross-border capital flows on a real-time basis through the improved computer-based surveillance system and the statistical system. Meanwhile, contingent arrangements should be made available and ready to handle any abnormal developments in the capital account. Should all preventive measures be in place, the risks of balance of payments disequilibrium can be defused and managed on a timely basis.

The continuous development of China's external sector and deepening of economic reform have called for more extensive liberalisation of its capital account. China will continue to participate actively in the process of economic and financial globalisation, accelerate domestic economic reform and steadily increase RMB convertibility so as to more vigorously serve the needs of reform and economic development.