Peter Pang: Capital account liberalisation – international experience and implications for China

Opening speech by Mr Peter Pang, Deputy Chief Executive of the Hong Kong Monetary Authority, for the conference "Capital account liberalisation: international experience and implications for China", Hong Kong, 17 November 2008.

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Good morning, ladies and gentlemen.

It is my great pleasure to open this conference on "capital account liberalisation: international experience and implications for China".

This conference is taking place at a crucial time, as one of the most tumultuous periods in the financial history has put to test our ability of crisis management. Even as governments across the world keep their focus on the immediate task of stabilising financial markets and supporting economic growth, wide-ranging discussions are already under way as to what lessons can be drawn from the crisis. These discussions are likely to affect many aspects of policy thinking on how best to monitor and manage risks in the financial system in order to achieve sustained economic growth and prosperity.

The topic of this conference – the costs and benefits as well as experiences of capital account liberalisation – is likely to be one such area of intense interest, particularly from emerging markets' point of view. As financially more closed economies have been less affected so far by the global turmoil, the merit of financial liberalisation and greater opening up to the rest of the world by the emerging economies has been questioned. Indeed, this crisis has brought us to a juncture where a better understanding of capital account liberalisation – through learning from in-depth analysis and open debates – is required in order to formulate better policies in the area.

The potentially destabilising effects that capital flows could inflict on the domestic economy are widely recognised. When it rains, it pours: as noted by an NBER research, capital flows tend to be pro-cyclical.[1] Large influxes of capital could push up the value of currencies, drive up inflation and fuel asset bubbles, while affecting the competitiveness of the export sector, posing challenges to the authorities of the host country in managing domestic monetary conditions and maintaining financial stability. Capital flows can also quickly reverse, often driven by changes in market sentiment or external environment. The "sudden stops" of capital flows have, in recent decades, brought severe financial stress to emerging markets, with substantial costs to the real economy. Such volatility is perhaps one main reason why the cross-country studies on growth benefits of a more open capital account have remained largely inconclusive. The current financial crisis brings home the message that integration with the global financial market could expose a country to global financial turbulence even when its own financial sector and real economy are fundamentally sound.

Despite the recent turbulence and the spillover effects of capital flows, we should not, in my view, lose sight of the many benefits of an open capital account. Free flows of capital across borders can make the domestic financial market deeper and wider, increase liquidity, and facilitate price discovery, thus improving efficiency of resource allocation. At the same time, diversification by investing overseas can help raise investment returns for households, which would in turn help promote private consumption and support sustainable growth. For emerging markets in particular, participation of foreign financial institutions can speed up the

[1] Kaminsky, G.L., C.M. Reinhart and C.A. Vegh (2004), "When it rains, it pours: procyclical capital flows and macroeconomic policies", NBER Working Paper, 10708.

learning process and facilitate the adoption of best international practices by the financial sector. Therefore, while a more liberal regime for capital flows could at times bring about negative impacts, the relevant response should not be to keep the capital account closed forever, but to find ways of effectively managing the potential risks.

International experiences have provided some broad suggestions on how such risks could be managed. Foremost is the importance of appropriate sequencing between liberalising the capital account and other domestic reforms. Development of financial institutions and markets, enhanced macroeconomic stability, and proper risk management by banks and enterprises would help to increase the resilience of the domestic entities in dealing with volatile capital flows. In addition, prudential regulation and supervisory framework need to be established, in order to prevent excessive risk-taking by domestic financial institutions. Such framework needs to be accompanied by adequate accounting, auditing and disclosure standards, to improve market transparency and enhance supervisory effectiveness.

Turning to Mainland China's experience, the liberalisation of capital account has been selective. Inflows of foreign direct investment have long been encouraged, which has contributed significantly to China's robust economic growth. In more recent years, steps have been taken by the authorities to allow greater portfolio flows. In particular, the Qualified Foreign Institutional Investors (QFII) schemes have enabled foreign investors to access the domestic financial market, while under the Qualified Domestic Institutional Investors (QDII) schemes, financial institutions can, upon approval, invest overseas on behalf of domestic investors.

Reflecting the limited channels of outward investment and market conditions, however, capital flows have been overwhelmingly inward bound in recent years, and China has experienced a rapid accumulation of foreign exchange reserves. This had fed into pressures on the exchange rate and inflation which were only eased somewhat by the global economic slowdown in more recent months. The People's Bank of China has employed sterilisation through open market operations, reserve requirements and credit quota in order to offset the impact of capital inflows on domestic monetary conditions. Such measures, however, have incurred costs to the central bank and the banking sector. Thus it would be useful to consider ways in which outflows of capital can be liberalised in an orderly and regulated manner to alleviate the BOP pressures in the near term. From a longer term perspective, greater financial integration with the rest of the world is probably inevitable, with China now becoming the fourth largest economy and the third largest trading nation. Indeed, large financial crises in the past such as the Mexican crisis of 1994 and Asian crisis in 1997-8 have not prevented global financial integration.

An open capital account has been generally considered as an ultimate policy objective in the Mainland, as its many benefits are well recognised. However, there have been lots of debates mostly with regard to the pace of the reforms. Although the stable macroeconomic conditions, the improvement of the financial institutions' balance sheets, and the enhanced supervisory framework in recent years have increased the economy's resilience, there are vulnerabilities. Most notably, financial market development and the price discovery mechanisms are still at their early stage, and the risk management capacity of the financial institutions and the corporate sector remains limited. It is therefore understandable that Mainland policymakers would prefer a gradual, controllable process in capital account liberalisation, in order to reduce the shock on the domestic financial system from capital flows.

Hong Kong fits well into this prudent strategy. It is well positioned to help the Mainland to manage the process of liberalisation, while ensuring important reforms move forward steadily. This unique role derives from Hong Kong's proximity with the Mainland and shared culture and language, the close cooperation of the financial authorities of the two sides, and importantly, Hong Kong's status as a well-established international financial centre. I will point out two particular areas for such cooperation.

First, Hong Kong can be used as a platform for pilot schemes for further expansion of cross-border fund flows. The use of Hong Kong as a financing platform has played an important role in Mainland's economic development and a continued and expanded use should be made going forward. In addition to the well developed platform for Mainland enterprises to list on the Hong Kong's stock exchange, consideration could be given to facilitate SMEs to raise funds through bond issuance with credit enhancement in Hong Kong. At the same time, Hong Kong can serve as a platform for more investment outflows from the Mainland, which would improve investment choices for Mainland investors. For instance, financial instruments issued in Hong Kong could be allowed to be listed on the Mainland, or Mainland investors could be allowed to use their own foreign currency deposits to invest overseas through Hong Kong.

Second, Hong Kong can be a testing ground for the international use of the renminbi, a process closely related to Mainland's capital account liberalisation. The renminbi business scheme in Hong Kong, which is supported by a clearing arrangement provided by the People's Bank of China, has developed steadily since its launch in early 2004. It has now extended from personal banking to bonds issuance by Mainland financial institutions. Renminbi deposits in the Hong Kong banking system have also risen significantly over the last few years. Further expansion of renminbi business into trade settlement and related financial services would bring convenience for traders and enterprises on both sides. More importantly, it will help to lay the ground work for the use of renminbi for trade related activities through a formal and supervised channel.

The demand for a wider use of renminbi outside the Mainland is likely to increase further as the Mainland economy grows. In addition, the recent global financial turmoil has highlighted the need for a more diversified international monetary system, including more currency choices for international transactions. In time renminbi could be one of the obvious choices for many countries. In this process, using the well-established institutional framework of renminbi business in Hong Kong for pilot schemes will enable better monitoring and assessment of the flows, and mitigate the potential risks particularly on the domestic monetary policy management.

One important pre-requisite for designing appropriate policies to facilitate the Mainland's capital account opening is a good understanding of the economy and financial system. Here at the HKMA, we have closely monitored, as well as undertaken in-depth analytical work on the Mainland economic, monetary and financial developments. Our *Half-Yearly Financial Stability Report* has a section devoted to the Mainland economy, and research reports on the Mainland are published as working papers available on our website. We also started in 2006 a China Economic Issues series dedicated to detailed analysis of economic and financial market issues in the Mainland. This conference series is also a good way to organise informed discussions on the Mainland's financial sector issues.

The first part of the conference examines the experiences of Chile, India, Korea and Thailand in their capital account liberalisation, with the view of drawing useful lessons for Mainland China. The second part focuses on the Mainland, assessing the effectiveness of current policies in dampening the impact of capital inflows on the domestic economy, their costs, as well as policy options of outward investment. A final paper will gauge the current level of financial integration between the Mainland and Hong Kong, and discuss the policy implications. I am pleased that this conference has brought together a group of experienced researchers and policymakers from a wide range of central banks, international organisations and research institutes. As earlier noted, the recent global financial turmoil will probably turn out to be the most critical time in recent economic history which will shape future economic and policy thinking. I hope this conference can provide a useful platform for fruitful discussions on capital account liberalisation to enhance our understanding on the issue.

I wish the conference great success.