Introduction

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This volume collects the papers presented at the joint BIS/SAFE seminar on “Capital account liberalisation in China: international perspectives”, held on 12-13 September 2002 in Beijing, China. Seminar participants from outside China were mostly experienced practitioners and policymakers from 13 economies across four continents. Chinese participants consisted mainly of staff from the State Administration of Foreign Exchange, the People’s Bank of China and the Chinese Academy of Social Sciences. The main aim of the seminar was to draw on the diverse international experiences in managing cross-border capital flows and to shed light on how China should proceed to implement capital account liberalisation in the years ahead, following its recent historic entry into the WTO. The present collection includes 16 seminar papers, which are organised under the following six topics:

- Overview
- Japanese experience
- Bank-related capital flows
- Corporate and non-bank flows
- Equity portfolio flows
- Offshore banknote flows

Our introduction should be read in close conjunction with the welcome speech by SAFE Deputy Director General Ma Delun and with the SAFE summary chapter by Wang Yungui and Xie Yuelan, which follow immediately.

1. Overview

The three contributions in the first session set the stage of the seminar and provide a broad overview of China’s capital account management. The first is the seminar opening speech made by Mr André Icard, Deputy General Manager of the BIS. Mr Icard contrasts China’s current position to that of many countries on the threshold of opening up their capital markets and capital accounts. China is experiencing stable prices (even modestly falling prices), low nominal interest rates and relatively high equity prices - not inflation, high local currency interest rates and cheap equities, as has been the case in many countries at such a stage. In addition, China enjoys strong foreign direct investment inflows, abundant foreign exchange liquidity and net international creditor status, rather than suffering from heavy reliance on short-term debt, scarce foreign exchange liquidity and rising international indebtedness. Mr Icard’s speech outlines the main factors that may be more or less favourable to China’s capital account liberalisation. Given the flows not only from China’s accumulating official reserves but also from its banking system to global securities markets and interbank markets, the question is not whether funds will be allowed to flow out of China in response to anticipated returns. Rather it is which additional channels will be permitted and what accompanying policies and regulatory frameworks are required.

The second paper, by Mr Zhang Xiaopu, Deputy Division Chief at the Capital Account Management Department of the SAFE, gives a brief overview of China’s capital account management and its control of both capital account transactions and related foreign exchange transactions. The author sums up the current key capital control measures in China and reviews the progress so far in opening its capital account. The paper also sheds light on the main considerations behind further capital account liberalisation, which include the restructuring of the Chinese economy, developing domestic capital markets and improving international competitiveness. In discussing China’s gradual move towards renminbi capital account convertibility, Mr Zhang anticipates that China’s capital account liberalisation would be likely to proceed at a different pace across assets, markets, type of investors, direction of flows and currencies. Thus, there could be many small steps rather than a few big steps in the process of opening up China's capital account.

In their joint paper, Mr Guonan Ma and Mr Robert McCauley (both from the BIS Representative Office for Asia and the Pacific) argue that the abundance of foreign currency liquidity in the Chinese economy is a positive factor for China's ongoing liberalisation of its capital account. The recent build-up of large dollar surpluses in China is partly a result of strong demand for foreign currency deposits, which mainly reflects interest rate differentials between dollar and renminbi deposits. This factor, at times supplemented by speculative currency expectations, in turn also dampens the demand for foreign currency loans in the Chinese banking system and thus the overall surplus dollar liquidity in the sector. The paper also argues that the same set of factors could also explain the recent marked shifts of surplus dollars from the banking sector to the accumulation of official foreign exchange reserves. Finally, the authors suggest that the experience of the Chinese government with private holdings of foreign currency assets and with managing high levels of surplus foreign currency liquidity over the years has prepared it for the next stage of capital account liberalisation.

2. Japanese experience

The second session turns to an in-depth discussion of initial conditions and broad strategies of capital account liberalisation, with special reference to the case of Japan. In his paper, Mr Mitsuhiro Fukao, Professor of Economics at the Faculty of Business and Commerce at Keio University and formerly Director of Economic Research at the Bank of Japan, describes the long road that Japan trod. He recalls that, throughout the 1960s, changes in official foreign exchange reserves broadly tracked the current account surplus. From 1971, however, reserve changes reflected, among other things, shifts in trade financing (leads and lags) and foreign direct investment in addition to the current account, despite strict exchange controls. This description of Japan in some ways resembles China today, whose reserve changes owe relatively little to fluctuations in the current account. Mr Fukao also provides a perspective on how long it took Japan to liberalise its capital account. From 1971, when there was partial deregulation of foreign exchange control, to Japan's new foreign exchange law of 1980, when onshore and offshore yen money market yields were equalised, took nine years. Another eight years passed before the limits on foreign securities holdings by institutional investors were raised enough to become non-binding. And another eight years intervened before the 1996 "big bang" liberalisation. Thus, depending on the milestone used, at Japan's pace, China could be 10, 15 or 25 years away from effective and full capital account liberalisation. Mr Fukao concludes that it is difficult to choose the timing of the transition to an open capital account so as to satisfy all the preconditions and that, in fact, Japan had not satisfied them. He also emphasises that the Japanese authorities mishandled the transition from fixed to flexible exchange rates, an inevitable transition in his view for a large country that needs an independent monetary policy and eventually free movement of capital. In particular, by resisting appreciation in an inflationary world, destructive inflation was inflicted on the Japanese economy. The lesson for China in a world in which prices of internationally traded manufactured goods have been falling for over six years is not obvious.

The paper contributed by Mr Richard Koo, Chief Economist of Nomura Research Institute and formerly a Federal Reserve Bank of New York economist, warns that our understanding of international capital flows remains rather limited and that the history of portfolio flows between Japan and the United States often proved a case of unintended consequences. Capital flows can be rather destabilising and may worsen current account imbalances. Mr Koo points out, moreover, that the list of conditions for a successful capital account opening had lengthened after the Asian financial crisis. At the same time he also highlights the benefits of international capital flows to large countries with well developed markets like the United States and Japan. In particular, he makes the point that foreign investors generally supported Tokyo's equity market during the 1990s when Japanese investors lost some of their capacity to take on risks owing to lower asset prices. However, he also cautions that once the capital account is opened, some of the previously strictly domestic issues in an economy can well become subjects for international discussion.

3. Bank-related capital flows

Key choices in opening up a financial system pertain to the management of capital flows related to the banking sector, and the third session takes up this subject. Whether and how to limit non-residents' ability to borrow domestic currency are important questions, particularly at times of exchange market pressure. The three contributions for this section cover the experience of managing bank-related capital flows in Italy, Korea and Singapore. The paper by Mr Antonello Biagioli, Head of the Statistics Department at the Italian Exchange Office, walks through a half century of post-World War II capital account management in Italy, discussing both main policy goals and instruments and detailing the two foreign exchange crises in 1976 and 1992. The paper provides an account of the international activities of Italian banks and the corresponding regulations governing the dimensions of dollar/lira, onshore/offshore, assets/liabilities and spot/forward markets until 1992. It underlines that it was only 12 or 13 years ago that non-residents in principle were allowed to borrow in Italian lire. The European exchange market crises of 1992-93 made clear the difficulty of maintaining exchange rate stability in the face of market pressure by relying largely on intervention and without deriving any support from the previous restraints on banking system credit to non-residents.

The paper by Mr Yoon-Je Cho (Professor, Graduate School of International Studies at Sogang University in Korea) and Mr Robert McCauley (Deputy Chief Representative of the BIS Representative Office for Asia and the Pacific) shows how unbalanced official strategies added to the already difficult challenges of Korea's capital account liberalisation in the presence of high corporate leverage and substantial current account deficits. In the course of both domestic financial liberalisation and capital account opening during the early 1990s, price liberalisation in short-term and non-bank financial liabilities moved far ahead of that of long-term and bank liabilities. This uneven approach was in part due to the political influence of the chaebol in Korea, which had an immediate stake in liberalisation of short-term and non-bank financing instruments compared with bank intermediation. Financial flows, including cross-border capital movements, thus shifted more into short-term and less regulated channels, leading to an excessive build-up of short-term foreign borrowing and thereby aggravating the financial vulnerability of the Korean corporate and financial sectors to external reappraisals. The paper also discusses further liberalisation measures (especially in the banking sector) and other prudential regulations that have been introduced in Korea since the crisis. These reforms adopt a more balanced approach to capital account opening in Korea, although in practice foreign investment in domestic bonds remains limited.

The paper by Mr Ong Chong Tee, Assistant Managing Director of the Monetary Authority of Singapore (MAS), provides a perspective on the non-internationalisation policy of the Singapore dollar. Its rationale is to support a monetary policy focused on the exchange rate in view of the small and open nature of Singapore's economy. Consistent with this policy and Singapore's desire to expand its role as an Asian financial centre, banks operating in Singapore operate less regulated "Asian Currency Units" that deal in currencies other than the Singapore dollar. Singapore's experience can be interpreted in two different manners. The step-by-step liberalisation of the policy to prevent the internationalisation of the Singapore dollar in 1998, 1999, 2000 and 2002, as described by Mr Ong, can be seen as amounting to the gradual lifting of the policy. The retention of the prohibition on credit extensions above a threshold to non-resident financial firms, however, can be read another way. An economy enjoying large fiscal and current account surpluses, a record of low inflation and relatively large official foreign exchange reserves chooses not to learn whether a reasonable degree of exchange rate, and therefore price, stability can be reconciled with an unrestrained ability of non-residents to short the currency. The implicit advice from Singapore to China is to move cautiously on the route to renminbi capital account convertibility.

4. Corporate and non-bank flows

Market developments have heightened the importance of policies constraining the asset choices of non-bank financial institutions and the liability choices of corporations, which is the subject of the fourth session. It contains three papers on the experience of foreign exchange control and capital account management in France, South Africa and the Philippines, respectively. The paper by Mrs Françoise Drumetz, Deputy Director of the Balance of Payments Directorate of the Bank of France, divides the experience of capital account management in the years since World War II in France into two distinct periods, with 1983/84 as the watershed. In the first period, close capital account management suited France's relatively closed and regulated economy, while in the second period, eased policy reflected an improving balance of payments, a stronger financial sector and faster liberalisation. The author views capital account opening as part of the overall economic and financial policy framework in France, arguing that it should and did proceed in step with other policy reforms. One of the last restrictions to be removed in France was the limit on French franc lending to non-residents. Mrs Drumetz also gives a potentially useful answer to how an unbalanced outflow into foreign securities might be prevented in the aftermath of liberalisation. By reforming the French government bond market before liberalisation, inflows into these domestic bonds generally exceeded French insurance companies' purchases of foreign securities. This experience suggests that reform of China's bond markets might help balance inflows and outflows associated with capital account liberalisation.

The paper contributed by Mr James Cross, former Senior Deputy Governor of the South African Reserve Bank (SARB), highlights the occasional reversal in the SARB policy in response to extreme external events and the asymmetry of South Africa's exchange controls. In the face of an abrupt cutoff of international credit in the mid-1980s, or of very strong pressure on the rand in late 2001, the SARB reverted to or tightened enforcement of controls on capital account transactions. As conditions permitted, however, liberalisation could and did move forward. Most recently, with the strengthening in the rand in the course of 2002 as the background, the February 2003 budget of the South African government proposed to ease restrictions on outflows by South African companies and institutional investors. Through these swings of policy, however, South Africa's exchange controls came to feature a consistent asymmetry in the treatment of non-residents and residents. Non-residents, whether holders of South African stocks, bonds or real assets or not, could short the currency freely. Meanwhile, South African companies faced limits in their ability to mobilise their equity to make acquisitions abroad, and insurance companies and pension funds faced limits in acquiring foreign assets. Resident individuals have also been subject to various ceilings on investing in overseas assets. Mr Cross sees little logic to this asymmetry in foreign exchange controls on residents and non-residents. China is in effect invited to consider whether it wants to proceed in such an asymmetric fashion.

In the same fourth session, the paper presented by Ms Celia Gonzalez, Director of the International Operations Department of the Central Bank of the Philippines, describes the Philippines' management of the foreign currency debts of the corporate sector. Foreign currency debts are subject to a system of registration, approval and monitoring in order to manage the burden of external debts. This system is used to prevent build-ups of short-term foreign currency debts and more generally to avoid bunching of repayments. There is at least one important difference between the Chinese and Philippine management: in the Philippines, approval is not required for foreign currency loans unless they are to be serviced with dollars from the domestic banking system, whereas in China, official approvals for any foreign currency loans are mandatory. Thus, the Philippine system may be regarded as lying between China's and a liberal system in which creditors and shareholders are expected to enforce prudent corporate debt management.

5. Portfolio equity flows

In the fifth session on the subject of equity flows, the paper by Mr Gopalaraman Padmanahan, General Manager of the Exchange Control Department of the Reserve Bank of India, offers an overview of India's experience with capital account liberalisation. The paper makes two key points. First, India's basic approach to liberalisation has been to create non-debt inflows, hence the opening of the local equity market (as well as improving access for foreign direct investment). Second, the original intention to achieve capital account convertibility in three years, first put forward in early 1997, was deferred for a while after the Asian financial crisis, in part owing to the concerns over India's weak fiscal position and fragile banking system. The paper argues the case for step-by-step liberalisation. Since the paper was submitted for publication, the Indian authorities have announced new capital account opening measures against the background of substantial growth of the country's official exchange reserves during 2001-02.

In the second paper of the equity flow session, the presentation by Ms Karen Lu, Vice President of Investor Services at JP Morgan-Chase Bank, outlines some of the key elements of the qualified foreign institutional investor (QFII) scheme in Taiwan, China (hereafter, Taiwan), which has been in place since 1990. The basic purpose of the scheme is to limit the potential volatility of non-resident demand for domestic equities and to smooth its effect on the foreign exchange market. The paper indicates that, in the pursuit of these ends, the Taiwanese QFII system has evolved over time, with restrictions gradually relaxed and loosened as the authorities gained confidence. In particular, the liberalisation of the Taiwanese QFII system proceeded along the dimensions of foreign exchange controls, minimum lock-up time, range of eligible foreign investors and classes of domestic financial assets open to investment by foreign investors. Often these liberalisation moves occurred piecemeal, and it is not easy to discern a pattern in the sequence. China's recent introduction of a similar scheme will lead to comparisons with this earlier experience.

6. Offshore banknote flows

In the sixth and final session, the discussion of the management of international flows of banknotes posed a stark choice for the Chinese authorities. On the one hand, the paper by Mr Stefan Hardt of the Cash Department at the Bundesbank describes the passive approach of the German, and now apparently European, monetary authorities. The approach entails allowing banks and central banks to pick up and deliver banknotes to the central bank, which is careful not to credit fully for returned notes until they are fully checked to avoid any extension of credit.

On the other hand, the paper by Mr Joseph Botta, Senior Vice President of the Financial Services Group at the Federal Reserve Bank of New York, profiles the more active approach taken by the US authorities. This approach entails stationing the Federal Reserve's cash holdings in selected locations offshore and forging partnerships with private banks in order to share the central bank's work and to provide it with information. It is an interesting question whether the difference in these approaches is related to the weight given to monetary aggregates by these central banks. To the extent that Europeans value broad money as an intermediate target, then a lack of enthusiasm for the necessarily variable foreign demand for banknotes could be expected; to the extent that Americans attach lesser importance to monetary aggregates, then a willing accommodation of the vagaries of demand, verging on marketing of the greenback, could be expected. Both, however, referred to banknotes as a "commodity".

But the example of Hong Kong, where policy leaves the amount of money to market forces but which also adopts a fairly passive approach to cross-border flows of banknotes, suggests that this parallel between monetary and cash policy should not be pushed too far. The paper by Mr Peng Wensheng and Ms Joanna Shi, of the Economic Research Division at the Hong Kong Monetary Authority, surveys the practical techniques available for estimating offshore circulation of local banknotes and applies the approaches to the case of Hong Kong dollar banknotes circulating offshore. The authors estimate that between 15 and 25% of the Hong Kong dollar banknotes circulate outside Hong Kong, principally in mainland China. Moreover, even as the holdings of Hong Kong dollar banknotes inside mainland China have increased in recent years, holdings of renminbi banknotes in Hong Kong have also increased. This trend rise in the interpenetration of cash holdings in Hong Kong and mainland China leaves it unclear whether there are more Hong Kong dollar notes in China or renminbi notes in Hong Kong, an extraordinary state of affairs given the convertibility of one and the capital account inconvertibility of the other.

7. Summing-up

A number of common experiences came into view in the seminar. First, the diverse international experiences suggest that many economies have adopted a step-by-step approach to their capital account liberalisation. This relates in part to the limits of our understanding of the risks associated with cross-border capital flows. Second, many economies have tried to strengthen their market and supervisory infrastructures ahead of opening their capital accounts. This is also consistent with the view that the initial conditions of the liberalising economy tend to have a major bearing on its choice of specific liberalisation policy measures. Third, there could be occasional delays or even policy reversals during the liberalisation process, often in response to unexpected external developments. Nevertheless, over time, many economies have, though not along a straight line, moved generally in the direction of capital account liberalisation. Finally, in most economies, policy measures adopted to manage the capital account vary across sectors, range of investors, markets, type of assets, currencies and directions of flow. Policymakers have often been quite practical in their handling of the actual capital account liberalisation process. In sum, there is a wide spectrum of policy instruments to manage capital flows of various types in economies with diverse endowments and in different market environments. But one thing is clear - our brief overview cannot do justice to the rich experience of capital account liberalisation contained in this volume.