China: the evolution of foreign exchange controls and the consequences of capital flows

People's Bank of China

I. Introduction

With the adoption of market-oriented economic system reforms and the opening-up policy since 1978, China's economy has become increasingly integrated in the world economy. Under the guidance of the opening-up policy, foreign exchange administration controls have gradually been eased. These reforms have fuelled the expansion of foreign trade and capital inflows. Between 1994 and 2006, China's trade volume increased eightfold and, during the same period, the foreign trade to GDP ratio increased from 45.7% to 65.7%, a 20 percentage point growth, and the country's share in world trade increased from 0.8% in 1978 to 7.7% in 2005. China has also become the largest recipient of foreign direct investment (FDI) among developing countries. Economic and financial integration have made remarkable contributions to China's rapid economic growth, but have also had a dragging effect on the adjustment of the country's structural imbalances, posing great challenges to China's monetary policy in recent years.

II. The evolution of China's foreign exchange administration policy since 1994

In November 1993 the Third Plenum of the Fourteenth CPC Central Committee approved a comprehensive reform strategy in which foreign exchange management reforms were highlighted as a key element for a market-oriented economy. A market-based unified floating exchange regime and RMB convertibility were seen as the ultimate goals of the exchange reform. A foreign exchange surrender and purchase system (FESPS) was put in place. Firms were to surrender their foreign exchange earnings from current account transactions and purchase foreign exchange from a foreign exchange designated bank (FEDB) when a payment in foreign currency was needed. The RMB thereby achieved so-called conditional convertibility under the current account. In 1996 foreign-funded enterprises were included in the system and China officially announced its acceptance of Article VIII of the IMF Articles of Agreement.

In recent years, quotas for enterprises holding their foreign exchange earnings under the current account have been raised several times; enterprises with authentic trade activities have been allowed to purchase foreign exchange in advance to pay foreign counterparties; enterprises' foreign exchange accounts under the current account have been managed on a recording basis; and foreign exchange purchase and payment procedures for trade in services have been simplified. Since 2007, annual foreign exchange purchases and sales quotas for individuals have been set at US$ 50,000 to meet their needs for holding and using foreign exchange.

In sequencing the liberalisation of the capital account, China has followed an "FDI first" policy. After 1994, significant progress was made in opening up to FDI. More regions were opened to foreign investment, and ownership requirements for FDI in most industries were relaxed. The authority to approve FDI projects was assigned to local governments. From 1995, foreign-funded enterprises (FFEs) could engage in state-owned enterprise (SOE) reform by purchasing equity or injecting capital.

Except for FDI, all capital account transactions were to be approved by the People's Bank of China (PBC). The receipts from capital account transactions, including external borrowing, IPO and bond issuance, had to be deposited in a specified account and used for specified expenditures. Conversion of receipts into RMB was generally not allowed.

In December 2001 China joined the World Trade Organization (WTO). This event marked a new era for China's external sector liberalisation. In addition to tariff cuts, China promised to eliminate over the next few years most restrictions on foreign entry and ownership, as well as most forms of discrimination against foreign firms. A large number of key services were to be opened up to foreign competition, including important business services, courier services, wholesale trade, franchising, tourism services, rail and road transport, and freight forwarding services. In many other services, substantial foreign entry was to be allowed, including in telecommunications, audiovisual services, construction, retail trade, insurance, banking, securities, and maritime transport.

Since China's accession to the WTO, significant progress has been made. In the banking sector, more cities have been opened to foreign banks to conduct business in RMB; China has also made a breakthrough in capital market liberalisation. Since 2001, domestic investors, including individual residents, have been allowed to invest their own foreign exchange in B-shares. Starting from 2002, qualified foreign institutional investors (QFII) have been allowed to invest in the domestic capital market. Since 2004, insurance companies have been allowed to use their own foreign exchange to invest in the international capital market. In 2005, the first foreign company was listed on the Shanghai Stock Exchange, and in the same year, domestic firms were allowed to set up special purpose corporations abroad to facilitate overseas listing, mergers and acquisitions.

Since China joined the WTO, the country has experienced a sharp increase in both current account surplus and capital inflows. By end-2007, the foreign exchange reserves had increased to USD 1,528.2 billion. The rapid build-up of foreign exchange reserves has complicated monetary policy and increased pressure for RMB appreciation.

In response to these developments, the authorities have taken measures to promote balanced capital inflows and outflows. The measures include: (i) enhancing the verification of export receipts to stop disguised capital inflows; (ii) expanding the right of firms to hold foreign exchange earnings abroad or in bank accounts; the qualifications for domestic firms retaining foreign exchange in a bank account were lowered and the ceiling on the account was raised several times during the period; and (iii) imposing limits on FFEs and foreign banks' external borrowing, etc.

In 2003, the provisional regulation on external debt further limited capital inflows. The long-term external debt quota was extended to foreign banks in China. In 2005, import payments overdue six months or amounting to over USD 200,000 had to be registered as external debt. Ceilings were imposed on the scale of the external debt of foreign invested companies. Measures introduced to facilitate capital outflows included: (i) in October 2002, a pilot programme was launched in six coastal provinces to allow provincial authorities to approve firms' purchase of foreign exchange for overseas investment; this policy was eventually extended nationwide in 2005; (ii) the ceilings on residents' carrying of foreign exchange in cash across the border and on residents' purchase of foreign exchange for purposes of tourism and overseas study were raised several times and, in 2004, the restriction on transferring assets overseas was further relaxed; (iii) the ceiling on firms' settlement account balance was abandoned; and (iv) in 2007, overseas financial investments were expanded by broadening the commercial banks' overseas investment instruments and including trust and investment companies to develop qualified domestic institutional investors (QDII) businesses.

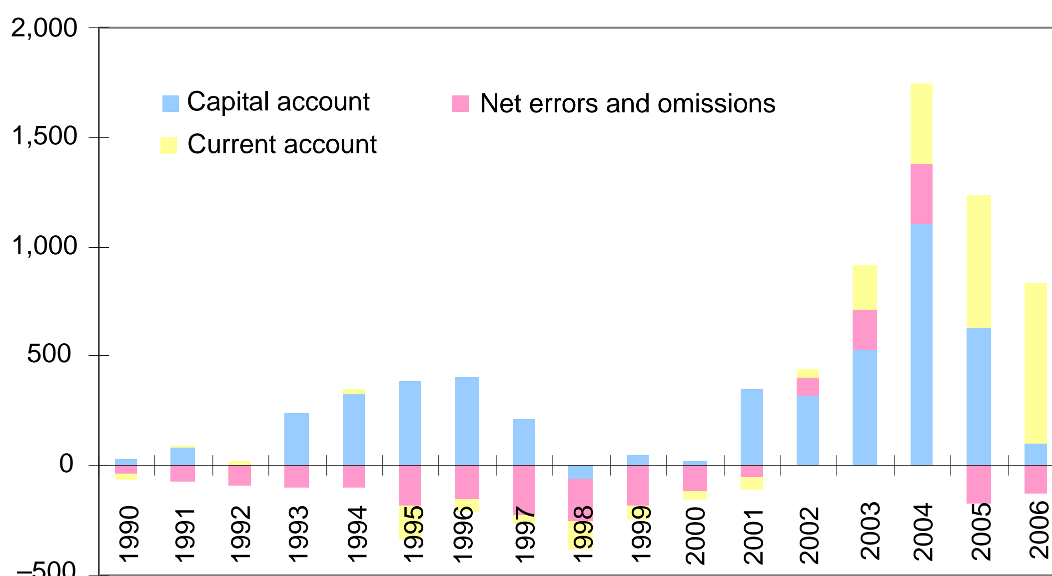
III. Capital flow conditions since 2000

Under the opening-up policy, together with the current account convertibility of RMB and the FDI-led financial integration, China has seen a vast expansion of foreign trade and FDI inflows. Since the 1990s, China has recorded twin surpluses on current and capital accounts. Since 2001, China has undergone a new round of foreign currency inflows due to twin surpluses in balance of payments (BOP) accounts. The current account surplus was USD 12 billion in 1990 and USD 249.9 billion in 2006. Since 2004, China has received annual FDI in excess of USD 60 billion, one of the highest levels in the world.

Graph 1

The structure of foreign currency inflows, 1990–2006

In USD 100 millions



Source: CEIC.

Since 1990, the current account surplus has come mainly from the trade surplus. The trade surplus rose from USD 25.5 billion in 2003 to USD 262.2 billion in 2007, up more than 90% annually. The share of the trade surplus in the current account surplus was 87.1% in 2006. The main source of the trade surplus is processing trade. During the period 1999–2006, the surplus from processing trade exceeded the total trade surplus. In 2006, the share of processing trade in the total trade surplus stood at 105%.

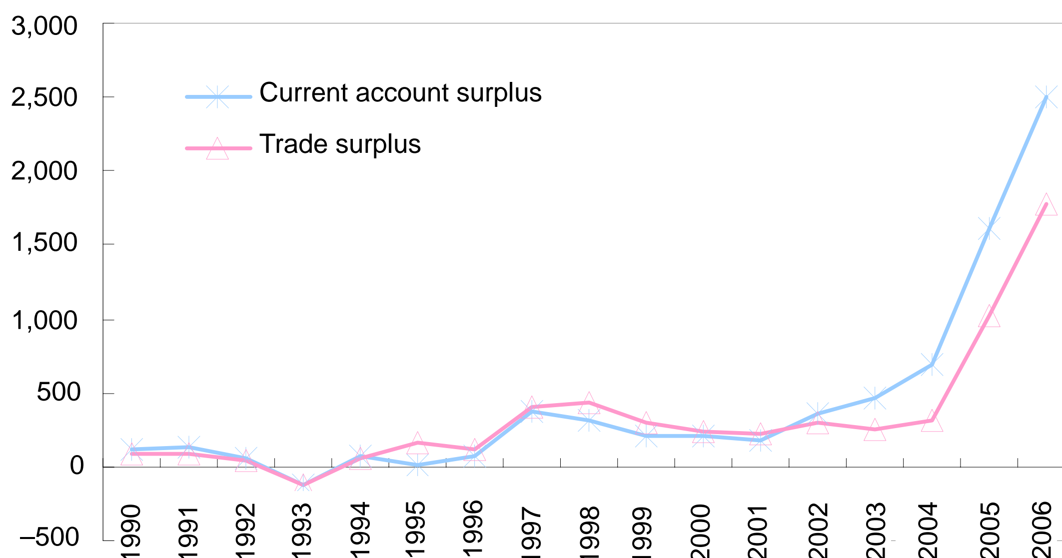
Net FDI inflow is the main source of China's large capital account surplus. Around 50% of FDI flows into the processing trade industry, which means that the capital and current account surpluses are mutually reinforcing.

Long-term capital accounts for the bulk of China's capital inflows, contributing to domestic productivity growth and reflect the comparative advantage of China, its high-saving, low-consumption structure and the global imbalance in the productivity distribution and economic structure.

Graph 2

The structure of current account surplus 1990–2006

In USD 100 millions

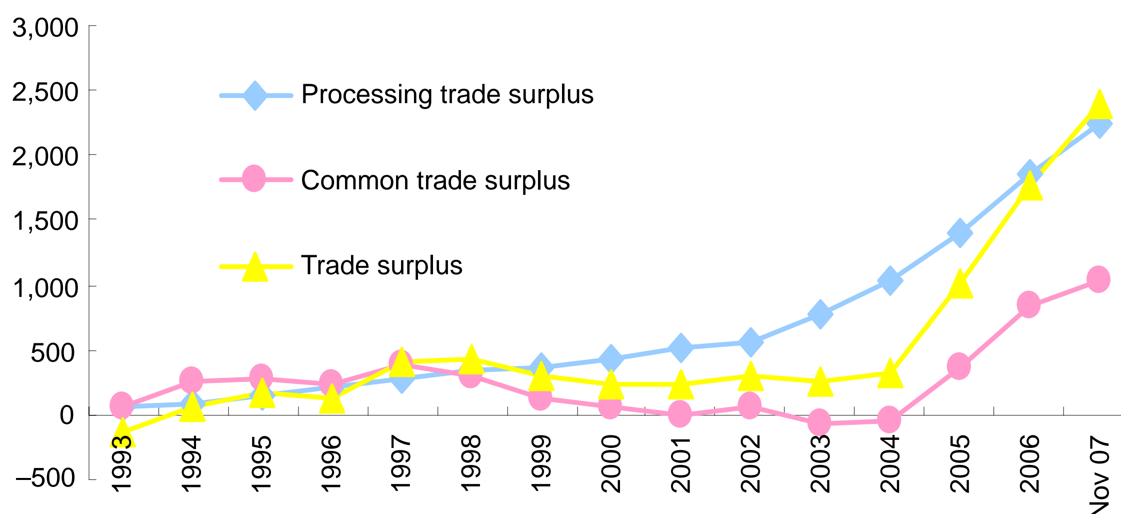


Source: CEIC.

Graph 3

The structure of trade surplus 1993–2007

In USD 100 millions



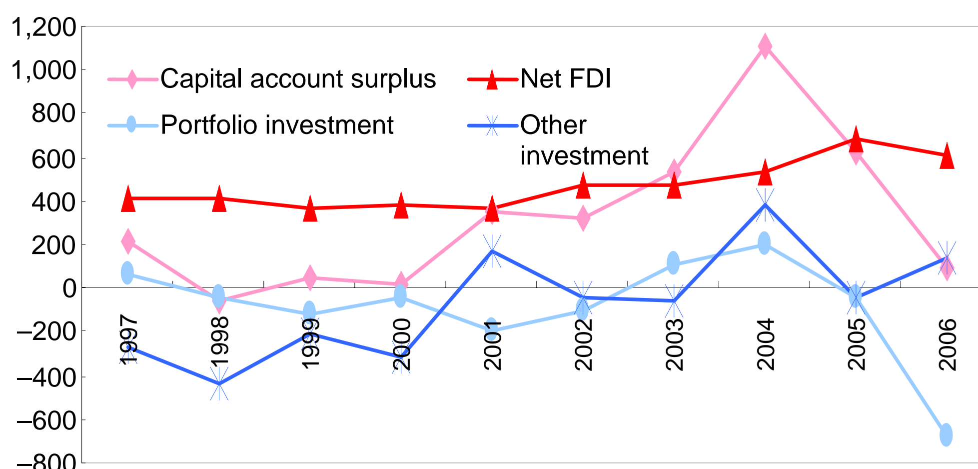
Source: CEIC, after adjustment and calculation.

Capital inflows go hand in hand with the persistent rapid economic growth and optimistic expectations for the economy. Since 2003 the economy has entered a new round of expansion. The average annual GDP growth rate was 10.3% with the pace accelerating in recent years as it increased to 11.1% in 2006 and 2007 Q1, and 11.9% in 2007 Q2. Meanwhile, non-trade capital inflows have increased. The non-trade current account surplus increased from USD 1.2 billion in 2003 to USD 3.21 billion in 2006, the result of structural imbalances.

Graph 4

Capital account surplus structure 1997–2006

In USD 100 millions



Source: CEIC, after adjustment and calculation.

China's long-term capital inflows contribute to the trade pattern. China's trade surplus has its origin in the division of labour in the global production chain, which is also the factor that attracts FDI. While China has a trade surplus, mainly with the United States and the European Union, it has a relatively large trade deficit with some Asian countries and regions – the main origin of its FDI. In 2006 China's trade deficit with Korea was as high as USD 45.3 billion, that with Japan as high as USD 20.5 billion, and its trade surplus with ASEAN countries was around USD 18.2 billion. The reasons for this combination relate to the structure of China's foreign trade. The processing trade takes about 50% of China's foreign trade volume, in which China imports capital goods mainly from Japan, the European Union and the United States, and the components mainly from Japan, Korea and Southeast Asia. After processing, the goods are mainly exported to the United States and Europe, demonstrating that China actually imports trade surplus from neighbouring countries. China has become an important link in the global production chain.

IV. Monetary policy in the face of foreign currency inflows

Persistent twin surpluses add to RMB appreciation pressures and many believe that large RMB appreciation is a way to correct the trade imbalance. However, the cause of economic imbalance is multifaceted, and systematic solutions are justified. Appreciation alone could not solve the problem and its outcomes are uncertain.

Capital inflows and the persistent BOP surplus in China are structural problems. They relate to the lack of saving in the United States and other developed countries and the fact that the international currency and financial system centre around the US dollar and are influenced by fiscal policy, income distribution, the trade system, price mechanisms etc. The exchange rate has its role to play, but coordination among different economies and macro-management policies, such as fiscal, monetary, industrial and investment policies, are needed. China has made consistent efforts in that regard. In its 11th Five-Year Plan, the Chinese government pointed out that economic growth would be rebalanced towards focusing on domestic demand, and to a balanced pattern driven both by consumption and investment and by internal as well as external demand. The Chinese government attaches much importance to the role of the exchange rate in the economic structural adjustment and rebalancing of

international payments. The exchange rate has its role to play, considering the time lag of the structural adjustment measures.

Structural and exchange rate regime reform need time, and liquidity management is an important part of monetary policy operations. In recent years, the PBC has employed sterilisation instruments such as open market operations and reserve requirements to withdraw excess liquidity.

During the period 2003–06, the annual growth rate of foreign exchange reserves was near 38.3% (Table 1) but the PBC managed to keep the annual average growth of M2 around 17%, which was generally in line with the annual economic growth rate.

Table 1

China's FX reserves

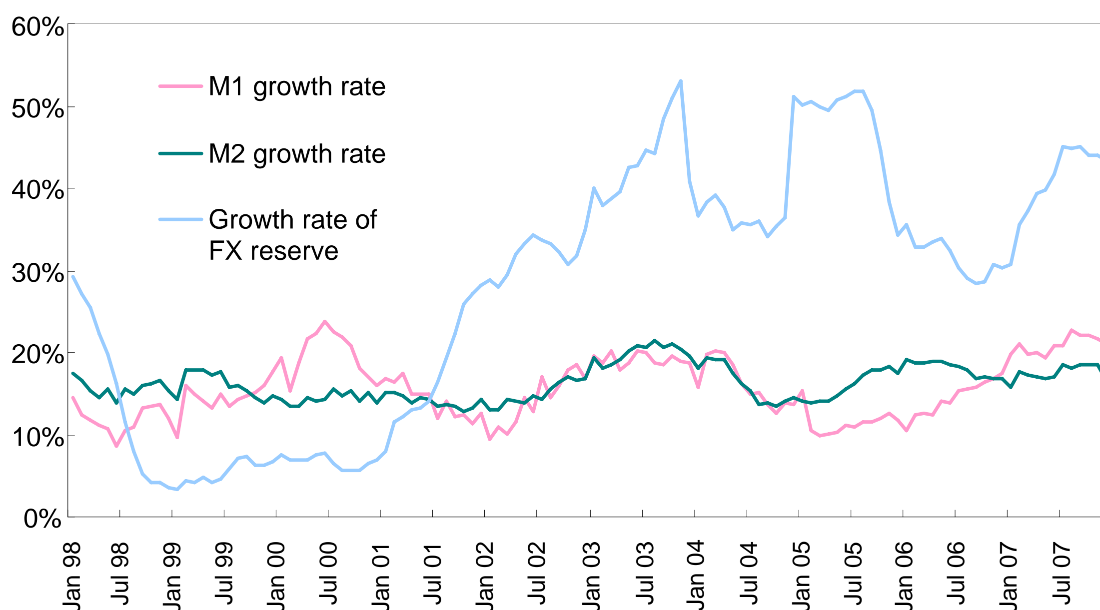
	Balance (USD 100 millions)	**Amount increase (USD 100 millions)**	**Growth rate (%)**
1993	212	18	9.28
1994	516	304	143.40
1995	735	219	42.44
1996	1,050	315	42.86
1997	1,399	349	33.24
1998	1,450	51	3.65
1999	1,547	97	6.69
2000	1,656	109	7.05
2001	2,122	466	28.14
2002	2,864	742	34.97
2003	4,033	1,169	40.82
2004	6,099	2,066	51.23
2005	8,189	2,090	34.27
2006	10,663	2,474	30.21
2007	15,282	4,619	43.32

Source: State Administration of Foreign Exchange (SAFE).

In the future, China will use different monetary policy instruments to further enhance liquidity management, and will gear up economic structural adjustment. In order to have balanced capital flows, China has implemented a reform of the foreign exchange management system and moved towards capital account convertibility, accelerated the pace of "going out" and promoted outbound FDI and portfolio investment by enterprises and individuals. China will further implement the reform of the foreign exchange management system, facilitate foreign investment and trade, and establish a multi-layered external investment system, so as to promote non-governmental external investment, further improve foreign exchange reserve management and enrich its modes. China will further strengthen the monitoring and management of capital inflows into the capital market, and improve short-term external debt management and the monitoring system of cross-border capital flows.

Graph 5

Money aggregates and foreign exchange reserve growth (yoy) 1990–2006



Source: PBOC.

V. RMB exchange rate regime reform

The Chinese government attaches due importance to the role played by the exchange rate regime in external rebalancing. On 1 January 1994 China adopted a unified managed floating exchange rate regime based on market supply and demand. After 1997, in the wake of the Asian financial crisis, China, as a responsible country in the world, voluntarily narrowed the RMB exchange rate band so as to prevent competitive currency depreciation in the region and a worsening of the crisis. In 2005, when the external environment and internal conditions improved, China made the decision to reform the RMB exchange rate regime. On 21 July 2005 China adopted a managed floating exchange rate regime based on market supply and demand with reference to a basket of currencies. The RMB/USD rate was adjusted to 8.11 at 19:00 on 21 July 2005.

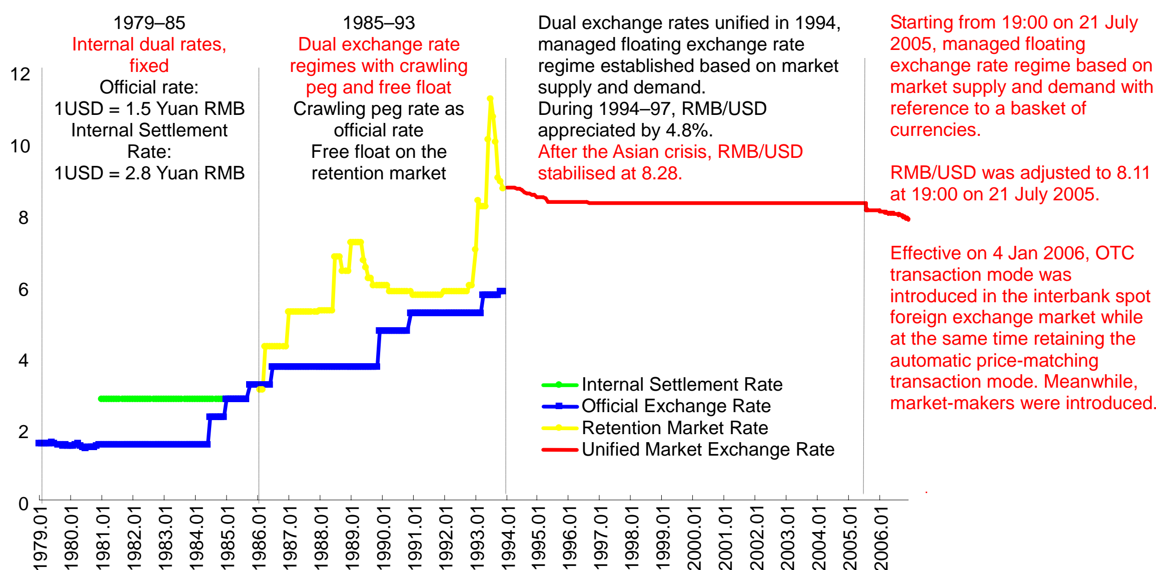
Since this reform, the PBC has endeavoured to improve the managed floating exchange rate regime in line with the principles of pushing forward the reform in a self-initiated, controllable and gradual manner; as a result, the flexibility of the RMB exchange rate has been greatly strengthened, with the currency steadily appreciating in real effective terms.

First, efforts have been made to promote the development of the foreign exchange market so as to provide institutional support for the new RMB exchange rate formation mechanism. Following the introduction of the over-the-counter (OTC) transaction mode and of the market-maker system, and the improvement in the formation of the RMB central parity, the interbank spot foreign exchange markets developed rapidly, including the interbank RMB forward and swap markets. Second, under the managed floating exchange rate regime, the RMB exchange rate indirect adjustment system and the primary dealer system in the foreign exchange market were established. Third, the RMB exchange rate band was enlarged to enhance its flexibility.

The flexibility of the RMB floating exchange rate was continuously improved. After the reform of the RMB exchange rate formation mechanism, the RMB exchange rate was no longer pegged to the US dollar; rather, it was adjusted with reference to a basket of currencies. In the two years since the reform of the exchange rate regime, the RMB has generally appreciated, fully reflecting the fundamental role of market supply and demand in the exchange rate formation process. The RMB exchange rate against the Japanese yen witnessed the largest appreciation, with a cumulative appreciation of 14% since the foreign exchange regime reform; the second largest appreciation was recorded against the US dollar, with a cumulative appreciation of 13.3%. The RMB appreciated in effective terms as well, indicating that the Chinese currency against the currencies of China's main trading partners had appreciated. According to the BIS statistics, as of end-2007, the real effective exchange rate index had risen by 11% since the reform, representing an appreciation larger than that of major currencies, such as the euro, pound sterling, and Singapore dollar. Over the longer term, against the background of the "twin surpluses" in the BOP, the RMB has in general continued to appreciate in real effective terms on a large scale since the exchange rate reform in 1994. From the beginning of 1994 until end-2007, according to the BIS calculations, the nominal and real effective exchange rate indices of the RMB rose by 26.6% and 43.8% respectively, commensurate with supply and demand in the foreign exchange market. Market participants, after many efforts, have gradually adapted to the managed floating exchange rate regime and have enhanced their ability to avoid exchange rate risks; and the profits of enterprises have increased. In terms of the macroeconomy, the reform of the RMB exchange rate formation mechanism has promoted economic restructuring, industrial upgrading and transformation of the economic growth mode, cultivating financial institutions' pricing and risk management capacities and boosting the flexibility of the macroeconomy.

Graph 6

The evolution of China's exchange rate regime 1979–2007



Source: People's Bank of China.

The PBC will closely monitor the potential risk of worsening structural imbalances and excess liquidity, considering the time lag in the adopted adjustment measures. In addition, the PBC will adhere to the policy of relying on a basket of structural adjustment measures, centring on

expanding domestic consumption and using the exchange rate as a complementary measure to promote external balance.

The PBC will implement tight monetary policy to strengthen macroeconomic management, address the excess liquidity in the banking system, ease the pressures on money and credit expansion, and strike a balance at the aggregate level. The market-based interest rate reform will be further advanced. It will also enhance the leveraging role of prices in macroeconomic adjustments and duly manage credit growth. The PBC will further reform foreign exchange management, guide balanced capital flows, monitor and manage short-term capital inflows, and further strengthen the financial market infrastructure and financial institution reform. Close attention will continue to be paid to the potential risks in the rise of asset price and general price levels caused by both capital inflows and outflows.

Last but not least, global capital flows closely relate to global integration and economic imbalances, which pose new challenges to monetary policy in all economies. Joint efforts and policy coordination are needed to realise an orderly adjustment of global imbalances and a stable and sustainable development of the world economy.

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