

**The Management of Cross-Border Capital
Flows and Macroeconomic Stability
in China**

YU YONGDING

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NOTE

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Chapter 1

INTRODUCTION

OVER the past 28 years, China has maintained an annual average growth rate of 9.7%. Since 1979, it has been the fastest-growing economy in terms of total and per capita income and labour productivity. By the end of 2007, with a GDP of \$3.6 trillion, trade volume of \$2.17 trillion and foreign exchange reserves of \$1.6 trillion, China became the fourth-largest economy, the third-largest trading nation and the largest foreign-reserve-holding country in the world. Though there are occasional ups and downs, on the whole the growth of the Chinese economy has been stable. Over the past 28 years, despite its rapid growth, China has never experienced any major balance-of-payments difficulties and financial crises, which have been so damaging to many developing economies.

China's gradual approach to financial liberalization and capital account openness is a key element contributing to its rapid and highly stable growth. Although China's domestic financial system was as fragile as those of the crisis-affected countries in the region in 1997, if not worse, the Chinese currency (the RMB) escaped attacks by international speculators, in large part because of capital controls. After the Asian financial crisis, capital controls in China have been gradually relaxed, as part of its efforts to integrate into the global financial system and to implement its commitment to financial sector liberalization. Since 2003, a policy of "difficult in and easy out" has been adopted by the Chinese authorities with the aim of reducing upward pressure on the RMB. Now with the rise in inflation, the role that the regulation of cross-border capital flows can play in China's macroeconomic management has become one of the most hotly debated policy issues.

Prepared for the Third World Network's research project on "Financial Policies in Asia", this paper aims at examining China's experience in the management of cross-border capital flows and its role in China's macroeconomic management. Chapter 2 provides a comprehensive account of the evolution of China's capital control regime and provides up-to-date information on China's control measures. This is followed by a review of the measures taken for the reconsolidation of China's banking system. While a resilient banking system is a necessary precondition for capital account liberalization and the Chinese government hopes that the measures taken for reconsolidation will allow a more liberalized capital control regime and a more efficient allocation of resources, whether this process of highly costly reconsolidation has improved the resilience of China's banking system remains to be seen. Chapter 4 discusses the effectiveness of China's capital control measures. Based on a discussion of capital inflows through various channels of the balance of payments in recent years, it is shown that the bulk of cross-border capital flows are traceable and can hence be controlled. Chapter 5 discusses China's macroeconomic management in recent years and the role that capital controls can play. Policy prescriptions based on a diagnosis of China's economic situation are presented, and it is argued that a carefully designed stabilization policy mix should include appropriate roles for capital control measures. This could allow China to achieve the dual objectives of sustaining rapid growth as well as bringing inflation under control. The paper ends with some concluding remarks.

Chapter 2

CHINA'S CAPITAL ACCOUNT REGIME

CHINA'S growth has been export-led and FDI (foreign direct investment)-driven since reforms and opening up in the 1980s. At the same time, the Chinese government has adopted a cautious approach towards capital account liberalization. Owing to capital controls during the Asian financial crisis, the Chinese economy escaped attacks by international speculators. In the wake of the Asian financial crisis, the pace of capital account liberalization in China slowed down and most planned liberalization measures were shelved. However, since 2002, capital account liberalization has returned to the policy agenda because of China's commitment to open the financial services sector as part of its World Trade Organization (WTO) accession commitments. Since 2003, the management of cross-border capital flows began to intertwine with Chinese monetary authorities' efforts to reduce the appreciation pressure on the RMB, based on a policy of "difficult in and easy out".

a. The need for capital controls

Generally speaking, the purpose of capital account restrictions is to manage various risks associated with capital flows by influencing their size and composition. Why does the Chinese government still impose capital controls? Firstly, capital controls are necessary for maintaining independence of monetary policy, since China is still not ready to adopt a floating exchange rate regime. According to Eichengreen (1996: p. 5), capital controls "loosened the link between domestic and foreign economic policies, provid-

ing 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 of 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.”

Secondly, 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 severely destabilize its economy. With a more flexible exchange rate, capital inflow will cause gyrations. Due to lack of financial instruments for hedging, Chinese enterprises cannot protect themselves against the risks created by sudden changes in exchange rates. Nor can they make quick adjustments to swings in exchange rates because of structural rigidity.

Thirdly, China’s economic reform has not been 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 would encourage money laundering and asset stripping, causing social tension.

Fourthly, because of wrong incentives created by China’s current fiscal system, in the absence of capital control there is the danger that local governments would be inclined to use foreign capital of all kinds to pursue local objectives irrespective of its consequences for the long-term interests of the country as a whole.

Finally, because of under-development of its financial system and the inefficiency of its capital market, China cannot withstand large swings in capital flows of the kind seen during the Asian crisis. A firewall of capital controls is needed to protect China from rapid surges and exits of capital.

b. Evolution of China’s capital account regime since the 1980s

China’s initial drive to attract foreign capital in the 1980s coincided with the Latin American debt crisis. Consequently, drawing on the Latin American experience, China introduced extremely strict capital controls in that period, in terms of both coverage and implementation. The main pur-

pose at that stage was to avoid a balance-of-payments crisis caused by excessive borrowings and chronic trade deficits.

The second stage in the evolution of China's capital account regime started with the Asian financial crisis and ended with its accession to the WTO. During that period, the purpose of China's capital controls was to prevent capital flight. While China's economic fundamentals, including growth, trade balance and foreign exchange reserve holdings, were quite strong, its banking system was weak and non-performing loans (NPLs) had reached a very worrying level. It was feared that, due to contagion, China could suffer from a large-scale capital flight which would, in turn, put strong downward pressures on the RMB, setting off a vicious circle whereby the weaker RMB could trigger even further outflows, leading to widespread bankruptcies among enterprises with foreign debts. Policy alternatives that could be used to contain capital flight under such circumstances include higher interest rates, budget cuts, floating as well as tighter capital controls. Of these, tightening capital controls can be the most effective option provided that there is an effective administrative mechanism in place.

This was indeed the case in China. In October 1998 China's Supreme Court called for a major crackdown on illegal foreign exchange activities. With a deadline set by the State Administration of Foreign Exchange (SAFE) for offenders to turn themselves in so as to get more lenient treatment, hundreds of cases were brought to the courts, and a large number of defendants who refused to surrender were prosecuted. The government sent tens of thousands of auditors for enterprises and financial institutions to track down and recover illegally transferred money. Consequently, capital flight was brought under control and growth of China's official foreign exchange reserves returned to the normal level after the fourth quarter of 1998.

The third stage started in late 2002, one year after China's entry into the WTO, which marked a new beginning of capital account liberalization. According to its WTO accession commitments, China had to fully liberalize its financial service sector within five years. Even though the financial service sector liberalization is not equivalent to capital account liberalization, the two are closely related. After China's WTO accession, FDI flows were fully liberalized. Requirements for foreign investors such as self-balancing

of foreign exchange were abolished. Application and approval processes were greatly simplified. Foreign commercial banks and non-financial institutions were allowed to operate with minimum restrictions. Besides the liberalization of the financial services sector, the government re-launched the process of capital account liberalization, encouraged by favourable internal and external financial conditions. Accession to the WTO, strong economic performance and tremendous growth potential increasingly attracted international investors. At the same time, China's trade surplus began to surge. As a result, the RMB came under strong upward pressure, but the Chinese government was reluctant to allow appreciation on the grounds that it would have negative impacts on China's trade, which would in turn slow economic growth and hence lead to increases in unemployment; it would strengthen the expectations for appreciation, thereby leading to increased speculative capital inflows and further upward pressure on the RMB; and it would bring back deflation at a time when the economy had just recovered from it after seven years.

The most important aim of China's capital controls in this stage was to reduce the upward pressure on the currency resulting from the surging twin surpluses (in the current account and the capital account), and minimize speculative capital inflows attracted by asset bubbles and expectations of RMB appreciation. In contrast to the policy adopted during the Asian crisis, Chinese monetary authorities sought to loosen controls over capital outflows while tightening controls over inflows. The new policy towards cross-border capital flows is characterized as "difficult in and easy out". In August 2008, the Chinese government introduced further measures along these lines.

c. China's present capital account regime

A focus on capital control measures in China would not adequately define the degree of restrictions over capital flows since, because of liberalization of the current account, speculative flows can enter disguised as trade revenues or investment incomes. Therefore, in China, a more frequently used concept is control of cross-border flows of funds, and the corresponding concept for the control regime is called *foreign exchange management*

regime. However, for simplicity, in the following discussion the concept of capital controls will continue to be used.

The major recent changes in China's capital control measures can be summarized as follows:

- Originally Chinese enterprises and commercial banks were allowed to keep a certain proportion of foreign exchange earnings from current account transactions in foreign exchange bank accounts. Currently there are no such limits.
- Residents are allowed to convert RMB to foreign currency up to \$50,000 per annum. They are now free to open foreign exchange accounts.
- Chinese enterprises' overseas investment is now much less restricted than in the past.
- Residents are allowed to buy foreign equities via 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 make overseas portfolio investment. By the end of October 2007, a total of some \$27 billion of funds had been invested outside the mainland 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) scheme. The QFII scheme is a transitional institutional arrangement opening China's capital markets to foreign capital. By the end of October 2007, a total of 52 foreign institutions had obtained QFII status from the China Securities Regulatory Commission (CSRC), of which 49 had been granted an aggregate investment quota of some \$10 billion by the SAFE. At this moment, the total quota of QFIIs is \$30 billion.
- Restrictions on domestic institutions' issuance of bonds abroad have been loosened. By the end of 2006, a total of 27 domestic institutions (including the Ministry of Finance) had been allowed to issue 141 international bonds in major capital markets such as Japan, the United

States, Europe, Singapore and Hong Kong SAR of China, raising \$30.8 billion.

- International development institutions have been allowed to issue RMB bonds domestically. In October 2005, the International Finance Corporation (IFC) was permitted to issue RMB1.13 billion and the Asian Development Bank (ADB) RMB1 billion bonds domestically.
- By the end of October 2007, the China Development Bank, the Export-Import Bank of China and Bank of China had issued RMB5 billion, RMB2 billion and RMB3 billion yuan bonds in Hong Kong SAR, respectively.
- Non-residents are allowed to buy houses in China as long as they have been in China for work or study for more than one year.
- The “extra-national treatment” previously granted to foreign banks which had allowed them to borrow abroad with fewer restrictions than domestic banks has been abolished.
- A new foreign exchange settlement system has been 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 exchange originating from “foreign investment” must be paid to designated recipients and are not allowed to enter into and stay in RMB accounts of enterprises in order to benefit from an appreciation of the RMB.

The main features of China’s current capital account regime are summarized in Table 1. According to the SAFE, among 43 items of transactions under the capital account, 8 items are completely liberalized; 11 items are under loose restriction; 18 items are under moderate restriction; and convertibility is strictly prohibited only for 6 items. Calculations based on the International Monetary Fund (IMF) formula show that so far 80% of China’s capital account has been liberalized.

It is worth emphasizing that, during all stages of the evolution of China’s capital account regime, prevention of transfer abroad of stolen state assets has always been an important objective of capital controls. In the current regime, the supervision of and control over cross-border flows, especially

those that enter China as export revenues and FDI, have been strengthened. Until 2003, China's policy was "easy in and difficult out". Due to a shortage of foreign exchange, the SAFE did not control the source of inflows. With the introduction of the "difficult in and easy out" policy during 2003-2004, it was expected that the SAFE would tighten control over inflows significantly. However, it turned out that the authority failed to implement the policy as stringently as expected. In August 2008, the public was told that the policy of "difficult in" had not been implemented effectively since its initiation during 2003-2004. In fact, controls over cross-border inflows were as loose as in the pre-2003 period. As a result, large amounts of foreign exchange funds, attracted by speculative opportunities in the stock and real estate markets, and exchange rate and interest rate arbitrage, have entered China since 2003, especially since 2005, posing serious challenges to macroeconomic management.

The new regime since August 2008 requires that all cross-border flows of foreign exchange recorded as entries in the trade account must be truly the results of trade transactions and those recorded as entries of investment income must be truly investment income and in line with existing rules and regulations. The same is applicable to foreign exchange funds entering via the FDI account. Correspondingly, the use of RMB funds resulting from selling foreign exchange funds to the SAFE must be in accordance with the use previously approved by the authorities when the application to introduce FDI was filed. The sanctions and penalties for illegal inflows of foreign exchange, illegal sale of foreign funds to the monetary authority and breach of the regulation on the use of RMB funds will be severely applied. The new regime gives the SAFE the power and responsibility of supervising and verifying flows of foreign exchange. For greater effectiveness, the SAFE, the Ministry of Commerce and the customs authorities have linked their computer systems in order to check the "authenticity" of underlying transactions. The key purpose of this arrangement is to eliminate the discrepancies between the true proceeds from exports and the reported receipts of foreign exchange. Data on exports are transmitted by the customs offices to electronic ports, which will in turn calculate the approximate amount of foreign exchange revenues that can be earned from these exports. Banks will buy

Table 1. China's Current Capital Controls: A Summary

		Inflows	Outflows
Money market	Non-residents	No permission	No permission
	Residents	Prior approval by the People's Bank of China (PBOC) and the SAFE is required	No permission for residents, except authorized entities
Stock market	Non-residents	B shares and QFII	Sell B shares, repatriation under QFII
	Residents	Sell H (or N or S) shares abroad, repatriation under QDII	QDII
Bonds and other debt	Non-residents	QFII	No permission, except for some international financial entities, repatriation under QFII
	Residents	Prior approval by the PBOC 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 and other instruments	Non-residents	No permission	No permission
	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.

the foreign exchange only after controlling the data and comparing them with reported foreign exchange revenues. In the event of serious discrepancies, banks must refuse to buy currencies.

A common practice is for export firms to receive an advance from foreign buyers. To prevent them from using this channel to receive and sell foreign exchange for profit, the new regime requires enterprises to present documents (contracts) to local branches of the SAFE to show that such an advance is necessary and make appropriate registration. After having obtained the advance, the enterprises must cancel the registration. If the enterprises fail to make the cancellation, they will be deemed to have made false export reports and will lose their right to receive advance payments in future. Furthermore, ceilings are imposed on the maximum amount of advance payments that enterprises can receive. As a general rule, enterprises cannot receive advance payments amounting to more than 10% of their total foreign exchange revenues received in the previous 12 months.

In the new regime, enterprises are encouraged to increase their holding of foreign exchange. Households and enterprises are given more freedom to invest overseas. The practice of the so-called forced sale of foreign exchange to the SAFE has been abolished, as has the regulation for enterprises to remit foreign exchange they own abroad back home and sell it to the SAFE. At the same time, new regulations have been introduced for portfolio investment, trading of derivatives abroad, and extending loans to foreign entities. The procedure of approval for outbound FDI has been further simplified.

In recent months, due to the turmoil in international financial markets, public opinion has become less favourable with regard to capital outflows. The SAFE has begun to talk about “a more balanced management of cross-border capital flows” and “difficult out.” So far only a few new specific measures towards outflows have been announced, and some others are expected to be in the pipeline. Obviously, the policy of allowing residents to buy and remit abroad foreign exchange up to \$50,000 per annum can be among those subject to change.

Chapter 3

THE CONSOLIDATION OF CHINA'S BANKS

AS pointed out by Akyüz (2004), “Since a large part of cross-border and cross-currency operations are intermediated by domestic financial institutions, notably banks, many prudential measures are considered ... as part of market-based, indirect controls influencing inward and outward capital flows and dollarization. In this sense capital control measures cannot always be distinguished from prudential policies. Several measures that come under prudential policies can in fact be used for managing capital flows.”

At the time of the Asian financial crisis, China's banks, like those in the crisis-hit countries, were beset by high non-performing loan ratios, low capital adequacy and poor corporate governance. In 1998, the issue of NPLs in China was becoming so serious that Lardy (2000: p. 59) concluded that “the most serious threat to macroeconomic stability in China is the possibility of a domestic banking crisis. The central precondition for a crisis, a largely insolvent banking system, already exists.” Because of the similarity between China and the crisis-hit East Asian countries in terms of financial fragility, many observers repeatedly predicted that the Chinese economy would fall.¹ Of course, as it turned out, mainly because of capital controls, the Chinese economy fared much better than most of the other East Asian countries during the crisis.

However, attention should be directed towards reducing banks' fragility by implementing prudential measures such as capital adequacy, reserve and liquidity requirements and loan-loss provisions since experience sug-

¹ For example, a 1998 cover story in the *Economist*.

gests that these can reduce the need for direct control over capital flows. In China, after 10 years of effort, banks' NPL ratio has been lowered to acceptable levels of less than 10% and their capital adequacy has surpassed 8%. Efforts have also been made in recent years to improve corporate governance. However, whether the objectives of these efforts have been achieved still needs to be tested.

a. *Writing off non-performing loans*

The quality of the assets of Chinese financial institutions had deteriorated significantly before the Asian financial crisis. In 1998, the NPL ratio was perhaps higher than those reported by financial institutions in Thailand and Korea in the run-up to the financial crisis in 1997. The lesson of the 1980s is that financial distress is likely to become systemic when non-performing loans, net of provisions, reach 15% of total loans. In China, non-performing loans were estimated in the range of 20% to 50% of total loans at the time (Woo et al. (eds.) 2000). China's highest officially reported NPL ratio was about 25%. In 1999, four asset management companies (AMCs) were established to securitize the banks' non-performing loans. Their funds were mainly raised from the Ministry of Finance (initial capital and follow-up capital), sales of special bonds guaranteed by the Ministry of Finance and borrowing from banks.

The AMCs took over RMB1,400 billion NPLs that were struck off banks' books by debt-equity swaps, the sale of bad loans to domestic and international investors, and other methods. Now China's NPL ratio is lower than 10%. But there is concern that this ratio may rise significantly because of a slowdown of the economy and the bursting of asset bubbles resulting from the global financial turmoil triggered by the subprime crisis.

b. *Raising capital adequacy and IPOs abroad*

Low capital adequacy was another important point of vulnerability of China's banking system. In 1998, in order to raise the capital adequacy of the four major banks from 3.5% to 8%, RMB270 billion was injected by the

People's Bank of China (PBOC). As a result of this recapitalization, the four major banks' capital adequacy reached 8%. It was ascertained at the time that in the next four to seven years, the capital adequacy of the four banks could be maintained at that level. However, this proved to be too optimistic an expectation. Despite repeated bailout actions, further loan losses quickly eroded the banks' capital base. Consequently, a major bailout was carried out once again in 2004.² This time, \$45 billion out of China's huge foreign exchange reserves was injected into two big state-owned banks, Construction Bank of China (CBC) and Bank of China (BOC).

The Chinese authorities were clearly frustrated by lack of progress in the banking reform. The need for recapitalization only six years after the first injection of RMB270 billion clearly demonstrated the failure of the approach pursued. The new thinking of the Chinese monetary authorities thus emphasized the need to attract international strategic investors to consolidate and reform the Chinese banking system. The purpose of the recapitalization was to allow the books of the two banks to reach international standards so that an initial public offering (IPO) could be made and international strategic investors attracted as soon as possible. In 2006 another large capital injection of \$15 billion was made for China's largest commercial bank, Industrial and Commercial Bank of China (ICBC).

The foreign exchange reserves used to raise the banks' capital adequacy were made available via a newly created state company called Central Huijin Investment Company, owned by the PBOC.³ As a result of the capital injection, Huijin Investment Company became the sole owner of the two banks. After the capital injection, restructuring was pursued and the three banks were listed in Hong Kong successfully. Capital of \$42 billion was raised, with international strategic investors becoming important minority shareholders. BOC raised \$11.1 billion in its IPO, CBC \$9.2 billion and ICBC \$21.9 billion (the largest ever global IPO). Soaring share prices made ICBC the world's largest bank.

² It is worth mentioning that the RMB270 billion special government bonds are long-term bonds. The maturity is 30 years. The bonds are marketable in the inter-bank bond market, and hence liquid. The coupon interest rate of the bonds is 7.2% p.a.

³ Huijin has since left the PBOC and become part of China Investment Corporation (CIC).

So far China's three big commercial banks that received capital injections have been performing quite satisfactorily. However, whether there is fundamental improvement in corporate governance is still too early to tell. Indeed, after debt write-off, capital injection, public listing, installation of new IT equipment, and adoption of other technical measures, China's commercial banks have become more up to international standards. However, it is difficult to say whether adequate progress has been made with regard to the more fundamental characteristics of China's banking system, such as nepotism, incompetence and susceptibility to government intervention, and whether the very large costs incurred for banking reform over the past 10 years ensure that the Chinese banking system is now strong enough to weather the storm of global financial crisis, rendering further capital controls unnecessary.

Chapter 4

RECENT CAPITAL FLOWS AND EFFECTIVENESS OF CAPITAL CONTROLS

CHINA'S statistics on cross-border capital flows are very poor. There is no reliable information on the extent of speculative capital flows. As a result, there are serious differences on the effectiveness of China's capital controls. Because of the difficulty in getting reliable data, discussion of the efficacy of the capital controls still relies to a large extent on what is effectively guesswork.

a. Cross-border capital flows

Now let us first examine the nature and size of international flows into and out of China in recent years when RMB appreciation expectations have been strong and monetary tightening has been adopted to control inflation. From Figures 1, 2 and 3, three observations can be drawn. First, FDI inflows have been relatively stable (Figure 3). Second, the trade balance has increased dramatically since 2005 (Figure 2). Third, there are large variations in the capital account as a whole in general and in many sub-accounts in particular (Figures 1, 2 and 3). These variations should be explained in order to explore how and where unwanted capital has entered.

Figure 1. China's Balance of Payments since 2001 (\$billion)

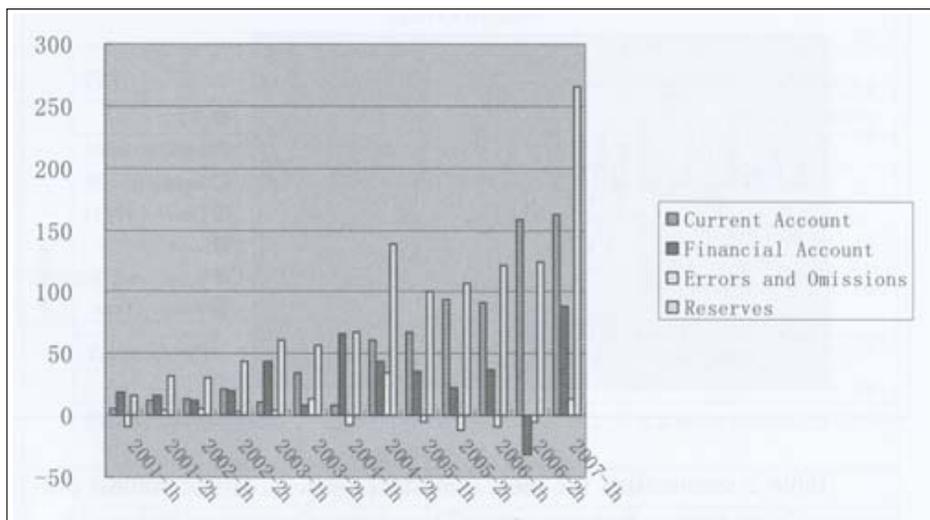


Figure 2. China's Current Account (\$billion)

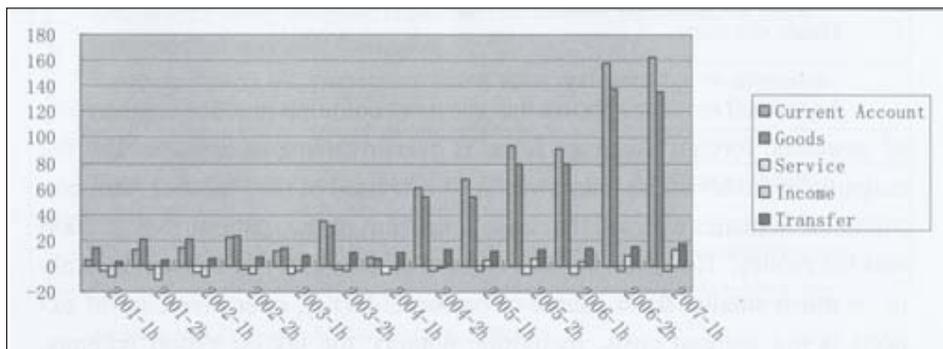


Figure 3. China's Financial Account (\$billion)

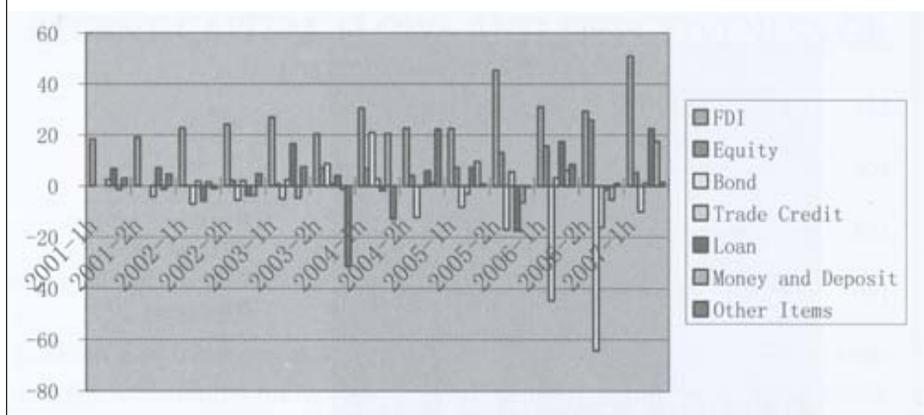


Table 2 summarizes the most important ways of capital control evasion in China during the Asian crisis. Though the direction of flows of foreign exchange is now different, the ways of capital control evasion have been more or less the same in recent years.

i. Trade account

Anecdotal evidence shows that the most common practice for the entry of unwanted foreign exchange funds is over-invoicing of exports. But the magnitudes involved are unknown. A former head of the National Administration of Statistics claimed that about one-third of the trade surplus in 2006 was hot money. However, the true amount of hot money of this sort is likely to be much smaller for a couple of reasons. Firstly, over-invoicing of exports is not without costs, including, notably, the tax on export receipts. Secondly, part of export invoicing may be motivated by the desire to minimize the possible losses caused by RMB appreciation. This would be the case when the settlement of export transactions is brought forward and dollar earnings are sold to the PBOC as quickly as possible. Although at the time of settlement no real transactions have happened, the resulting inflow of foreign exchange should not be characterized as hot money.

Table 2. The Major Forms of Evading the Capital Controls of the Government

Inflow	FDI	Fixed high return without participating in management
		Selling the rights of using infrastructure and fixed assets
	International Borrowing	Borrowing without government approval
		Borrowing with high interest rates
		Using domestic collateral to borrow by foreign ventures or joint ventures
	Trade Credit	Forging documents to disguise borrowing as export earning so as to get tax rebate
		Forging import documents to get trade credit though T/T and L/C
Equity Investment	Using residents as agents to buy shares prohibited to non-residents	
Outflow	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 guise of payment for patents, commissions, travel expenses, transportation insurance	
	Invoicing imports with higher than actual value and remitting the difference abroad	
	Multinational transfer price	
	Forging documents to obtain foreign exchange to pay for faked imported intangible assets	
	Forging documents to obtain foreign exchange 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.

ii. *Investment incomes*

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 2). According to SAFE officials, this change should be attributed

mainly to the accumulation of foreign exchange reserves. Field studies also show that some foreign enterprises are using this channel to benefit from RMB appreciation. Another important change is the increase in the transfer account. Surveys show that the transfer account has been used by overseas Chinese to channel unwanted money into China to buy assets. However, the precise amount of these inflows is unknown.

iii. Equity investment

Figure 3 shows that equity investment increased significantly in 2006, especially in the second half of that year, which coincided with the rapid recovery of China's equity market, which had been in the doldrums for years. This flow subsided in the first quarter of 2007, because most foreign investors considered that China's equity prices were already too high and unwinded their long position.

iv. Foreign loans and trade credits

China's foreign loans and trade credits have increased significantly since 2003 (Figure 3). One possible reason for such a surge is that, due to expectations of RMB appreciation, short-term borrowing in dollars is attractive. Another reason is that due to monetary tightening, RMB loans are no longer easily available. By borrowing dollar loans and selling these dollars immediately for RMBs, enterprises not only obtained credits but also made profits on RMB appreciation. Finally, in order to hedge against exchange rate risks, enterprises sign futures contracts with domestic banks, and the latter in turn borrow from foreign banks on spot markets.

Despite the complexity of the foreign borrowing, the PBOC has been concerned about the sudden increase in foreign borrowing and has taken measures to tighten control over short-term foreign borrowing.

v. *Foreign bonds*

Purchases of foreign bonds increased dramatically in 2006 at the same time as China was piling up foreign exchange reserves. The increase in capital outflows in the form of acquisition of bonds may be related to measures taken by the PBOC to usher out funds to reduce RMB appreciation pressure. The negative sign of “other items” in Figure 3 in 2004 may reflect the PBOC’s capital injection into the commercial banks. Because banks were not allowed to convert their newly acquired foreign exchange into RMB, they had to keep the foreign exchange in overseas accounts.

vi. *Money and deposits*

Since 2005, commercial banks were requested to do currency swaps from time to time. The increase in the inflows of money and deposit accounts in 2007 may be related to the unwinding of their previous positions.

Some analyses of China’s international balance of payments focus attention on the so-called unexplained capital flows. According to a report by Stone & McCarthy, a large proportion of unexplained capital flows, which were not recorded as FDI or trade surplus but contributed to changes in foreign exchange reserves, was related to unwinding of currency swaps, IPO repatriations, and options with Central Huijin. The report 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).”⁴ On this view, a large portion of Q1 and Q2 foreign exchange reserves remains unexplained by the trade surplus, foreign direct investment, interest income, unwinding of swaps, IPO repatriations and the exercise of options with Central Huijin. Hence, speculative capital betting on a rise in China’s currency or property and equity markets seems a likely suspect. There are no reliable statistics on these

⁴ Logan Wright, “China: Another Look at FX Reserves, Unwinding Swaps, and Hot Money”, Stone & McCarthy, 22 November 2007.

transactions. However, it appears that an important part of the unexplained portion of foreign exchange reserve growth in the first half of 2007 can be attributed to the unwinding of previous positions built up a year before by the commercial banks, which had been designed to reduce appreciation pressures on the RMB in 2006 in line with the policy pursued by the PBOC.

b. How effective are controls over capital inflows in China?

The most commonly used criterion for examining the effectiveness of capital controls is to compare covered interest rate differentials between different countries. On this measure, if China's capital controls are effective, the covered interest rate differentials between China and the euro-zone or between China and the United States should be significant. This is in fact the case. The Chinese monetary authorities have succeeded for years in maintaining significantly different interest rates in China from those in the US. If capital controls were ineffective, according to the uncovered interest rate parity theorem, large capital inflows should have already forced down China's interest rate to make the interest rate spread equal to expected RMB appreciation. There is ample reason to believe that those bringing in funds would most likely be interested in getting hold of an asset which adds another 10-20% a year to one's return rather than 3%. This is because in China capital cannot move freely across borders, capital markets are not efficient, and there is a home preference by investors. In other words, foreign investors including speculators need a much higher interest rate premium to compensate for risks as well as transaction costs created by capital controls.

Another meaningful measurement is the magnitude of errors and omissions in China's balance of payments. The clearest indication of the effectiveness of China's capital controls was the fact that the 1998 crackdown on the illegal activities facilitating capital flight enabled China's official foreign exchange reserves to increase significantly after the fourth quarter of the same year and turned the capital account deficit back to surplus.

The analysis in the previous section shows that most of the anomalies in the international balance sheet of China are explainable. Until recently, short-term capital flows, especially speculation-oriented short-term capital

flows, were not significant enough to nullify the independence of monetary policy. The experience also shows that, despite leaks and loopholes, capital controls can be made effective as long as the government has the determination and costs of control are regarded as affordable.

In 2008, due to the heightened appreciation expectations and interest rate spreads in favour of China, the incentive for speculative capital inflows has certainly been much stronger and control over capital inflows may become much more difficult. But this does not mean that China's capital controls are not effective or cannot be made effective. An interesting development is that over the past two months when the SAFE has started to implement tight control over inflows of capital in earnest, the pace of increase in foreign exchange reserves has declined significantly, and inflows disguised as trade earnings or FDI have fallen. This is vivid evidence supporting the proposition that capital controls are effective, as long as the government is determined to implement them.

c. The need for control over outflows

I have long argued for symmetrical controls over capital flows. Stricter control over capital inflows is correct. However, loosening control over capital outflows will not be very helpful in relieving the pressure on the RMB exchange rate. On the contrary, loosening control over capital outflows will encourage, rather than discourage, capital inflows, especially speculative capital inflows. If exit becomes easier and the risk premium lower, entry would be encouraged.

It is generally agreed that for many of the emerging markets with underlying fragilities like a huge fiscal deficit, a banking sector with significant non-performing loans, or an opaque corporate or financial sector, full capital account convertibility is risky. China suffers, in addition, from lack of clearly defined property rights. A great portion of public assets has been stolen in the process of the so-called stealth privatization. Much of this stolen money ends up in offshore centres like the Virgin Islands and/or Cayman Islands. In enterprises owned by the state both in name and in fact, managers tend to be very careless about where public money goes due to a lack of

appropriate incentives and moral laxity. In short, before further institutional reform is accomplished for property rights and appropriate corporate governance is put in place, encouraging capital outflows for the purpose of relieving the pressure on the RMB would indeed amount to “putting the cart before the horse”.

More importantly, China is a highly monetized country, with the M2/GDP ratio as high as 160%. This implies that Chinese households have huge claims on the official foreign exchange reserves. China’s household saving deposits amounted to RMB18 trillion (\$2.5 trillion) and reached 85% of GDP in 2006. A decision by the households to diversify 20% of their savings into foreign assets would imply a capital outflow of some \$500 billion. Furthermore, with an FDI stock of more than \$600 billion, the corresponding investment income outflow can be as high as \$120 billion, assuming a rate of return of 20% on foreign investment. Finally, China has a relatively large amount of short-term foreign debt – more than \$170 billion – as well as hot money. If there is a loss of confidence for whatever reason, the total outflow can be huge, capable of creating payments and currency instability which could be translated into a domestic financial crisis, given the fragility of the banking system, and a fully fledged economic crisis. All these suggest that utmost care should be exercised in the liberalization of resident capital outflows.

Chapter 5

MACROECONOMIC AND EXCHANGE RATE POLICIES AND CAPITAL CONTROLS

SINCE reforms and the opening up in 1978, the Chinese economy has experienced several cycles. From 1997 to 2002 it was in deflation, where a relatively low growth rate of about 7-8% was combined with a negative rate of inflation. During that period, the government implemented expansionary monetary and fiscal policy to reflate the economy. As a result, the pace of growth picked up in the second half of 2002, but inflation remained at a very low level. However, in 2004, signs of overheating appeared, and the government started to adopt tight monetary policy to cool down the economy. The economy softened in the first half of 2005, before heating up in the second half, but inflation was still subdued. In July 2007, the year-on-year inflation rate suddenly jumped to 5.6% and since then it has increasingly become a major concern.

a. Causes of overheating

Inflation is the result of overheating of the economy since 2003. For many years, the consensus was that China's potential growth rate was 8%. In 2007, the growth rate of GDP was 12%. It is hard to believe that China's potential growth rate has jumped from 8-9% to 11-12% over the past few years. No convincing empirical evidence has been provided to support this argument.

According to calculations by the Center of Economic Information of the National Development and Reform Commission (NDRC), since 2003 China's actual growth rate has been consistently higher than its potential

growth rate (Table 3). The existence of excess demand (domestic plus foreign) is bound to lead to inflation. Demand for fixed asset investment (FAI) and a rapid increase in exports are the two most important contributing factors to excess demand. The single most important contributing factor to the growth of FAI is demand for housing, supported by easy mortgage loans, which contributed more than a fifth of the growth of FAI over the past several years. As supply of housing could not keep pace with the rapid increase in demand, the result has been a rapid increase in house prices which, in turn, stimulated speculative demand for houses and added to the price momentum.

Table 3. The Gap between Actual and Potential GDP Growth Rates

	Actual Growth Rate	Potential Growth Rate	Gap
2002	9.1	9.2	-0.1
2003	10.0	9.7	0.3
2004	10.1	9.9	0.2
2005	10.4	10.0	0.4
2006	11.6	10.1	1.5
2007	11.9	9.9	2.0

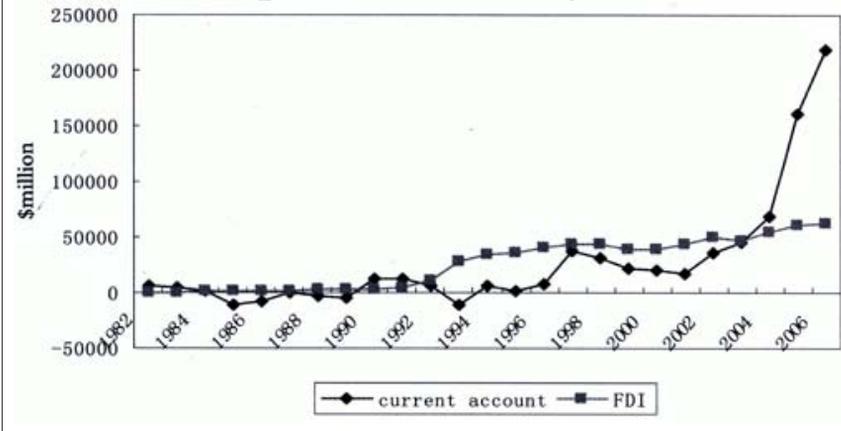
Source: Zhu Baoliang, NDRC, 2008.

China's export drive is another important contributing factor to the excess demand experienced in recent years. China's exports and trade surplus have risen strongly since 2003. It is worth noting that the increase in exports is not a result of sluggish domestic demand. In fact, the processing trade accounts for about 60% of China's exports. Strong global demand and undervaluation of the RMB rate are the two most important factors underlying the strong export performance.

b. The root cause of China's monetary accommodation

Without accommodating monetary conditions, excess demand cannot be sustained and inflation cannot be ignited. How, then, did such monetary

Figure 4. China's Twin Surpluses

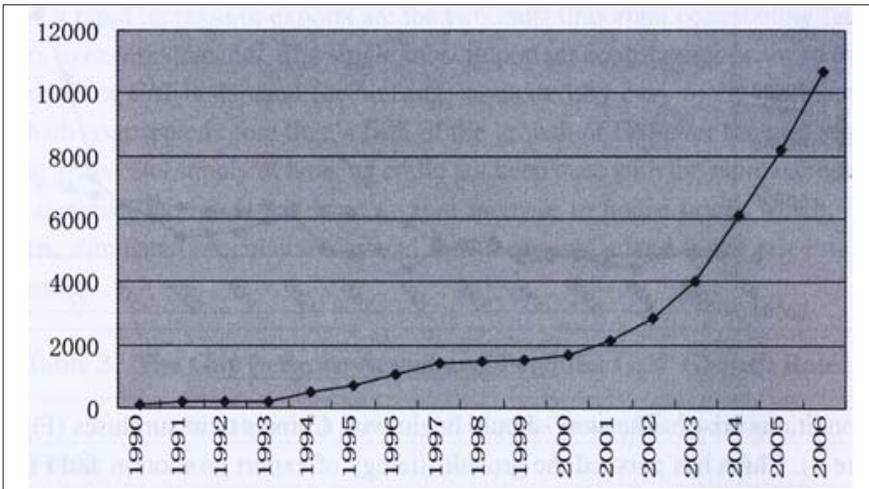


conditions arise? The story should begin with China's twin surpluses (Figure 4). China has pursued the growth strategy of export promotion and FDI attraction since the early 1980s. To implement the strategy, China adopted several measures including high tax rebate rates for exports, preferential policy towards FDI, and a competitive exchange rate. After more than two and a half decades of these export promotion and FDI attraction policies, China has created an economic structure characterized by a very high share of trade in GDP, the dominance of processing trade, and a high share of FDI in total investment. This economic structure, in turn, consolidates the pattern of consistent trade surpluses and net FDI inflows.

As a result of persistent surpluses in its balance of payments, China's foreign exchange reserves have been increasing steadily (Figure 5). The dramatic increase in the trade surplus since 2002 has played an increased role; while China's foreign exchange reserves were about \$200 billion in 2001, they have now surpassed \$1.8 trillion. Under a more flexible exchange rate regime, China would not have run twin surpluses and would not have to accumulate ever-growing amounts of foreign exchange reserves.

From 1980 to 1994, China's exchange rate regime was characterized by the so-called real target approach (Zhang 2001). In order to promote exports and restrict imports, a policy of multiple exchange rates was pursued. For each category of imports and exports, there was a separate exchange

Figure 5. The Accumulation of Foreign Exchange Reserves (\$100 million)



rate, calculated on the basis of production costs. After 1994, a managed floating regime was adopted. In the following years until the Asian financial crisis, the exchange rate of the RMB vis-à-vis the US dollar appreciated 1-2% per annum. During the Asian financial crisis, the RMB was subjected to great pressure for devaluation. While other currencies in the region fell significantly, the Chinese government was committed to adopting a policy of stable exchange rate. The exchange rate regime thus shifted from a managed float to a de facto peg to the dollar. After 2002, due to China's strong export performance, appreciation pressure on the RMB started to build up. In July 2005, China adopted a new exchange rate regime which referred to a basket of currencies. It was feared that if the RMB was allowed to appreciate dramatically, its negative impact on China's trade would be too great to bear. The Chinese authorities hoped that the peg to a basket would allow China to implement a policy of autonomous, gradual and controlled appreciation. It would allow two-way movement of the RMB vis-à-vis the US dollar, so that the one-way bet on RMB appreciation by speculators would be eliminated and the slow appreciation that could occur would not necessarily lead to large inflows of hot money and pressures for a once-for-all

appreciation of the RMB. However, as the US dollar has constantly depreciated against other major currencies since 2002, the peg to a basket has failed to produce two-way fluctuation as desired. Although the RMB appreciation was slow, it appreciated continuously, generating one-way bets.

If the peg to a basket failed to deter capital inflows aimed at exchange rate arbitrage, what else could China do? In order to discourage capital inflows, China had to maintain a negative interest rate differential with the US, equal to China's desired pace of RMB appreciation – that is, some 3% per annum. Therefore, until late 2007, the PBOC tried hard to maintain an interest differential of 3%. It is worth mentioning that the rationale of such a policy is based on free flows of capital. But this is not the case. Besides, by sticking to the hypothesis of uncovered interest rate parity (UIP), China failed to raise the interest rate as necessary.

In summary, due to persistent twin surpluses and capital inflows motivated by exchange rate and interest rate arbitrage, and disguised as export revenues and FDI inflows, or entering via other channels, the RMB has been under constant pressure for appreciation. Because the Chinese government does not wish the RMB to appreciate significantly to undo the appreciation pressure, the PBOC has to step in to intervene in the foreign exchange market to buy up foreign exchange. As a result, the PBOC has injected large amounts of liquidity into circulation while accumulating growing foreign exchange reserves. In other words, accommodating monetary conditions have emerged in large part because the PBOC failed to sterilize fully the additional liquidity created by its intervention in the foreign exchange market.

c. China's sterilization policy

Excess liquidity is a widely used but controversial concept. Here, for the sake of simplicity, we define excess liquidity as the difference between supply of money (M2) and demand for money.

Assume the supply of money can be depicted as

$$M = mH$$

where M , m and H represent broad money, the monetary multiplier and the monetary base, respectively. The multiplier is represented by

where r and c are the reserve ratio and the currency-deposit ratio, respectively. It is worth noting that the currency-deposit ratio c is not very stable. In China it tends to vary in a pro-cyclical way. Define demand for money as follows:

$$M^* = P^*Y^*$$

where M^* , P^* and Y^* are demand for money required by nominal growth of the economy, the target price index, and potential output, respectively.

The purpose of sterilization is to offset the excess liquidity created by the central bank intervention in the foreign exchange market to ensure the supply of money (M) is equal to the demand for money (M^*). From the simple money supply function, we have

$$\Delta M = H\Delta m + m\Delta H$$

Namely, the change in money supply is caused by changes in either the multiplier or the monetary base, or both. If the increase in money supply exceeds the increase in money demand, to avoid price increases excess liquidity would need to be eliminated by a reduction either in the monetary multiplier or in the monetary base, namely

where Δm^s represents the reduction in the multiplier, and s is the rate of sterilization of the increase in the monetary base ($s = 0$ means that none of the increase in the monetary base is sterilized; $s = 1$ means that all the increase in the monetary base is sterilized).

Table 4. Changes in the Reserve Requirement	
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%
2008 (01/25)	15%
2008 (03/25)	15.5%
2008 (04/15)	16%
2008 (05/25)	16.5%
2008 (06/15-25)	17.5%

It is worth noting that the multiplier can be reduced by increasing the reserve ratio. The decrease in the multiplier due to an increase in the reserve ratio can be represented by

$$\Delta m^s = \frac{1+c}{r+c} - \frac{1+c}{r(1+\delta)+c}$$

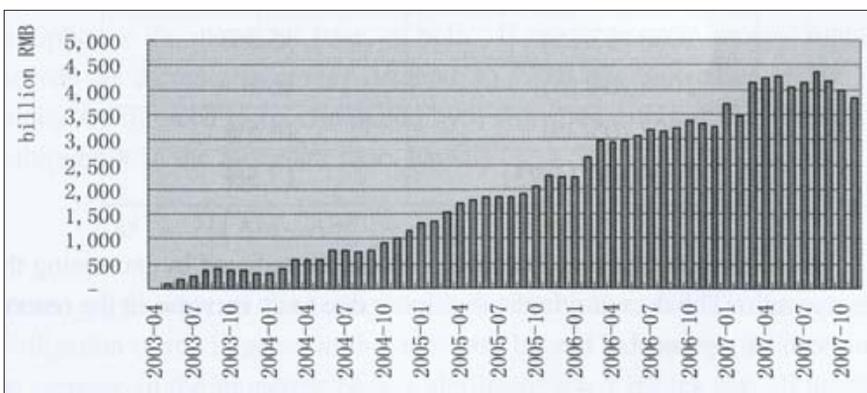
where δ is the percentage point increase in the reserve ratio.

$\Delta m^s H + s \Delta H m$ is the liquidity sterilized by the central bank via raising the reserve requirement and selling central bank bills.

As a matter of fact, over the past five years, China's monetary policy has been mainly about sterilization policy. The Chinese monetary authorities have slowed down the increase in domestic credit by raising the reserve requirement (and hence the reserve ratio) and by selling central bank bills (CBBs) to commercial banks, with the former being the most frequently used instrument. Since 2003, the PBOC has raised the reserve requirement 20 times. As a result, the reserve requirement has increased from 7% in 2003 to the current 17.5% (Table 4).

In China, reserves consist of two components: required and excess reserves. The former is legally binding. The second is decided by commercial banks based on their liquidity considerations. Given excess reserves, which have been about 3% of total bank deposits for years in the past, the increase in reserve requirements can reduce the liquidity of commercial banks and hence check their ability to extend loans to the public. The end result should be a slowdown in the growth rate of money supply. However, due to the abundance of liquidity and improvements in the efficiency of settlements,

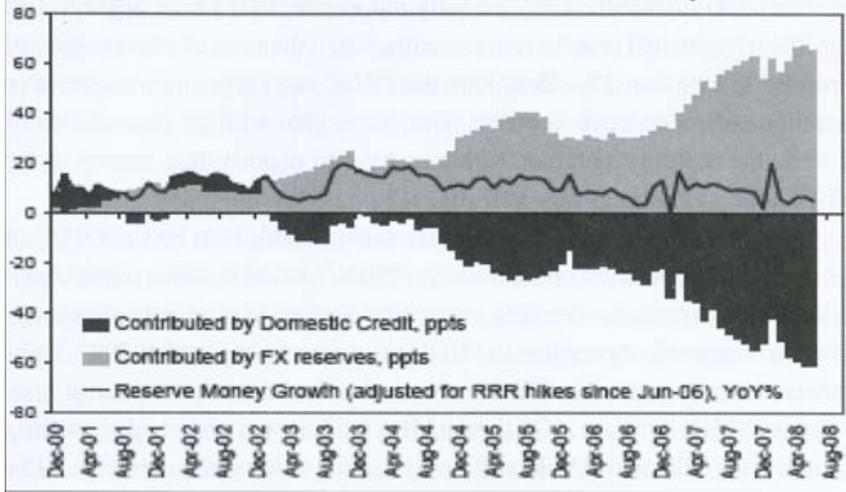
Figure 6. Central Bank Bills



Source: www.chinabond.com.cn. Calculated by Zhang Ming.

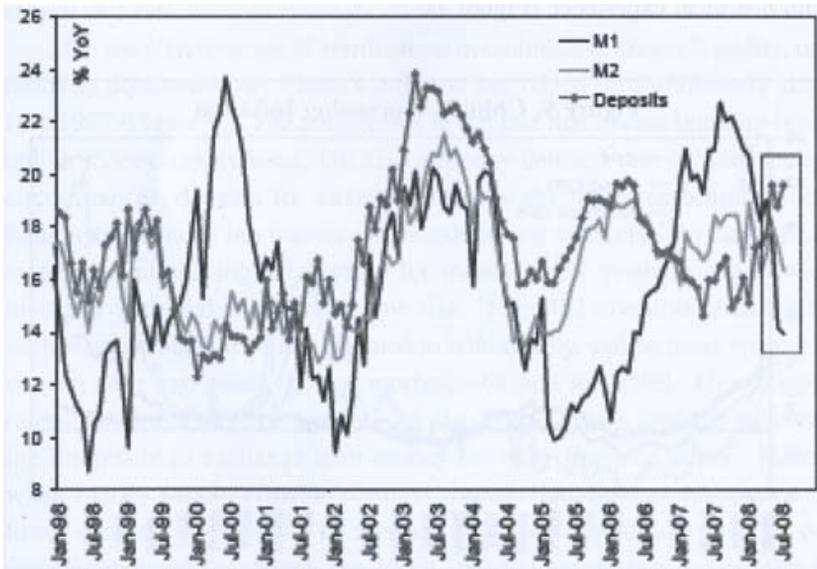
Note: Our assumption is that the balance of central bank notes is zero at the end of 2002. The highest balance till now is RMB4.3 trillion in August 2007.

Figure 7. Sterilization and Growth of the Monetary Base



Source: Wang Qing, Morgan Stanley.

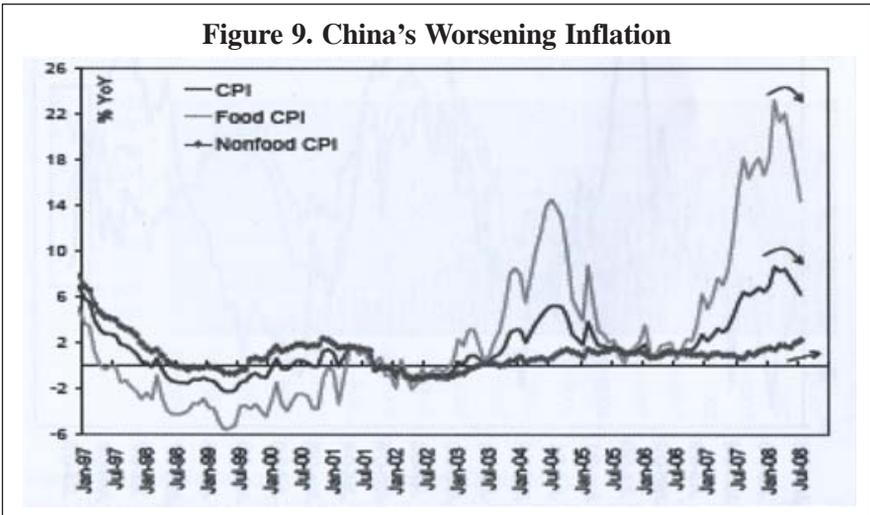
Figure 8. The Growth Rate of Money Supply



Source: Wang Qing, Morgan Stanley.

commercial banks have reduced their excess reserves to offset the increase in reserve requirements. Only recently did commercial banks begin to feel the bite of tightened reserve requirements, when the ratio of excess reserves dropped to less than 2%. How long the PBOC can carry on raising reserve requirements is an open question. The fact is that with an interest rate of 1.89%, the more the commercial banks have to deposit their money in the PBOC, the more losses they will run.

In 2003, after having sold all government bonds held by the PBOC in its previous sterilization operations, the PBOC started to issue central bank bills to mop up excess liquidity created by foreign exchange market intervention (Figure 6). According to PBOC resources, as of October 2007, high-powered money created by PBOC intervention in the foreign exchange market was RMB11 trillion. Of this, RMB5 trillion was absorbed by selling central bank bills and RMB3 trillion by raising reserve requirements. The rest, RMB3 trillion excess liquidity over five years, was just enough to meet the need to support the growth of demand for broad money. It is claimed by the PBOC that the growth of the monetary base has been more or less in line with historical experience (Figure 7).



Source: Wang Qing, Morgan Stanley.

As a result of sterilization, excess liquidity created by the PBOC's intervention in the foreign exchange market was basically mopped up, and the growth rate of broad money M2 has been more or less in line with the needs of economic growth (Figure 8). China's nominal economic growth rate was more than 16-17%. The M2 growth rate of 17-18% was not widely off the mark.

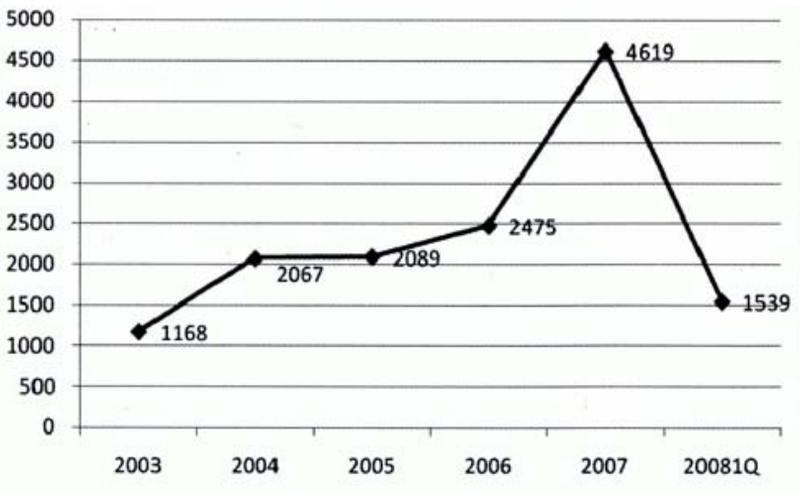
Putting aside the question of whether the sterilization has been sufficiently effective in eliminating excess liquidity, there is considerable uncertainty over its sustainability. Sterilization has created serious problems for commercial banks, which have to buy ever-larger amounts of low-yield central bank bills and to deposit an increasingly higher proportion of their liquidity with the central bank. As a result, the share of low-yield assets already accounts for more than 30% of total assets in many banks. The steady increase in the share of low-yield assets in the total assets has erased the profitability of commercial banks, thereby creating fragility. It is obvious that the policy of sterilization cannot be sustained forever. The root cause of excess liquidity, namely payments imbalances, must be addressed head-on sooner or later.

On the effectiveness of sterilization in eliminating excess liquidity, one needs to determine why China's inflation has edged up significantly since July 1997 (Figure 9). 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 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 attracted by such instruments will be less inclined to hold money, and be more willing to convert cash into assets such as mortgage-backed securities. Greed, 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 can be created by lower demand for money. To mop up the excess liquidity created by decreasing demand for money, the PBOC needs to encourage households to hold money as well as to slow the growth rate of money supply. In recent

months, due to the fall in share prices, slowdown in growth of housing prices, and rising inflation, demand for money in China seems to be increasing again.

Given that the money demand function – velocity of circulation – is unstable and sterilization imposes a heavy toll on commercial banks, China’s monetary tightening could well be achieved by interest rate tightening. Before examining why the Chinese monetary authorities are reluctant to use interest rate rises, it should be pointed out that in China interest rate policy refers mainly to changes in interest rates on bank loans and deposits. Because of underdevelopment of the money market, the PBOC cannot change the liquidity in the money market so as to change the cost of bank credit (such as the overnight call rate). Therefore, China’s benchmark interest rate is not equivalent to the US Federal Funds Rate. For loans, the benchmark interest rate is a floor reference rate. Commercial banks are free to charge rates on loans above the floor. For deposits, the benchmark interest rate is a ceiling reference rate and the commercial banks are free to pay rates below

Figure 10. Dramatic Increase in Foreign Exchange Reserves (\$100 million)



Source: SAFE, 2008.

Note: In the first quarter of 2008, the increase in foreign exchange reserves is \$150 billion. If this trend is maintained, by the end of 2008, the increase can be as high as \$600 billion.

the ceiling. In contrast to the role of interest rate adjustment in developed countries, raising the rate on loans shifts neither the supply of nor the demand for credit. But raising the interest rate on loans can make credit rationing less necessary and hence reduce the scope for rent-seeking activities. On the other hand, raising the deposit rate can stabilize or increase demand for money (demand for deposits).

The most important constraint on the PBOC's using interest rates as a main policy instrument is that higher rates can increase capital inflows and hence bring in new liquidity from the supply side. Other policy instruments, as long as they are aimed at monetary tightening, can lead to the same problem. For example, because of the increasingly heavy burden of rolling over debt on banks, the PBOC has had to allow yields on CBBs to rise. Actually, on many occasions in the auction of CBBs, the PBOC failed to sell out the bills according to plans when it pre-fixed their price.

Since the onset of the subprime crisis, the lowering of the Fed funds rate has increased the interest differential with the US in favour of China and made China's monetary tightening much more difficult. On top of RMB appreciation expectations, the increasingly large positive interest rate spreads have attracted more capital inflows since late 2007 (Figure 10). It is possible that in 2008 China may add \$600 billion to its already huge foreign exchange stock. Sterilizing such a huge amount of liquidity is a very difficult task.

There is no doubt that China needs to continue its policy of monetary tightening because of inflation. Nominal interest rates should be further increased so as to make real interest rates positive gradually. Credit rationing should be avoided by allowing interest rates to balance the demand for and supply of credit. Some observers in China argue that the RMB should be devalued or re-pegged to the US dollar so that expectations of RMB appreciation can be eliminated. This is totally unrealistic. The fundamental cause of appreciation is China's twin surpluses. The elimination of appreciation expectations, if possible, can at most eliminate capital inflows driven by the prospect of RMB exchange rate appreciation. It can do nothing about the twin surpluses. In fact, other things being equal, the devaluation of the RMB will lead to larger twin surpluses and hence to an increase rather than

decrease in the appreciation pressure. Furthermore, in the face of twin surpluses, to push down the RMB exchange rate would mean heavier intervention in the foreign exchange market and more sterilization. As mentioned earlier, the scope for further sterilization is very limited. Therefore, the RMB should continue to appreciate to reduce the twin surpluses and to reduce the burden of sterilization.

What, then, can China do about international capital flows aimed at interest rate and exchange rate arbitrage? It has to maintain a relatively high interest rate to control inflation no matter what the US Federal Reserve does. At the same time, it should continue to allow the RMB to appreciate to eliminate the twin surpluses. With the large twin surpluses, China cannot make the market believe that there will be no further appreciation of the RMB. But it can reduce the inflows of capital attracted by interest rate and exchange rate arbitrage via capital controls. The strengthening of control over cross-border flows can minimize the arbitrage inflows, so that the authorities can gain more space to implement tight monetary policy, and export firms more time to reduce their reliance on foreign markets and FDI inflows.

It seemed that in late 2007, China was opting for an acceleration of RMB appreciation. However, due to the deepening of the subprime crisis and the slowdown of the global economy, the growth rate of China's trade surplus has turned negative. Out of fear of an economic downturn, the government has recently shifted its policy, trying to slow down the pace of appreciation.

Currently, the economic prospects are shrouded in uncertainty. How will the subprime crisis unfold? What will be the prospects of global inflation and growth? Will China's inflation subside? Will China's economic growth slow down? Is the narrowing of the trade surplus temporary? How much hot money is there in China? Faced with great uncertainty over such questions, the Chinese government is torn between tightening and loosening monetary policy. It is also hesitant about the exchange rate policy. But it is determined to stem unwanted capital inflows. Theoretically speaking, a once-for-all appreciation of the RMB can achieve the objective of eliminating the latter. However, if the pace of RMB appreciation is not accelerated, the only

option left would be to tighten controls over capital inflows. As already noted, the government has recently strengthened the management of capital flows and the new policy seems to be working. The accumulation of foreign exchange reserves has slowed down recently, alongside the pace of RMB appreciation.

Chapter 6

MANAGEMENT OF FOREIGN EXCHANGE RESERVES

ACCUMULATION of foreign exchange reserves means passive export of capital and accumulation of foreign claims by the governments. That an increased number of poor countries have become lenders to rich countries is one of the most puzzling developments in the contemporary world economy. This pattern of global capital flows shows that there is something fundamentally wrong with the current international financial and trade systems and in developing countries' growth strategy.

Developing countries' reserves have risen rapidly since the Asian financial crisis. In the 1970s and 1980s the reserves ranged from 6-8% of GDP. By the end of 2004, they rose to almost 30% of GDP. By contrast, reserves held by industrial countries have remained roughly at below 5% of GDP since the 1950s. The traditional rule of thumb was that central banks should hold a quantity of foreign exchange reserves equivalent to three months of imports. According to the so-called Guidotti-Greenspan-IMF rule, countries should hold liquid reserves equal to their foreign liabilities which will come due within a year. Measured by any rule, however, China's foreign exchange reserves are exceptionally high. The return on investment in Treasury bills has been low and now is actually negative.

To increase the return on its vast foreign exchange reserves, based on the Singaporean experience, China established a corporation separate from the SAFE to manage the foreign exchange reserves allocated to it. The new corporation, China Investment Corporation (CIC), is a state-owned company, and answerable to the state council instead of the PBOC, because the official rank of the head of the CIC is a minister equivalent to the governor

of the PBOC and the minister of finance. The mission of the CIC is to seek higher returns for China's foreign exchange reserves. Different from the SAFE which puts emphasis on safety and liquidity, it can pursue a more aggressive strategy in the management of the foreign exchange reserves it owns.

The road ahead for the CIC is bumpy. In fact, its first batch of investment has caused serious controversy. Before it was even formally founded with an address and telephone number, it had already struck a deal with American private equity fund Blackstone. Under the deal, the CIC purchased a \$3 billion stake in the Blackstone Group when the fund went public, and acquired its shares at a discount of just 4.5% to the initial offering price, or \$29.605. In exchange, the CIC agreed that the shares it acquired would not give voting rights and could not be sold for at least four years. The deal immediately aroused unfavourable reactions from the suspicious public⁵: With so many foreign investment options for China, why should a secretive private equity firm be the first choice? What is the CIC's investment strategy?

Since Blackstone went public on 22 June, the company's shares have fallen steeply, pushing down the value of the Chinese government's investment by more than \$425 million in just six weeks.⁶ The CIC was widely criticized for the deal. However, with the benefit of hindsight, it is clear that there were not many opportunities for the CIC as well as the SAFE to invest abroad with a satisfactory return. With the worsening of the subprime crisis, the values of US assets are falling, and their default risks increasing. It is already very difficult, if not impossible, for the CIC to preserve the values of its assets, let alone earn higher returns. It is thus not fair to blame the CIC and SAFE for the losses on the assets they are managing. The real problem is China's continued accumulation of foreign exchange reserves. This has put the two foreign exchange management institutions in a no-win situation.

Matters can actually become much worse. The apparent paradox of the poor lending to the rich will reach new heights if China becomes the lender of last resort for the US. According to US sources, China has pur-

⁵ He Fan and Sheng Shihua, "A Dangerous Jump", *The First Finance Daily*, June 2007.

⁶ Keith Bradsher, "Feeling the Heat, Not Breathing Fire", *New York Times*, 2 August 2007.

chased \$370 billion mortgage debts from Fannie Mae and Freddie Mac which are effectively insolvent. It is no longer unthinkable that the US could default on its debt. If this happens, the impact on China will be devastating. However, it is already too late for China to avoid the risks. What China can do is to keep reminding the US government of its international duty and keep faith in the Treasury and the Federal Reserve.

In an article, Lawrence Summers pointed out that “inevitably, and appropriately, countries possessed of publicly held foreign assets far in excess of anything needed to respond to financial contingencies feel pressure to deploy them strategically or at least to earn higher returns than those available in US Treasury bills or their foreign equivalents ... But on any plausible path over the next few years, a crucial question for the global financial system and indeed for the global economy” is how these Sovereign Wealth Funds (SWFs) will be invested.⁷

Contrary to these fears, so far there is no evidence whatsoever to show that SWFs have created any important impact on exchange rate volatility, let alone any serious disturbance in the global financial market. In fact, developing countries’ SWFs are the outcome of a desperate effort to obtain a decent return on their investment. With or without SWFs, under current international financial arrangements, developing countries are clearly losers. However, the US complains loudly as if it is a victim of unfair trade, while happily enjoying the benefits from cheap exports and finance from developing countries, whereas China seems unnerved and constantly in a defensive position. It has to be admitted that the US government has found a brilliant way of keeping America’s good times rolling.

⁷ Lawrence Summers, *Financial Times*, 29 July 2007.

Chapter 7

THE CHALLENGES AHEAD

BECAUSE of capital controls over the past several years, China has not been inundated with hot money. However, the situation could change. In responding to the subprime crisis, the US Federal Reserve has been cutting the interest rate and injecting liquidity into the financial system. As a result, cross-border capital inflows driven by interest rate and exchange rate arbitrage can increase significantly and pose a serious threat to the stability of the Chinese economy.

Based on the assumption that China's capital controls are still largely effective, the following policy instruments should be adopted. As a first line of defence, China should improve its management of cross-border capital flows, so that unwanted capital inflows aimed at gains in the capital market or arbitrage on the interest rate and/or the exchange rate can be discouraged. Secondly, the RMB should be allowed to appreciate in order to absorb the pressure created by the twin surpluses and the hot money that manages to evade the capital controls. Thirdly, sterilization policy should be maintained to mop up remaining excess liquidity. Fourthly, interest rates on households' deposits should be increased, so that households' desire to hold money in the form of saving deposits can be increased. Interest rates on credit should also be increased, so that credit rationing and the resulting misallocation of resources can be avoided.

However, even though a strengthening of capital controls would give the government respite, it will not solve the problem of imbalances. Unless this problem is addressed head-on via policies aimed at restructuring the economy, the twin surpluses are unlikely to disappear and RMB apprecia-

tion pressure will persist. Without allowing the RMB to appreciate adequately, excess liquidity will remain and so will the inflationary pressures. Now with the deepening of the US financial crisis, China is facing the very challenging task of preserving the value of its foreign exchange reserves. It seems that it has fallen into the trap of holding US debt. It is all but impossible to do anything about its foreign exchange reserves. It is unfortunate that in order to maintain growth and employment, China has to rely on its trade surplus, which means continued lending to the US. This is something China must rectify as soon as possible. It must allow the RMB to appreciate and reduce its dependence on external markets. On the other hand, China cannot rule out the possibility of a sudden reversal of capital flows, triggered by whatever shocks. Therefore, for both short-run macro-stability and long-run financial security, China should further improve its management of cross-border capital outflows as well as inflows. It still has a long way to go before it can consider liberalizing capital controls and making the RMB fully convertible.

Despite the severe challenges China is facing, the long-term prospects for the Chinese economy remain bright. Short-term difficulties such as inflation and a slowdown in growth are surmountable. China's economic fundamentals are still strong. Its institutional frameworks are improving by the day, resulting in a healthier financial system and sustained competitiveness in manufacturing. The country will continue its open policy and play its part in helping the global economy to maintain its growth momentum in one of the most difficult periods in recent history. The maintenance of capital controls is an indispensable condition for China's success in the years to come.

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THE MANAGEMENT OF CROSS-BORDER CAPITAL FLOWS AND MACROECONOMIC STABILITY IN CHINA

China has been an economic success story over the last three decades, but in recent years persistent balance-of-payments surpluses have subjected the Chinese currency to appreciation pressures and the economy to the danger of overheating. Among the policy measures the Chinese government can use, and has used, to address these challenges is the imposition of capital controls.

This paper examines China's management of cross-border capital flows and the role it plays in the stewardship of the Chinese economy. The author also traces the evolution of the country's capital account regime from the 1980s till the present-day policy, which aims at relieving upward pressure on the currency and minimizing volatile speculative capital inflows.

China's experience shows that, notwithstanding some leakages and loopholes, capital controls are effective if the government has the will and determination to implement them. Indeed, this paper contends, the maintenance of capital controls should be a key part of policy efforts to sustain China's remarkable record of rapid and stable growth.

YU YONGDING is *Director-General of the Institute of World Economics and Politics, Chinese Academy of Social Sciences.*

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