

# **China, the Choice of Exchange Rate Regime, and Capital Account Convertibility**

A policy paper.

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*(the following policy paper is directed at the head of the Chinese Ministry of Finance)*

## **Statement of Issue**

Should China move towards a true floating exchange rate policy while pursuing capital account liberalization? In the context of China's continuing reform efforts, deflationary environment, weakening domestic demand, WTO accession, and global economic downturn, what is the regime that will best encourage economic growth and reform while maintaining domestic stability and avoiding external volatility and crises?

## **Background**

### **Evolution of the Exchange Rate System in the Reform Period**

Since the reform period began in 1979, the exchange rate has become increasingly relevant as China's trade, investment, and general integration with the global economy has steadily increased. Now with China firmly in a post-WTO accession era, the exchange rate as a economic variable, indicator, and tool stands to become even more important and critical to China's growth and stability.

The following outlines the major events and characteristics of the evolution of China's exchange rate system since 1981:<sup>1</sup>

1/1981	A multiple rate structure is created with different exchange rates for different trade-related foreign transactions. The "Foreign Trade Rate" and "Effective Rate" succeeds the previous "Official Rate". The "Foreign Trade Rate" is fixed at 2.8 ¥/\$
1/1985	The multiple rate structure is unified into a single Effective Rate. Firms are allowed to retain a portion of their FX earnings based on a retention quota.
1/1986	The Effective Rate for trade is put under a "controlled float" based on balance of payments and costs and rates of competitors, but it was effectively fixed at 3.72 from 1986-1989, and devalued twice in 1989 and 1990 followed by a period of frequent adjustments.
11/1986	A market driven Foreign Exchange Swap Rate is created, forming a second tier exchange rate allowing foreign investment corporations and SEZs to trade currencies
1988	All firms with retention rights are allowed to participate in the FX swap markets
1/1994	The Effective Rate and swap market rate is unified. A reference rate is announced against the USD, HKD, and Japanese Yen. Currency Swap centers are replaced by the China Foreign Exchange Trade System (CFETS) in Shanghai in what is officially a managed float exchange rate system. The exchange rate is kept very stable but is allowed to slowly appreciate 4% from 1994-1997.
12/1996	Current account convertibility is achieved.

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<sup>1</sup> "International Economics - Historical Exchange Rate Regime of Asian Countries", The Chinese University of Hong Kong, [http://intl.econ.cuhk.edu.hk/exchange\\_rate\\_regime/index.php?cid=8](http://intl.econ.cuhk.edu.hk/exchange_rate_regime/index.php?cid=8)

1997	It is announced that capital account convertibility will be achieved in 2000. This policy is halted in the wake of the Asian financial crisis.
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## Current Regime

Ever since current account convertibility was achieved in late 1996, China has been on a managed floating system. In fact, however, the RMB has maintained a stable exchange rate of 8.28 RMB to the US Dollar since that time. Because this de facto peg is not announced as official policy and the central bank retains the discretion to change it at will, it is still officially a managed float, however, it is widely considered to be a de facto fixed peg, or sometimes a FBAR (fixed but adjustable exchange rate regime).<sup>2</sup> This is a similar arrangement to many of the countries involved in the Asian financial crisis which maintained a de jure managed float regime, but in fact acted as a pegged regime, defending their pegs until a crisis and forced devaluation. Indeed, during the Asian financial crisis of 97-98, many observers anticipated China to follow suit with a competitive devaluation.

Following the full current account convertibility in 1996, China followed with an announcement in 1997 indicating that capital account convertibility was to be achieved in 2000. However, in the wake of the Asian financial crisis, Chinese officials have backed away from a strict schedule for capital account liberalization towards a more gradual approach towards opening up its capital markets. Currently enterprises may only buy foreign exchange for trade-related purposes and must either sell all foreign exchange earnings to designated foreign exchange banks or hold them in designated approved FX accounts within China. In the non-trade related realm, foreign investors may only convert FX in order to remit investment related income (e.g. profits, dividends, interest). While international portfolio flows in and out of China exist, these are limited to the small “B-Shares” stock exchange.<sup>3</sup> However, there is significant evidence that China’s capital controls are becoming increasingly porous. Gloombridge recounts two recent studies:

A new study estimates that the amount of money leaking through China's supposedly closed--but infinitely porous--capital account amounted to \$36.4 billion in 1997, \$38.6 billion in 1998, and \$23.8 billion in 1999. That contrasts with official reports of "errors and omissions" of \$16.5 billion in 1997 and 1998 (Kynge 2000c). Moreover, Dong Fu of the Federal Reserve Bank of Dallas

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<sup>2</sup> Max Cordon in Too Sensational: On the Choice of Exchange Rate Regimes notes, “That regime is best described as a low-speculation FBAR.(p 219)” McKinnon in “The East Asian Standard, Fear of Floating, and Original Sin” calls it a “stable peg”. In Li Xiao-Ming’s “China’s Macroeconomic Stabilization Policies Following the Asian Financial Crisis”, he writes, “Though the PRC government claims the country has a managed floating exchange rate regime, experience since 1994 shows that China in fact has adopted an internally fixed exchange rate policy.”

<sup>3</sup> Details on the current capital controls structure are found in Groombridge, Mark A., “Capital Account Liberalization In China: Prospects, Prerequisites and Pitfalls,” CATO Journal, Spring/Summer2001, Vol. 21 Issue 1, p119, 13p. A chart summarizing capital controls can be found in Figure 1 of the appendix.

estimates that 40 percent of total foreign direct investment injected into China from 1991 to 1998 actually left the country (Dorn 2000: 10)<sup>4</sup>

However, despite the limits to the effectiveness of China's capital controls, they still act successfully as a deterrent to destabilizing speculation, shielding China's financial markets from the "hot money" flows that afflicted other more liberalized economies in the region. Indeed, the majority of illegal capital flight seen in China has been in the form of underreporting or overreporting of exports and imports, respectively, in order to maintain FX earnings abroad.<sup>5</sup>

Therefore, given China's practice of exchange rate determination as well as its capital control system, China's current exchange rate regime can best be described as a de jure managed float but de facto low-speculation FBAR.<sup>6</sup>

### **Changing environment, changing needs**

By many different measures, China's exchange rate regime can be considered successful. The stable exchange rate promotes trade flows, and despite the lack of a nominal anchor<sup>7</sup>, inflation has not become a sustained problem. The most frequent acknowledgement of the success of China's exchange rate regime, though, was her ability to weather the Asian financial crisis storm relatively unscathed.

If China's exchange rate regime has been so successful for China in the past, why should we be looking to change something that is not broken? One of the reasons that diverse exchange rate regimes are practiced in different countries is that each regime serves different purposes depending on the economic environment. It is true that through the first twenty years of China's reform, her exchange rate system has allowed her to increase trade and maintain relative international financial stability. However, there is a tradeoff for this stability, and as Chinese reforms, development, and integration into the world economy deepen, the costs of maintaining capital controls with a fixed peg will rise. Additionally, as the reform efforts continue, China's priorities will evolve to where efficient capital allocation and its associated efficiency gains will dominate over exchange rate stability and the gains from an undervalued exchange rate.

For an example of furthering reform and integration driving the evolution of the regime, consider the effects of the recent accession to the WTO. While it is recognized

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<sup>4</sup> Groombridge, Mark A., "Capital Account Liberalization In China: Prospects, Prerequisites and Pitfalls," *CATO Journal*, Spring/Summer2001, Vol. 21 Issue 1, p119, 13p in reference to Kyngé, J. (2000c) "Capital Flight from China 'Twice Estimates'." *Financial Times*, 9 July. and Dorn, J. (2000) "China's Creeping Privatization." *Asian Wall Street Journal*, 12 July: 10.

<sup>5</sup> Groombridge, Mark A., "Capital Account Liberalization In China: Prospects, Prerequisites and Pitfalls," *CATO Journal*, Spring/Summer2001, Vol. 21 Issue 1, p119.

<sup>6</sup> This matches Max Corden's classification of China based on his taxonomy as described in Corden, W. Max, *Too Sensational: On the Choice of Exchange Rate Regimes*. MIT Press, 2002, Ch. 5

<sup>7</sup> Despite the fact that China has a de facto peg, the capital controls allow the central bank the freedom of monetary policy.

that the current capital control system is porous, WTO entry stands to further erode the efficacy of capital controls. In his article arguing that WTO entry will catalyze capital account liberalization, Fred Hu writes, “The plain dilemma is that capital controls cannot be fully enforced once there is a freely convertible current account. The more open the trading regime, the more channels of leakage and evasion there will be.”<sup>8</sup> Gloombridge puts this more succinctly, “Clearly, one impact of China's accession to the World Trade Organization (WTO) will be to accelerate and expand options for individuals who want to invest capital outside of the country illegally. That makes capital account liberalization all the more necessary.”<sup>9</sup>

Even though capital account liberalization has been put on hold, it is the eventual goal to eliminate all capital controls and consequently to adopt a more flexible exchange rate.<sup>10</sup> Therefore the real question is: when should China do this, and in what manner? In other words, at this point in time, is it optimal for China to make the switch towards a liberalized capital account and free floating exchange rate?

### **Current Environment and Trends**

As mentioned before, the decision in regards to an optimal exchange rate regime depends on certain characteristics of the current economic environment. The literature covering Optimal Currency Unions (OCU) examines “level of trade integration” measurements and the probability of asymmetric shocks in order to ascertain the relative costs and benefits of forming some kind of currency union (of which pegged exchange rates are a weaker form) versus currency independence (signified by floating exchange rates). As can be seen from Figure 4 in the appendix, the level of exports to the US as a percentage of total exports has steadily increased from 34% in 1996 to 40% in 2000 while the level of imports from the US as a percentage of total imports has hovered around 8%. This indicates that China’s level of trade to the world and to the US is not only increasing in absolute terms, but the level of trade with the US as a percentage of total trade has been increasing signifying an increasing level of trade integration. The propensity for asymmetric shocks are more difficult to see analytically, but from an intuitive theoretical standpoint, shocks to the economies should be highly asymmetric because of the asymmetric relative endowments and comparative advantages of the two economies.

Other measurements, such as the current account and capital account balances, overall balance of payments, levels of international reserves, and fiscal situation are used to predict the relative susceptibility to financial crisis or volatility when opening up an economy to capital flows, especially when running a pegged exchange rate regime. As can be seen in Figures 2 and 3, China has consistently run both a positive current account and a positive capital account, indicating a strong positive balance of payments position.

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<sup>8</sup> Hu, Fred, “China’s WTO Accession as a Catalyst for Capital Account Liberalization,” *CATO Journal*, Spring/Summer2001, Vol. 21 Issue 1, p101, 11p.

<sup>9</sup> Groombridge, Mark A., “Capital Account Liberalization In China: Prospects, Prerequisites and Pitfalls,” *CATO Journal*, Spring/Summer2001, Vol. 21 Issue 1, p119.

<sup>10</sup> Kenneth Rogoff, “The IMF Strikes Back”, IMF, <http://www.imf.org/external/np/vc/2003/021003.htm>

This points to the undervalued nature of the RMB, and has naturally lead to the massive accumulation of foreign reserves by the People's Bank of China<sup>11</sup>

## **Two Policy Options**

### **Choosing an optimal ER regime**

As noted earlier, different exchange rate regimes serve different functions and purposes for countries that adopt them. While it is not necessarily clear from the literature if there is a preferred exchange rate regime for developing former command economies in the process of a market transformation, China would still be a unusual case given its unique size and developmental path. The choice of exchange rate regimes is further complicated by the fact that even amongst China economists, a single exchange rate regime prescription has not emerged, but rather several contradictory opinions. Clearly there are tradeoffs between options, and the ultimate decision as to an optimal exchange rate regime most likely depends on the relative weight given to these tradeoffs. The following section will try to work through the associated costs, benefits of each regime choice.

### **The Choices and Decision Making Framework**

While there is an infinite spectrum for exchange rate regimes ranging from the most credible peg (monetary union or dollarization) to the freest floating, China is practically seen as having two feasible options – maintaining its de facto pegged exchange rate system with capital controls, or liberalizing its capital account and allowing the exchange rate to float more freely. Why cannot, for example, in-between regimes such as crawling pegs, or a more flexible peg be considered viable options? The simple answer is crisis vulnerability. Especially after the episodes of the Asian financial crisis of 97-98, it is seen that if China is to open up its economy to capital flows, the only viable crisis-averse regime available to China is to allow the exchange rate to float. The only other alternative is to keep the capital controls in place. Therefore, as hinted above, the primary question to answer, then, is this: Is the time ripe for China to relax its capital controls and accept free flowing international capital flows? The answer to this question will inform the decision as to which exchange rate regime to adopt.

### **Capital Account Liberalization and a Floating Exchange Rate**

The IMF has been the main proponent for China, pushing harder to make her exchange rate more flexible and to open up its capital markets. As was stated in the most recent Article IV consultation,

Directors considered that a gradual move toward greater exchange rate flexibility would facilitate China's adjustment to the major structural changes underway and its growing integration into the world economy...A number of Directors underscored that the present strong external position and favorable growth

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<sup>11</sup> “China's Foreign Exchange Reserves Reach 154.7 Billion US Dollars“, People's Daily, <http://fpeng.peopledaily.com.cn/200001/12/eng20000112X114.html>

outlook provide an important opportunity for China to make such a move from a position of strength.<sup>12</sup> and in the previous consultation explicitly stated that Directors ... stressed that the authorities should undertake further reforms in the financial sector and capital account liberalization in conjunction with the move to a more flexible exchange rate system.<sup>13</sup>

Taking note of the current economic environment, by allowing the exchange rate to float, China would probably see a rapid appreciation of its currency, producing a favorable terms of trade effect, making exports less competitive, but imports more affordable. The relaxing of capital controls would cause domestic financial markets to quickly develop as well as the development of advanced intermediation markets.

There are various arguments for and benefits from both capital account liberalization and a switch to the exchange rate regime:

### Freeing the RMB from the Dollar

While a large percentage of China's trade and investment is done with the United States, from a regional standpoint, McKinnon argues that the dollar is an "outside" currency since most of the trade in the region is intra-regional. He concludes, therefore, that "with respect to regional countries, pegging to the dollar can cause disturbances and unbalances"<sup>14</sup>. This is because when pegging to a foreign currency, you are forced to accept the monetary policy and exchange rate movements of the hegemon currency. From a regional standpoint, when the hegemon currency is external to the region, then its movements create imbalances.

### It is possible for economies with liberalized and developed capital markets to successfully resist crises

Stiglitz makes the argument that capital controls are not the only way to prevent crises caused by large scale capital flight. He argues that a combination of developed domestic capital markets, trade flows (for export industries), and liberalized capital markets can be successful against crises, and points to Australia and New Zealand as having also successfully weathered the Asian financial storm without resorting to capital controls. Therefore the costs of capital account liberalization can be mitigated by the development of robust domestic capital markets while the benefits of greater efficiency of capital allocation can be reaped.

### Capital account liberalization can increase the speed of reform

One of the stronger arguments for liberalizing the capital account and freeing up the exchange rate is that it provides an impetus towards greater reform. Similar to the

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<sup>12</sup> "IMF Concludes 2002 Article IV Consultation with the People's Republic of China", <http://www.imf.org/external/np/sec/pn/2002/pn0297.htm>.

<sup>13</sup> "IMF Concludes 2000 Article IV Consultation with the People's Republic of China", <http://www.imf.org/external/np/sec/pn/2000/pn0071.htm>

<sup>14</sup> Ronald McKinnon, "The East Asian Exchange Rate Dilemma", <http://www.stanford.edu/~mckinnon/briefs/EADilemma.pdf>

obligations associated with WTO entry, Gloombridge describes how a commitment to a capital account liberalization timeline can give accelerate the reform process. This is not only because it acts as a commitment mechanism, he argues, but also because capital account liberalization is integral to the overall reform process.<sup>15</sup>

### The time is ripe for China to make a graceful exit from the peg

As noted by Professor Arroyo<sup>16</sup> in a recent interview, one of the difficulties of maintaining an exchange rate peg is the problem of how to exit the regime, should this situation arise. The paradox is that the only time countries will have enough incentive to exit a peg regime is when it has an overvalued currency. However, speculators, anticipating a devaluation will stimulate capital flight, pre-empting the government's devaluation and draining the foreign exchange reserves, causing a liquidity crisis similar to that experienced by the Asian economies during the Asian financial crisis, and finally forcing a massive devaluation under unfavorable terms. However, if China, with an undervalued currency and huge foreign exchange reserves, were to make the switch "from a position of strength," as the IMF has suggested<sup>17</sup>, any speculation against the appreciation of the RMB would cause foreign exchange accumulation rather than depletion, and therefore would be theoretically sustainable indefinitely, solving the "exit problem".

### **Maintaining the current peg and capital controls**

There have been some noted economists, one of the foremost Ronald McKinnon, who argue that it would be a mistake for China to open up its capital markets to volatile international financial flows, and that the costs would outweigh the benefits. There are various arguments supporting this view:

### A stable exchange rate promotes trade

A fixed RMB/USD exchange rate benefits both the US and China since it minimizes the exchange rate risk, transaction costs and uncertainties for trade and investment as well as encouraging longer term investment<sup>18</sup>. If US-China trade as a percentage of total trade continue to increase, benefits that both countries reap will increase as well. That a stable

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<sup>15</sup> Gloombridge, Mark A., "Capital Account Liberalization In China: Prospects, Prerequisites and Pitfalls," *CATO Journal*, Spring/Summer2001, Vol. 21 Issue 1, p119.

<sup>16</sup> Interview with Professor Cristino Arroyo, April 17, 2003.

<sup>17</sup> "IMF Concludes 2002 Article IV Consultation with the People's Republic of China", <http://www.imf.org/external/np/sec/pn/2002/pn0297.htm>.

<sup>18</sup> Benefits from a exchange-rate stability approach are from Cordon, Max, "Too Sensational: On the Choice of Exchange Rate Regimes," MIT Press, 2002. p.29. It should also be noted here that US is in fact second to Japan as China's largest trading partner. So all things equal, China would benefit more with a exchange rate fixed to the Japanese Yen. On the other hand, with respect to investment, Hong Kong which is pegged to the US Dollar comprised 38% of FDI in 2000. Combined with the US's share (11%), the total percentage of FDI denominated in dollar-equivalents would be 49%. There is a clear preference for a RMB/USD peg here.



exchange rate supports trade becomes even more important when one considers that “the leading demand source for China’s growth last year was export performance”<sup>19</sup>

### China is not ready to handle capital flows

As noted by Professor Arroyo<sup>20</sup>, opening up to international capital flows requires more than simply developing robust domestic and intermediary markets. This is because when a country dismantles capital controls, they must then give up either exchange rate stability or independent monetary policy according to the impossible trinity theory. By giving up either independent monetary policy or exchange rate stability, macroeconomic management becomes a much more subtle task, which may require difficult decisions when trying to negotiate the twin balances of internal and external equilibrium. Especially when China is suffering from the pains of SOE reform – coping with unemployment faced and an underdeveloped social safety net – these difficult macroeconomic decisions may prove to be ones that China’s macroeconomic managers are unable or unwilling to make.

### Politically motivated exchange rate movements can damage the economy

McKinnon in a recent article<sup>21</sup> argues against the appreciation and the general floating of the RMB. His argument focuses on Japan’s experience in the early 1980’s when the yen rapidly appreciated against the US Dollar as a result of political pressure from the US to improve the trade balance. By McKinnon’s analysis, this appreciation created Japan’s deflationary spiral that resulted in its current liquidity trap:

In open economies, the ongoing current account surplus is determined by a nation's net saving propensity, not by exchange rate changes. The exchange rate eventually determines domestic inflation or deflation. Thus the strengthening of the yen during the 1980s and 1990s imposed deflationary pressure on Japan's slumping economy, while forcing nominal interest rates towards zero.

In this article, McKinnon’s argument falls short when he attempts to draw analogy to China’s current situation in order to warn of deflationary fears as a result of RMB appreciation. This is because, even in that same article, McKinnon notes that the Chinese RMB is undervalued as it is. Any appreciation would be equilibrating and therefore would not be transferred into deflation.

However, McKinnon’s point that politically motivated exchange rate movements can damage the economy should not be lost. Indeed, in a separate article about exchange rates in East Asia in general,<sup>22</sup> McKinnon explicitly states that strictly fixed exchange rates prevents “manipulating [of] exchange rates for commercial advantage.”

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<sup>19</sup> Xie, Andy, “China: Is Deflation Ending?“, Morgan Stanley Global Economic Forum, <http://www.morganstanley.com/GEFdata/digests/20030224-mon.html#anchor7>

<sup>20</sup> Interview with Professor Cristino Arroyo, April 17, 2003.

<sup>21</sup> Ronald McKinnon, Financial Times, March 10 2003.

<sup>22</sup> Ronald McKinnon, “The East Asian Exchange Rate Dilemma”, <http://www.stanford.edu/~mckinnon/briefs/EADilemma.pdf>

### China's Fixed Exchange rate system is stabilizing to the region

In the same McKinnon article, he further argues for the continued dollar-yuan peg by arguing for its stabilization effect on the region:

Because of China's rapid economic growth and now huge GNP, its ongoing commitment to a longer-term dollar parity is (would be) particularly beneficial for the East Asian economic system as a whole. Indeed, China's maintaining a fixed exchange rate of 8.3 yuan to the dollar during the great crisis of 1997-1998 prevented contagious devaluations from being much worse.<sup>23</sup>

Here, he recognizes the lingering effects of the Asian financial crisis in the region.

### Free floating exchange rates are not necessarily stabilizing

One of the theoretical arguments for adopting floating exchange rates is that it is a stabilizing mechanism that brings automatic balance to a country's external equilibrium since the exchange rate acts as a information transmission price mechanism that brings together supply and demand. Furthermore small scale, but constant exchange rate fluctuations prevent crisis causing currency and maturity mismatch problems which then prevent financial crises. However, Paul Volcker has recently questioned the assumption that stabilizing free floating exchange rates. In his article entitled, "The Quest for Exchange Rate Stability: Realistic or Quixotic,"<sup>24</sup> he notes that if you examine the last twenty years of floating exchange rates, you will notice that in practice,

currency prices have been prone to abrupt and erratic fluctuations. Contrary to earlier theorizing, there has been no discernible evidence of a spontaneous damping of volatility as time has passed. Apparently, neither learning experience nor the proliferation of new techniques and instruments for operating in exchange markets has led to dominance for the kind of stabilizing speculation so prominent in textbook analyses.

Therefore, following this conclusion, China may not gain significant benefits from letting its exchange rate float while suffering the double cost of capital flow volatility and exchange rate volatility.

## **Policy Recommendation**

Our policy recommendations are as follows:

### Retain capital controls

We agree with the argument that China is not yet prepared to deal with the volatilities of international capital flows – especially the destabilizing speculative "hot money" flows seen during the Asian financial crisis. With the fragilities of the banking sector and those of the reformation of the state industrial sector, we feel that the uncertainty and potential volatility of capital flows may exceed the macroeconomic management capabilities of the

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<sup>23</sup> *ibid.*

<sup>24</sup> Paul A. Volcker, "The Quest for Exchange Rate Stability: Realistic or Quixotic", Institute for International Economics, <http://www.iie.com/publications/papers/volcker1195.htm>

current system. While it is recognized that the current capital control system is porous, and will become increasingly so, it will continue to function as a control over short term capital flows, and so will continue to prevent speculative volatility.

### Maintain a pegged exchange rate at an appreciated rate

As long as capital controls are able to prevent short term capital flows, China should be able to maintain a pegged exchange rate system without the danger of international financial crisis. Therefore, China should maintain strict exchange rate stability while it is able to, in order to reap the low transaction costs and other benefits of a stable exchange rate. However, recognizing that there are explicit costs of maintaining an undervalued exchange rate, China should appreciate the RMB/USD peg in order to reap the efficiency gains from having a exchange rate closer to its true market value.

### Create timeline and roadmap for capital account liberalization

It should be recognized that while we do not recommend capital account liberalization at this point in time for China, it is because we feel that the financial markets and macroeconomic system are not developed enough and because of the fragility of the system at the current stage of reform. It is not, however, because we do not recognize a floating exchange rate regime and open capital account as a preferable long term regime. Indeed, we agree that a liberalized and integrated financial system is the eventual goal of China's reform. Therefore, the Ministry of Finance and the Central Government should create a timeline and roadmap for capital account liberalization.<sup>25</sup> This way, China will be able to mitigate risks and ensure the robustness of the domestic financial and intermediary system as it opens up its capital markets. Additionally, with a firm timeline and roadmap backed by commitment from the central government, China can reap the reform-inducing benefits of capital account liberalization before even opening it.

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<sup>25</sup> Refer to Appendix B for more detail on structuring capital account liberalization

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## **Appendix A : Terms and Tables**

### **Terms**

HKD – Hong Kong Dollar  
SEZ – Special Economic Zone  
FX – Foreign Exchange

### **Table 1: Summary of Capital Controls**

Any Form of Capital Control	Yes
Comprehensive Controls	Yes
On outflows	Yes
On inflows	Yes
Foreign Direct Investment	Yes
Of nonresidents	No
Of residents	Yes
Profit repatriation and capital liquidation	No
Taxes on capital transactions	No
Nonresident-controlled enterprise	No
Portfolio Investments	Yes
Of nonresidents	Yes
Of residents	Yes
Security issuance by nonresidents	Yes
Security issuance abroad by residents	Yes
Debt-to-equity conversion	Yes
Financial Transactions	Yes
Of nonresidents	No
Of residents	Yes
Trade-Related Financial Transactions	No
Deposit requirements for borrowing from abroad by residents	No
Deposit Accounts	No
Of nonresidents in foreign exchange	No
Of nonresidents in local currency	No
Of residents abroad	No
Of residents in foreign currency with	

domestic banks	No
Other Capital Transfers	Yes
Personal capital transfers	Yes
Blocked accounts	Yes
Real estate transactions	Yes
Of nonresidents	No
Of residents	Yes

SOURCES: IMF, Annual Report on Exchange Arrangements and Exchange Transactions; People's Bank of China.

## Table 2: Selected Economic and Financial Indicators

### People's Republic of China: Selected Economic and Financial Indicators 1/

	1998	1999	2000	2001	2002 (IMF Staff Projections)
	(Change in percent)				
<b>Domestic economy</b>					
Real GDP	7.8	7.1	8.0	7.3	7.5
Consumer prices (period average)	-0.8	-1.4	0.4	0.7	-0.4
	(In billions of U.S. dollars)				
<b>External economy</b>					
Exports	183.5	194.7	249.1	266.1	292.8
Imports	-136.9	-158.7	-214.7	-233.1	-257.1
Current account balance	31.5	15.7	20.5	17.4	18.9
Capital and financial account balance 2/	-6.3	7.6	1.9	34.8	28.0
Of which: Foreign direct investment, net	41.1	37.0	37.5	37.4	41.0
Gross official reserves 3/	149.8	158.3	168.9	216.3	258.2
Current account balance (in percent of GDP)	3.3	1.6	1.9	1.5	1.5
	(In percent of GDP)				
<b>Public finance</b>					
Overall budgetary balance	-3.0	-4.0	-3.6	-3.2	-3.3
Revenue	13.0	14.3	15.3	17.2	17.8
Expenditures	16.1	18.3	18.9	20.4	21.1
	(Change in percent)				
<b>Money and interest rates</b>					

Broad money (M2)	15.3	14.7	12.3	14.4	...
5/					
Interest rate 6/	3.8	2.3	2.3	2.3	...

(source: "IMF Concludes 2002 Article IV Consultation with the People's Republic of China"<sup>26</sup>)

### Table 3: China's Balance of Payments

Legend for Chart:

B - 1995  
 C - 1996  
 D - 1997  
 E - 1998  
 F - 1999  
 G - 2000

A	B E	C F	D G
Trade Balance	18.1 46.6	19.5 36.2	46.2 34.5
Exports	128.1 183.5	151.1 194.7	182.7 249.1
Imports	110.1 136.9	131.5 158.5	136.4 214.7
Services Balance	-6.1 -4.9	-2.0 -7.5	-5.7 -5.6
Income Balance	-11.8 -16.6	-12.4 -18.0	-15.9 -14.7
Current Account	1.6 29.3	7.2 15.7	29.7 20.5
(% of GDP)	0.2 3.1	0.9 1.6	3.3 1.9
Foreign Direct Investment	33.8 41.4	38.1 37.0	41.7 37.5
Direct investment in China	35.8 43.8	40.2 38.8	44.2 38.4
Direct investment abroad	-2.0	-2.1	-2.6

<sup>26</sup> "IMF Concludes 2002 Article IV Consultation with the People's Republic of China", <http://www.imf.org/external/np/sec/pn/2002/pn0297.htm>

	-2.6	-1.8	-0.9
Portfolio Investment	0.8	1.7	6.8
	-3.7	-11.2	-4.0
Other Investment	4.0	0.2	-25.5
	-43.7	-18.1	-31.5
Capital and Financial Account	38.7	40.0	23.0
	-6.3	7.6	1.9
Net Errors and Omissions	-17.8	-15.6	-17.0
	-16.6	-14.8	-11.9
Overall Balance	22.5	31.6	35.7
	6.4	8.5	10.5
Change in Reserves	-22.5	-31.6	-35.7
	-6.4	-8.5	-10.5

**Table 4: Share of US-China trade on Total Chinese Trade**

China's Trade with the world

	1996	1997	1998	1999	2000	H1 2001
<b>Exports</b>	151.1	182.7	183.8	194.9	249.2	
<b>Imports</b>	138.8	142.4	140.2	165.7	225.1	
<b>Total</b>	289.9	325.1	324	360.6	474.3	
<b>Balance</b>	12.3	40.3	43.6	29.2	24.1	

China's Trade with the US

	1996	1997	1998	1999	2000	Q1 2001
<b>US Exports</b>	12	12.8	14.3	13.1	16.3	
<b>US Imports</b>	51.5	62.5	71.2	81.8	100.1	
<b>Total</b>	63.5	75.3	85.4	94.9	116.4	
<b>Balance</b>	-39.5	-49.7	-56.9	-68.7	-83.8	

US Percentage Chinese Trade

	1996	1997	1998	1999	2000	Q1 2001
China Exports	34.08%	34.21%	38.74%	41.97%	40.17%	17.1%
China Imports	8.65%	8.99%	10.20%	7.91%	7.24%	3.3%
<b>Total</b>	<b>21.90%</b>	<b>23.16%</b>	<b>26.36%</b>	<b>26.32%</b>	<b>24.54%</b>	<b>11.1%</b>

(source: computed from data from the US-China Business Council<sup>27</sup>)

<sup>27</sup> "China's Trade with the World", The United States – China Business Council, <http://www.uschina.org/statistics/tradetable.html>



## **Appendix B:**

As Gloombridge has written:

Capital account liberalization has important prerequisites and should be viewed as an important component in a broad scheme of reforms. Notable examples include a healthy banking system with an effective system of prudential regulation in place. If a country does not yet have such a system in place, liberalizing its capital account could lead to massive capital flight and incite a currency crisis.<sup>28</sup>

In the same article, he lists these prerequisites explicitly:

- Establishment of solid fiscal consolidation and prior stabilization.
- A strong, autonomous central bank that can find the right monetary-fiscal policy mix to dampen the loss of monetary autonomy, with emphasis on exchange rate management.
- Building of primary and secondary securities markets for monetary policy implementation and financial stability.
- Enforcement of domestic competition to foster allocative and operational efficiency within the financial sector.
- Strengthening of prudential regulation and supervision, legal and accounting systems to cope with systemic risks of financial systems.
- Restructuring the domestic banking system to remove excessive bad loans, so enabling unfettered competition on level playing fields.
- Reformation of the tax system to compensate for the loss of explicit and implicit taxes on financial intermediation

In order to ensure a successful capital account liberalization that is protected against currency crises, a roadmap towards capital account convertibility must ensure that these prerequisites are met before capital account liberalization can proceed.

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<sup>28</sup> Groombridge, Mark A., “Capital Account Liberalization In China: Prospects, Prerequisites and Pitfalls,” CATO Journal, Spring/Summer2001, Vol. 21 Issue 1, p119, 13p.