



China's Capital Control: Stylized Facts and Referential Lessons*

After the fully liberalization of its current account in 1996, China began to liberalize its capital account in a gradual and cautious way. From the capital flow category perspective, the control on direct investment has already been removed, but portfolio investment and short-term debt are still regulated tightly. From the capital flow direction perspective, the intention of Chinese government on capital control is determined by the real direction of capital flow at current stage. For example, during 1990s when China had a limited foreign exchange reserve and faced capital outflow pressure, the government adopted an “easy in, difficult out” strategy. However, during 2000s when China had already accumulated a huge foreign exchange reserve and had been facing dramatic capital inflow, the government turned to an alternative “easy out, difficult in” strategy. The counter-cyclical style of China's capital control strategy demonstrates the government's effort to avoid vast capital outflow or inflows.

* This essay is prepared for the conference of “Task Force on Managing Capital Flows for Long-run Development”, Boston University, September 16, 2011.

China's capital account has already been partially opened by now (Table 1). According to People's Bank of China (PBC), by the end of 2010, inside the 40 specific items under capital account transactions classified by IMF, 12% had been fully opened, 20% had been basically opened, 43% had been partially opened, and the rest 25% had not been opened yet (Ge, 2011).

Chinese government has already removed the major obstacles on inward and outward direct investment, thinking that direct investment is very stable and productive. FDI can flow in freely as long as the foreign enterprises get the permission of Ministry of Commerce, and the FDI companies can remit their legal profits to home country as they want. By the end of 2010, Chinese government had approved the establishment of over 680 thousand FDI companies and had utilized over 1.1 trillion USD foreign capitals (Sun, 2011). Chinese government began to allow domestic enterprise to make overseas direct investment in 2001, whereas China's outbound direct investment has been accelerated since 2008. By the end of 2010, Chinese enterprises had established over 160 thousand firms overseas, and the accumulated investment amount reached 259 billion USD (Sun, 2011).

Chinese government has been very cautious to loosen the control of portfolio investment, let alone financial derivatives, because portfolio capital flow tends to be more volatile and speculative. The experience of Southeast Asia financial crisis had strengthened the above belief. The typical way has been setting the quotas for inward and outward portfolio investment. On the one hand, a Qualified Foreign Institutional investor mechanism (QFII) was established in late 2002 to introduce overseas portfolio investment. By the end of 2010, Chinese State Administration of Foreign Exchange (SAFE) had approved 97 foreign investors to enter domestic capital markets and the accumulative amount reached 19.7 billion USD (Sun, 2011). On the other hand, a Qualified

Domestic Institutional Investor mechanism (QDII) was founded in early 2006 to allow domestic financial institutions to invest on global financial markets. By the end of 2010, SAFE had approved 88 domestic investors to invest overseas and the accumulative scale reached 68.4 billion USD.

Chinese government has been take different treatments to foreign and domestic enterprises in cross-border debt financing. As for debt inflows, foreign enterprises are allowed to borrow freely for many years as long as total foreign liability does not exceed the gap between the registered capital and the investment amount, but qualified domestic enterprises did not get the permission to borrow short-term foreign debt under quotas until early 2010. As for debt outflows, Chinese commercial banks have been authorized to lend overseas since 2008, and qualified domestic enterprises have been approved to lend money to their overseas subsidiaries from 2009.

After the burst of global financial crisis, Chinese government has been promoting RMB internationalization aggressively. Therefore, the further liberalization of Chinese capital account from then on has been interweaving with the measures to develop offshore RMB financial center. The existing and potential progresses include: First, Chinese financial institutions were allowed to issue RMB bonds in Hong Kong in 2007, and the issuers have gradually expanded to domestic enterprises, Chinese Ministry of Finance, Hong Kong's financial institutions and enterprises, and even transnational companies. Second, certain RMB-holding foreign financial investors (including foreign central banks, Hong Kong's RMB settlement banks and participation banks) were allowed to invest on China's domestic bond market. Third, a RMB QFII mechanism will be established to facilitate foreign institutional investors to invest on China's domestic financial markets with RMB. Fourth, Chinese household will be authorized to invest ETF funds based on Hong Kong's stock market.

Why China has been taken a gradual and cautious way to liberalize its capital account? First, Chinese government prefers a more independent monetary policy because China is a large economy and has different business cycle compared with United States. Considering RMB exchange rate is still inflexible against US dollar, if capital account is fully opened, PBC could do nothing but import Fed's monetary policy. Second, Chinese financial markets are still underdeveloped and domestic investors are significantly inexperienced. They could not afford the drastic boom and bust of asset prices resulted from huge capital inflow and outflow. If there is a similar financial crisis in China, the consequence will be much more serious than in United States. Third, capital control has been a key element in Chinese characteristic financial repression, which underpins the dominating investment-driven growth strategy. By limiting Chinese households and corporations to invest on overseas portfolios, Chinese government could maintain a very low deposit and loan interest rates, which boosts the heavy investment of state-owned enterprises and local government on manufactures and infrastructures. Fourth, China's economic reform has not been completed and the property rights still need to be defined more clearly. Lots of Chinese wealthy people (some of them are corrupted officials or entrepreneurs with original sin) fear that their properties may be nationalized some day. Once the capital account is fully opened, there might be a massive capital outflow, even accompanied by money laundering and asset stripping (Yu, 2007).

Is China's capital control still effective? The majority voice from the recent literatures shows that, although there are some leakages, China's capital account control is still effective to a large extent. For example, Ma and McCauley (2008) found the sustained and significant gaps between onshore and offshore RMB interest rates and persistent USD/RMB interest rate differentials, which reflected the efficacy of China's capital account control. Another example is, Otani et al. (2011) discovered that the empirically quantified strength of capital

control (by increasing the transaction costs of cross-border financial transactions) was consistent with Chinese government's intention to influence capital movements.

There is other evidence about the efficacy of China's capital control. In the first half of 2008, China faced a dramatic short-term capital inflow (Figure 1). To mitigate the capital inflow, Chinese government has adopted three measures: first, a data exchange program was established between the Customs, the Ministry of Commerce and SAFE to screen the capital inflow through transfer pricing in foreign trade, namely high export-invoicing and low import-invoicing; second, another data exchange program was founded between Ministry of Commerce, SAFE and commercial banks to check whether the registered capitals or loans of foreign enterprises flow into domestic asset markets; third, the government began to investigate and punish cross-border underground banking businesses extensively and severely. These measures achieved an instant and significant effect. From the June of 2008, the short-term capital inflow declined dramatically.

After the bankruptcy of Lehman Brothers, China began to face short-term capital outflow, therefore the government loosened the above measures. However, under the global excess liquidity exacerbated by collective quantitative easing, China has been facing a new wave of short-term capital inflow since the late of 2009. Therefore the focus of Chinese capital control turned to dealing with massive capital inflow again.

Are there any referential lessons which could be drawn from China's experience of capital control for other developing countries? First, in comparison with other emerging market economies such as Chile or Brazil which prefer price measures in capital control, China prefers quantitative measures instead, especially on quotas and administrative approvals. On the one hand, this demonstrated that

China's liberalization of capital account still lags behind the above economies significantly. On the other hand, because the quantitative measures tend to make more distortions than price measures, China is suffering a much high welfare cost than Chile or Brazil in executing capital controls. Therefore, China may turn to more price-oriented capital control tools in the future such as unremunerated reserve requirement and withholding tax.

Second, it seems that Chinese government does not follow the prescriptions made by IMF about how to deal with capital inflow. IMF suggested that the countries should take a three-edge tool kit to handle with capital inflow: the macroeconomic policies, the macro-prudential regulations and the capital controls. Capital control should not be a replacement but a complement to proper macroeconomic and macro-prudential policies (IMF, 2011). However, China does not satisfy the criteria of using capital control tools directly. On the one hand, Chinese government hasn't utilized all the necessary macroeconomic tools to manage capital inflow, especially the exchange rate appreciation. According to IMF, the systematic macroeconomic policy responses toward capital inflow include: tight fiscal policy, interest rate cut, exchange rate appreciation and sterilized intervention. As for China, in order to mitigate the negative impacts of global financial crisis and promote domestic structural adjustment, the fiscal policy should be properly expansionary. To fight with inflation pressure, PBC has to raise interest rate. PBC has been doing sterilized intervention heavily in the past several years. As the result, either required reserve ratio or the outstanding of central bank bills are already very high. The only available tool for PBC to adopt now is a faster appreciation of RMB exchange rate. However, the concerns that a fast RMB appreciation might hurt export and employment, and a fast RMB appreciation may result in a even higher appreciation expectation thus leading to exchange rate overshooting, dominated the debate among policy-making circle. The probability for a significant faster appreciation of RMB remains low. On the other hand, China

has a long way to go in operating appropriate macro-prudential regulations. Although Chinese major commercial banks got a good overhaul in early 2000s, after the burst of global financial crisis, the banks lend heavily to local government to make infrastructure investments, which might bury the seed of a new wave of NPLs after several years. Beside of that, there are still lots of financial fragilities in domestic financial sectors, and this may be why Chinese government could not afford faster capital account liberalization.

Third, China still faces the challenge of sequencing capital account openness and the liberalization of interest rate and exchange rate. Some economists argue that, due to the resistance of interest groups, it is very difficult to complete the liberalization of interest rate and exchange rate in the short-term, therefore Chinese government should speed up the opening of capital account first. Ideally and theoretically, the fast liberalization of capital account will exert external pressure on the government to further liberalize interest rate and exchange rate. However, if the capital account is fully opened before the liberalization of interest rate and exchange rate, there will be a significant interest rate spread between domestic and overseas markets and a strong RMB appreciation expectation, which will no doubt arouse more dramatic short-term capital inflow. The volatile and speculative capital inflow will exacerbate the domestic excess liquidity, thus leading to asset price bubbles and inflation pressure first. If the capital inflow suddenly stops or even reverses in the future, there will probably be a devastating financial crisis. Therefore, the liberalization of interest rate and exchange rate should be a prerequisite for the fully opening of Chinese capital account. Moreover, the liberalization of interest rate and exchange rate could improve resource allocation and promote the transition of growth model. Chinese government should try to overcome the resistance of interest groups, and liberalize interest rate and exchange rate as soon as possible.

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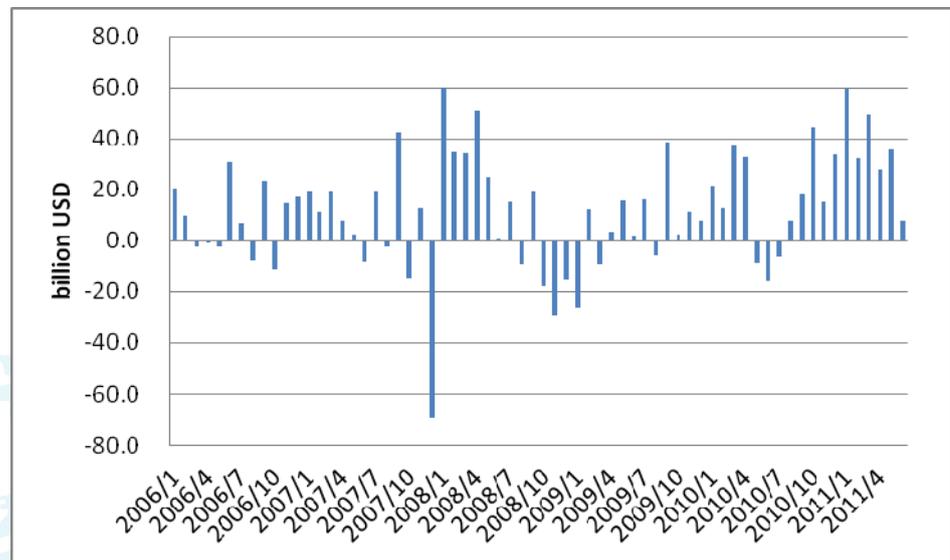
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Table 1 China’s Capital Account Control At Present

Market		Inflow	Outflow
Money Market	Residents	Prior approval by PBC and SAFE	No permission except for authorized entities
	Non-Residents	No permission	No permission
Stock Market	Residents	List H/N/S shares abroad, repatriate of QDII	QDII
	Non-residents	B shares, QFII, RMB QFII	Sell B shares, repatriate of QFII and RMB QFII
Bond and Other Debts	Residents	Prior approval by PBC and SAFE	No permission except for authorized entities
	Non-residents	QFII, RMB QFII	repatriate of QFII and RMB QFII
Derivatives and Other Instruments	Residents	Operations by financial institutions are subject to review of qualifications and to limit on foreign exchange position	Operations by financial institutions are subject to review of qualifications and to limit on foreign exchange position
	Non-residents	No permission	No permission

Sources: Yu (2007), and we made some revisions.

Figure 1 China's short-term international capital flow



Notes: The monthly short-term international capital flow is calculated by the monthly foreign exchange purchase by PBC minus the sum of monthly trade surplus and FDI utilized, which is a very rough estimation of high frequency short-term capital inflow.

Sources: CEIC and the author's calculation.

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