

Policy Brief No. 2014.024

Jul. 9 2014

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## Capital Account Liberalization in China: A Cautionary Tale

In many ways China can be seen as the great “globalizer”. Rather than abruptly opening to global trade under the “Washington Consensus”, beginning in the early 1980s China followed the pragmatic expression attributed to its great reformer Deng Xiaoping: “cross the river by feeling each stone.” China combined opening to global trade with significant and gradually sequenced government attention to infrastructure, industrialization, and logistics to become the largest trader on earth in just a few decades. Such an approach will prove even more important as China considers the need to globalize its financial sector. The history of other emerging markets’ previous experiences with financial liberalization offer China some lessons as well. Fully opening the Chinese financial system will require keen attention to

**prioritizing other important reforms and to designing a strong and flexible set of cross-border financial regulations.** Such regulations will be important to preventing and mitigating financial fragility and ensuring that financial markets serve the productive employment of the Chinese people.

These words of caution come out of a February 2014 workshop of the Pardee Task Force for Regulating Capital Flows at Boston University. The workshop was sponsored by Boston University's Global Economic Governance Initiative, along with Columbia University's Initiative for Policy Dialogue, and the Institute for World Economics and Politics at the Chinese Academy of Social Sciences. It brought together scholars and policy-makers who discussed experiences with capital account liberalization in Japan, India, South Korea, Latin America, Central and Eastern Europe and beyond. Participants also reviewed the economic evidence pertaining to capital account liberalization, as well as new policy at the International Monetary Fund with respect to financial globalization.

This policy brief synthesizes some of the main themes and policy recommendations discussed at the workshop and presented in this report, though the specific recommendations discussed in this brief are our own. The main message is that China would do well to draw lessons from both the economics literature and country experiences with capital account liberalization. Such an approach would guide China to adopt a carefully sequenced and cautionary approach to capital account liberalization.

### **Capital Account Liberalization in China**

**Regulating the inflow and outflow of capital has been a cornerstone of China's development reforms.** For more than three decades after Deng Xiaoping's crucial reforms began, China's capital account policies were part of an apparatus to direct credit toward strategic development goals while maintaining financial stability. That period of economic history in China

is among its best ever and among the best ever in the world, having recorded more than 10 percent income growth per year for those decades. Moreover, its limited financial globalization helped keep reforms on track. During the 1990s when emerging markets, especially in Asia, were wrecked by contagious financial crises, China's relatively closed capital account buffered the country from the worst of those crises.

Chinese officials have decided that a new economic model is needed, and thus China has been experimenting with a variety of reforms toward that new model. Gradual capital account liberalization started in 1994. Since then, China has removed almost all restrictions for inbound foreign direct investment and loosened controls over portfolio investments —though maintaining quota schemes— but cross-border money market transactions and financial derivatives have remained under strict control. **However, as a result of RMB internationalization, China's capital account liberalization has accelerated since 2009.** The RMB trade settlement scheme and so-called “recycling mechanism” has led to a significant opening of short-term cross-border capital flows. The trading of the RMB in Hong Kong has created significant opportunity and risk for RMB exchange rate arbitrage. Owing to stable RMB appreciation expectations, carry trade against the RMB became rampant. The development of the Hong Kong market along with other markets and the partial opening of the capital account for short-term cross-border capital flows has led some to suggest that China's capital account is even more porous than policy would suggest. According to one estimate, China's gross cross-border bank exposure stood at \$1 trillion in 2014, or 12 percent of China's GDP (Verma 2014). Since 2009 a new two-track capital flow regulation structure has been established. The cross-border capital flows denominated by USD were still regulated by SAFE (State Administration of Foreign Exchange) at the People's Bank of China (PBOC) which was more strict; however, the capital flows denominated by RMB were regulated by the subsidiaries of

Department of Monetary Policy II under PBOC, which was much looser. In other words, the experiment of RMB internationalization opened new loopholes for short-term capital flows into and out of China.

China appears to have re-committed to this exercise during its 18th Party Congress in 2013, where China said it would work to:

“Promote bidirectional openness for capital markets, raise the extent of convertibility of cross-border capital and financial trading, establish and complete foreign debt and capital flow management systems under prudential macro-level management frameworks, accelerate the realization of the convertibility of Renminbi capital accounts.” (CPC Central Committee, 2013)

Therefore, **it is not fruitful to debate whether China should open its capital account, because the decision to move forward already has been made. However, it is still vitally important to consider how the capital account should be opened, and at what pace.**

### **Risks Associated with Capital Account Liberalization**

Theoretically speaking, capital account liberalization can bring significant benefits to an economy after a nation has reached a certain threshold of institutional capabilities needed to manage its financial sector. Capital account openness can create more financial sector competition, can enable portfolio diversification, and can provide finance for current account imbalances. By the turn of the century many nations from both the industrialized and developing world had open capital accounts.

However, according to the economics literature there is no clear association between capital account liberalization and economic growth in emerging markets. **Moreover, there appears to be an association between capital account liberalization and the incidence of financial crises.** Finally,

there is also evidence that capital account liberalization can lead to increased inequality.

Olivier Jeanne, Arvind Subramanian and John Williamson of the Peterson Institute for International Economics did a comprehensive survey of the literature on capital account liberalization and economic growth and find that there is no clear cut relationship between the two. Indeed, the authors (two of them former IMF officials) go so far as to conclude that “the international community should not seek to promote totally free trade in assets—even over the long run—because free capital mobility seems to have little benefit in terms of long run growth” (Jeanne et al. 2012, 5).

Columbia University economists José Antonio Ocampo, Shari Spiegel and Joseph Stiglitz, as well as Harvard University economists Kenneth Rogoff and Carmen Reinhart have also shown that capital account liberalization is associated with an increased incidence of banking crises in a country (Ocampo, Spiegel and Stiglitz, 2008; Reinhart and Rogoff, 2009). Examples of such crises over recent decades are Mexico, Brazil, Turkey, South Korea, Russia, Iceland, and Latvia. **Open capital accounts leave emerging markets susceptible to the pro-cyclical nature of global finance.** Short-term capital flows occur in surges and sudden stops that can be a cause of financial fragility. A surge in capital inflows can lead to exchange rate appreciation, a swelling of asset prices, and an expansion of bank balance sheets given that actors feel that they have more collateral at hand for foreign currency denominated debts. All of this can unwind during a sudden stop of capital flows: currencies depreciate significantly and balance sheets expand as financial actors still need to pay debt in foreign currency (Korinek, 2011).

Of particular concern for China may be new evidence that capital account liberalization can be associated with rising inequality. An IMF study written by Furceri and Loungani (2013) examined over 50 cases of capital account liberalization in advanced economies, and found that inequality (as measured by the Gini coefficient) increased by approximately one percent during the

first year after liberalization and by as much as two percent after five years.

Government officials and economists also fear that capital account liberalization causes a loss in policy-autonomy for economic policy-making. It has long been established that policy-makers face a “trilemma” when it comes to the capital account. The economist Robert Mundel formalized work of John Maynard Keynes that established that a country can only use two of the three instruments commonplace in a world of international finance: the use of the interest rate as a monetary policy tool, the control of the exchange rate, or the regulation of cross-border financial flows. The loss of policy autonomy when the capital account has been liberalized could be even more severe than Mundel proposed, as authorities may lose full monetary control and in a sense would be able to choose only where they want capital account volatility to be reflected: in monetary and credit aggregates, or in the exchange rate. With respect to China, there are also significant sterilization costs associated with managing the exchange rate with respect to the trilemma.

### **The Importance of Sequencing**

The risks associated with capital account liberalization are unsettling. That is why there is an emerging consensus that capital account liberalization, if pursued, should to be sequenced according to country-specific characteristics. The International Monetary Fund (2012) conducted a thorough re-evaluation of capital account liberalization and the management of capital flows from 2010 to 2012 and produced a new ‘institutional view’ on such matters. The new view notes that exchange rate flexibility, monetary reform, and financial regulation are among the pre-requisites that may be necessary for countries to benefit from capital account liberalization. As Kenji Aramaki in this report notes, Japan is considered the exemplar in terms of sequencing the opening of the capital account, a process that took over 40 years to

complete after significant reform of its exchange rate, interest rate, and financial sector policies.

Indeed there is also a growing consensus that the option to regulate cross-border financial flows should be a permanent feature of any 21st century financial system, even one that is relatively open. New research in economic theory has stipulated that it may be optimal -- rather than distortionary-- to regulate surges in capital inflows. In the presence of significant information externalities, investors do not internalize their contribution to the system risks associated with surges and sudden stops. Conditions when numerous market participants make investments without incorporating such risks can quickly lead to financial instability. Thus, the case is made for counter-cyclical Pigouvian taxes on the inflows of capital in order to correct for such inherent market failures in the financial sector (Korinek, 2011).

Most econometric evidence finds that regulations on the inflow of capital can have the desired impact if designed and implemented properly. A comprehensive review of the literature before the financial crisis--that includes nations with open capital accounts such as Chile and Colombia-- for the National Bureau of Economic Research in the United States concluded that "In sum, capital controls on inflows seem to: make monetary policy more independent and alter the composition of capital flows; to a lesser extent it seems to reduce real exchange rate pressures (Magud et al, 2011, 13)." **In the wake of the financial crisis a number of countries with open capital accounts have begun to re-introduce regulations on the inflow and outflow of capital.** Nations such as Brazil, Indonesia, South Korea, and Taiwan are among those that regulated cross-border finance in the wake of the financial crisis, while maintaining some level of capital account openness (Erten and Ocampo, 2013; Gallagher, 2014).

**Lessons for China: Reform and Regulate First**

It will be important for China to sequence capital account liberalization in tandem with other economic reforms and regulations in order to maintain economic growth, productive employment, social cohesion, and financial stability in the country.

In terms of sequencing, it will be important to reform interest rates and exchange rates before fully opening the capital account—especially to short-term debt, portfolio, and derivatives flows. Very low interest rates, coupled with the fact that China’s savers will seek to diversify their portfolios as the Chinese economy adjusts to re-balancing, may bring some risks. A recent IMF study suggests that liberalization could trigger net outflows from both equity and bond markets as domestic investors seek to diversify large domestic savings (Bayoumi and Ohnsorge, 2013).

It will also serve China well to put in place significant domestic financial regulations in order to maintain financial stability. Two important regulations that need priority attention are the implementation of a national deposit insurance company to allow for the bankruptcy and liquidation of domestic financial institutions. Another set of policies needed before full capital account liberalization is a full-fledged macro-prudential regulatory regime to avoid asset bubbles. Of key importance in such a macro-prudential regime would be the regulation of the rapidly expanding set of shadow banking products in China.

Counter-cyclical capital flow management regulations are needed in tandem with those macro-prudential regulations. Interest rate and growth differentials between China and the rest of the world will leave the country susceptible to pro-cyclical surges and sudden stops of short-term capital flows. Two countries with open capital accounts, Brazil and South Korea, have been pioneering in this area. Both countries have pieces of legislation that permanently allow the monetary and financial authorities to regulate cross-border financial flows in a flexible manner on an as needed basis. Both countries were struck with significant financial crises after they liberalized

their capital accounts. They thus decided to reintroduce regulations on the inflow and sometimes outflow of capital in a counter-cyclical manner.

In recent times, the channels for surges and sudden stops of capital flows in Brazil and South Korea have been the foreign exchange derivatives market via the carry-trade. Both countries designed regulations to attempt to stem the fragility associated with such flows. South Korea's regulations have been much more successful because the derivatives market is deliverable and conducted onshore. Brazil's market is non-deliverable and much of it is conducted offshore—making it much more difficult for the authorities to regulate.

Finally, it will be important for China to ensure that it maintains the policy space to regulate cross-border finance as needed. **Recently, the IMF has articulated a new “institutional view” on capital flow management that recognizes the need to regulate capital flows.** This move has expanded the policy space to regulate capital flows in an institution that was once very adverse to regulating capital. However, certain commitments under the World Trade Organization's General Agreement on Trade in Services, and under some free trade agreements and bi-lateral investment treaties make it more difficult to regulate cross-border finance (Gallagher and Stanley, 2013). Indeed, the negotiating position of the United States under the United States-China Bilateral Investment Treaty negotiations is that China should not be permitted to regulate cross-border finance without recourse. In its negotiations on an investment treaty with Germany, China was able to maintain the policy space to regulate capital (Anderson, 2009). China should seek to strike such a balance in all future treaties moving forward.

Chinese authorities have always taken a gradual and sequenced approach to the reform process. It is paramount that such an approach be applied to capital account liberalization. Gradual liberalization after higher priority reforms that are safeguarded by strong regulation of both the domestic financial system and cross-border finance is a prudent course of action. In

so doing China will not have to learn the hard way—as so many other countries across the world have— that premature financial opening can lead to financial crises, slow growth, and inequality. Such a course of action will maintain China’ s tools to continue to deliver long-run prosperity for its people.

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