

EADN WORKING PAPERS

No. 3
November 2001

Liberalising China's Capital Account: Lessons Drawn From Thailand's Experience*

Gao Haihong

*Previously published as ISEAS Working Paper, Visiting Researchers Series No. 6(2000)

ISSN 0219-6417



Published by
INSTITUTE OF SOUTHEAST ASIAN STUDIES
for the EAST ASIAN DEVELOPMENT NETWORK (EADN)

LIBERALISING CHINA'S CAPITAL ACCOUNT: LESSONS DRAWN FROM THAILAND'S EXPERIENCE

Introduction

There are two commonly asked questions on the issue of China and the Asian financial crisis: one is how did China survive the Asian financial crisis? China had the same domestic weaknesses as Thailand and other troubled economies in Asia, such as a bank-dominated financial system, poorly regulated banks making loans to inefficient, over-leveraged state-owned enterprises (SOEs), a huge build-up of non-performing loans, existence of government guarantees and implicit moral hazard problems. However, the external position of China was quite strong, as evidenced by a current account surplus of 3 percent of GDP in 1997 and 1998, a debt-service ratio of 7.3 percent and a foreign debt ratio of 63.2 percent. The latter two were far below the critical levels of 20 percent and 100 percent respectively in 1997. There was a healthy external debt structure in terms of maturity, with the ratio of short-term foreign debt to total foreign debt below 23 percent from 1986 to 1997, except in 1985 (41.0 percent). This favourable external account was attributed to tight controls on capital account transactions. So, the answer to the above question can simply be that China survived because of its relatively closed capital account. This answer leads to the second question: how long can China maintain tight capital controls? Or, in other words, what is China going to do with the further liberalisation of its capital account? To answer this, it is first necessary to understand what the theories say about capital account liberalisation; secondly, a case study might help to draw some lessons for China. I choose the experience of Thailand to help us understand the difficulties an economy might have with a radical liberalisation of its capital account. Thirdly and finally, a full picture of China's capital account controls is presented, followed by reviewing how it works

and the direction it will be going in the future.

This paper is organised into four parts. In part 1, I will survey the theoretical discussions on capital account liberalisation by classifying them into three groups and specifying the preconditions for a smooth transition to capital account liberalisation. Thailand's experience of capital account liberalisation will be discussed in part 2. I will also examine how difficulties built up when Thailand's capital controls were liberalised rapidly without the first satisfying the preconditions. In part 3, I will provide the framework of policies and controls over China's capital account transactions, examine the evolution of such a framework, which is typically characterised by a gradual approach, and analyse the effectiveness of controls under a convertible current account. The issues of sequencing and establishing preconditions for China's liberalisation of the capital account will also be discussed. I will make a conclusion in the last part.

A General Analysis of Capital Account Liberalisation

Radical Versus Gradual Approach.

From the practical perspective, we can see that capital account liberalisation is an inevitable step on the path of economic development. In the past two decades, all developed countries have realised their capital account convertibility. The number of developing countries pursuing capital account liberalisation is growing. The approach to opening up the capital account, however, has varied across countries. Some countries adopt a gradual and phased approach to reducing and eliminating external capital controls; some countries prefer a radical and almost one-step process in opening up their capital account.

According to the gradual pattern, capital account convertibility occurs after current account convertibility has been established. It is usually sequenced very prudently in the context of domestic financial sector reform and is regarded as a goal to be reached in the relatively long term. The examples given by Quirk and Evans (1995) are Malaysia, Mexico and Indonesia. Korea and Chile are also on the list of countries adopting the gradual pattern. Chile eliminated controls on international capital flows very gradually, although it undertook the most extensive trade liberalisation. Chile reduced restrictions on medium-term capital flows, while maintaining controls on short-term capital inflows until late 1981.¹ As a matter of fact, most developed

countries achieved their capital account liberalisation in a very gradual manner. In the early 1960s, most of the developed member countries of IMF accepted Article 8 of the IMF agreement and removed their exchange controls over current account transactions (Gao 1995). However, none of the developed countries eliminated all exchange controls on both capital inflows and outflows until 1995.²

In a significant number of cases, capital account convertibility was realised rapidly after current account liberalisation. Examples of such a radical approach are the Baltic countries and some Latin American countries, such as Argentina.³ Thailand is another example of the radical approach which I will concentrate on in Part 2, even though its liberalising policies were heavily dependent on capital inflows.

On the theoretical level, discussions on the speed and sequencing of capital account convertibility can be roughly divided into three views: the gradual view, radical view and the middle view.

The gradual approach suggests that opening up the capital account should be the last step in the process of economic liberalisation and structural reforms in developing countries. Traditionally, most of the concerns centre on the relationship between the stability of the macro economy, the sustainability of economic reforms and the free flow of international capital. McKinnon (1991) argues that:

“...before allowing enterprises (or households) to borrow freely from, or deposit in, international capital markets, the national capital market should be fully liberalised, which in turn depends on the stabilisation of the domestic price level and the elimination of substantial reserve taxes on domestic banks (monetary intermediaries)” (McKinnon 1991).

The optimal order of economic liberalisation, according to him, usually has free foreign exchange convertibility on the capital account as the last stage. Only when domestic borrowing and lending take place freely at the equilibrium (unrestricted) rate of interest and when domestic inflation is curbed, so that an on-going exchange rate depreciation is unnecessary, are the arbitrage conditions right for free international capital mobility. He warns that premature capital account liberalisation could lead to unwarranted capital flight or the build-up of foreign indebtedness or both.⁴ The optimal order of economic liberalisation is determined by the different speeds of adjustment in the financial, goods and factor markets (Mathieson and Rojas-Suarez 1993). Since

financial markets adjust much faster than the goods markets, stabilisation and reform programs should be conducted in the following order: first, remove domestic distortions in the goods and capital markets and attain fiscal order, so as to reduce the reliance on inflationary finance; second, liberalise foreign trade controls; third, as a final step, open up the capital account. The recent Asian crisis has strengthened the argument for the gradual approach to some extent, and put the question of whether capital account liberalisation has moved too quickly at a forefront of economic debate.

On the contrary, the radical view on capital account convertibility, like Lal's opinion, argues that capital account liberalisation, trade reforms, the adoption of floating exchange rate, and fiscal reform should occur at the beginning of the reform process (Mathieson and Rojas-Suarez 1993). Lal also recommends that portfolio and real investments be based on world interest rates and world prices for traded goods. This radical view is based largely on political economy considerations and emphasises the constraints on reforms and the limited capacity of countries to reform themselves under pressure from outside. Early capital account liberalisation can have an important catalytic role in broader economic reforms, and help overcome entrenched vested interests that would otherwise postpone necessary reforms.

However, there is also a growing concern for carefully sequencing capital account liberalisation, regardless of how fast capital account open up, given that current account convertibility has been realised. This middle view stresses that capital account liberalisation should be part of a concurrent, integrated and comprehensive approach to overall macroeconomic and structural reform. Thus, the co-ordination of specific reforms in the domestic and external sectors becomes the critical concern. This middle approach, however, does not directly contradict either the radical view or the gradual view. Fischer (1997) rejects the argument that capital account liberalisation should be delayed. But he also stresses that fears about the consequences of capital account liberalisation should not be lightly dismissed. He agrees that there are dangers in liberalising capital movements in an economy where the macroeconomic framework and the financial sector are weak. The issue that should be considered, according to Fischer, is how to manage a liberalised system so as to maximise the benefits and minimise the cost of capital account liberalisation. John, Darbar and Echeverria (1997) provide a conceptual framework for an orderly liberalisation of the capital account and

treat capital account liberalisation as an integral part of an economic reform program. Eichengreen and Mussa (1998) analyse the dangers of financial liberalisation, and emphasise the problems of asymmetric information, both of which are intrinsic to financial markets. They also point out safeguards for a beneficial financial liberalisation, including sound macroeconomic policies to contain aggregate financial imbalance, sound prudential policies to ensure proper private incentives for risk management, and adequate supervision and regulation, especially of the financial sector.

Concerning the above views, two points need to be added. One is that the gradual path should not be seen as an immobile one. Although some economists and policy-makers argue that capital controls are preferable to a currency crisis, or question the actual relationship between an open capital account and economic performance (Rodrik 1998), the costs of capital controls should not be neglected, especially in the long term. These costs come from the following sources. First, from the classical perspective, capital controls can create inefficiencies in the domestic financial system and inhibit diversification, which in turn, weaken the competitiveness of domestic producers in international trade, and increase the vulnerability of domestic spending and wealth to domestic financial shocks. The second point concerns the cost of maintaining controls, such as enforcing capital control regulations, investigating suspected violations of controls, and prosecuting violators of the capital control code. Because new channels are constantly developed for evading capital controls, this kind of cost tends to be increasing.⁵ We can see this in China's case, especially after China realised full convertibility of the RMB for current account transactions in the late 1996. Third, capital controls may increase the adjustment cost, if they create the illusion that the authorities target nominal variables without addressing the fundamental causes of inflation and balance of payments problems. Finally, rent-seeking activities are easily induced by capital controls.

Another point is that the sequencing of capital account liberalisation needs time. This means that a gradual removal of capital restrictions is generally desirable, especially for developing countries. The basic reason is that the growth and composition of capital movement, and efficiency in the use of foreign capital flows depend heavily on the stage of development and the efficiency of the domestic financial

system. It always takes time for an economy to reach a certain level of economic development and to establish a mature and efficient financial system.

These two points, although seemingly contradictory, support the idea of a gradual path in which capital account liberalisation is pursued positively in view of control costs, but paced very carefully, in consideration of the dangers of an open capital account. It also means that only when some preconditions are established, can full capital account convertibility be realised.

Preconditions for Capital Account Liberalisation

The experiences of many countries show that if certain policies are implemented before opening up the capital account, capital account convertibility would more likely be maintained. Some of the following preconditions are so critical that they should be put at the top of the list. However, it is necessary to recognise that capital account liberalisation should not be delayed until all the preconditions are established. Some controls on certain items of capital transactions may be relaxed first, which in turn can help build the preconditions for further capital account liberalisation.

First and most importantly, weaknesses in the domestic financial system should be addressed. The first weakness is a distorted bank-dominated financial system, like in most of the East Asian economies. Such financial systems are characterised by a high percentage of domestic credit to GDP. This high credit ratio reflects a distortion of the domestic financial structure, i.e. the lack of well-developed capital markets. It is easy to create a high potential for systematic under-pricing of loans by banks. That in turn contributes to the excessive growth of credit. The increased foreign capital inflow under an open capital account would enlarge this excessive lending. Therefore, the quality of lending easily worsens (Hu, 1998). More generally, in bank-dominated financial systems, capital markets do not provide sufficient competition for banks. This vulnerability could induce rampant bankruptcy if foreign banks are allowed to enter the domestic markets.

The second weakness is a build-up of non-performing loans. In international practice, non-performing loans are loans on which either an interest or principle payment is 90 or 180 days overdue — an important indicator of the health of a banking system. If only several banks have a liquidity problem induced by non-performing bad

loans, the problem can be resolved either by a well-developed money market or help from the central bank (Wu, 1998). But if a huge amount of non-performing loans builds up in a financial system, the public might lose their confidence, withdraw their money from banks and put the money into the goods market. If the country maintains capital controls, this confidence crisis easily induces domestic inflation pressure. However, if the capital account is liberalised, there will be a direct attack on the country's currency. A currency crisis is therefore unavoidable.

The third weakness is the lack of prudential regulation and supervision, which is well known and cited by many authors. Generally, prudential regulation provides the benefit of efficient allocation of savings and investments by seeking to strengthen and preserve the effective functioning of the financial and payments system. Inadequate regulation and supervision of central banks are one of the main elements leading to fraud and corruption. In a country where the regulatory authority has limited capacity to provide effective supervision of the financial system, its banking sector is also weak.

Weak banks are likely to lead to a banking crisis when they extend their balance sheets either from domestic or external sources. Therefore, prudential measures in such countries should focus on capital adequacy, loan loss provisioning, credit assessment, liquidity management, pricing of risk, improvement in bank management, and increasing foreign participation.

Secondly, either the domestic interest rates or exchange rates, or both should be allowed to become more flexible. An iron law of open macroeconomics is that only two of the three following features can be obtained at the same time: a fixed exchange rate, full capital mobility and monetary policy independence. Any pair is possible but any attempt at achieving all three inevitably results in a currency crisis. The reason for the inconsistency is well known. Full capital mobility implies that short-term interest rates will be determined by the covered interest rate parity condition, where the foreign interest rate and the forward exchange rate are predetermined. A country can determine the domestic interest rate or the spot exchange rate, but not both. Therefore, an attempt to set a domestic interest rate and an exchange rate that are not consistent with the parity condition could give rise to incentives for significant short-term capital flows. If the exchange rate is fixed, or targeted to achieve current account objectives, the central bank must stand ready to buy or sell its own currency in unlimited quantities since

money supply is fully demand-determined and monetary independence is lost. To recover independence, a country can either give up the fixed exchange rate target or recover control of its interest rate and the demand for money by preventing capital movement. If the domestic interest rate is fixed, or targeted to achieve domestic stabilisation objectives, the exchange rate has to be flexible. Therefore, the exchange rate cannot be used as an expenditure-switching tool for current account objectives.

Bearing the above picture in mind, two policy implications can be concluded. One is that a country with a fixed exchange rate system should find an orderly way to exit before opening up its capital account.⁶ Otherwise, this fixed regime will be abandoned at the cost of a currency crisis, just like what happened during the East Asian currency crisis. Before the crisis, most of the East Asian countries pegged their currency to the US dollar, which had been a key ingredient in their past record of strong, steady economic growth. It was the lack of exchange rate flexibility, however, that helped build up troubles for the financial crisis beginning last July. Therefore, the troubled countries could only exit the fixed rate system accompanied by a severe financial crisis (Gao 1998).

Another policy implication is that in a country where indirect instruments are to become the dominant tools in monetary policy, domestic interest rates need to be liberalised before establishing capital account convertibility. For a developing country or a transitional economy, both of the two shifts — from direct monetary policy to indirect monetary policy, from controlled interest rates to market-determined interest rates — should be done before eliminating capital controls. There are two reasons. One, the effectiveness of indirect instruments of monetary policy greatly depends on the central bank's ability to influence the commercial bank's behaviour. If the central bank chooses the interest rate as the operational target, the interest rates must be flexible in order to achieve certain macroeconomic goals. Two, domestic interest rates on traded financial instruments must be comparable to those prevailing in international financial markets in order to avoid massive capital inflow and exchange rate appreciation after dismantling capital controls.

Thirdly, the problem of moral hazard that implicit guarantees generate should be reduced. The problem of moral hazard is generally induced by an official safety net, especially in a closed financial system or in emerging markets. In the countries where

financial systems are heavily regulated and relatively closed, their financial structures are also inflexible. It means that most of the financial institutions hold relatively undiversified portfolios containing few external assets. Large, economy-wide shocks that create debt-servicing difficulties in the enterprise sector therefore have an immediate effect on the financial sector's income and capital positions. Official safety assistance is often needed in such circumstances. In addition, the monopolistic or oligopolistic position of the financial institutions in a repressed financial system has often allowed the institutions to operate with relatively large spreads between lending and deposit interest rates (often buttressed by official interest rate ceilings). Although the spreads often reflect inefficient operations, they are typically large enough to enable financial institutions to earn high profits. When the system is liberalised gradually, competitive pressures on financial institutions will increase and lead to small spreads (an important efficient gain) and the erosion of oligopolistic profits. This development may increase the need for official assistance. Moreover, an emerging market is generally given implicit exchange rate guarantees, both implicit and explicit guarantees attached to the liabilities of the financial system and to the external debt of the economy. These safety nets, just as with other types of insurance, can create a moral hazard. If deposits are fully insured, for instance, depositors may have little incentive to monitor the activities of bank managers, and an element of market discipline will be lost. Some economists argue that an open capital account may decrease the need for official insurance and therefore limit the problem of moral hazard (Mathieson and Rojas-Suarez, 1993). Others say that moral hazard can result from asymmetric information even in liberalised international capital transactions.⁷ In countries where capital account is not fully open but the domestic financial system is being liberalised, the official guarantees are not easy to remove. To reduce the problem of moral hazard in such countries, the determination of interest rates and exchange rates should be left to the market, central banks should keep control of short-term rates as a means of implementing their monetary policy, and the financial system should be adequately regulated and supervised.

Fourthly, fiscal reforms that significantly reduce the fiscal deficit and finance the remaining deficit in a non-inflationary manner are needed.

Finally, a sustainable current account deficit and a low inflation rate are also important for the success of capital account liberalisation.

Thailand's Experience and its Lessons

The economic crisis in Thailand was caused by a number of factors. One of them was the rapid elimination of external capital controls, especially over capital inflow, without first fulfilling the preconditions. The major steps taken by Thailand to open up the capital account and external transactions in the period under review are summarised first. Then the lessons with regard to the lack of necessary preconditions for the capital account liberalisation are discussed.

Liberalising Capital Account and its Consequences

Thailand maintained a relatively open capital account with regard to capital inflows before realising the current account convertibility. According to John, Darbar and Echeverria (1997), under the Alien Business Law of 1972 and the Investment Promotion Act of 1977, the sectors for foreign investment and the screening requirement of such investments had been liberalised. Portfolio investment inflows were treated liberally, although initially exchange controls were applied to the repatriation of interest dividends and the principal. Foreign borrowing could be conducted freely but had to be registered with the Bank of Thailand (BOT).

In 1985, Thailand began to reform its trade sector and liberalise foreign trade in line with a policy orientation toward export-led growth. This development strategy gave priority to promoting capital inflows through tax and institutional reforms.

On May 4, 1990, Thailand's government announced the acceptance of Article 8 of the IMF Article of Agreement. Further liberalisation followed, with the removal of limits on the amount of foreign exchange that could be purchased, brought into or taken out of the country, the relaxation of surrender requirements, and broadening the uses of non-residents' baht accounts and residents' foreign currency accounts.⁸ From the early 1990s, Thailand embarked on a course of deregulation and financial liberalisation, phased in further liberalisation of capital flows, deregulation of financial institution operations, and allowed partial entry of foreign competitors into the domestic financial system. Three new closed-end mutual funds were approved to mobilise foreign capital

and commercial banks were allowed to approve the repatriation of proceeds from the sale of securities.

In 1991, three major measures were taken to promote foreign direct investment. They included amendments to the Investment Promotion Act to induce more foreign investment, allowing 100% foreign ownership of firms that exported all of their output, and permitting Thai investors to freely transfer (up to a certain amount) funds in US dollars abroad for direct investment. At the same time, several measures with respect to portfolio investment were undertaken. They are as follows: the repatriation of investment funds, loan repayment, and interest payments by foreign investors could be made without any restriction; the tax on dividends remitted abroad was reduced from 20 percent to 15 percent; the tax on payment (from royalties income) to non-residents was lowered from 20 percent to 15 percent; the maximum amount that Thai residents could invest abroad or lend to companies abroad, which had at least 25 percent Thai equity participation, was set at \$5 million per year, without the need for authorisation from the BOT.

A great jump in the process of opening up the capital account was the approval by the Thai government for the establishment of Bangkok International Banking Facility (BIBF) in 1992. The decision to establish BIBF was related to the strategy of promoting Thailand as a sub-regional financial centre, which was a part of a national policy aimed at capturing some of the benefits from the end of the Cold War and the entry of former centrally planning economies into the global market (Bank of Thailand, 1998).⁹

The BIBF aimed to serve the increasingly sophisticated needs of international trade and investment and enhance the capacity of domestic banking businesses in their preparation for intensified competition. Under the BIBF, commercial banks registered to conduct international banking facilities were allowed to accept deposits, and to borrow in foreign currencies from abroad and from foreign banks or residents; lend foreign currencies in Thailand (limited to \$500,000); conduct cross-currency transactions with overseas customers; give acceptance or guarantee debts in foreign currencies, etc. Foreign direct investment was liberalised with further tax concessions. At the same time, more aggressive steps were taken to open up the domestic stock market, including the reduction in dividend taxes, taxes on interest payments from

debentures to foreign juristic persons, tax on capital gains from the sale of securities by juristic persons, and tax on dividends remitted abroad.

In 1993, BIBF commenced operations. BOT relaxed some of the regulations governing the BIBF, especially on foreign commercial banks branches. Rules and regulations on offshore units were kept to a minimum to lessen the burden on the operating institutions. In 1995, the Provincial International Banking Facility (PIBF) was established, which could extend credit in both baht and foreign currencies with funding from overseas.

If we view the measures of liberalising capital account in terms of inflow and outflow separately, we can see that, compared with the promotion of capital inflows, Thailand's controls on capital outflows were liberalised more gradually. In 1990, commercial banks were allowed to lend limited amount of foreign currencies to non-residents, and to approve the repatriation of proceeds from sales of securities. In 1994, the limit on Thai residents investing abroad to companies that had at least a 25 percent Thai equity participation was even increased. The purchase of capital and money market securities abroad, foreign direct investments exceeding \$10 million, and purchase of real estate remained subject to BOT approval; locally issued mutual funds were restricted to investing their total portfolio in the domestic market.

Thailand's promotion of capital inflows combined with other key measures, which included high interest rates and domestic stock market reforms, etc., and rapid economic growth contributed to very substantial net capital inflow in the range of 9-13 percent of GDP between 1989-95. Net capital inflow to non-banks accelerated from approximately 20 billion baht per month in 1991 to some 40 billion baht per month at the end of 1995. Prior to the emergence of the crisis, commercial bank debt including BIBF's loans rose from \$20.6 billion to \$41.9 billion from the end of 1991 to 1996, while non-bank private debt increased from \$20.6 billion to \$31.8 billion. It was thus inevitable under such circumstances of rapid capital inflow, ample liquidity and insufficient profitable investment projects to support such a large influx of capital, that much investment moved into the stock and property markets.

The relative risk and term structure of interest rates in favour of short-term loans led to a significant shortening of the average maturity of Thailand's external debt (*Figure 1*). In particular, the share of short-term debt rose from 26% in 1989 to 50% by the end of

1995, before falling to 42% in 1996 and 37% in 1997. This was still relatively high when compared to the emerging market countries' average of around of 25 percent.

The high growth of the Thai economy over the past several years was largely financed by external funds, as reflected by the prolonged current account deficits, of 4.9 to 8.3 percent of GDP during 1990-1996. In 1996, however, growth and investment levels deteriorated in the face of an appreciating real exchange rate and capital inflow and exports declined sharply. The persistence of a large current account deficit, high interest rates, increasing inflation and the appearance of serious weaknesses in the financial system left the country vulnerable to external shocks and shifts in the market sentiment, triggering a series of exchange rate attacks, banking crises and capital flight the following year.

Lessons From Thailand's Experience

As regards the preconditions for capital account liberalisation, if certain policies are implemented and the weaknesses of a financial system are addressed before opening the capital account, capital account convertibility is not only inevitable, but will clearly be beneficial. From Thailand's case, we learn that without the necessary conditions, a radical type of capital account liberalisation is destined to result in financial disaster.

Failure in coping with the inconsistent trinity of macroeconomic policies

Firstly, in response to a large amount of capital inflow and its impact on burgeoning domestic aggregate demand and triggering inflation, the Thai government chose to maintain a high interest rate policy as a tool of neutral intervention. Instead of curbing economic overheating, high domestic interest rates made it even much cheaper for Thai business to borrow foreign loans at lower costs than they could domestically. The Bank of Thailand's effort to slow down an overheated economy by raising interest rates in 1995 caused foreign borrowing to grow even more rapidly. By the end of 1996, foreign borrowing had grown to \$31.2 billion. These were mainly short-term loans and most were not hedged against currency fluctuations (Doner and Ramsay, 1999).

Secondly, with regard to the effectiveness of monetary policy, Thailand's opening up of the capital account also had important implications for the mechanism through which the effects of monetary policy are transmitted to the real economy. One

example is the erosion of the effectiveness of monetary policy conducted through the credit channel. The establishment of BIBFs in 1993 enhanced access to overseas financing which helped bring down the cost of funds. As a result of this, bank credits (including BIBF) grew at a rapid rate, averaging 23 percent, in the period 1993-96. Commercial banks and finance companies played a significant role in financing the private sector, with the share of private credits financed by these two types of financial institutions accounting for around 89.0 percent of total credits. In response to the rapid credit growth, the monetary authorities launched a number of policy measures in 1996, aiming at slowing down credit expansion to a level consistent with the objective of stable economic growth. Examples of the measures included the requirement for BIBFs to submit their credit plans to the authorities, and raising their minimum disbursement from US\$0.5 million to US\$2.0 million. However, under a more liberal and developed financial system, the private sector has greater direct access to foreign financing, enabling them to bypass any domestic financial intermediary, thus eroding the effectiveness of monetary policy conducted through the credit channel.

Thirdly, Thailand maintained a rigid exchange rate system by pegging the baht to a basket of currencies with the US dollar weighted at 90 percent of the total for many years until the crisis broke out in 1997. This policy, together with the rapid liberalisation of capital inflow, posed problems for monetary policy autonomy and worsened the balance of current account, which had largely relied on funding through capital inflows. In Thailand, the relationship between monetary and economic variables became unstable, forcing the Bank of Thailand to adopt the “multiple-indicators” approach in monitoring monetary conditions and in assessing the need for policy actions.¹⁰ While the multiple-indicators approach provided much-needed flexibility within a volatile economic and financial environment, it sometimes undermined the central bank’s ability to make a timely and reliable assessment of economic and financial market developments, as well as its ability to communicate meaningful policy signals to the market. Additionally, the Bank of Thailand’s domestic open market operations were severely constrained by a small and non-liquid public bond market, due to years of fiscal surplus.

Defending or abandoning the exchange rate peg was a difficult policy dilemma for the Thai government. In fact, before the float, the real effective exchange rate had

appreciated in line with the US dollar trend, making Thai exports less competitive and contributing to the export difficulties. For fear of intense speculative pressure and losing domestic confidence, which would have resulted in a huge run on the baht and prompted an immediate currency crisis, the Thai government decided to protect the exchange rate system for as long as possible.¹¹ The basic rationale of the decision was that it could buy more time to tackle fundamental problems in the economy and the financial sector, without having to face a currency crisis at the same time. Against the Thai government's will, the fundamental problems worsened, the currency crisis came, and the fixed exchange rate system had to be abandoned in the circumstance of an entire financial system melting down.

The existence of guarantees and moral hazard.

The implicit guarantees, combined with the lack of prudential supervision, was a key weakness in the Thai financial system. Those guarantees existed in various areas. First, the pegged exchange rate regime provided an implicit guarantee of currency value. In other words, short-term assets in Thai baht had fixed nominal values, so that in practice, there was effectively an implicit guarantee of the value of those assets in foreign currency. Hence the exchange risk premium remained low and investors kept up their confidence in Thailand's financial situation. However, this guarantee evaporated when there was a massive capital outflow in 1997.

Second, implicit government guarantees existed for Thai commercial banks and other financial institutions. The financial system in Thailand was often characterised as one of "no entry, no exit" (BOT 1998). It meant that both getting into and out of the system (to let a financial institution fail) were difficult in Thailand. Although the establishment of the BIBF allowed partial entry into the domestic financial system, the core banking business has long remained in the hands of local institutions. As a matter of fact, the combination of economic and political influences ensured that Thai-owned commercial banks would not be allowed to fail. Additionally, the banking system in Thailand continued to have an oligopolistic structure that was reflected in large spreads between the deposit and lending rates (*Figure 2*). The need for official assistance was to be increased with the liberalisation of the system, the increase in competitive pressures on financial institutions, and the erosion of oligopolistic profits.

With this safety net, Thailand's bankers and financial institutions were encouraged to finance risky projects in the expectation that they would enjoy the profits while the government would cover serious losses, which made many banks vulnerable to asset deflation. In 1994 and 1995, when the Bangkok Bank of Commerce got into trouble and a run on the bank began, the Bank of Thailand supported it with nearly \$7 billion from the Bank's Financial Institutions Development Fund. The bank was supported even though it had violated several central bank orders and had engaged in fraudulent behaviour (Doner and Ramsey, 1999). Such safeguards became extremely difficult and had to be abandoned in 1997 when the Bank of Thailand was confronted with the tasks of supporting troubled banks and defending the value of baht from foreign speculators.

Weaknesses of an over-banked financial system and the lack of prudential supervision and regulation

The institutional development of the Thai financial system has long had a bias towards growth of credit relative to equity. From 1991 to 1997, the ratio of credit to GDP of Thailand almost doubled from around 70% to 130%. Compared with the U.S, which had a relatively constant ratio of around 80%, the Thai financial system was somewhat over-banked relative to other modes of financing and the total output of the economy. This bank-dominated financial system contributed to the excessive growth of credit. Increased foreign capital inflows under an open capital account enlarged this excessive lending. Additionally, collateral-based lending by banks and large re-lending to real estate sector by corporations in Thailand made the excessive lending very vulnerable to assets deflation.

In Thailand, a large portion of lending by financial institutions was collateral-based and real estate could be used as collateral for bank loans. With the property and stock market boom, financial institutions did not spend resources on valuing the underlying collateral because of the widespread belief that the gains would be substantial. The growing risks inherent in the system were, unfortunately, overshadowed by the real estate and stock market boom.

The other side of bank lending is corporate borrowing. Most of the Thai businesses were family-owned and depended heavily on borrowing from banks. Direct

financing and the development of long-term debt instruments lagged behind the development of indirect financing instruments. Fund mobilisation through a public offering was generally more costly than borrowing from banks, which were lending largely to customers with whom they had long established a relationship. Therefore, Thai corporations were very vulnerable to increases in interest rates and the cost of external capital financing. Moreover, most of the banks' lending was to the so-called priority sectors: large manufacturing sector and export industries. A significant proportion of these loans, however, was also re-lent by these corporations to their subsidiaries in the real estate sector (BOT, 1998).

With an open capital account in Thailand, large amounts of foreign capital gushed into the real estate sector. Domestic banks played the role of intermediation (Hu, 1998). The boom of massive capital inflows stimulated further expansion of lending in the Thai financial system. As overall economic activities began to slow down in 1996, the stock and property market prices came under severe pressure. Since these assets had also been used as collateral for loans, the health of the lending institutions became a concern for the investors, including foreign investors who could withdraw their money instantly.

With regard to prudential supervision and regulation, Thailand had serious problems. The Thai financial system lacked the transparency and disclosure of timely and reliable information. In Thailand, the figures for non-performing loans were first released only in June 1997. Lax supervision and the lack of transparency in the financial system played a crucial role in the misallocation of economic resources, especially the misuse of large amounts of capital inflow, which were supposed to be a benefit to the country's economy from opening up the capital account.

Liberalising China's Controls on Capital Account Transactions

China did not experience a crisis like that in Thailand and some other Asian economies. The most important reason is the Chinese currency was not convertible for capital account transactions.¹² To some extent, however, this is a short-term insulation. Two points are implied here. One is that China's capital account liberalisation will be realised sooner or later, since it has become an inevitable step in the process of China's economic reform and development. The other is that the weaknesses in the domestic

financial system and the inconsistent macroeconomic policy design that contributed to the Thai financial crisis are also present in China. To avoid the tragedy of the Thai financial crisis, two departures from the Thai experience need to be made by China. One is to follow a gradual method of opening up the capital account. The other is to pay enough attention to establishing the preconditions for capital account liberalisation.

Following the summary of China's policy and regulatory framework on controls over capital account transactions, the evolution of financial liberalisation, its performance and effectiveness are discussed. The discussion will then proceed to concentrate on establishing preconditions for capital account liberalisation and its sequencing issues.

The Framework of Policies and Controls Over Capital Account Transactions and Their Effects

Encouraging foreign direct investment (FDI). Compared with the policies of liberalising China's indirect capital flows, policies on freeing FDI in China started relatively earlier, and current controls over FDI are more liberal than controls over any other international financial transactions.

China has imposed few controls over the inflow of direct investment. As long as non-residents meet the requirements of the Sino-foreign joint-venture laws and other relevant regulations, and are approved by Ministry of Foreign Trade and Economic Cooperation (MOFTEC), they are free to invest in China. On the aspect of foreign exchange management, there is no restriction on the inward remittance of funds. For outward direct investment, the State Administration of Foreign Exchange (SAFE) first reviews the sources of foreign exchange assets and assesses the investment risk involved, before the MOFTEC grants an approval, and finally the investment is registered with SAFE. This legal framework, combined with many policy-related incentives for inward direct investment, shows that China's financial liberalisation stresses on attracting a high level of FDI, accelerating the transfer of technology and modern management skills, and earning foreign exchange. As a matter of fact, the rapid growth of FDI became the most prominent factor in prompting China to integrate with the global financial market. Nevertheless, the process of liberalising China's FDI followed a gradual pattern in three phases.

Period One: 1979-1986. The first step was marked by the passing of the *Law of the People's Republic of China on Joint Ventures Using Chinese and Foreign Investment* in 1979. It was China's first law permitting and governing the establishment and operations of foreign economic entities in its territory since 1949. From 1979 to 1986, China's policy toward FDI was characterised by the attitude that FDIs were welcome, but to be highly regulated (Chai 1997). The legal aspect of this period was mainly marked by the adoption of its Implementing Regulations, and by the promulgation of the "Regulations of the People's Republic of China on Special Economic Zones in Guangdong Province" (Chen 1997).

During this period, the screening and approval of FDIs was highly centralised and involved a number of government bureaucracies. Though no upper limit was formally imposed on foreign ownership, joint ventures (JVs) were preferred and wholly owned foreign enterprises (WOFEs) were discouraged. Moreover, both the management and the transaction of FDI ventures were subject to many restrictions. Certainly, foreign funded enterprises (FFE) were not allowed to convert their RMB earnings into foreign currencies.¹³ The FDI firms were required to balance their foreign exchange account expenditures with their foreign exchange earnings.¹⁴

Period Two: 1986-1990. The second step began with the passing of the Law of the People's Republic of China on Enterprises operated exclusively with foreign capital in 1986. It granted permission for the operation of WOFEs on a nationwide scale. In the period from 1986 to 1990, the setting up of WOFEs in China was encouraged, the screening and approval of FDIs was decentralised and the procedure was simplified. New policies adopted in this period also offered more incentives in the form of tax reductions and import tax exemptions, etc. The preferential treatment areas were enlarged from the original 4 Special Economic Zones (SEZs) to 14 open coastal cities.

With regard to exchange controls related to FDI, the Foreign Exchange Balance Provisions and the Encouragement Provisions were issued in 1986. The foreign exchange requirement was also relaxed. To cover their shortfall, FDI firms were allowed to use their RMB earnings to produce local products for export or to convert them into foreign exchange at the swap markets opened in 1985.¹⁵ The foreign swap markets became the major and more direct option for FDI firms to balance their foreign exchange accounts.

Period Three: 1990-Present. The Amendments to the Equity Joint Venture Law and the Wholly Foreign Owned Enterprises Implementing Rules were adopted in 1990. Thus began the setting up of a systematic regulatory framework for facilitating and regulating FDI. Through continuing tax concessions and more importantly, through promulgating the Interim Regulations Guiding Foreign Investment by the State Planning Commission in 1995, China succeeded in channelling foreign investment to priority sectors.¹⁶

A great step in liberalising FDI in China was that China realised the currency convertibility for current account transactions in 1996. One of the main measures adopted was incorporating the FFEs into the system of sale and purchase of foreign exchange with designated banks. In the past, only FFEs with approved certificates could sell and purchase foreign exchange in the swap centre; the certificates were reviewed annually. Under the new regulation, when buying or selling foreign exchange through the designated banks, the FFEs can enjoy the same privileges extended to domestic enterprises. It meant that they could trade foreign exchange directly with the designated banks or through the foreign exchange swap centre without requiring any authorisation (SAFE, 1996). Besides, the FFEs also enjoyed some preferential policies, such as retaining foreign exchange accounts and a certain amount of foreign exchange income, while domestic enterprises were not allowed to keep foreign exchange accounts and were required to sell all foreign exchange earnings except the small amount that was specially authorised to designated banks.¹⁷

On October 25, 1998, another step made in China's foreign exchange system was the Circular of Ceasing Foreign Exchange Swap Business announced by the People's Bank of China. The foreign swap business for the FFEs was closed by December 1, 1998 and all exchange payments were brought into the banking settlement system. Under the new policy, the process of purchasing and selling foreign exchange by the FFEs was simplified, which in turn, helped unify and standardise China's exchange market.

In line with China's steady liberalisation of FDI regulations since 1979, the inflow of FDI to China, while virtually non-existent before 1979, rose to \$41.73 billion by 1996 (*Figure 5*). The significant inflow of FDI, which led the overall capital inflows to China, increased more than fivefold in the 1990s.

Limiting entry to China's financial market. China is opening its capital and money markets very gradually. Most of the financial instruments are still closed to foreign investors; the scope of businesses for foreign financial institutions is restricted; the entry to domestic capital markets is strictly limited (Table 1). Currently, China's securities markets are open to foreign investors in two main ways: the B share market and overseas listing and issuing.¹⁸

Table 1: Controls on Capital and Money Markets in China (by end-1996)

		Inflows*	Outflows*
Money market	A	No permission	No permission
	B	Prior approval by PBC and SAFE is required	No permission for residents, except authorised entities
Stock market	A	Purchase of B shares locally#	No permission
	B	Sale of H (or N or S) shares abroad#	No permission for residents, except authorised entities
Bonds and other debt securities	A	No permission	No permission
	B	Prior approval by PBC and SAFE is required. Issuing bonds abroad must be incorporated into the State external debt plan.	No permission for residents, except authorised entities
Collective investment securities	A	No permission	Approved by the Securities Policy Commission
	B	Prior approval by the PBC and SAFE is required	No permission for residents, except authorised entities
Derivatives and other instruments	A	No permission	No permission
	B	Operations by financial institutions involving such instruments are subject to prior review of qualifications and the limit on open foreign exchange position.	Operations in such instruments by financial institutions are subject to prior review of qualifications and the limit on open foreign exchange position.

Source: SAFE, Collection of People's Republic of China Foreign Exchange Administration Laws and Regulations, China's Laws Press, January 1998; IMF, Exchange Arrangements and Exchange Restrictions, Annual Report, 1997.

Note: Inflows A: purchase locally by non-residents. Inflows B: sale or issue abroad by residents. Outflows A: sale or issue locally by non-residents. Outflows B: purchase abroad by residents.

#The face value of B shares is denominated in RMB, which are listed on the Shanghai Securities Exchange and Shenzhen Securities Exchange, and can only be bought by foreign investors. The face value of H shares is denominated in HK dollars, and is listed on Hong Kong Joint Securities Exchange. N shares or S shares are listed on New York Stock Exchange and Singapore Securities Exchange respectively.

In 1991, the Shanghai Stock Exchange (SHSE) and Shenzhen Stock Exchange (SZSE) began to offer B shares, providing foreign investors with a legal channel to invest in China's equity markets.¹⁹ B shares were offered and traded in these Exchanges, where designated domestic or overseas securities dealers acted as specially licensed brokers to accept the foreign investors' consignment for trading. These Exchanges began to offer special seats for B-share trading in 1994 and overseas securities dealers were allowed to engage in floor trading via the seats. By the end of 1998, 106 companies had issued a total of 9.589 billion B shares and raised a total of US\$ 4.745 billion (*Table 2*).

Table 2: China's Shares Offering from 1987 to 1998

	Total	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
Shares issued (bil.share)	74.6	1.0	2.5	0.7	0.4	0.5	2.1	9.6	9.1	3.2	8.6	26.8	10.2
A share	34.3	1.0	2.5	0.7	0.4	0.5	1.0	4.3	1.1	0.5	3.8	10.6	7.9
B share							1.1	1.3	1.0	1.6	2.5	1.0	9.6
H share								4.0	7.0	1.5	3.2	13.7	13.0
Capital raised (bil. Yuan)	355.3	1.0	2.5	0.7	0.4	n.a	9.4	37.5	32.7	15.0	42.5	129.4	83.7
A share	168.7	1.0	2.5	0.7	0.4	n.a	5.0	19.5	5.0	2.3	22.4	65.5	44.0
B share							4.4	3.8	3.8	3.3	4.7	8.1	2.6
H share								6.1	8.9	3.1	8.4	36.0	38.0

Source: China Securities Regulatory Commission (CSRC), 1987-1998

Another channel for foreign capital inflow to China's securities markets is the overseas issues, which include mainly: H share (and N share and S share), American depository receipts (ADR) and global depository receipts (GDR), convertible bonds, and dual-listed shares. In 1993, Chinese companies began to list shares abroad. At the end of 1998, the number of B shares and H shares-listed companies reached 124, even though it was much more less than that of A shares-listed, 727 (*Table 3*). Entering the global capital markets has been an instructive and beneficial experiment for these companies. By the end of 1998, 43 Chinese companies had listed shares overseas, of which 31 were in Hong Kong, 8 dual-listed in Hong Kong and New York, 1 in New York, 2 dual-listed in Hong Kong and London, and 1 in Singapore. The total capital raised is US\$ 10.02 billion.

Table 3: Number of Listed Chinese Companies from 1990-98

Companies	1990	1991	1992	1993	1994	1995	1996	1997	1998
Issuing A share	10	14	35	140	227	242	431	627	727
Issuing B share				6	4	12	16	25	26
Issuing A and B share			18	34	54	58	69	76	80
Issuing A and H share				3	6	11	14	17	18
Total	10	14	53	183	291	323	530	745	851

Source: China Securities Regulatory Commission (CSRC), 1990-1998

So far, overseas listing is an important policy for the reform of Chinese enterprises, especially the State-owned enterprises (SOE), and for liberalising foreign capital flows in China. To offset the negative impact of the Asian financial crisis on Chinese companies listed overseas, CSRC and the State Economic Commission issued *Measures on Promoting Standardised Operations and In-depth Reform of Overseas Listed Companies* in 1998, proposing eleven opinions. The aim was to raise requirements for overseas-listed companies with regard to standardising operations, increasing transparency and deepening restructuring. This effort at improving the operations of overseas-listed companies and regulatory measures aimed at protecting the interests of investors and strengthening investor confidence in Chinese companies, and improving the image of overseas-listed companies.

However, compared with the overseas listing that makes it possible for foreign investors to purchase shares of Chinese firms outside of China, the chances of buying shares locally in the Chinese domestic market are very limited. This is reflected in the small size and inactivity of the B share market (*Figure 3*). A major step was taken in 1996 to open China's stock markets: The PBC announced that foreign investors would have partial access to the A share market through authorised investment funds. This is the first step to unify China's separated stock markets.

After all, China's stock market is still under strict controls through segregating B shares and H shares from the domestic A shares. Although the enterprises that issued B shares or H shares have also issued A shares, the B or H shares are not convertible to A shares.²⁰ This control over the entry of foreign capital has effectively enabled the domestic financial market to avoid external shocks and ensured its orderly expansion.

Unlike stock markets, China's fixed-income securities markets remain tightly closed to foreign investors. Non-resident investors are not allowed to do any

transaction locally in China's bond and other yuan-denominated debt instruments in the medium term. But China's annual volume of new overseas bond issues is growing fast (*Figure 4*).

China's control over the entry of foreign financial institutions has been liberalised gradually since the foreign bank branch, the Nan Yang Commercial Bank Shenzhen Branch, was established in 1981. However, most of the regulations and laws on foreign financial institutions were set up in or after 1994. The major and the highest law was the *People's Republic of China Regulations on Foreign Financial Institutions*, which was passed in 1994. Under the framework of regulations before 1996, the scope of foreign financial institutions' business was strictly limited. For example, the branches of foreign banks and joint venture banks in China may not operate RMB-based businesses, and their foreign exchange-based business was limited to certain types. Branches of foreign banks and joint venture banks are allowed to participate in a maximum of 13 types of foreign exchange-based businesses; foreign finance companies and joint venture finance companies are restricted to nine. This limit, however, was relaxed in 1996 when foreign banks in China were allowed to engage in the business of sale and purchase of foreign exchange for FFEs and to become authorised banks dealing with foreign exchange. This was the first step in liberalising the RMB-based businesses. Moreover, in March 1996, nine foreign banks were granted permission to engage in RMB-based businesses in Shanghai's Pudong New Zone. But their RMB debt was not allowed to exceed 35 percent of their total foreign exchange debt. Toward the end of 1998, a second group of foreign banks received the approval for operating in RMB businesses in China. At the same time, geographical restrictions on the operation of foreign financial institutions were being relaxed gradually. China had allowed foreign financial institutions to set up branches in only 23 cities as well as the subtropical island province of Hainan. In January 1999, China's financial authorities announced that they would allow foreign financial institutions to do business in all the nation's large and medium-sized cities. With the gradual liberalisation of entry to China's financial market, the number of foreign financial institutions registered in China is growing, though the trend is biased towards the banking sector (*Table 4*). As the reform of China's financial system progresses, access limits will be relaxed and replaced by more open policies. This process will surely follow a gradual path and be

paced carefully.

Table 4: Number of Foreign-funded and Joint Venture Financial Institutions Registered in China

Year	Foreign Funded and Joint Venture Banks	Branches of Foreign Banks	Finance Companies	Insurance Companies	Investment Banks	Financial services companies of foreign funded enterprises
1981	1					
1982	1	1				
1983						
1984	1					
1985	1	6				
1986		7		1		
1987		3				
1988		2		1		
1989		1				
1990		4	3			
1991		13				
1992	2	15		2		
1993	4	27		2		
1994	1	16	1			
1995	1	18		2	1	
1996	1	16	1	2		
1997	1	13	1	1		
1998	1	10				

Source: The People's Bank of China Quarterly Statistical Bulletin, No. 1, 1999.

Controls over external debt. The principles of China's external debt controls are based on the following aspects: First, to utilise foreign capital through various channels to meet the needs of economic development. Second, to limit the total amount of external debt with regard to China's economic growth rate, aggregate investment plans, fiscal budget and balance of the international account, etc. Third, to restrict the amount of foreign exchange when converted into RMB in China in order to limit its impact on effectiveness of monetary policy. Fourth, to optimise the composition of external debt and discourage short-term borrowing.

Those principles are put into effect by the following methods:

First, all long- and medium-term borrowing from abroad must be incorporated into the State plan for utilising foreign capital and every borrowing must be examined and approved. The State draws up annual plans to control and co-ordinate borrowings.

Short-term borrowing is constrained by stipulations on the ratio of foreign exchange assets to liability.

Second, financial institutions, including the Bank of China and some ITICs, such as the Guangdong-ITIC (GITIC), are designed to act as special windows to commercial borrowing from abroad and for issuing bonds on international market.²¹ Only authorised institutions are permitted to borrow commercially or to issue medium or long-term bonds abroad.

Third, in 1996, China introduced a reporting system for international payments and receipts. This system provides the government with reliable statistics for monitoring external debt, including short-term inflow and outflow.

The legal framework of China's external debt comprises four aspect:

First, the primary law on external debt management is the Regulations of People's Republic of China on Foreign Exchange adopted in 1997. Such regulations are based on the following points: international commercial loans must be repatriated back to China; prior approval is required for any foreign borrowing, foreign currency-denominated bond issues, and guarantees in foreign exchange; the settlement of foreign exchange earnings from foreign loans must be approved by SAFE; and all foreign loans managed by the functional departments and by the designated Chinese banks must be registered on a regular schedule. Second, four major management rules are designed for the examination and approval of foreign debt borrowings. Third, there are two major rules regarding guarantees in foreign exchange. Fourth, three laws co-ordinate the repayment of principals and interest of foreign borrowings (Hong, 1998). China has drawn up a unified external debt plan and instituted a strict registration system that is centrally managed. Apart from the commonly known international commercial borrowing, export credit and international financial leasing, international debt and repayment schemes also include compensation trade, which requires payments in foreign exchange; foreign exchange deposits by overseas institutions and individuals; project finance and trade finance over a maturity of 90 days, etc.

Due to the strict external debt controls, limits on total volume and the close monitoring system, China's foreign debt indicators have always been kept within state targets and below the internationally recognised critical levels. For example, in 1997, both China's debt-service ratio of 7.3 percent and its debt ratio of 63.2 percent were far

below the critical levels of 20 percent and 100 percent (*Table 5*). Additionally, China has maintained a healthy external debt structure in terms of maturity (*Figure 5*). For example, from 1986 to 1997, the ratio of short-term foreign debt to total foreign debt had been below 23 percent, except in 1985 (41 percent).

Table 5: Foreign Debt Indicators of China, 1985-1997 (%)

	85	86	87	88	89	90	91	92	93	94	95	96	97
Ratio of Outstanding foreign debt to GNP ¹	11.1	8.3	10.0	10.6	12.2	15.5	16.4	16.0	15.4	15.4	15.4	14.4	14.5
Ratio of Outstanding Foreign debt to foreign exchange income ²	53.5	70.0	75.2	84.4	83.1	89.3	87.0	90.7	94.5	94.5	69.9	75.6	63.2
Debt service Ratio ³	2.6	14.9	8.8	6.3	8.0	8.5	8.0	7.3	9.7	9.1	7.3	6.7	7.3

Source: SAFE, China's Administration of Foreign Exchange, Annual Report 1997.

¹ GNP value in US dollar calculated at RMB 8.2781 yuan per US dollar.

² Foreign exchange income is identical with that in the current account of payments.

³ Debt service ratio is the ratio of repayment of principal and interest on foreign debt to foreign exchange income.

Restrictions on foreign exchange system. China's foreign exchange system has evolved from a system of rigid foreign exchange controls to full convertibility for current account transactions. This process took almost 20 years but strict controls on foreign exchange market transactions in China still remain.

Before the reform and liberalisation of the Chinese economy, China imposed planned and rigid controls on foreign exchange. All foreign exchange incomes and expenditures were centralised in the hands of the government. The Bank of China (BOC) handled all foreign exchange transactions and was the sole authorised foreign exchange bank in China. On 17 April 1980, China assumed its seat on the executive Board of the IMF and accepted the transitional arrangements stipulated in Article 14 of the IMF General Agreement with regard to the domestic economy and the balance of payment. A market-oriented approach was gradually introduced to the foreign exchange management system. A significant step adopted for the reform of China's

foreign exchange system was the establishment of 12 experimental foreign exchange swap markets in 1980. The number of participants in the foreign exchange market was increased to include a limited number of state-owned and domestic collective enterprises. These domestic enterprises had priority in retaining foreign exchange in the form of retention quotas, and selling their foreign exchange to other domestic enterprises authorised to buy it. The BOC was not the only trader in China's foreign exchange market. In fact, it began to act as broker for transactions between authorised domestic enterprises. All transactions were executed at a banded rate of internal settlement that was higher than the fixed official rate.

In 1986, permission to trade in the Chinese foreign exchange market was extended to FFEs in China. Thus, the FFEs, government departments, authorised state-owned and domestic collective enterprises, and individuals were permitted to participate in the swap markets.²² The use of the internal settlement rate was discontinued and the exchange rate of the swap markets was allowed to float without any band.

In 1988, the first foreign exchange centre in Shanghai began to operations. This was followed by the establishment of 80 centres across the country. At that time, all domestic entities allowed to retain foreign exchange earnings were also allowed to trade in the centres. The scope of participants was continually broadened. In 1991, individuals were allowed to transact foreign exchange, both of selling and purchasing, in these centres.

Following a series of reforms of foreign exchange swap centres, an inter-bank market based on swap centres was established in 1994. Several other significant reforms were also carried out at the same time: a unified foreign exchange market—China's Foreign Exchange Trading Centre (CFETC) began to operate; the two-tier exchange rates of RMB finally gave way to a managed and unified floating exchange rate regime, in which the exchange rate is basically determined by market forces; foreign exchange quotas were abolished; domestic enterprises were incorporated into a system for the sale and purchase of foreign exchange with domestic banks; and RMB convertibility for current account transactions was partially realised.

On 1 December 1996, China accepted Article 8 of the IMF Agreement and realised full convertibility of RMB under current account transactions. In line with this

effort, a series of reforms and deregulation of China's foreign exchange system were conducted.

First, FFEs were incorporated into the system for the sale and purchase of foreign exchange with designated banks from 1 July 1996. In the past, FFEs could only transact foreign exchange through swap centres. Under the new measure, upon the receipt of the application and differentiation of the account, FFEs can buy or sell foreign exchange either through the designated foreign exchange banks or through foreign exchange swap centres. When buying or selling foreign exchange through the designated banks, FFEs can enjoy the same treatment extended to domestic enterprises. Besides, they also enjoy preferential policies, which allow them to keep foreign exchange accounts and a certain amount of foreign exchange income, while domestic enterprises are not allowed to keep foreign exchange accounts. Other than a small amount of foreign exchange income, almost all domestic enterprises' foreign exchange earnings must be sold to the designated banks.

Second, restrictions on the private use of foreign exchange were relaxed in 1996. SAFE issued the Rules for Purchasing Foreign Exchange for Private Use by Domestic Citizens, which drastically relaxed the limits on the private use of foreign exchange by domestic individuals and enlarged the scope for private use. Individuals in need of foreign exchange for private use can buy up to the limit from banks. For demand above the limit, they can apply for purchase approval from the authorities. Meanwhile, the Regulations of Remitting Foreign Exchange Deposits Abroad by Domestic Citizens was abolished, further relaxing the control on remittance of foreign exchange deposits abroad by residents.

Third, remaining restrictions on foreign exchange in non-trade and non-operational sectors were abolished. Subject to a limit, foreign exchange used for non-trade and non-operational transactions can be obtained from designated banks without the need for approval for each transaction from the authorities. Non-residents' legal RMB income can be converted freely into foreign exchange and remitted abroad.

Finally, controls on foreign exchange in the trade account were relaxed further.

On 14 January 1997, the State Council approved the amendments to the Foreign Exchange Regulations of the People's Republic of China, codifying the reform package for China's foreign exchange system into rules and regulations. Following the approval

of the State Council, some domestic enterprises were allowed to retain a certain amount of foreign exchange without any time limit, and to transact with the authorised banks.

In the past couple of decades, China has relaxed the restrictions on foreign exchange system successfully. More importantly, this deregulating process has followed a gradual method. On the one hand, such a gradual approach brings China's foreign exchange system to the outside world step by step. On the other hand, gradual liberalisation of foreign exchange system helps China maintain an adequate supply of foreign funds, maintain RMB exchange rate stability and insulate the domestic financial market from violent fluctuations of world interest rates and exchange rates (*Figure 6*). Moreover, the sound structure of China's foreign debt, enhanced capacity of China's debt-serving and import-paying, massive build-up of foreign exchange reserves and, perhaps, the avoidance of Asian crisis contagion, are mostly, if not fully, due to the maintenance of remaining controls over the foreign exchange system.

Two aspects underline the remaining controls on foreign exchange system so far. One is the controls over entry to the foreign exchange market, which effectively restrict the demand for and supply of foreign exchange; another is the heavy intervention of the Chinese government in the foreign exchange market.

Currently, China's foreign exchange market is divided into two connected sub-markets: the retail market and the wholesale market. In the retail market, foreign currencies are transacted between banks and enterprises. The wholesale market is also called inter-bank market in which foreign exchange transactions are conducted between authorised financial institutions. In such markets, the demand for and supply of foreign exchange are virtually based on current regulations on the sale and purchase of foreign exchange. Under these regulations, the participants in the retail market are authorised foreign exchange banks on the one hand, and some domestic enterprises, FFEs, some departments of the government and domestic individuals on the other. The scope of participants has obviously been growing in line with China's opening up of the financial system. The restrictions, however, still exist. For instance, mandatory requirements for the sale and purchase of foreign exchange incomes by domestic enterprises were relaxed in 1997, and some domestic enterprises are permitted to retain a part of their foreign exchange without any time limit. However, only domestic enterprises with a total trade volume of over \$30 million and a capital base above 10

million yuan RMB, foreign companies with a total trade volume of over \$10 million and a capital base above 30 million yuan RMB, and manufacturers licensed to import and export are eligible. Moreover, each eligible business could only keep an amount of foreign exchange not exceeding 15 percent of the total trade volume in the previous year. Any excess amount must be sold to the authorised banks. Each independent legal Chinese and foreign entity can only have one foreign exchange account. The PBC delegates to SAFE hold the authority to determine the maximum amount of foreign exchange retained by Chinese and foreign businesses. The source of foreign exchange for the settlement accounts must come from current account transactions, and the payment from these settlement accounts can only be for the purpose of current account transactions and for capital account transactions approved by SAFE. The exchange rate used by banks for the purchase and sale of foreign exchanges has to be within a certain band of the previous day's reference exchange rate published by the PBC. Thus, most domestic enterprises cannot transact at the current day's exchange rate. They cannot purchase or sell foreign exchanges directly in China's Foreign Exchange Trading System (CFETS) either.

With regard to the inter-bank foreign exchange market, China's Foreign Exchange Trading Centre (CFETC) in Shanghai is fully computerised and linked to 37 cities throughout China. Entry to the foreign exchange inter-bank market is based on a membership system. All the authorised foreign exchange banks and non-bank financial institutions, including foreign-funded banks, can apply to be the members. SAFE has the right to grant the approval. So far, the members include state-owned commercial banks, foreign banks and non-bank financial institutions. The central bank of China, PBC, as a special member participating in transactions, is a major player in this market.²³ This is reflected by the Central Bank's dominant share of the transactions. Since authorised foreign banks have to manage their balances, a bank has to sell foreign exchange when its overturn position in foreign exchange purchasing and selling exceeds the limit, and has to buy foreign exchange when the position is below the limit. The price in such markets, therefore, cannot reflect real demand and supply, and the participants cannot conduct normal operations. Moreover, the PBC has authorised SAFE to set and adjust the bands to limit the daily fluctuation of the RMB exchange rates. The PBC has to intervene in the market in order to keep the exchange rate within

prescribed limits.²⁴ Such intervention could induce a surge in the official foreign exchange reserves, increase the supply of high-powered money, thereby resulting in inflationary pressure when supply of foreign exchange significantly increases because of large capital inflow.

Should China Slow Down the Progress of Capital Account Liberalisation?

In early 1999, China promised that there would be three ‘no-changes’ in the foreign exchange system: currency convertibility for current account transactions would not be reversed, the current controls on capital account transactions would not be tightened, and the goal of realising capital account convertibility in the future would not be changed.

Such a promise aimed to allay worries among foreign investors over a possible slowdown in China’s policy of financial opening in the light of the Asian financial turmoil. Inasmuch as the government is somehow the last guarantee for China’s whole financial system and any firm attitude taken by the government can be carried out in practice, this promise is virtually reliable. More importantly, some other rationales also support the China’s irreversible movement towards capital account liberalisation.

One force behind the continuing liberalisation of China’s capital account is China’s effort to join the World Trade Organisation (WTO). Basically, such an effort is built on a series of concessions made by the government. Therefore, the entry restrictions to China’s goods and capital markets will be further relaxed, through reducing tariff rates and eliminating non-tariff barriers, permitting foreign companies to involve themselves more freely in restricted industries, opening China’s insurance market, broadening foreign banks’ geographical access to RMB businesses in China, etc.

Another force, probably the most important one driving the progress of China’s capital account liberalisation, is the increasing growth of capital flight, and especially illegal capital activities.

In December 1996, China accepted Article 8 of the IMF agreement and permitted full convertibility of RMB in current account transactions. Since then, China has been facing a difficult task of ensuring the stability of the exchange rate and the effective functioning of the foreign exchange system in the light of relatively tight

controls on the capital account. The difficulty is evidenced in the erosion of the effectiveness of capital account controls, in terms of growing capital flight and illegal foreign exchange activities. In 1998, SAFE and other departments launched nationwide investigations to deal harshly with foreign exchange infractions. According to Zhao (1999), illegal capital flows took at least 12 forms through the current account and 18 forms through the capital account channel.²⁵ For example, some authorised import companies or FFEs use fake import invoices to purchase foreign exchange from the authorised banks and then remit the foreign exchange overseas. Other illegal flows include arbitrages of foreign exchange from designated banks by presenting false and invalid certificates, commercial documents or other means for the purpose of evasion of foreign exchange controls, laundering of illegal money and tax defraud. Some forms of capital flight are related to the underground economy, such as smuggling. Many illegal foreign exchange activities take the form of under-invoicing of exports and over-invoicing of imports so that large amounts of foreign currencies can be kept abroad. These forms of capital flight do not show up in “errors and omissions”. It is also difficult to detect the true purposes of capital flows and draw a clear demarcation line between current account transactions and capital account transactions. The convertible current account makes possible some illegal capital flows for the purpose of avoiding the controls on capital account. For example, some remittances from abroad can flow into the tightly restricted domestic stock market because China has allowed the remittances of domestic individuals from abroad to be freely exchanged for RMB since 1994.²⁶ A large number of illegal foreign exchange intermediary services also help channel the illegal foreign exchange inflows and outflows.

Some Chinese enterprises and FFEs also take advantage of loopholes in the regulations and weaknesses in foreign exchange management to move capital in and out of the country. For example, according to the rules set by SAFE, deferred payments that are over three months should be registered as foreign debt. This sort of foreign debt can be repaid through the authorised banks at the due date as long as the “borrowers” obtain approvals from SAFE. That means that this amount of foreign exchange flows out legally under the capital account. At the same time, those “borrowers”, mostly FFEs, can also use the valid certificates for imports to obtain the foreign exchange payment through banks without the approval of SAFE. Hence such

foreign exchange can flow out again legally under the current account. Therefore the same amount of foreign exchange can be moved out twice through both the current account and capital account from the same entity. In this case, the loophole is due to the weak and inefficient co-ordination between the foreign exchange authorities and the authorised foreign exchange banks.

It is difficult to assess the illegal foreign exchange activities statistically in China. Most of them can not even be covered by “errors and omissions”. If we use a broad concept of capital flight, the figures could be much bigger. According to the studies undertaken by the Institute of National Economic Studies in China, the value of capital flight of China can be calculated using the following formula: ²⁷

$$\text{Capital Flight} = \text{Gross Capital Outflow} - \text{Legal Capital Outflow} + \text{Capital Flight Executed by Trade 'Mis-invoicing'}$$

where: (1) gross capital outflow = net foreign capital inflow - current account deficit – change of foreign reserves; (2) legal capital outflow = net foreign assets of depository money banks + non-banks normal capital outflow; (3) capital flight executed by trade ‘mis-invoicing’ is measured by the difference between the trade data provided by China’s 15 major trade partners and that provided by China’s official statistical source. Using the above method, the resultant estimate of China’s capital flight is summarised in Table 6 below.

Table 6: Estimation for China’s Capital Flight in Selected Years (billion US dollars)

	1987	1990	1992	1994	1996	1997
Gross capital inflows (1)	18.68	102.22	225.15	240.82	292.64	555.87
Legal capital outflows (2)						
A: net foreign assets of depository money banks	20.79	39.47	53.81	31.99	31.11	124.32
B: non-banks normal capital outflow	10.71	13.33	45.06	25.14	31.32	65.63
Capital flight executed by trade mis-invoicing (3)	15.44	4.61	13.95	21.40	31.26	123.04
Capital flight (4)*	2.62	54.03	140.23	205.09	261.47	488.96

Source: China Macroeconomic Analysis, No. 01, 1999, Institute of National Economic Studies, China

From China's balance of payment sheet, we can see the sharp increase beginning in the middle of 1990s, as shown by the "errors and omissions" figures, which offset a large part of foreign investment (*Figure 7*).

In order to cope with growing capital flight and fight illegal foreign exchange activities, SAFE moved to co-operate more closely with the Customs offices. In mid-1997, SAFE and the General Administration of Customs signed a memorandum on cracking down on exchange fraud involving the use of false declaration forms. The State Council of China submitted the draft on "Decisions on Punishing Fraud, Dodging and Illegal Trading of Foreign Exchange" as a supplement to the criminal code, in late 1998. Under the regulations, purchase of foreign exchange by deception was listed as a crime and the punishment of violations was extended from only state-owned companies, enterprises and other state-owned units to all companies, enterprises and units. In addition, the regulations provided that working personnel of the Customs, foreign exchange management departments and other financial institutions and foreign trade enterprises found to have collaborated with criminals or provided conveniences or services to them would be punished severely.

Such strengthening efforts do not mean that China has tightened its controls further. The implication is that China realises the difficulties and high cost of implementing controls over capital account in the circumstance of an open current account. If the convertibility of RMB under current account transactions cannot be reversed, capital account liberalisation will follow sooner or later.

Sequencing and Establishing Preconditions for Capital Account Liberalisation

Understanding China's gradual approach to liberalising the capital account needs a broad perspective, taking in not just cautious liberalisation, but also the active effort to overcome the weaknesses in the domestic financial system and establish the conditions for capital account liberalisation.

Establishing preconditions for liberalising China's capital account

- De-controlling interest rates
It is generally recognised that unless domestic interest rates are flexible and become internationally competitive, there will be substantial pressure on the balance of payments and the exchange rate when capital account convertibility

is introduced. In China, the liberalisation of interest rates is undoubtedly a critical aspect of financial reform. After two decades of reform, however, domestic interest rates are still under planned controls. The marketisation of interest rates is placed at the last stage of China's financial reform package.

The key component in the administrative framework of domestic interest rates is the central bank, PBC, which sets and adjusts the interest rate according to a basket of macroeconomic indicators. Although the flexibility of the interest rate policy has been increased since 1995, as reflected by the frequent changes of interest rates, the mechanism of setting the interest rate is still rigid and interest rate adjustment is lagging behind changes in market demand and supply. Hence the presence of the following serious problems: First, the narrow spread between the deposit rate and loan rate has lasted almost 20 years, limiting the banks' ability to gain profit. Second, there are too many preferential rates, which increase the cost of management. Third, due to the low level of interest rates, commercial banks have a strong tendency to borrow from the central bank to boost their fund resources. Thus, the PBC has to face the pressure of increasing lending to commercial banks, effectively constraining the autonomy of the central bank's monetary policy and its effects. Finally, the interest rate controls stimulate the innovation of financial instruments by commercial banks and other financial institutions in order to evade the controls. Interest rate liberalisation, however, must be carefully co-ordinated with other structural reforms, especially the reform of state-owned enterprises (SOEs) and commercialisation of banks. Many SOEs are operating with narrow margins or are incurring losses. Once interest rates are liberalised, any significant increase in the interest rates would rapidly erode those margins and induce many bankruptcies. Without the successful reform of SOEs, liberalising the interest rates could be very risky. Commercialisation of banks is another element affecting the process of interest rate liberalisation and its success largely depends on a sound and competitive financial sector whose behaviour can be influenced by interest rate signals. In China, banking system reform is closely related to SOEs reform. A growing volume of loans from state-owned banks has flowed to the SOEs during the past two decades. The ratio of outstanding loans to GDP increased from 53% at the end of 1978 to 85% in 1990. At the end of 1996, this ratio was still at a high level of 74% (Lardy, 1997). This rapid growth of bank loans helped phase out fiscal subsidies to money-losing enterprises in 1990s. However, it also left many banks exposed to large amounts of bad loans because of the weakness of the SOEs, hence impeding the progress of banking system reform. The call for the commercialisation of state-owned banks was raised many years ago. Progress, however, has been slow. A well developed money market which could provide the basic conditions for a market-determined interest rate is also an important factor in interest rate liberalisation. Thus, the liberalisation of interest rate has to proceed very incrementally, to be followed by a gradual process of opening up China's capital account.

It is suggested that the liberalisation of China's interest rates should be paced in the following sequence: first, liberalise the interest rates on inter-bank lending; then free the lending rates. At the last stage, lift the controls on deposit

rates. On 1 June, 1996, the ceiling limit on China's inter-bank rate (CHIBOR) was eliminated. Inter-bank rates have since been determined freely by the market. Some lending rates have been partially liberalised, reflected by the various floating limits on loans either based on different types of loans or on different types of financial institutions. For example, many of the lending rates for urban credit co-operatives and rural credit co-operatives are allowed to change within a wider band than those of other financial institutions. Additionally, the controls on interest rates for indirect financing activities, such as limits on the interest rate of corporate bonds and the issuing rate of treasury bonds, have already been relaxed. Most of the deposit rates, except the rate for CDs which was allowed to float up to 5% of the basic rate, are still under strict controls. China will not be able to liberalise the interest rates on deposits as long as the largest domestic banks and their principal borrowers remain financially fragile. However, it can be predicted that the process of liberalisation of interest rate will speed up once the focus of reform shifts to the development of the money market.

- Addressing the weaknesses of the financial system
Some economists argue that China shares many of the characteristics that contributed to the crisis in Thailand and Korea (see, for example, Lardy 1998, 1999). These include a bank-dominated financial system, poorly regulated banks making loans too inefficient, over-leveraged SOEs, and a huge build-up of non-performing loans. Other authors, however, argue that even though China's domestic financial weaknesses look very similar to some of the frontline crisis economies, they are not likely to induce a crisis because of the government's support. Capital controls in China are certainly another key element in maintaining a sound external economic position (Fernald 1999).

Indeed, China has the same weaknesses as pre-crisis Thailand. It is also true that, with the Chinese government's support of the domestic financial system and the controls on capital account transactions, China survived the Asian financial crisis very well. If we look from the perspective of China's market-oriented economic reform, however, we would see that the guarantees provided by Chinese government are not likely to last long term and China's capital account controls will eventually be eliminated. As a matter of fact, the government guarantees themselves have already become part of the weakness by encouraging corruption and moral hazard problems. Under a market-oriented system with little government support and an open capital account, China's domestic financial weaknesses would have been severe enough to lead to a systemic bankruptcy, like what happened in Thailand and other troubled economies. Therefore, without addressing the weaknesses in China's domestic financial system, fully opening up China's capital account would be extremely risky.

There is an inner chain linking the weaknesses in China's financial system. Like most Asian economies, China's financial system is heavily dependent on bank loans. In terms of the ratio of domestic credit to GDP, China's bank-dominated share is even higher than that of Indonesia, the Philippines and Latin American countries (Table 7). The majority of those loans, mainly provided by state-owned banks, keep flowing to the SOEs despite

their severe losses. This has led to an excessive growth of domestic lending, along with an extraordinary deterioration in the balance sheets of SOEs. The SOEs' ratio of debt to equity was in excess of 500% by the end of 1995, implying that a significant portion of China's SOEs were insolvent, i.e. the value of their liabilities far exceeded the value of their assets. Moreover, the over-leveraged SOEs are chiefly responsible for the rise in the banks' non-performing loans. According to the Governor of the PBC, Dai Xianglong, at the end of 1997, non-performing loans of the four largest state-owned banks reached 25%. This figure is much higher than the pre-Asian-crisis levels in the banking systems of Thailand, South Korea and Indonesia. Moreover, the capital-adequacy ratio of the big four state-owned commercial banks has been alarmingly low.²⁸ The international standard, written into China's banking law in 1995, is 8 percent. The four state-owned banks officially registered 5.86 percent in 1997, but actually only managed 3.5 percent. However, the poor bank health did not lead to a "credit crunch", like in most Asian economies, because of public confidence that the state would guarantee individual deposits in the banks and, to a lesser extent, in the urban and rural credit co-operatives. Moreover, the government could order the banks to lend even if the banks were sceptical about the quality of the loans.²⁹ The faith in government support has kept deposits at levels which ensure that banks would still be able to lend even if their loans went bad. If a financial system is running on faith in the government's guarantee and not on a basis of a fully commercialised market, it could be very fragile.

Table 7: Ratio of Domestic Credit to GDP (%), 1996

Asian economies:						
China	Thailand	Korea	Singapore	Indonesia	Philippines	India
96	157	134	114	63	65	29
Latin American economies:						
Chile	Mexico	Brazil	Argentina			
70	22	30	18			
Developed countries:						
U.S.	U.K.	France	Italy	Spain		
58	123	82	52	75		

Source: Fred Hu, 1998, The Problems of Banks and the Crisis of Asian Financial Crisis, Working Paper No. 199806, National Centre for Economic Research at Tsinghua University, Beijing, April, 1998.

The consequences of China's unhealthy financial system make it hard to give a priority to the government's list of tools for problem resolution. There should be a co-ordinated approach to policy implementation. In order to decrease the large proportion

of bank credit, more direct financing instruments should be provided and capital markets should be further developed. Recapitalisation of the banks could help them write off part of their non-performing loans. In 1998, the Chinese government announced a 270 billion RMB (\$33 billion) program to recapitalize the banks, aimed at pushing the capital-adequacy ratio to 8 percent. In order for this to happen, the commercialisation of banks must continue and concentrate on solving the inherent incentive problems. The reform of SOEs should speed up, but this, to a large degree, will depend on the development of the domestic capital market. The government must find a way to phase out the guarantees cautiously. An example of withdrawing government guarantees was the closure of GITIC in 1998.³⁰ In the meantime, strengthening prudential supervision and regulation of the financial system is critical for a smooth transition from non-market-oriented financial system to a market-oriented one, especially when some of the government guarantees have to remain, with their attendant moral hazard problems.

- **Exiting to a more flexible exchange rate regime**
The absence of capital account convertibility in China means that the ability of capital to flow in and out of the country instantaneously is limited and speculators, either foreigners or Chinese, have no way to short sell the currency in the belief that the RMB is overvalued and likely to depreciate. Since 1994, when China unified multiple exchange rates and adopted a single and managed floating exchange rate regime, the external value of the RMB has been relatively stable. Even when most of the Asian currencies experienced sharp devaluation during the financial crisis, the RMB kept its pegged rate very well.³¹ The controls on the capital account was one of the main pillars supporting the Chinese authorities' ability to hold on to the pegged exchange rate of the RMB.³²

China's current exchange rate regime is based on a series of regulations on the sale and purchase of foreign exchange. The demand for and supply of foreign exchange, therefore, are restricted and the market price — the RMB exchange rate — is distorted to a large extent. However, as China continues with its capital account liberalisation, high capital mobility will be inevitable and a tightly managed float regime will be difficult to sustain. Experiences of other developing countries have shown that it is desirable to move away, over time, from a regime of exchange rate rigidity toward one of greater flexibility. The exiting methods, however, were quite different from country to country.³³ In Thailand's case, the abandonment of a fixed rate precipitated a crisis. When the economy and financial systems were already in some difficulty, when private capital inflow that had been financing a

substantial current account deficit were beginning to decline, when businesses and banks had significant unhedged foreign currency liabilities, and the credibility of the government policy was somewhat questionable, the switch to a flexible regime could be very costly with an open capital account.

China is facing the challenge of effecting a smooth transition to a more flexible exchange rate regime. The continuing dismantling of controls over entry to the foreign exchange market can help increase market competition, which in turn contributes to a real market determined rate of the RMB. In the meantime, China needs to introduce more tradable foreign currencies and establish forward and future trading in the RMB. Currently there are only three tradable foreign currencies in China's foreign exchange market: the U.S. dollar, Japanese yen and Hong Kong dollar. Only spot transactions exist in the market, even though there is an offshore non-deliverable forward market in Hong Kong, where all transactions take place in U.S. dollars, based on the underlying value of the RMB.

On the issue of when the exit of fixed rate brings about less risk, it is suggested that the move should be conducted during a period of relative tranquillity in the foreign exchange market. In such circumstances, there is no reason for markets to conclude that the change was forced on the authorities and, correspondingly, there is less risk of the government losing its policy credibility (Eichengreen and Masson, 1998). However, it is unrealistic to assume that this period can last for long, especially when China continues to open up its capital account. Thus, a second best and most likely scenario for moving to a flexible rate is when there are market pressures for the appreciation of the RMB. These pressures are likely to be induced by a surge of capital inflows under a relatively free and open capital account. It means that the shift from a fixed rate to a flexible rate will be realised with an appreciation. Unlike a shift under depreciation, appreciation hardly damages the credibility of the government's policy. To reduce the negative effects of an exchange rate appreciation, such as the unfavourable effect on exports, and to decrease the incentives for capital inflows, some other policies, including fiscal policy, should be adopted at the same time. The success of an orderly transition toward a flexible exchange rate also depends on the ability of the central bank to conduct monetary policy in a more flexible exchange rate environment, as well as the diversity of financial instruments and the soundness of the financial sector.

A gradual move to a flexible exchange rate regime is also recommended. It is both feasible and desirable to move gradually on a pre-announced schedule by widening the bands for exchange rate fluctuations in stages. The transition from a fixed rate regime to a greater flexible rate regime can be carried out by reducing the limits of the float over time, rather than all at once.

Sequencing of China's capital account liberalisation.

It is not easy to determine an optimal sequence for the deregulation of the various types of capital transactions, and the speed at which liberalisation should proceed. Theoretical analysis provides a general idea of the risks associated with an open capital account when certain conditions have not been met. However, there is no uniform sequencing package suitable for every country. Experiences of sequencing capital account liberalisation in other countries are also quite different. Thus, there is no clear-cut model or example for China to follow.

Apparently, the design of China's sequencing of liberalising capital account is constructed with the idea of the gradualist reform. This gradual method, however, does not mean that China should maintain tight restrictions on virtually all forms of capital flows until the preconditions mentioned above are fully and successfully established. The implication is that some controls on certain items of capital transactions may be relaxed first. This in turn can help build the preconditions for further capital account liberalisation. With this principle in mind, the Chinese authorities may need to consider several stages for the coming years.

Firstly, liberalisation of the long-term capital inflows could be carried out in the early stage of sequencing. Among the different types of long-term inflows, direct inward investment and trade-related finance may be opened first before indirect investment is liberalised. China has had a successfully practised reducing the controls on FDI investment since the beginning of the reform and opening up in the late 1970s. The opening up of the domestic insurance market is already under way. Apparently, the liberalisation of FDI is the first step on the list of opening up China's capital account transactions. It can be predicted that, as the freest part of capital flows to China, FDI will continue to be the main element in China's integration with the world market in the near future. In order to ensure sustained flows, however, the regulatory and institutional framework for FDI needs to be improved. Fernald and Babson (1999) proved that reduced capital flows seemed likely, as indicated by the apparent increase in China's risk premium after the Asian financial crisis. That means foreign investors may not have the same enthusiasm for China's market as before in the next few years. As regards the host, there are also inefficiencies in direct capital flows to China, such as round-tripping and biased distribution in terms of both sector and geographic area.

Moreover, as Wei (1998) discovers, China was actually an under-achiever in attracting funds from the world's major source countries (e.g. the U.S., Japan, Germany, UK and France) even though the absolute figures of FDI flows into China in recent years looked very impressive.³⁴ China has to improve its FDI policies by reducing fiscal incentives, increasing the transparency of tax and foreign exchange rules, diversifying the sources of FDI, adopting more open trade policy and establishing better property rights for investors.

Secondly, in phasing the liberalisation of indirect capital inflows, the opening up of the domestic securities market may be placed at a later stage. The opening up of the domestic banking sector could take place earlier than that of portfolio inflow. This order of liberalising long-term indirect inflow, however, contradicts the experiences of some other countries, where restrictions on entry to the domestic banking sector were retained even after controls on short-term inflows were eased.³⁵ Partly because of China's weak and less-developed securities markets, which need to be protected in the relatively long term, the liberalisation of the portfolio market may take time. And because of a heavily biased banking sector and the lack of competition in the banking system, more free entry of foreign banks may introduce greater competition, which in turn can help narrow the gap between China's financial sector and its international counterparts. As discussed above, the entry channels to China's banking system have been widened gradually for foreign financial institutions since 1981. The Chinese authorities took a significant step recently by allowing some foreign banks to operate RMB businesses and broadening the geographic limit for foreign banks. Further 'de-controlling' on foreign banks' entry to the domestic banking sector may take place in the coming years.

Roughly speaking, there are four considerations for such liberalisation. The first one is to eliminate restrictions on the location of foreign bank branches in China. Allowing foreign banks to establish operations anywhere they want in China will accelerate the development of China's central and western areas. The second one is to lower the threshold for the entry of foreign banks' representative offices. But, the financial supervision authorities must strengthen the daily management of the representative offices once they begin operations. The third one is to continue opening up the local currency businesses to foreign banks. The last one is to give foreign banks

the same treatment as domestic ones. Since China allowed foreign banks to enter its markets, they have been given preferential interest rates and tax rates, allowing them to operate under relatively lower interest rates and tax rates than domestic banks. Such a policy did play a positive role during the early stage of opening, but it is becoming more and more inefficient with changing financial and economic situations. For example, the preferential tax policy offered to foreign banks is generating fading enthusiasm in the wake of agreements signed between China and most countries on the avoidance of double taxation, even as domestic banks continue to bear a heavy tax burden.

The securities market offers great potential for further liberalisation. To standardise market practices in line with those in most other markets in the world, China has to unify its segregated stock markets. Until the RMB becomes fully convertible for capital transactions, foreign investors will not be allowed to enter the A-share market freely. However, when the markets have grown and are unlikely to be easily manipulated by the big players, it will be possible to introduce foreign investment funds into the A-share market. The first step might be “joint-ventures” and Sino-foreign mutual funds. Meanwhile, other foreign investors will have access through the B-share market and overseas arrangements. The transition from a partial merger between A-share and B-share market to a complete unification of the segregated markets will be a time-consuming process. It will be proceeding in tandem with the creation of a suitable operational framework to improve the functioning of the securities market, development of intermediary organs, prudential regulations on firms, securities companies and other participants on the market as well as the introduction of a sufficient variety of financial instruments.

As for the fixed-income securities markets, it is unlikely that foreign investors will be permitted in the RMB-denominated debt instruments in the medium term. Greater flexibility in interest rates will surely help ensure the orderly issue of fixed-income securities. It is imperative to create an efficient and transparent mechanism for bond issuance before foreign investment is allowed to enter the local currency bond market.

Thirdly, openness to short-term capital inflows should be the last stage in the whole process of liberalising capital transactions. According to the concept of prudent

liberalisation of short-term capital inflows provided by Williamson and Mahar (1998), some conventional preconditions should be satisfied before short-term capital inflows are liberalised. They are: initiation of trade liberalisation, average fiscal deficit of less than 5 percent of GDP, domestic financial liberalisation, the reduction of government ownership of the banking sector to less than 40 percent and the presence of a system of prudential regulation and supervision adjusted for a market-based financial system. Most of those should have been established for at least two years prior to the removal of controls. Apparently, meeting all of the conditions will take a long time. Moreover, the specific preconditions, which include liberalising the interest rates, adopting a more flexible exchange rate regime and overcoming the weaknesses of financial system, also need to be set up before China fully 'de-controls' the short-term capital inflows.

Fourthly, controls on capital outflow should be lifted in a more cautious way than those on capital inflow. China urgently needs to establish a suitable framework of laws and regulations on the management of capital accounts related to foreign exchange outflow. By the end of 1997, there were a total of 28 laws and regulations on the management of foreign exchange in capital accounts. Only 6 of them were applicable to the management of capital outflow. Because of the lack of clear rules and adequate monitoring on outward investment, state funds have sometimes been wasted on inappropriate projects. Many investments abroad are losing. Other preconditions are also recommended before the removal of controls on both long and short-term outflows. They include the establishment of sound government finances, resolution of the bad loans problem, and elimination of controls on domestic interest rates so that the differential between domestic and world interest rates is brought down to a low level. Short-term outflow should be liberalised after long-term capital outflow, and certainly after sound supervision and prudential regulations of the financial system are in place and a sufficient level of competition is present in the banking sector.

Finally, China should proceed very carefully with the development of offshore markets. Currently, China has a very small offshore market where the domestic market is strictly separated from the foreign market and business is dominated by the banking sector. By the end of 1997, only 6 domestic banks in Shenzhen were allowed to operate the offshore banking businesses. As part of its liberalisation strategy, China is aiming to promote Shanghai as a sub-regional financial centre. However, this process should

be paced prudently. On the one hand, the real needs of such a market, both domestic and foreign demand, should be assessed carefully. In this regard, the government should have an evaluation of the advantages and disadvantages of promoting Shanghai as a financial centre, especially when compared with other regional financial centres, such as Hong Kong and Singapore. A well-designed and carefully prepared economic and financial infrastructure must be in place in order to avoid creating a financial centre in a haphazard way. This is one of the most important lessons that we have learned from Thailand — from the establishment of the BIBF in 1993, to the breakout of the crisis in 1997 and the subsequent self-examination by the Bank of Thailand to reorient the operation of the BIBF.

CONCLUSION

Capital account liberalisation is a natural follow-up to the establishment of current account convertibility. However, no clear-cut models are provided by theory and no exact examples are given by experience. The traditional dispute between advocates of the gradual approach and the radical approach focuses on the speed of capital account liberalisation. The conservative view believes that the opening up of the capital account should be brought about gradually and as the last step in the process of general economic liberalisation and structural reform in developing countries, while the radical view argues that capital account liberalisation should occur rapidly at the beginning of the reform process.

The middle approach, which has appeared recently, is concerned with the issues of careful sequencing, regardless of how fast to open up the capital account, after current account convertibility has been achieved. Since the careful sequencing of capital account liberalisation needs time, a gradual removal of capital restrictions may be desirable for developing countries like China. Basically, there are some preconditions for a successful transition to full capital account liberalisation. Some of them, like addressing the weaknesses of the domestic financial system, are so critical that they should be put on top of the list. However, it is also necessary to recognise that the opening up of the capital account should not be delayed until all the preconditions have been established because of the cost of maintaining a closed capital account in the

circumstance of free current account transactions, as well as the benefits accruing from partially liberalised capital flows.

From the survey of Thailand's experience in opening up the capital account, we can see that one of the factors leading to Thailand's financial crisis in 1997 was the rapid elimination of external capital controls, especially over capital inflows, without first satisfying certain preconditions. The following lessons are particularly useful for China. First, the Thai government failed to cope with the inconsistent trinity of macroeconomic policies — choosing high interest rates policy as a tool of neutral intervention while fixing the exchange rate in the circumstance of unimpeded capital inflow. Second, implicit guarantees, combined with the lack of prudential supervision, were present in various areas like the pegged exchange rate regime and government support for commercial banks and other financial institutions. Third, a severe bias towards the growth of credit relative to equity in Thailand's financial system, which had resulted by the feature of collateral-based lending by banks and the lack of prudential supervision.

It is true that China shares the same weaknesses of Thailand. Without the controls over the capital account, it is unlikely that China could have escaped the violent speculative capital movement like what happened in Thailand in 1997. The framework of China's controls over capital account transactions is characterised by the following aspects: First, the policies of relaxing FDI controls were begun very early at the beginning of China's reform in late 1970's, and evolved gradually through the establishment of a legal framework, combined with many policy-related incentives. The current controls on inward direct flows are more liberal than the controls on any other capital account transaction. FDI plays a primary role in China's integration with the international capital market. Second, China maintains relatively tight restrictions on entry to its financial market. The money market is still strictly closed to foreign investors. The securities markets are opened to foreign investors in two main ways: a small B share local market, and overseas listing and issuing, such as H or S shares and ADR.

Third, restrictions on the entry of foreign financial institutions are maintained in various areas even though the process of 'de-controlling' started very early in 1981. Fourth, the centrally managed unified external debt plan and strict registration system

constitute the pillar in the framework of China's foreign debt control, helping China keep its foreign debt indicators within state targets and below the internationally recognised critical levels. Finally, China's foreign exchange system is partially liberalised by its acceptance of Article 8 of the IMF agreement in 1996. However, the foreign exchange market is still distorted by limiting demand and supply of foreign exchange under the capital account.

The design of sequencing of the capital account deregulation is largely influenced by China's idea of gradualism in reform. Such a gradual approach to capital account liberalisation does not mean that China should maintain tight restrictions without any partial 'de-controls'. The sequencing, however, should be designed carefully. On the one hand, some preconditions, such as addressing the weakness of financial system, 'de-controlling' domestic interest rates and adopting a more flexible exchange rate regime, should be established before realising full currency convertibility for capital account transactions. On the other hand, it is also recommended that with regard to pacing the liberalisation of the different forms of capital transactions, long-term capital inflow may be liberalised earlier than the short-term inflow. With regard to the lifting of controls over long-term capital inflow, foreign direct investment may be liberalised ahead of foreign indirect investment. The limits on capital outflows, especially on short-term outflow, should be the last stage of the whole sequencing package. The development of offshore markets should be done very carefully. Last but not least, a successful transition to capital account liberalisation in China cannot be realised without other domestic reforms, such as the reform of SOEs and the commercialisation of China's banks.

NOTES

1. Carlos Massad gives a complete analysis of Chile's liberalisation of its capital account.(Carlos Massard, 1998)
2. Peter J. Quirk and Owen Evans(1995) provide more detailed information on the experience of capital account liberalization in both industrial countries and developing countries (p.11-26).
3. In the Baltic countries, exchange controls were liberalized in a very short time, with both Latvia and Lithuania establishing convertibility at the same time as when their national currencies were introduced. Argentina began to liberalize current account transactions in 1989, and completed full capital account convertibility two years later in 1991.
4. McKinnon's analysis concerns less-developed countries and transitional economies sharing the common problem of financial depression.
5. One of the most frequently used channels is the under- and over-invoicing of export and import contracts. Another is the transfer pricing policy of multinational companies. The third one consists of lags in the settlement of commercial transactions or variations in terms offered on short-term trade credits. Fourthly some transactions under the current account, like remittances of savings by foreign workers in the domestic economy and by domestic nationals working abroad, family remittances and tourist expenditures, have been used as vehicles for the acquisition or remission of foreign assets. Finally, financial innovations, like non-deliverable forwards, increase the incentives to evade capital controls.
6. Eichengreen and Masson (1998) give a detailed analysis for the policy options for countries seeking greater exchange rate flexibility.
7. For details, see Barry Eichengreen and Michael Mussa, 1998.
8. The first round of the relaxation foreign exchange regulations was undertaken in 1989. The second round of relaxation was introduced in 1990 when Thailand accepted Article 8 of the IMF Agreement of Article. The third and fourth rounds of the relaxation were carried out in 1991 and 1992 respectively. The complete description for Thailand's sequencing of reforms in the domestic and

external sectors from 1985 to August 1997 is provided in R. Botry John, Salim M. Darbar and Claudia Echeverria(1997).

9. According to a report written by BOT(1998), in financing the capital needs of both the country and the region, Thailand could exploit its geographical advantage as a gateway to the former centrally planned economies in Southeast Asia, and promote the intermediation of international capital to meet the long-term needs of these countries in the reconstruction of their economies. But the report also pointed out that the aim to promote a sub-regional financial centre was premised on an artificial market place. Southeast Asian countries competed among themselves to divert global funds to their offshore market using tax incentives, while the political, economic and financial infrastructures were not yet in place. Consequently, there was effectively no real demand to foster the development of a truly offshore centre. Following the crisis, the Thai authorities would have to intensively review the policy and implementation and reorient the operation of BIBF to serve and complement the existing and established financial centres such as Singapore and Hong Kong (Bank of Thailand, 1998).
10. The indicators included short-term interest rates, commercial bank deposit and lending rates, bank reserves, monetary aggregates, capital flows, private credit expansion and sectoral allocation. See Bank of Thailand, Bank of Thailand Economic Focus, Vol.2, No.2, April-June 1998.
11. According to the bank of Thailand (1998), such a policy decision was premised on the rationale that a devaluation of the baht would have done more harm than good for the following reasons: first, the high import-content of Thai export products implied that there would be only limited gains in export competitiveness. Second, large losses on unhedged foreign currency debt would result in a large number of corporate bankruptcies, leading to unemployment and consequent social problems. Third, asset quality of financial institutions would be further impaired due to a weakened corporate sector. Fourth, inflationary pressure would intensify through higher import cost and wage demand. Finally, higher interest rates to contain inflation would make it even more difficult for weak financial institutions to recover.

12. Other reasons, compared with that in Thailand, included the good nature of China's capital inflows, which were dominated by long-term maturates and a good record of current account balance.
13. FFEs include three types in China: equity joint venture, co-operative joint venture and wholly foreign owned venture.
14. In practice, China's foreign exchange regulations relating to FDI are implemented through requiring FDI firms to open a RMB deposit account and a separate foreign exchange deposit account with either the Bank of China or another bank approved by the State administration for Foreign Exchange (SAFE). All foreign exchange receipts and disbursement must flow through the foreign exchange account.
15. The first foreign exchange swap market was established in Shenzhen in 1985. In 1992, the first nation-wide foreign exchange swap centre was opened in Beijing.
16. The Interim Regulations Guiding Foreign Investment promulgated by the State Planning Commission in 1995, identified the projects for which foreign investment should be encouraged, limited, or prohibited.
17. On October 15, 1997, following the approval of the State Council, a certain amount of permissible foreign exchange earnings could be retained by some Chinese enterprises which have large import and export trading and have good financial and business performance. This is an important policy in the whole process of China's foreign exchange reform.
18. For a complete analysis of China's securities markets, please see Zhou, 1998.
19. In China, the stock market is strictly separated by two sub-markets: A share market and B share market. A shares are only for Chinese residents to buy with RMB. Non-residents only have access to B shares which are denominated in RMB and are listed locally on China's securities exchanges.
20. With regard to such market segregation, H shares have the feature of inconvertibility as A shares as well (Lan, 1997).
21. Before 1993, China's fund raising on the international securities market was undertaken entirely by what was called the "ten major windows", one of which was Guangdong ITIC, or GITIC. As intermediaries, these "windows" borrowed

money abroad and extended loans to domestic borrowers, who were operating on a basis of an implicit government guarantee. For a long time, the GITIC handled trust and investment involving many areas, thereby playing a significant role in Guangdong's economic growth. However, because of the lack of supervision, a large amount of funds did not flow into the productive sectors, but rather, through various channels, into securities and real estate sectors. On October 6 1998, GITIC, as the largest non-bank financial institution in Guangdong province, and the second largest of its kind in China, was closed because of its insufficient liquidity and inability to repay maturing debts. This event has had an enormous impact domestically and internationally. In the short-term, there is a fear among foreign investors about the insolvency problem of China's non-bank financial institutions. In the long-term, it is a positive signal that Chinese government might withdraw its guarantees step by step.

22. Individuals were only permitted to sell their foreign exchange, but they were not allowed to buy foreign exchange in the swap markets.
23. Actually the Office of Open Market Operation of the PBC is the special member of the CFETS.
24. The bands on the market rate around the basic exchange rates published by the PBC in the inter-bank market are different: for the exchange rate between RMB and US dollar, the floating limit is $\pm 0.15\%$; for the rate between RMB and Hong Kong dollar and Japanese yen, it is $\pm 1\%$. The rates set by the authorised banks for the retail transactions are different as well. For the exchange rate between RMB and US dollar, the limit of floating is $\pm 0.15\%$, for the rate between RMB and Hong Kong dollar and Japanese yen is $\pm 1\%$.
25. According to Zhao(1999), illegal flows through the current account include capital flight by using false documents for interest and dividends of foreign investment to obtain foreign exchange from authorised banks, foreign exchange arbitrages by using fake documents of transfer payments; withdrawals of capital illegally by FFEs, etc. The forms of illegal capital flows through the capital account include avoiding the state controls on total amount of foreign debt by establishing FFEs or using a fixed rate of repayment to attract foreign investment in joint-venture projects. For details, see Zhao (1999).

26. At the end of May 1999, SAFE announced that remittances from overseas to domestic branches of the Bank of China would be halted starting from 10 June. This suspension is aimed at plugging loopholes in foreign exchange management.
27. There are various methods of calculating capital flight. For details, see Cuddington, 1986.
28. This ratio is a key measure of bank health, and is calculated by dividing a bank's total capital by its risk-adjusted assets.
29. The government has vindicated their faith. When the central bank closed Hainan Development Bank in June, it assigned the Industrial & Commercial Bank to pay back depositors. The government also closed about 30 credit co-operatives this year. Each time, it made sure individual depositors got their money back (Lawrence, 1998).
30. Detailed description of the closure of GITIC is provided by Gao Zhanjun (1999).
31. There is a debate on whether it is a good idea to keep the RMB exchange rate stable. Some authors doubt the feasibility of keeping the value of RMB unchanged, while some believe that China does not need to devalue the RMB at this critical moment (see, for example, Hu, 1998b). Meanwhile, the Chinese authorities have reiterated their firm attitude of maintaining the stability of RMB in order to allay the fears about the devaluation of the RMB.
32. Besides the controls on the capital account, other elements such as China's strong external positions and ample official foreign exchange reserves also contributed to the stability of the RMB. To a large extent, however, the sound external positions were brought about by restrictions on capital flows, especially on the short term flows.
33. For a complete analysis on exit strategies and experiences of countries seeking greater exchange rate flexibility, see Eichengreen, 1998.
34. Wei Shangjin (1998) points out that a significant fraction of Hong Kong investment in mainland China can be "round-tripping" capital in disguise; the remaining part of Hong Kong investment in China should be regarded as quasi-foreign direct investment. Taking out these two parts would reduce the annual

flows of FDI into China by half, and the stock by 60%. China's relatively high corruption and regulatory burden may be other important impediments discouraging investors from the major source countries.

35. In the survey of capital liberalisation by Williamson and Mahar (1998), 29 economies are selected for the examination of liberalisation of short-term capital inflows. They found that when controls on short-term capital inflows were relaxed, 15 countries had significant restrictions on entry into the banking sector, 18 countries had state-owned banks that accounted for at least 40% of the total assets in the banking sector, and 13 countries did not even meet the minimum standard of setting up a market-based system of financial regulation.

REFERENCES

- BOT 1998. *Bank of Thailand Economic Focus 2* (April-June).
- Chai, Joseph C.H. 1997. *China: Transition to a Market Economy*. Oxford: Clarendon Press.
- Chen, Chunlai. 1997. The Evolution and Main Features of China's Foreign Direct Investment Policies. *Working Paper* (15). Adelaide, Australia: Chinese Economics Research Centre, The University of Adelaide.
- Cuddington, John T. 1986. Capital Flight: Estimates, Issues, and Explanations. *Princeton Studies in International Finance* (December). Princeton, New Jersey: International Finance Section, Department of Economics, Princeton University.
- Doner, Richard F and Ramsey, Ansil. 1999. Thailand: from Economic Miracle to Economic Crisis. *The Asian Contagion: the Causes and Consequences of a Financial Crisis*, edited by Jackson, Karl D. Singapore: Institute of Southeast Asian Studies.
- Eichengreen, Barry and Masson, Paul. 1998. Exit Strategies: Policy Options for Countries Seeking Greater Exchange Rate Flexibility. *IMF Occasional Paper* (168).
- Eichengreen, Barry and Mussa, Michael. 1998. Capital Account Liberalisation — Theoretical and Practical Aspects. *IMF Occasional Paper* (172).

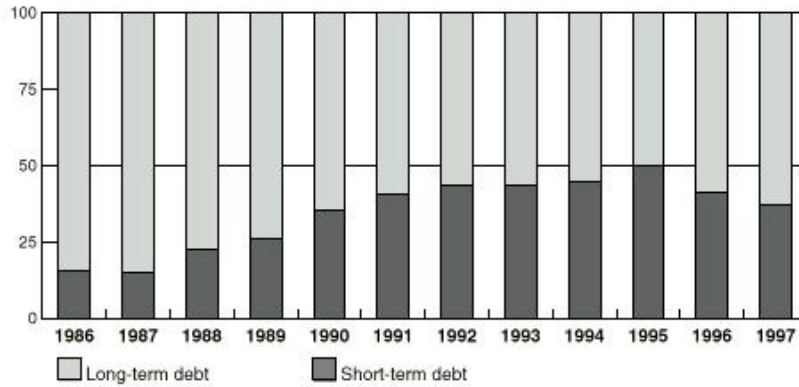
- Fernald, John G and Babson, Oliver D. 1999. Why Has China Survived the Asian Crisis So Well? What Risks Remain? *International Finance Discussion Papers* (February). Board of Government of the Federal Reserve System.
- Fischer, Stanley. 1998. Capital-Account Liberalisation and the Role of the IMF. *Essays in International Finance* (207). Princeton, New Jersey: International Finance Section, Department of Economics, Princeton University.
- Gao, Haihong. 1998. Alternative Exchange Rate Regimes: Lessons Drawn from the East Asian Currency Crisis. *Management World* (5).
- Gao, Haihong. 1995. The Preconditions of Currency Convertibility — A Comparative Study Reform (2).
- Gao, Zhanjun and Liu, Fei. 1999. The Closure of GITIC: Latent Financial Risks and Government Approach. *World Economy and China* 8 (3-4).
- Hong, Zhihua, et. al. 1998. *Laws and Regulations on Foreign Exchange Management: Explanation and Illustration*. China's Law Press.
- Hu, Fred. 1998. The Problems of Banks and the Crisis of Asian Financial Crisis. Working Paper (6) National Centre for Economic Research at Tsinghua University, Beijing, April, 1998.
- John, R. Botry and Darbar, Salim M. and Echeverria, Claudia (1997), Sequencing Capital Account Liberalisation: Lessons from the Experiences in Chile, Indonesia, Korea and Thailand. *IMF Working Paper* (November).
- Lan, Yisheng. 1997. The Stock Market in China: Problems and Prospects for Domestic and Foreign Investment. *Working Paper* (August). Chinese Economics Research Centre, The University of Adelaide, Australia.
- Lardy, Nicholas R. 1999. China and the Asian Financial Contagion: *The Asian Contagion: the Causes and Consequences of a Financial Crisis*, edited by Jackson, Karl D. Institute of Southeast Asian Studies.
- Lardy, Nicholas R. 1998. *China's Unfinished Economic Revolution*. Washington, D.C.: Brookings Institution Press.
- Lardy, Nicholas R. 1997. China's Unfinished Economic Experiment. Paper presented at conference, China As A global Economic Power: Market Reforms and the New Millennium in Shanghai, 15-18 June.

- Lawrence, Susan V and Saywell, Trish. 1998. In Banks, We Trust. *Far East Economic Review* (10 December).
- Massard, Carlos. 1998. The Liberalisation of the Capital Account — Chile in the 1990s. *Should the IMF Pursue Capital-account Convertibility? Essays in International Finance* (May). Princeton, New Jersey: International Finance Section, Department of Economics.
- Mathieson, Donald J. and Rojas-Suarez, Liliana. 1993. Liberalisation of the Capital Account — Experiences and Issues. Occasional Paper (March). IMF.
- McKinnon, Ronald I. 1991. *The Order of Economic Liberalisation — Financial Control in the Transition to a Market Economy*. Baltimore and London: The John Hopkins University Press.
- Quirk, Peter J. and Evans, Owen. 1995. Capital Account Convertibility, Review of Experience and Implications for IMF Policies. *Occasional Paper* (October). IMF.
- Rodrik, Dani. 1998. Who Needs Capital Account Convertibility? *Essays in International Finance* (May). Princeton, New Jersey: International Finance Section, Department of Economics, Princeton University.
- The State Administration of Foreign Exchange (SAFE). 1996. *Annual Report*.
- The State Administration of Foreign Exchange (SAFE). 1998. *China Foreign Exchange Administration* no. 6, July.
- Wei, Shangjin. 1998. Why Does China Attract So Little Foreign Direct Investment?, *Working Paper*, No. 199807 (June). Beijing: National Centre for Economic Research, Tsinghua University.
- Wu, Xiaoling. 1998. The Influences of Banks' Non-Performing Loans on the Financial System — Lessons from Southeast Asian Financial Crisis. *Working Paper* No. 199811 (October). Beijing: National Centre for Economic Research at Tsinghua University.
- Zhao, Linghua. 1999. A Perspective on Various Ways of China's Illegal Capital Flows. *International Economic Review* (.3-4).
- Zhou, Zhengqing, ed. 1998. *Introduction to Securities Market*. China's Finance Press, 1998.

Gao Haihong is Associate Research Fellow, Institute of World Economics and Politics, Chinese Academy of Social Sciences, People's Republic of China and Visiting Research Fellow, Institute of Southeast Asian Studies, Singapore.

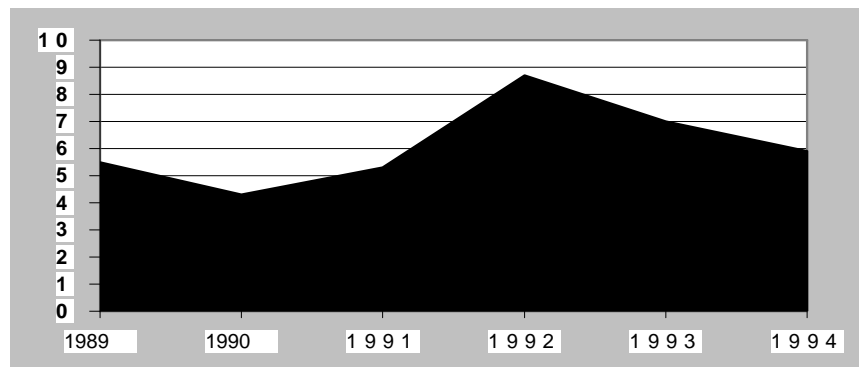
* The author would like to thank the Institute of Southeast Asian Studies (ISEAS), and Prof. Chia Siow Yue, for the opportunity to join the World Bank Fellowship Programme. This paper has benefited from a discussion at a seminar held by ISEAS, as well as from detailed drafting and revising suggestions from Dr. Nick Freeman.

Figure 1. Share of Short-Term External Debt (%)



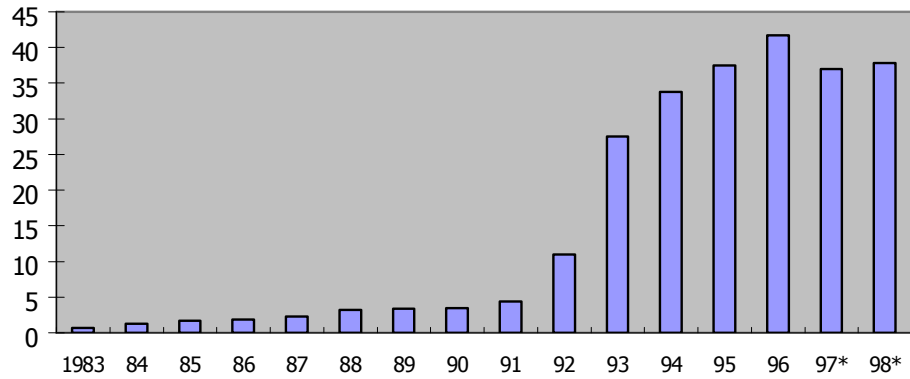
Source: Bank of Thailand Economic Focus, Vol.2, No.2, April-June 1998.

Figure 2. Lending/Deposit Spread (in percent)



Source: R. Botry John, Salim M. Darbar and Claudia Echeverria, 1997, *Sequencing Capital Account Liberalisation: lessons from the Experiences in Chile, Indonesia, Korea and Thailand*, IMF Working Paper No. 157, November 1997.

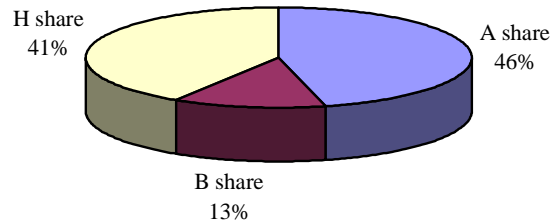
Figure 3a. Realised FDI Inflows into China
(in billion US dollars at current price)



Source: Wei, Shangjin, 1998, *Why Does China Attract So Little Foreign Direct Investment?*, Working Paper No. 199807, National Centre for Economic Research, Tsinghua University, Beijing, June, 1998

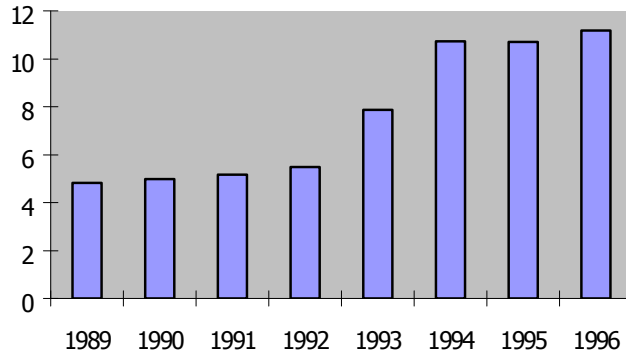
Note*: Estimated figure by the China State Statistics Bureau.

Figure 3b: Structure of Shares Issued by Chinese Enterprises, end of 1998



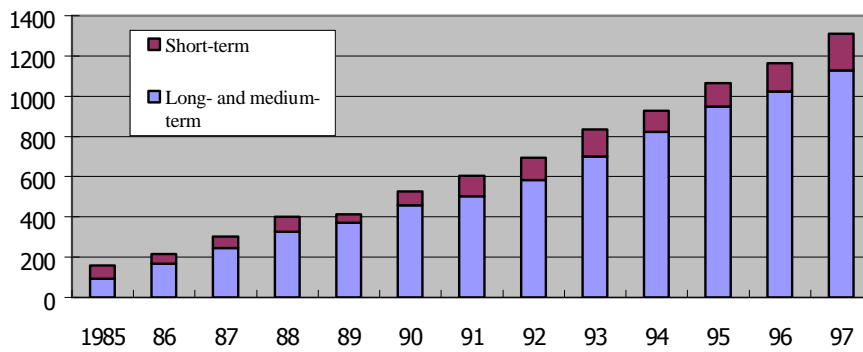
Source: China Securities Regulatory Commission (CSRC), 1998

Figure 4. China's Overseas Bond Issues
(in billion U.S. dollars)



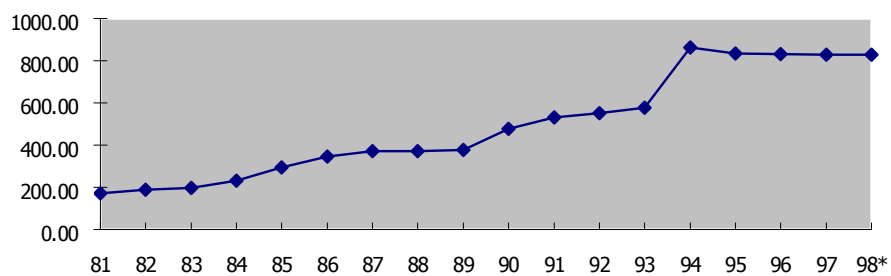
Source: China's Economic Yearbook, 1989-1996

Figure 5: Structure of China's Outstanding External Debt by Term (US \$100 million)



Source: SAFE, China's Administration of Foreign Exchange, Annual Report 1997.

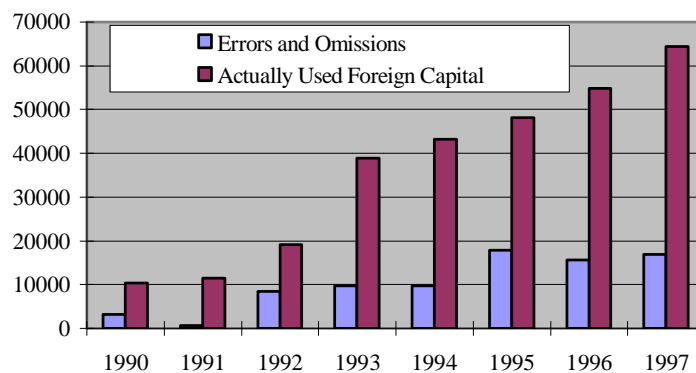
Figure 6. Exchange Rate of RMB Against US Dollar
(Annual Average, RMB yuan/100 US dollar)



Source: China Statistical Yearbook, 1998.

Note*: the figure of 1998 is an average of 11 months, from January to November.

Figure 7: China's Errors and Omissions and Capital Flows
(in million US dollars)



Source: China Statistical Yearbook, 1998; SAFE Annual Report, 1996, 1997.

Appendix 1-1: Selected Economic Indicators of China

	1975-83	1983-89	1990	1991	1992	1993	1994	1995	1996	1997	1998
Real sector											
Real GDP growth ¹	6.0	10.7	3.8	9.2	14.2	13.5	12.6	10.5	9.6	8.8	7.8
Inflation ¹	2.1	9.0	2.1	2.7	5.4	13.0	21.7	14.8	6.1	1.5	-0.8
Domestic savings ²	39.3	35.2	38.1	38.1	38.2	37.7	40.6	41.0	42.9	40.8	----
Fixed capital formation ²	21.3	29.5	25.5	27.5	31.2	37.5	36.0	34.7	35.6	35.8	26.5
Public sector											
General government balance ²	-0.1	-1.7	-2.0	-2.2	-2.3	-2.0	-1.6	-1.7	-1.5	-0.8	-1.2
Financial sector											
M2 growth(end of year) ¹	22.3	26.1	28.9	26.7	30.8	42.8	35.1	29.5	25.3	19.6	14.8
Domestic credit growth (end of year)	18.8	17.0	23.6	20.0	22.3	42.1	23.8	22.9	25.3	----	----
Credit to private sector	13.0	23.6	22.8	19.5	20.8	43.2	24.2	23.6	24.4	----	----
Foreign liabilities of banks ³	3.4	3.8	3.5	4.6	4.0	5.4	7.1	6.4	5.6	----	----
Commercial bank foreign liabilities ⁴	----	3.3	3.5	4.6	4.0	5.4	7.1	6.4	5.6	----	----
Interest rates ⁵											
Deposit rate	----	7.59	8.64	7.56	7.56	10.98	10.98	10.98	7.47	5.67	----
Lending rate	----	8.36	9.36	8.64	8.64	10.98	10.98	12.08	10.08	8.64	----
External sector											
Current account balance ²	0.7	-1.0	3.4	3.5	1.5	-2.7	1.4	0.2	0.9	2.5	----
Foreign debt service ²	----	8.1**	8.5	8.0	7.3	9.7	9.1	7.3	6.7	7.3	----
Current account	----	-2857	11997	13273	6401	-11609	6908	1618	7243	29718	----
Financial account	----	4363	3255	8032	-250	23474	32645	38674	39966	22978	----
Foreign direct investment (in millions of US dollars)											
Foreign direct investment abroad	----	-512	-830	-913	-4000	-4400	-2000	-2000	-2114	-2563	----
Foreign direct investment in Rep. Econ	----	2047	3487	4366	11156	27515	33787	35849	40180	44236	----
Portfolio investment(in millions of US dollars)											
Portfolio investment assets	----	134	-241	-330	-450	-597	-380	79	-628	-899	----
Portfolio investment liabilities	----	717	----	565	393	3646	3923	710	2372	7703	----
Other investment(in millions of US dollars)											
Other investment assets	----	-231	-156	-3267	-2114	-1189	-1089	-1081	-1126	-33929	----
Other investment liabilities	----	2762	1070	4500	-4082	-576	-1496	5116	1282	8430	----
Foreign exchange reserves (in billions of US dollars)	1.4	4.7	11.1	21.7	19.4	21.2	51.6	73.6	105.1	139.9	145.0

¹Annual percent change; ² percent of GDP; ³ percent of total liabilities of the banking system; ⁴ percent of total liabilities of commercial banks; ⁵Percent per annum; *Consumer price; **Average from 1985-89. Source: IMF International Financial Statistics; Annual Report of The State Administration of Foreign Exchange; IMF World Economic Outlook; John, Darbar and Echeverria (1997).

Appendix 1-2: Selected Economic Indicators of Thailand

	1975-83	1983-89	1990	1991	1992	1993	1994	1995	1996	1997	1998
Real sector											
Real GDP growth ¹	7.0	8.1	11.6	8.1	8.2	8.5	8.9	8.7	6.4	-0.4	-8.0
Inflation ¹	9.0	3.1	6.0	5.7	4.1	3.4	5.1	5.8	5.9	6.0	8.1
Domestic savings ²	19.6	25.4	32.6	35.2	34.3	34.9	34.9	34.3	33.1	31.8	----
Fixed capital formation ²	23.1	27.7	40.2	41.6	39.2	39.4	39.9	41.8	40.8	35.8	----
Public sector											
General government balance ²	-5.80	-3.0	4.4	4.2	2.6	2.1	2.0	2.6	1.6	-0.7	-2.4
Financial sector											
M2 growth (end of year) ¹	19.3	18.8	26.7	13.8	15.6	18.4	12.9	17.0	12.6	16.4	9.5
Domestic credit growth (end of year)	15.6	19.8	26.8	15.5	18.0	22.7	28.9	23.1	14.0	34.5	-1.2
Credit to private sector	20.6	21.0	34.7	20.4	20.5	24.0	30.3	23.8	14.6	----	----
Foreign liabilities of banks ³	5.8	6.3	6.4	6.0	6.9	11.7	20.3	24.3	23.3	----	----
Commercial bank foreign liabilities ⁴	10.6	6.4	6.4	6.0	6.9	11.7	20.3	24.3	23.3	----	----
Interest rates ⁵											
Deposit rate	----	11.04	12.25	13.67	8.88	8.63	8.46	11.58	10.33	10.52	----
Lending rate	----	13.71	14.42	15.40	12.17	11.17	10.90	13.25	13.40	13.65	----
External sector											
Current account balance ²	-5.6	-3.2	-8.3	-7.7	-5.6	-5.0	-5.6	-8.0	-7.9	-2.0	12.3
Foreign debt service ²	3.8	5.8	3.8	4.0	4.3	4.4	4.8	5.0	5.4	7.1	---
Current account	-1379	-1542	-7281	-7572	-6304	-6364	-8086	-13554	-14692	-2917	14300
Financial account	1401	2492	9098	11760	9475	10500	12167	21909	19487	-15441	----
Foreign direct investment (in million of US dollars)											
Foreign direct investment abroad	----	-35	-140	-167	-147	-233	-493	-886	-931	-532	----
Foreign direct investment in Rep. Econ	151	630	2444	2014	2113	1804	1366	2068	2336	3029	----
Portfolio investment(in million of US dollars)											
Portfolio investment assets	----	----	----	----	----	----	-5	-2	-41	-446	----
Portfolio investment liabilities	----	----	-38	-81	924	5456	2486	4083	3585	4302	----
Other investment(in million of US dollars)											
Other investment assets	----	83	-164	352	104	-3265	-1027	-2738	2661	-1588	----
Other investment liabilities	1237	1467	6997	9642	6480	6739	9839	19383	11876	-20206	----
International reserves (billion of dollars)	----	----	14.3	18.4	21.2	25.4	30.3	37.0	38.7	27.0	29.5

¹Annual percent change; ² percent of GDP; ³ percent of total liabilities of the banking system; ⁴ percent of total liabilities of the commercial banks; ⁵ Percent per annum; *Consumer price; **Average from 1985-89. Source: IMF International Financial Statistics; Annual Report of The State Administration of Foreign Exchange; IMF World Economic Outlook; John, Darbar and Echeverria (1997).

Appendix 2

Types of Capital Transactions that are Subject to Controls in China (by end of 1997)

Inflows: purchases made locally by non-residents or sales or issues carried out abroad by residents

Outflows: sales or issues carried out locally by non-residents or purchases made abroad by residents

Capital and money markets

A: Shares or other securities:

Inflows:

- Non-residents may only purchase B shares locally. The face value of B shares is denominated in RMB, which is listed on the Chinese Securities Exchange and can only be bought by foreign investors.
- Residents may only sell or issue H shares abroad. The face value of H shares is denominated in foreign currencies. Prior approval by SAFE and the Securities Supervisory Board is required. The foreign exchange obtained from share issuing should be repatriated back to and be used in China.

Outflows:

- Non-residents are not permitted to sell or issue locally.
- Residents, except financial institutions permitted to engage in foreign borrowing and authorised industrial and trade enterprises or groups, are not allowed to purchase shares and other securities abroad. An eligibility review by SAFE is required for financial institutions to purchase securities abroad.

B: Bonds or other debt securities

Inflows:

- Non-residents are not permitted to purchase locally.
- Prior approval by the PBC and SAFE is required. Bonds issued abroad must be incorporated into the State external debt plan. Bonds can only be issued by financial institutions approved by the PBC. The fund raising from overseas should be repatriated back to and be used in China.

Outflows:

- Non-residents are not permitted to sell or issue locally.
- Same regulations for share purchase by residents apply.

C: Money market instruments

Inflows:

- Non-residents are not allowed to purchase locally.
- Sale or issue abroad of securities, other than stocks, requires PBC and SAFE approval.

Outflows:

- Non-residents are not allowed to sell or issue locally.
- Residents, except financial institutions permitted to engage in foreign borrowing and authorised industrial and trade enterprises or groups, are not allowed to purchase foreign money market instruments, like TB, CD and CP. Financial Institutions must undergo a review of eligibility by SAFE before purchasing. SAFE also imposes a limit on the open foreign exchange position of financial institutions.

D: Collective investment securities**Inflows:**

- Non-residents are not allowed to purchase locally.
- Same regulations for sale or issue of money market instruments abroad by residents apply.

Outflows:

- If those instruments are sold or issued locally, they must be approved by the Securities Policy Commission.
- Same regulations for purchase of money market instruments abroad by residents apply.

Derivatives and other instruments**Inflows:**

- Non-residents are not allowed to purchase locally.
- Operations of such instruments by financial institutions are subject to prior review of eligibility and to a limit on open foreign exchange position.

Outflows:

- Non-residents are not allowed to sell or issue locally.
- Residents, except financial institutions permitted to engage in foreign borrowing and authorised industrial and trade enterprises or groups, are not allowed to purchase foreign derivatives and other instruments, like financial futures, options, forward trading and swap, etc. Operations in such instruments by financial institutions are subject to prior review of eligibility and a limit on open foreign exchange position.

Credit operations**A: Commercial credits****By non-residents to residents (inflows):**

Prior approval is required for residents receiving commercial credit from non-residents. Borrowers are limited to financial institutions approved by SAFE to engage in borrowing in foreign currencies, and non-financial enterprises approved by the State Council. The PBC review the conditions of loans and decide on the borrowing target. SAFE, authorised by the PBC, is in charge of the approval of the borrower's eligibility and supervising and managing the whole process of expenditure and repayment. For medium and long-term credit (over 1-year maturity), the loan must be part of the state plan for utilising foreign capital. The plan is made annually by the State Planning Committee.

For short-term credit, financial institutions permitted to engage in foreign borrowing can conduct short-term foreign borrowing within the target balance set by SAFE, but such borrowing may not be used in long-term investment, fixed capital credit and other unapproved ventures.

Short-term foreign financing with maturity of 3 months or less provided to enterprises (excluding foreign-funded enterprises, FFEs) is not subject to the limit on target balance. But short-term foreign financing of longer than 3 months is subject to the short-term foreign exchange balance requirement, and the loan must be registered with SAFE. FFEs may borrow from non-residents without obtaining approval, but must report the borrowing to SAFE.

By residents to non-residents (outflows):

Industrial and commercial enterprises may not provide loans to non-residents. Provision of loans to non-residents by financial institutions is subject to the review of eligibility by SAFE and to a foreign exchange asset-liability ratio requirement.

B: Financial credits

Same regulations for commercial credits apply.

C: Guarantees, sureties, and financial backup facilities

By residents to non-residents (inflows):

The regulation of External Guarantees Provided by Domestic Entities of October 1, 1996 allows the provision of guarantees, foreign or RMB, by authorised financial institutions authorised to engage in external guarantee business and non-financial legal entities, including both domestic enterprises and FFEs. Financial institutions must meet the required assets to liabilities ratio. The total volume covered by the guarantee cannot exceed 50% of the guarantor's net assets, and must be below the guarantor's foreign exchange income in the previous year. Non-financial entities Government agencies or institutions cannot provide guarantees.

Direct investment

Inward direct investment

As long as the non-resident meets requirements under the Sino-foreign joint-venture laws and other relevant regulations, and are approved by MOFTEC, non-residents are free to invest in China. There is no restriction on the inward remittance of funds as far as exchange control is concerned. For environmental and security reasons, inward direct investment in some industries is prohibited. SAFE and other government departments conduct joint annual examinations on foreign-invested businesses.

Outward direct investment

Foreign exchange is provided for investment after a SAFE review of the sources of foreign exchange assets and an assessment of the investment risk involved, approval by MOFTEC, and registration with SAFE.

Liquidation of direct investment

None.

Real estate transactions**Purchase locally by non-residents:**

Same regulations as for direct investment apply.

Purchase abroad by residents

Same regulations as for direct investment apply.

Provisions specific to commercial banks**Borrowing abroad (inflows):**

Same regulations for commercial credits apply.

Purchase of locally issued securities denominated in foreign exchange (inflows)

No securities denominated in foreign exchange is issued locally.

Maintenance of account abroad (outflows)

Domestic households and individuals are not allowed to open private accounts abroad. Domestic entities and FFEs opening exchange accounts abroad must obtain prior approval from SAFE.

Lending to non-residents and lending locally in foreign exchange (outflows)

Lending foreign exchange to non-residents abroad or locally must be approved by SAFE and subject to the asset-liability ratio requirement. For banks, the volume of net lending should not be more than 20% of their own foreign exchange assets. This ratio is 30% for non-bank financial institutions.

Differential treatment of non-residents' deposit accounts and/or deposit accounts in foreign exchange

- **Reserve requirement:**

There are different reserve requirements for deposits in RMB and in foreign currency, and also between the latter in domestic banks and in FFEs. For deposits in RMB, the reserve requirement is 13%; for deposits in foreign currency in domestic banks, the ratio is 5%; for foreign currency deposits in FFEs the ratio is 3% and 5% for maturity of more than 3 months and less than 3 months, respectively.

- **Liquid asset requirements:**

Banks' foreign exchange liquid assets (1 year or less) should not be less than 60% of liquid liabilities (1 year or less) and 30% of total foreign exchange assets. Total deposits with 3-month maturity, deposits in both domestic and foreign banks, funds for purchasing transferable foreign-currency-denominated securities, deposits with the central bank, and cash holdings should not be less than 15% of total foreign exchange assets.

Non-bank foreign exchange liquid assets (1 year or less) should not be less than 60% of liquid liabilities (1 year or less) and 25% of total foreign

exchange assets. Total deposits with 3-month maturity, deposits in both domestic and foreign banks, funds for purchasing transferable foreign-currency-denominated securities, deposits with the central bank, and cash holdings should not be less than 10% of total foreign exchange assets.

- **Credit controls:**

Total loans, investment guarantees (calculated as 50% of the balance guaranteed), and other foreign exchange credits provided to a legal entities or non-bank financial institutions should not exceed 30% of the foreign exchange capital owned by the banks or non-bank financial institutions.

Investment regulations:

Banks' equity investment should not exceed the difference between the banks' capital and mandatory paid-in capital. Non-bank financial institutions' total equity investment (excluding trust account) should not exceed the difference between their capital and mandatory paid-in capital.

Open foreign exchange position limits:

For financial institutions trading foreign exchange on their own behalf, the daily total amount traded (total open foreign exchange position) should not exceed 20% of the foreign exchange working capital. As authorised by the highest level of management, financial institutions trading foreign exchange on their behalf may retain a small amount of overnight open position, but this should not exceed 1% of the foreign exchange working capital.

Controls apply to non-residents' deposits and to foreign loans and deposits (outflows).

Provisions specific to institutional investors:

None

EADN WORKING PAPERS

EADN Working Papers

(ISSN 0219-6417)

1(2001): Thawatchai Jittrapanun, *The SIMEX Experience: Implications for Thailand's Futures Exchange*, November 2001.

[Previously published as ISEAS Working Paper, Visiting Researchers Series No. 4 (2000).]

2(2001): Le Minh Tam, *Reforming Vietnam's Banking System: Learning from Singapore's Model*, November 2001.

[Previously published as ISEAS Working Paper, Visiting Researchers Series No. 5 (2000).]

3(2001): Gao Haihong, *Liberalising China's Capital Account: Lessons Drawn From Thailand's Experience*, November 2001.

[Previously published as ISEAS Working Paper, Visiting Researchers Series No. 6 (2000).]

4(2001): Liliana Halim, *Reviving the Indonesian Banking Sector? Indonesia's Economic Crisis: Impact on Financial and Corporate Sectors 1997-1999*, November 2001.

[Previously published as ISEAS Working Paper, Visiting Researchers Series No. 7 (2000).]

5(2001): Wang Xiaomin, *Zhongguancun Science Park: A SWOT Analysis*, November 2001.

[Previously published as ISEAS Working Paper, Visiting Researchers Series No. 10 (2000).]

6 (2001): Doan Phuong Lan, *The Asian Financial Crisis and its Implication for Vietnam's Financial System*, November 2001.

[Previously published as ISEAS Working Paper, Visiting Researchers Series No. 11 (2000).]

7(2001): Tracy Yang Su-Chin, *Regulatory Reforms in the Asia-Pacific Region: A Preliminary Study*, November 2001.

[Previously published as ISEAS Working Paper, Visiting Researchers Series No. 12(2000).]

8(2001): Akhmad Bayhaqi, *Education and Macroeconomic Performance in Indonesia: A Comparison with Other ASEAN Economies*, November 2001.

[Previously published as ISEAS Working Paper, Visiting Researchers Series No. 13(2000).]

9 (2001): Tubagus Feridhanusetyawan and Haryo Aswicahyono, *Gender Assessment of the Indonesian Labour Market*, December 2001.

10 (2001): Vo Tri Thanh, Dinh Hien Minh, Do Thu Huong and Nguyen Thi Hong, *The Sustainability of the Current Account Deficit and External Debt in Vietnam*, December 2001.

11 (2001): Ari Kuncoro, *Microeconomic Determinants of Economic Growth in East Asia*, December 2001.

12 (2001): Medhi Krongkaew, *The Political Economy of Growth in Developing East Asia*, December 2001.

13 (2001): Chin Hee Hahn and Jong-il Kim, *Sources of East Asian Growth: Some Evidence from Cross-country Studies*, December 2001.

14 (2001): Ammar Siamwalla, *Markets and Economic Growth in East Asia*, December 2001.

Editorial Committee

Chia Siow Yue
Supriti Bezbaruah
Nick J. Freeman
Riyana Miranti
Tin Maung Maung Than

Papers in this series are preliminary in nature and are intended to stimulate discussion and critical comment. The Editorial Committee accepts no responsibility for facts presented and views expressed, which rests exclusively with the individual author. No part of this publication may be produced in any form without permission. Comments are welcomed and may be sent to the author at the Institute of Southeast Asian Studies.

