Débat 4

The Evolution of Capital Controls in China

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I. The evolution of the Chinese government's policy towards capital controls

Over the past 3 decades, while various financial crises have happened in the rest of the world, China by and large has maintained its financial stability without suffering any major crises, which to a large extent is attributable to China's capital controls. In calmer days, capital controls enable the Chinese government to concentrate on urgent domestic issues without being distracted too much by external shocks. When mistakes are made, capital controls give the government breathing time to make correction without having to face irreversible consequences.

According to Robert Mundell, a country can have two –but only two– of three policy objectives: independence of monetary policy, a fixed exchange rate, and free cross-border movements of capital.

There is no doubt that the People's Bank of China (PBOC) has largely maintained the independence of monetary policy over the past three decades. And it is not deniable that China's exchange rate is actively managed by the PBOC. Based on these two facts, one may jump to the conclusion that China must have strict controls over cross-border capital flows.

However, the truth of the matter is that China liberalized inbound FDI more than 20 years ago and then a large number of items in capital account thereafter. On the one hand, China has maintained capital controls. On the other hand, the controls have been porous. During the Asian Financial Crisis, China had to implement draconian measures to stop capital flight. Since the early 2000s, short-term capital started to flow into China persistently betting on the RMB appreciation. From 2004 to 2006 capital inflow surged to speculate on China's rising asset prices. At the same time, the Chinese government loosened its controls over capital outflows, in hope of reducing RMB appreciation pressure.

China's policy toward capital controls changed significantly since 2009, when the PBOC launched the RMB settlement scheme. Since then, due to the de facto liberalization of some categories of short-term cross border capital flows, RMB exchange rate arbitrage and carry trade have become rampant.

II. RMB internationalization and capital account liberalization

On the surface, the supposed objectives of RMB internationalization include: to avoid exchange rate risks, to reduce the holding of dollar-denominated foreign exchange reserves, the amount of which has been way beyond any reasonable needs, to make Shanghai an international financial center, and lastly, to cut transaction costs by decommissioning the US dollar as a vehicle currency in China's trade with its counterparts. However, according to a

Wall Street Journal Report, the true purpose of the RMB internationalization is capital account liberalization. The PBOC "used the language of economic nationalism to push an agenda that ultimately would loosen state control of the economy by making the RMB, … more dependent on market forces than government orders. Call it a Trojan horse strategy: Make the policy arguments so attractive that decision makers will approve the ideas without realizing the implications -- like the Trojans accepting that beautiful horse from the Greeks without realizing what was inside." Certainly, the WSJ was making a wide guess. However, its claim is not entirely untrue. According the then senior vice-governor of the PBOC, "it is too difficult to reach consensus among all parties concerned on how to reform the exchanger rate (regime). Hence, the PBOC looks one way and rows another to promote the use of the RMB for international trade settlement… Thus it will force us to speed up capital account liberalization with a 'fight or die' attitude. Because so many RMBs have flown out of China (when the RMB has been internationalized—added by the author) you have to create channels to allow these RMBs to flow back. Without channels for recycling, no one will be interested in using RMBs for trade settlement. Thus, pressures will be created to force open China's capital account."

In 2011, less than two years after the launch of RMB internationalization, dissatisfied with the slower than expected progress in RMB internationalization, some Chinese economists started to argue openly that the remaining controls over capital account impeded the progress in RMB internationalization. Hence, for the sake of RMB internationalization, capital account liberalization should be speeded up. The true purpose of RMB internationalization has revealed itself increasingly clearly over time.

In my view, the attempt to use capital account liberalization to push domestic reforms in China is a reflection of the frustration of liberal-minded Chinese decision-makers for the lack of progress in China's shift of growth paradigm and structural adjustment. Due to the strong opposition of vested interests and the prevalent misconception among the public, it is difficult to tackle key problems such as exchange rate appreciation head on. As a result, the PBOC chose a roundabout way. Instead of solving the exchange rate issue once for all, as most countries did on their road to become developed countries, China first chose to encourage capital outflows when the RMB appreciation expectations were strong, then used RMB internationalization as a means to promote capital account liberalization, and now is hoping to force through the reforms of the exchange rate regime as well as other financial reforms via capital account liberalization. However, there is no concrete explanation on how capital account liberalization will make what reform inevitable. For me, this approach is highly subjective and contains too much wishful thinking, and hence is more likely to cause new problems than solve the old ones.

III. Controversies over capital account liberalization

In 2012, the PBOC came to the fore in the campaign for the acceleration of capital account liberalization. This time RMB internationalization was no longer weighted heavily in the argument for the acceleration of capital account liberalization. The critics argued that there is no compelling reason for China to accelerate capital account liberalization. Instead, China should stick to its traditional approach of gradualism. The PBOC's rationales include the following.

First, China is in a period of "strategic opportunity" for capital account liberalization, though it is not quite clear why and how China is facing such an opportunity. Instead facing a strategic opportunity for accelerating capital account liberalization, in my view, China is facing unprecedented challenges at the moment both domestically and internationally.
a. The economy is under the large downward pressure of overcapacity and as a result, Chinese enterprises' profit margins in recent years are very low. On the other hand, China's corporate debt-to-GDP ratio is very high, significantly higher than global average.
b. China's local governments debt is very high, it could be as high as more than 30 percent of GDP. Whether they will be repaid is doubtful. In fact, non performing loan ratio of local government debts has begun to rise.
c. China's capacity of risk management in both monetary and capital market is still weak. So far, neither a short-term interbank interest rate, nor a risk-free yield curve in the government bond market has been established.
d. Shadow banking activities aimed at "regulatory arbitrage" are rampant.
e. Due to whatever reasons, the trend of moving assets abroad by some rich Chinese is more and more discernable.
f. Housing prices are continuing to rise. At least in some first-tier cities, real estate bubbles are serious.
g. Seventh, emerging economies are under the shadow of Federal Reserve's QE tapering. The interest rates in the US will rise and more often than not, capital in developing countries will flow back to US and some other developed countries. Under such circumstances, it goes without saying that a wholesale liberalization of capital account and making the RMB fully convertible is highly risky, if not riskier than ever before.

Second, there will be no large risks, if China opens its capital account. According to the PBOC, China's short-term external debts account for only a small share of China's total external debts, and China's property bubble and other bubbles in the capital market are controllable.

Third, capital control is ineffective any way and hence it is better to dump the controls all together. The legalization of the previous illegal flows will enable regulatory authorities to have a better knowledge about the flows and place them under better supervision and management.

Fourth, even if there is no intervention in the foreign exchange market, without allowing short-term capital to play its role, the exchange rate is not a true equilibrium exchange rate, and hence cannot play the role of an equilibrium exchange rate in balancing international balance of payments.

Last but not least, external pressure generated by capital account liberalization will force China to forge ahead in economic reforms. Chinese economists like to invoke China's experience in the WTO entry. The implementation of the rules and regulations stipulated by the WTO helped the Chinese government to overcome the resistance of interest groups to the reform of China's production and trade systems. So the liberalization of capital account will do the similar trick.

In 2012 there was a strong rumor that the PBOC was going to public a timetable for the capital account liberalization. According to this rumored timetable, capital account will be liberalized “basically” in 2015 and the RMB will be made fully convertible in 2020. It seems that owning to whatever reasons the PBOC shelved the timetable for the time being. However, the PBOC is continued to push for capital account liberalization in close connection with its endeavor in RMB internationalization.

The PBOC's policy of accelerating capital account liberalization encountered strong reservations from some economists in China. While supporting the ultimate objective of fully liberalizing China's capital account, they see no reason why China should be in a rush for such liberalization. China needs capital controls to retain monetary-policy independence until it is ready to adopt a floating exchange-rate regime. Without adequate controls over short-term cross-border capital inflows, despite the fact that these controls are porous, the PBOC will find it impossible to maintain monetary-policy independence and exchange-rate stability at the same time. China can use sterilization policy to juggle the Mundell trilemma. However, the sterilization has been increasingly becoming costly.

China's financial system is fragile, and its economic structure rigid. Hence, the Chinese economy is highly vulnerable to capital flight. In recent years, China's financial vulnerability has been rising, with enterprise debt being estimated to have exceeded 120% of GDP, and broad money supply (M2) being about 200 % of GDP. Without capital controls, an unforeseen shock could trigger large-scale capital flight, leading to significant currency devaluation, skyrocketing interest rates, bursting asset bubbles, bankruptcy and default for financial and non-financial enterprises, and, ultimately, the collapse of China's financial system.

China's economic reforms remain incomplete, with property rights not yet clearly defined. Amid ambiguity over ownership and pervasive corruption, even without a financial crisis, the free flow of capital across borders would encourage money laundering and asset-stripping, which would lead to the losses of national welfare and incite social tension.

Finally, the Fed is exiting from QE policy. Taper will lead to the rise in US interest rates, which in turn will cause large capital exodus from developing countries to the US. Experience shows that whenever there is a major rise in the US interest rates, some sorts of financial crisis will happen in developing countries. Now many emerging market economies are suffering from capital outflow, devaluation of their national currencies. Despite China's strong external position and large foreign exchange reserves, the possibility of large capital outflows from China cannot be ruled out. Taking into consideration its financial fragility, without the firewall of capital control, whether China can endure a large scale of capital outflows triggered by the Fed tapering is questionable.

As a matter of fact, despite all the rhetoric about capital account liberalization and some new measures in promote the liberalization, partially due to the controversies over capital account liberalization, the Chinese government is still pragmatic with capital account liberalization. Recently, the governor of the PBOC wrote an article emphasizing the necessity of the management of short-term cross border control and argued that liberalization dose not mean that there will be no management and controls. In fact, in the first half of the last year, the Chinese regulatory authority and the PBOC crack down on interest rate arbitrage promptly and severely. It also seems that the authority has dumped the idea of formulating a timetable for capital account liberalization. Despite some adjustment, the PBOC seems very firm on pushing for capital account liberalization.

Sequencing issue is another area of bitter debate among Chinese economists. Some officials not only dismissed the –impossible trinity and– sequencing of capital liberalization as irrelevant to China‘s reality, but also went as far as saying that without the liberalization of capital account, there will be no liberalization of interest rate and exchange rates. In other words, for them the liberalization of capital account is a prerequisite for interest rate and exchange rate liberalization, not other way around. In those officials‘ view, if capital account is not liberalized, the exchange rate decided by current account balance plus long-term capital flows is not a truly market-determined exchange rate, because of the absence of short-term capital flows. It is also argued that with a liberalized capital account, massive interest rate arbitrage will make the control of interest rates too costly and hence the government would be forced to allow interest rates to rise and fall in response to market conditions.

China‘s liberalization of capital account has followed roughly the orthodox sequence: liberalizing current account before liberalizing capital account, liberalizing FDI before liberalizing indirect investment, liberalizing long term capital before liberalizing short-term capital, liberalizing portfolio before liberalizing borrowing, liberalizing capital inflows before liberalizing capital outflows and so on.

Those who oppose the policy of accelerating capital account liberalization emphasize the importance of sequencing. For them, before entirely liberalizing the short-term capital flows and making the RMB fully convertible, the Chinese government needs to deal with many other issues besides the sequencing of capital account liberalization proper.

First, macroeconomic stability has to be achieved. If the economy is suffering from high inflation and serous asset bubbles, the liberalization of short-term capital flows will create large volatility in capital flows, which in turn will further destabilize the economy.

Second, financial institutions should be strengthened. With high leverage and high nonperforming loan ratios, the financial system will become very vulnerable to changes in capital flows, which in turn will make capital flows more volatile.

Third, a rational interest structure has yet to be created. In China, the benchmark interest rate is commercial banks' interest rate on one-year deposits, which is set by the PBOC with some leeway for individual commercial banks. There is no short-term interest rate in the interbank money market that can be used as benchmark interest rate. At the same time there is not a functioning risk-free yield curve in the government bond market. Hence, there is not an interest rate structure that can guide rational allocation of financial resource in China. As a result, it is difficult to price financial assets in different financial markets. This in turn means that China's risk management capacity is weak. As a result, when speculative capital attacks, Mainland China will lack the ability to fend off international speculative attack.

Fourth, China's exchange rate is still subject to frequent intervention by the PBOC, due to lack of flexibility of China's exporting sector. With an inflexible exchange rate and open capital account, China is bound to lose its monetary independence. Though the sterilization policy by the PBOC was successful in retaining a large proportion of independence in the past, with an entirely opened capital account, whether the PBOC will continue to be successful is doubtful. Lack of flexibility in interest rates and the exchange rate created conditions for persistent interest rate and exchange rate arbitrage. Welfare losses for China due to carry trades could be very large.

Last but not least, confidence in the safety of the assets, which is based on China's conditions of political economy, is also important or even more important than other factors. China's economic reforms remain incomplete, with property rights not yet clearly defined. Amid ambiguity over ownership and pervasive corruption, the free flow of capital across borders could be used to facilitate money laundering and asset stripping, which in turn would incite social tension. Without having dealt with the preconditions of the political economy for capital account liberalization first, the consequence of capital account liberalization could be disastrous. Taking into consideration both China's current economic and financial instability, and the volatile global financial situation under the shadow of QE exit, it can not be ruled out that an unforeseen shock could trigger large-scale capital flight, leading to significant currency devaluation, skyrocketing interest rates, bursting asset bubbles, bankruptcy and default for financial and non-financial enterprises, and, ultimately, the collapse of China's financial system.

IV. Exchange rate arbitrage and dollar/yuan carry trade

Short-term capital flows are aimed at interest rate and exchange rate arbitrage, speculation on asset prices. Generally speaking, these flows are a result of market distortion and will result in the worsening of resource allocation. They not only lead to misallocation of investment but also to unfair allocation of incomes. Because of market distortions, arbitrage activities will not able to eliminate arbitrage opportunities and arbitrage may persist for long time. These flows tend to be pro-cyclical and can suddenly surge or stop unexpectedly. The most extreme form of short-term capital flows is capital flight. Triggered by fear or greed, capital flight out of the borders and leave the country of origin suffering permanent losses. Over the past few years, this sort of cross-border capital movement has become rampant. Unfortunately, most Chinese economists still see this phenomenon from a bright side, and hail it as progress in RMB internationalization.

During the Asian Financial Crisis, capital flight was mainly realized via the trade account by under-invoicing exports and over-invoicing imports. After 2003, due to strong RMB appreciation expectations, speculators did the opposite. The launch of the RMB trade settlement marked a new stage of capital account liberalization. Measures to promote RMB internationalization have opened a large hole in China's wall of capital controls. Without RMB trade settlement, short-term cross-border capital inflows would be blocked by capital controls and so were short-term cross-border capital outflows. However, with RMB trade settlement short-term cross-border capital flows now are able to, to a large extent, move across borders of Mainland China via Hong Kong, where there are no capital controls. Via import settlement, RMBs flow into Hong Kong. This can be done legally and easily via the transactions between a mainland firm and its subsidiaries in Hong Kong.

The "recycling mechanisms" as an integral part of RMB internationalization allows the reminbis to be invested in RMB denominated assets in the Mainland. Hence, international investors will be able to invest in the RMB assets that are still forbidden or restricted under China's capital control regime.

The RMB trade settlement scheme and recycling mechanisms enable and incentivize Mainland enterprises and Hong Kong residents to build up a RMB pool there. As a result, an offshore RMB market, known as the CNH market, was created in Hong Kong, side by side with the onshore market dubbed the CNY market. The former is a free market and RMBs can be freely converted into US dollars and visa versa, while the People's Bank of China (PBOC) tightly regulates the latter. Hence, two RMB exchange rates for the RMB co-exist and a material CNH–CNY spread exists for most of the time. Foreign investors who wish to purchase RMB assets can purchase RMBs in CNH market and then invest in RMB assets via eligible banks in Hong Kong. When they unwind their RMB positions and take profits, they can convert their RMBs proceeds back into dollars in the CNH market. However, it is worth noting that there are still controls over the net amount of RMB settlement, while there is no restriction on the gross amount of RMB settlement. Hence, a full liberalization means that the remaining restriction should also be dismantled.

Empirical study shows that the RMB import settlement-to-RMB export settlement ratio is positively correlated with the changes in CNH-CNY spreads. When CNY is under appreciation pressure, the RMB import settlement-to-RMB export settlement ratio tends to increase. In contrast, when CNY is under depreciation pressure, the ratio trends to fall.

Besides exchange rate arbitrage, short-term cross-border capital movement is also aimed at interest rate arbitrage. A mainland enterprise can deposit a certain amount RMB in its bank for, say, three months. Using the deposit as collateral, the enterprise can obtain a letter of credit (LC) and then use the LC as collateral to borrow US dollars for three months from a Hong Kong bank. The enterprise will lock in the exchange rate in Hong Kong's forward market. Because stable RMB appreciation expectations, the cost for locking the exchange rate in the forward market is cheap. Three month later, the Mainland bank and Hong Kong bank settle their transaction, and the enterprise withdraws its RMB deposit and repays the dollar loans. Because the interest rate on RMB deposits is much higher than that on US dollar loans, the enterprise profits by interest arbitrage. Owing to the handsome profits, many Chinese enterprises are engaged in interest rate arbitrage, which is one of the most important contributing factors to the rapid increase in RMB trade finance.

Ideally, arbitrage not only will eliminate any exchange rate spread and close the gap for arbitrage, but also eliminate the arbitrage opportunity based on interest rate spread. For example, when there is positive interest rate spread, arbitrage will lead to the rise in the exchange rate and the formation of exchange rate depreciation expectations ("interest rate parity theorem"), which in turn will offset the possible gains from interest rate arbitrage.

However, in China, due to the inflexibility of the exchange rate, space for arbitrage can exist for a very long time. In the early 2013, China's trade volume increased dramatically, the suspicious Ministry of Commerce later found out that this was a result of interest rate arbitrage via trade finance. Enterprise A in the Mainland sold products to its affiliate Enterprise B in Hong Kong and then buy these products back from B. Though in statistics, both exports and imports increased significantly, there was no increase in real trade. The only purpose for trade between Enterprises A and B is to facilitate interest arbitrage via trade finance. In order to clamp down on the arbitrage, the PBOC tightened the control over and regulation on arbitrage via trade finance. However, the clamp down does not seems that effective. Dollar/yuan carry trade earned the reputation of "the easiest and most profitable carry trade in the world". To a significant extent, because of the rampant arbitrages, in 2013, China's foreign exchange reserves increased by 300 billion US dollars. In the first quarter of 2014, the increase was 125.8 billion US dollars. One of the proclaimed purposes of RMB internationalization is to reduce the accumulation of foreign exchange reserves. The result is just opposite.

The prevalent practice of using trade finance for interest rate arbitrage shows that sequencing is important in the process of capital account liberalization. Without freeing-up the exchange rate first, the liberalization of short-term cross-border capital flows will lead to rampant exchange rate and interest rate arbitrages, which in turn will lead to welfare losses for China as a whole. If enterprises can profit easily from arbitrages, why on earth should they care about producing goods and trading products and services?

In the early 2014, the RMB devalued suddenly, while China was still running current account and capital account surpluses. Over the past ten years, the PBOC's policy is to intervene in the foreign exchange market to prevent the RMB to appreciate too speedily. Now the policy is to break the ingrained market expectation of currency appreciation. By widening the trading band and intervening in the market, the PBOC aimed to create an expectation of two-way volatility in the currency.

Under current situation, RMB depreciation, while perhaps providing a somewhat welcome boost to exports in the short term and punishing those who engage in risk-free RMB carry trade, will ultimately do more harm than good for the economy.

China is still running two surpluses. If you run these surpluses, by definition, net demand for your currency has to increase, creating appreciation pressure. The only way to generate depreciation given these surpluses is for the PBOC to intervene by buying foreign exchange with RMB. But this leads to foreign reserve accumulation. Some foreign reserve accumulation is beneficial for developing economies because if there is a speculative attack on your currency, you can use your foreign exchange reserves to fend off the attack. But China has already accumulated close to $4trn in foreign exchange reserves, which is way too high and far beyond any amount that would ever be needed to defend its currency. At this point, this buying is inefficient and a waste of resources. And instead of using the US dollars to buy products and make profitable investments, China has primarily bought US treasuries that are yielding a low 2-3%. So China is exchanging real resources for paper that is not worth much.

The process of buying foreign exchange reserves with RMB also injects a lot of RMB liquidity into the banking system, which, if left unchecked, could create too much demand and ultimately asset bubbles. So policymakers must mop up this excess liquidity by implementing sterilization policies and by forcing banks to maintain high reserve requirements of 20%, among other measures. This need to manage overall liquidity in the system causes distortions because while only certain sectors of the economy are cash rich (i.e., the exporters), the economy as a whole is subject to liquidity tightening by the PBOC, even those participants that need and should be given more liquidity.

It is nearly impossible to establish and maintain expectations for two-way volatility as long as the current and capital account surpluses persist. If they do, the financial market will expect to return to the old path of appreciation sooner or later. So while this temporary devaluation may have caused some confusion in the short term, it has not ended the carry trade. There is only one condition under which expectations will change, and that is if the twin surpluses disappear; people will not change their expectations unless economic fundamentals change.

The PBOC should allow the RMB to float. If the RMB became a freely floating currency fully determined by market forces, then in a very short period of time it would reach its equilibrium level, and by definition there would be real two-way volatility around this central parity, without the need for further intervention and foreign reserve accumulation.

If the currency became fully floating tomorrow, the exchange rate would not appreciate too much, because the current exchange rate is not far away from its equilibrium level. Many people even argue that the RMB is no longer undervalued at all. If that is the case, why should China be afraid of floating? I don't think that there would be a large appreciation if the PBOC halted its intervention. And any excessive appreciation pressures would come from the capital account, which can and should be muted by careful management of cross-border capital flows. Of course, if there were to be large appreciation and, in particular, an overshooting of the exchange rate, then the PBOC could intervene, but I don't think this would be necessary, especially, when we still have capital controls as a buffer.

V. A short summary

China has engaged in capital account liberalization since 1996. After a gradualist liberalization of capital account for 17 years, the bulk of China's capital account has been liberalized. The controls are mainly over short-term cross-board capital flows. Hence, when Chinese economists are discussing capital account liberalization, they refer mainly to the liberalization of short-term capital account liberalization.

Since 2009, the speed of capital account liberalization has been accelerated significantly. More and more short-term capital flows have been liberalized entirely or partially.

Capital account liberalization in China since 2009 is pursued under the disguise of RMB internationalization. The rapid progress in RMB internationalization is to a large extent a result of liberalization of short-term cross-border capital flows.

Sequencing is still important. China should make its house in order first. In particular, China should liberalize its exchange rate first. The process of RMB internationalization at the same time is the process of capital account liberalization. However, the road map of RMB internationalization designed by the PBOC is not consistent with the "right" sequencing of capital account liberalization. Without making the RMB exchange rate flexible enough first, RMB trade settlement scheme and RMB recycling mechanisms have to be resulted in rampant exchange rate arbitrage and carry trades at the expense of China's national welfare and financial stability.

Although the current problem is hot money inflows, the bigger worry in my mind is households' behavior after capital account has been fully liberalized and the RMB fully convertible. There are huge household saving deposits in China on the order of more than 40trn RMB, accounting for more than 75 percent of GDP. With a fully liberalized capital account, people will naturally want to diversify part of their deposits away from RMB-denominated deposits to foreign currency denominated assets. Even if only 10% of current deposits were diversified, the associated capital flight would be enormous and could potentially generate a dangerous spiral should such capital flight lead to a large devaluation that then prompts more capital flight; such a situation could quickly get out of control.

Clearly, I do not believe that now is the time to scrap the remaining controls over short-term capital flows given that our house is not in order and sentiment on China is not particularly good, especially with concerns over the property sector rising once again.

All in all, if China wishes to accelerate capital account liberalization, it is fine. But it must first accelerate its domestic reform and adjustment. Without thinking through all details, to push capital account liberalization in a rush is self-destructive.