Capital Control in China

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Abstract: Capital controls were useful during the financial crisis but long term capital control is detrimental to China’s economic growth. Although China has reformed its capital control policies, (World Bank, 2012) more should be reformed in order for China to grow to the next level of economic success. The economic theory posits that capital controls like tariffs on goods are negative to economic efficiency because they prevent productive resources from being used where they are most needed. This paper investigates the history of capital control and discusses the costs and benefits for China to abolish or reform its capital control policy.

I. Introduction

No topic in international monetary economics has been more hotly debated over the past 5 years than China’s foreign exchange policy (Goldstein, 2005). While China’s economy has grown dramatically over the past three decades, its financial markets have remained closed to the rest of the world. The International Monetary Fund and the World Bank have both advised Beijing to relax its tight investment controls. The closed capital account has fuelled soaring property prices and generated inflationary pressures. Relaxing the capital control and opening the capital account would give foreigners access to Chinese stocks and bonds and allow Chinese citizens to invest abroad freely. This in turn will help transform the renminbi (RMB) into a global currency and potential rival to the dollar. It will also solve many of China’s economic overheating.

Policy makers in China have remained reluctant to completely abolish capital controls despite numerous calls for further liberalization of its capital market (World Bank, 2012). One of the reasons is the fear that “hot money” tends to create asset bubbles. Their entry and sudden exit causes financial turmoil given that China’s capital market is not well developed. Large capital inflows will cause real domestic currency appreciation, rendering exports uncompetitive while sudden exit will create panic and run on the banks.

The economic theory posits that capital controls like tariffs on goods, are negative to economic efficiency because they prevent productive resources from being used where they are most needed. As a result, capital controls gradually had been phased out in developed countries during the 1970s and 1980s, and by the 1990s there was substantial pressure on less developed countries to remove their restrictions, too (New York Times, 1999).

This paper investigates China’s international monetary policy past and present, and reviews the theoretical literature and the historical case studies of other nation internationalization experiences to review the path and long-term prospects of an “international Chinese currency” renminbi (RMB).

II. What Exactly Is Capital Control?

Capital controls are rules, taxes or fees associated with financial transactions that discriminate
between domestic residents and those outside the country (OECD 2009). “Any measure taken by a government, central bank or other regulatory body to limit the flow of foreign capital in and out of the domestic economy” (Investopedia). This includes taxes, tariffs, outright legislation and volume restrictions, as well as market-based forces. Capital controls can affect many asset classes such as equities, bonds and foreign exchange trades. Capital controls are seen as giving policy makers an extra degree of freedom to moderate the volume and composition of capital flows. They could increase the policy space for using expansionary monetary and fiscal policy to boost an economy without worsening the external balance, reducing the prospects of destabilizing capital outflows especially during periods of political instability (Jongwanich, Bautista & Lee, 2011).

A capital control is any policy designed to limit or redirect capital account transactions. This broad definition suggests that it will be difficult to generalize capital controls because they can take many forms and may be applied for various purposes (Bakker, 1996). Controls may take the form of taxes, price or quantity controls, or outright prohibitions on international trade in assets (Grilli, and Ferretti, 1994);Grilli and Ferretti. 1995).

Modern capital controls were introduced during World War I to maintain a tax base to finance wartime expenditures. Controls began to disappear after the war, only to return during the Great Depression of the 1930s to permit countries greater ability to reflate their economies without the danger of capital flight. The International Monetary Fund (IMF) Articles of Agreement (Article VI, section 3) signed at the Bretton Woods conference in 1944 explicitly permitted capital controls.2

The United States, for example, removed its most prominent capital controls in 1974 (Congressional Quarterly Service, 1977). During the last 10 years even less-developed countries began to liberalize trade in assets and costs of controls and why some advocate their reintroduction.

Many countries had imposed capital control during a crisis such as the European Monetary System crises of 1992-93, the Mexican crisis of 1994 and the Asian financial crisis of 1997-98.

III. Benefits and Costs of Capital Controls

The free movement of capital across borders can have widespread benefits. Capital inflows can provide financing for high-return investment, thereby raising growth rates. Capital inflows—especially in the form of direct investment—often bring improved technology, management techniques, and access to international networks, all of which further raise productivity and growth. Capital outflows can allow domestic citizens and companies to earn higher returns and better diversify risk, thereby reducing volatility in consumption and income. Capital inflows and outflows can increase market discipline, thereby leading to a more efficient allocation of resources and higher productivity growth. Implementing capital controls can reduce a country’s ability to receive these multifaceted benefits. On the other hand, the free movement of capital across borders can also have costs.

Countries reliant on foreign financing will be more vulnerable to “sudden stops” in capital inflows, which can cause financial crises and/or major currency depreciations. Large volumes of capital inflows can cause currencies to appreciate, undermining export competitiveness and causing the “Dutch Disease”. The free movement of capital can also complicate a country’s ability to pursue an independent monetary policy, especially when combined with a fixed exchange rate. Finally, capital inflows may be invested inefficiently due to a number of market distortions, thereby leading to overinvestment and bubbles that create additional challenges.

IV. Literature review

The literature has been rather inconclusive. While (Ma & Mccauley, 2007) agreed that China still needs capital control, the main stream economic

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theory advocates the abolishment of capital control (Sachs and Warner, 1995); (Dornbusch, 1998); (Summers, 2000); (Fischer, 2003); (Bhagwati, 1998); (Rodrik, 1998); (Stiglitz, 2002). Economists have long argued that trade in assets (capital flows) provides substantial economic benefits by enabling residents of different countries to capitalize on their differences. Fundamentally, capital flows permit nations to trade consumption today for consumption in the future and to engage in intertemporal trade (Eichengreen, et al. 1999). The authors gave Japan as an example and where Japan had a population that is aging; it makes sense for Japanese residents to purchase more U.S. assets than vice versa. This allows the Japanese to save for their retirement by building up claims on future income in the United States while permitting residents of the United States to borrow at lower interest rates than they could otherwise pay. Capital control by the Japanese government would be detrimental for both nations.

Another example cited after an earthquake devastated southern Italy on November 23, 1980, leaving 4,800 people dead, Italians borrowed from abroad (ran a capital account surplus) to help repair the damage. Between 1960 and 1980 Koreans borrowed funds from the rest of the world equal to about 4.3 percent of gross domestic product (GDP) annually to finance investment during Korea’s period of very strong economic growth.

These arguments for free capital mobility are similar to those that are used to support free trade. Countries with different age structures, saving rates, opportunities for investment, or risk profiles can benefit from trade in assets. More recently, economists have emphasized other benefits of capital flows such as the technology transfer that often accompanies foreign investment or the greater competition in domestic markets that result from permitting foreign firms to invest locally (Eichengreen, et al. 1999).

The benefits of capital flows do not come without a price, however. Because capital flows can complicate economic policy or even be a source of instability themselves, governments have used capital controls to limit their effects (Johnston and Tamirisa, 1998).

Recently IMF has accepted the role of capital control (Ostry, Ghosh, Habermeier, Chamon, Qureshi and Reinhardt, 2010; Ostry, Ghosh, Habermeier, Laeven, Chamon, Qureshi, and Kokenyne, 2011; IMF, 2011). While the current IMF position is that capital controls become an option only after other policy choices have been exhausted, Jeanne, Subramanian and Williamson (2012) argue that they should not be a last resort, rather “…properly designed they might even be a regular instrument of economic policy.”

V. Capital Control in China

Despite of opening its economy to trade internationally, China had never liberalized its financial system. China and India practice a long term capital control which is different from those short term capital control during financial crisis (Jongwanich, Bautista & Lee, 2011). This has contributed to chronic problems such as asset bubble in China (World Bank, 2012).

Historically, capital controls allowed China to fend off disruptive capital movements, set the exchange rate independently and mobilise scarce resources of foreign exchange to national development projects (Yin, et al., 1991). China has greatly benefited from the protection provided by capital controls in avoiding mayhems of the Asian financial crisis (Han, 2002). However, as the Chinese economy becomes mature, the effectiveness of the control regime is diminishing (Zhong, et al., 2004). As a result, calls for reforming the control regime steadily become stronger (Yu, 2001; World Bank, 2012).

The capital controls regime has long been an integral part of the economic system (Gao, 2000). China is aware of the immensity of the tasks involved in the management of the process of capital account liberalization (Yu, 2001; Guan 2002).

In March 1979, the State General Administration of
Foreign Exchange (SGAFE) was created within the Bank of China to supervise capital control. In 1982 the People’s Bank of China (PBOC, the Chinese central bank) took over the responsibility of capital control (Liu, et al., 1997). Several special privileges introduced for Sino-foreign joint ventures, special methods for Special Economic Zones, foreign debt registration, outward investment, tourists’ foreign exchange, and foreign exchange guarantees in 1980 (Wu, 2001). Controls over the amount of retained foreign exchange that could be actually spent in a year were dropped. From 1st September 1989, private residents were gradually allowed to sell foreign currency on the swap market, resulting in total freedom in selling foreign exchange on the swap market (Wu and Chen, 1992).

With the free pricing of retention quotas and an increased amount of foreign exchange that could be retained by Chinese agents, the swap market expanded dramatically. In 1988, amid an increased number of authorized local swap centers, a national swap center was created in Beijing to deal with swap business between ministries and between regional swap centers. By the end of 1993, there were 119 swap centers in China, with at least one swap center in every province (Wang, 2003a).

The dramatic development of the swap market was a milestone in China’s exchange reform. The swap market itself entailed liberalization of foreign exchange allocation. As the foundation of this market, foreign exchange retention schemes granted exporters easier access to foreign exchange, and hence lower costs due to reduced bureaucracy. Also, the schemes made it possible for exporters and local governments to readily import for their own needs that were not necessarily high in the central government’s priorities.

The swap market furthered the beneficial effects of retention schemes. The transferability of the retention quotas at a depreciated rate gave an implicit subsidy to exporters. As a result, the swap market provided—at least partially—compensation for the general anti-export bias of the trade system. More fundamentally, it allowed interactions between demand and supply, leading to the introduction of the essential elements of a market system into China’s foreign exchange allocation and so providing gains in terms of allocative efficiency.

On top of these, it also contributed to the reform of the exchange rate. There is evidence that the authorities had used the movements of the swap rate to gather information about changes in the domestic cost of foreign exchange. Such information was then used by the authorities to assess the prevailing exchange rate policy and to decide possible adjustment of the official exchange rate. As a result, the Chinese exchange rate policy became largely market-driven.

Thus, the rigid Chinese regime of capital controls was shaken to its foundations. The relatively free supply of and demand for foreign exchange at a market-driven rate spelt the beginning of the end of a regime that relied on quantity and price controls to insulate the domestic economy.

However, the liberalizing experiment was not without its problems. The most intractable was a multiple exchange rate regime that emerged when a swap rate existed in parallel with the official exchange rate. The authorities tolerated the existence of a more depreciated swap rate to redress overvaluation. But the multiple rate regimes did lead to unpredictable discrimination, rent-seeking activity and corruption, which gradually made the swap market a matter for wide concern and finally an object of further reform.

Further liberalizing reforms were adopted by the Chinese government. Entry and usage controls were progressively relaxed, the retention ratio increased, and a national swap center was created to reduce market fragmentation. Finally, the government unified the exchange rates and established partial currency convertibility on the current account in 1994 (Lu and Zhang, 2000).

The liberalization process continued after 1994 (Wu, 1997). In preserving the swap business for FIEs, the 1994 reform program caused some resentment. Compared with the freedom granted to domestic enterprises, FIEs felt that they were discriminated against because they still had to
obtain SAFE’s approval for access to swap centers and pay a fee. It was also feared that the government might tighten the requirement for individual FIEs to balance their foreign exchange account. In response, the government abandoned the arrangement in July 1996 and allowed FIEs to buy foreign currency freely on the inter-bank market. Furthermore, from 1995 individuals can buy $1000 for one overseas trip ($600 to Hong Kong). Starting on 1 January 1997, authorized foreign banks may provide financial services in RMB in Shanghai, and later on in Shenzhen. With most current account transactions freed, China on 1 December 1996 officially notified the IMF of RMB’s convertibility on the current account2.

It was only logical that China’s next move would be to allow RMB’s convertibility on the capital account. However, because of the Asian financial crisis, the process was disrupted. To many Chinese economists, the crisis was largely due to volatile movements of international capital. This belief persuaded the Chinese government to be more cautious about liberalizing capital controls. Despite this, convertibility of the RMB on the current account has significantly reduced the extensiveness of capital control in China (Song, 1999). The once all-inclusive system of foreign exchange management has now given way to a mixed system in which the current account is free while the capital account remains restricted. As a result, whereas the general term of foreign exchange management is still used in China, what one may now hear is the term capital account management.

VI. Benefit and Risk of Capital Control

The citizen of China is one of the largest savers in the world. They provide cheap capital that fueled the economic growth of China. Unfortunately China is running out of good profitable project that would ensure the best returns to this capital. The low interest rates offered by China's banks represent a tax on depositors and a subsidy for industry. They distort the economy, suppressing consumption, services and private business in favor of investment, industry and the state. Savers seeking to avoid being fleeced by the country's banks inflate housing bubbles instead. And controls on capital outflows prevent sound investments abroad, resulting in large and dangerous piles of foreign-currency reserves.

Freer movement of capital within its borders would certainly be beneficial in the long run. China's direct investments abroad, in firms and factories, amount to less than Sweden's. Looser controls would encourage more productive investments that are less likely to unbalance the world economy.

Unfortunately as witness with numerous countries in crisis capital mobility has its risk. Low domestic interest rates would encourage China firms and individual to borrow at home and invest overseas for example Japan in the 80’s and 90’s. Unfortunately many of these firms and individual do not have the expertise to invest profitably and therefore they may incur huge losses. This is one of the reasons for Japan lost decade.

China approach to this problem is to liberalize the capital control step by step.

Hopefully China would do a better job than Japan. The relatively liberal People's Bank of China (PBOC) has just circulated a study that recommends opening up the financial system, with a ten-year timetable for easing capital restrictions. It would start by encouraging Chinese businesses to buy foreign companies—many of which, the report points out, are going cheap right now. Next would come greater cross-border commercial lending, including loans in Chinese currency. After that, foreigners could invest more freely in Chinese shares, bonds and property. Remaining controls could be lifted at the government's discretion, with suitable curbs on “speculative” capital flows staying in place indefinitely.

VII. Conclusions

China under the central planning economy had always practice long term capital control. The reform of capital control had been slow. Although capital control may be useful for short term financial crisis, long term capital control hinder the efficient flow of capital across border. Reform in
capital control policy may solve many of the chronic problems faced by the Chinese financial system. We conclude that short term capital control during a financial may be necessary but long term capital control hinders financial reform and will be an obstacle for the next phase of China economic growth.

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