Capital Account Liberalization in China: Prospects, Prerequisites, and Pitfalls

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The currency crises afflicting Asia in 1997 and 1998 reopened the debate on the wisdom of capital controls and liberalization of the capital account for emerging market economies. In a world awash in what some pejoratively refer to as "hot money," where capital, or financial claims to capital, can be transferred across borders instantaneously with very low transaction costs, there is growing concern that investors and analysts can wreak havoc on developing economies. Well-known free market-oriented economists now debate the proper sequencing of reforms, of which capital account liberalization is part and parcel. Still others question the prudence of capital account liberalization altogether, instead calling for at least partial erection of capital controls.

Nowhere is this debate more salient than in the People's Republic of China. In 1997, the leadership in Beijing announced the goal of achieving capital account convertibility by the year 2000. Four years later, that goal has yet to be achieved. Moreover, it is now apparent that President Jiang Zemin and the PRC's "economic czar," Zhu Rongji, are much more sanguine about the desirability of such a move. Some four years later, while leaders in Beijing acknowledge the ultimate goal of achieving liberalization of its capital account, they no longer speak of any firm timetable, instead emphasizing a "gradual" liberalization.

It is clear that Beijing firmly accepts the conventional wisdom holding that the PRC avoided the Asian economic crisis because of its closed capital account. As John Williamson notes, there is a sharp distinction between those countries that fell ill from the Asian economic flu and those that did not. In his own words: "The one dimension in which there is a systematic difference between the two groups

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is with respect to whether or not they had liberalized their capital accounts" (Williamson 1998: 5).

To be sure, there is some truth to that argument, as I have argued elsewhere (Groombridge 1998). While the PRC did see a decline in exports due to slack demand in the Asian region, as well as a decline in foreign direct investment from Asian neighbors, the clear consensus is that the country weathered the economic storm better than its neighbors. The reason for that view is straightforward: capital injected into the PRC was largely through direct, not portfolio, investment. As foreign direct investment is more illiquid, it cannot be readily pulled out, even if investors do lose confidence. Similarly, with a closed capital account, the PRC was able to thwart currency speculators who had no way to act even if they did believe (likely correctly) that the renminbi was overvalued.

The short-term benefit of the protection afforded to the PRC by the lack of convertibility of its capital account, however, is not without a downside cost. It is impossible to ever know definitively, of course, but there is a compelling and intellectually honest argument to be made that China's reforms are stalling and that a crisis would have prompted, even enabled, the PRC leadership to take bolder reform efforts.[1] Having said that, it is not lost upon this author that the two countries that were the most open during the crisis, Hong Kong and Singapore, have subsequently been the most active in deepening economic reforms and liberalization. The lessons that leaders in those two countries correctly learned, though, is that more reform, not less, is the answer.

While that lesson is not lost upon other leaders, some have implied that perhaps the crisis was not deep enough. As Philippine President Joseph Estrada remarked in July 2000, several years after the crisis: "After a brief period of recovery from the financial crisis, the Asian region is suffering from a mild relapse. . . . Under threat of a national and regional slowdown, we must keep working at the basics which, because they had been forgotten, led to the Asian crisis in the first place. We must keep up the pace of reforms" (Reuters 2000).

[1]A number of authors have examined economic reform programs and concluded that the most dramatic ones, whether implemented by the current regime, a faction of the regime, or an entirely new leadership, are preceded by an economic crisis of some sort. The policymakers implementing the reforms sense that they have increased legitimacy in light of popular discontent with the old policy. In the case of breaking up state monopolies (which would be similar to the case at hand of the PRC), see Waterbury (1993). A similar framework has been applied to the case of the PRC as well in the context of Deng Xiaoping's breaking with the old entrenched heavy industrial interests when he came to power in 1978 (see Solinger 1991).

The degree to which a crisis is necessary to encourage leaders to move in a reform-oriented direction is directly relevant to debates on the pace at which the PRC should adopt liberalization of its capital account. On the one hand, most acknowledge important prerequisites that should be in place before a country liberalizes its capital account. Capital account liberalization has important prerequisites and should be viewed as an important component in a broad scheme of reforms. Notable examples include a healthy banking system with an effective system of prudential regulation in place. If a country does not yet have such a system in place, liberalizing its capital account could lead to massive capital flight and incite a currency crisis. As Nicholas Lardy observes:

> It is erroneous to draw sharp distinctions between the public policy approach to the deregulation of the capital account on the one hand, and the approach to the regulation and development of financial markets on the other. Rather capital account liberalization should be treated as an integral part of economic reform programs [Johnson, Darbar, and Echeverria 1997: 6].

On the other hand, it is also quite possible that establishing a firm timetable or date for China to liberalize its capital account might actually provide an impetus for speeding up China's reform process, which many acknowledge (and even by the Chinese governments own admission) is moving much slower than anticipated. What should the People's Republic of China do?

The Argument

The argument advanced in this paper is that China should set a firm timetable in place to achieve capital account convertibility, with a safety valve that allows for the imposition of clearly defined capital controls that are quite limited in both scope and duration. Simply put, while China's economy continues to grow, many of the most difficult reforms have yet to be undertaken. Chairman Mao is well known for saying, "Strike while the iron is hot." Unfortunately, now the iron is cold and is likely to remain so for some time without pressure. While not always the case, there is strong evidence to suggest that in China, with its system of decentralized property rights, bureaucrats at the lower levels need external pressure given their incentive to capture rents at the expense of the national economy.

One way to "make the iron hot" is to impose a firm timetable. Already, there is an illegal capital market. The Chinese leadership would be wise to recognize those forces at play and take decisive action by announcing a firm date. Early data from the banking sector already suggest that decisive action at the top has led to some reforms, albeit still relatively minor. Still, the Chinese leadership is naïve to think that keeping China's capital account closed over the long term will work. As Walter B. Wriston, formerly chairman emeritus of Citibank, wisely cautions: "Capital will go where it is wanted and stay where it is well treated. It will flee from manipulation or onerous regulation of its value or use, and no government power can restrain it for long" (Dorn 2000: 10).

This is not to say, however, that China should not leave a fail-safe option for some controls to remain in place. The scope and duration of the controls should, of course, be limited. Martin Wolf has pointed out in a column several years ago that, yes, "controls do breed corruption, but carefully limited controls need not breed it to a ruinous degree" (Wolf 1998). While some might consider that heresy, because I do consider myself a free-trader, it is important to bear in mind the potential for a crisis causing even more retrenchment on the part of China's leaders. We are all aware of the divisions—or factions, if you will—in Beijing, many of which are anti-reform. While a minor crisis might be beneficial to "get the iron hot," a full-fledged banking and currency crisis is in no one's interest. It is important to bear in mind that capital account liberalization is not just a question of economics but of politics as well. As Bernard Fischer and Helmut Reisen (1992: 13) point out:

> Any move from a restricted to a liberalized financial regime implies a redistribution of income, rents and decision-making powers. Therefore it is likely to meet opposition from the affected groups, such as favored borrowers under domestic credit rationing, companies entitled to subsidized foreign exchange and banks enjoying a comfortable life as a national monopolist.

Overcoming the opposition groups and entrenched forces will not be easy, particularly given the reticence of the top leadership on the overall desirability of capital account liberalization, which is the subject of the next section.

Is Capital Account Liberalization Beneficial?

As the Asian economic crisis has weighed heavily on the minds of the Chinese leadership, it bears mentioning briefly where economists now stand on the whole issue of capital account convertibility in the wake of the crisis.

Two debates on capital account convertibility have emerged in the wake of the Asian economic crisis. The first focuses on the desirability of full capital account liberalization. What is striking is the players entering this fray, including well-known economists who entrench themselves firmly in the free-trade camp. Jagdish Bhagwati, for example, who has done as much as any economist to advance the cause of free trade, notes that there is an inherent "difference between trade in widgets and dollars." In the case of trade in goods and services, Bhagwati notes that numerous studies have measured and documented the negative costs of trade protection. Those studies, however, have "in-effect been hijacked by the proponents of capital mobility." While not against capital account liberalization per se, he points out that the proponents "fail to evaluate its crisis-prone downside" and that the mantra of "substantial gains have been asserted, not demonstrated" (Bhagwati 1998: 7–12). Other economists such as Dani Rodrik go further, lamenting the canonization of capital account convertibility because "it will leave economic policy in the typical 'emerging market' hostage to the whims and fancies of two dozen or so thirty-something country analysts in London, Frankfurt, and New York" (Rodrik 1998: 10).

Those are legitimate concerns, of course, and it is important to acknowledge that trade in capital is more subject to panics, whether rational or irrational, than trade in goods and services, which by its very nature can allow cooler heads to prevail. Moreover, there tends to be a euphoria surrounding the opening of certain markets (recall selling 1.2 billion razors in China?). As Eduardo Yeyati notes, "Capital account liberalization may induce banks in low-risk industrial economies to invest in high-risk/high yield projects in emerging markets, even when expected returns in the latter are below those in the former" (Yeyati 1999: 17).

One way, of course, to allow cooler heads to prevail is to increase the transparency of one's financial systems (the lack of which was the primary cause of the Asian financial crisis). Still, over the long-term, most agree (including the Chinese government) that liberalization of the capital account is beneficial for several reasons:

1. The improved ability to tap savings globally (at lower cost than using only domestic savings).
2. Allowing domestic economic agents freedom to diversify risk by choosing how and where to borrow, invest, or exchange assets.
3. Improvements in resource allocation through increased competition for financial resources.

4. Increased availability of resources to support investment and to finance trade and other significant economic entities.
5. Imposition of macro-economic discipline on national governments.

The second debate on capital account liberalization emphasizes the proper sequencing of reforms. The conventional wisdom dictates that there are several preconditions that should be met first before a country liberalizes its capital account (see McKinnon 1973 and Frenkel 1982). To quote Stanley Fischer, "Liberalization without a necessary set of preconditions in place may be extremely risky" (IMF 1998: 82). A somewhat exhaustive list includes:

1. Establishment of solid fiscal consolidation and prior stabilization.
2. A strong, autonomous central bank that can find the right monetary-fiscal policy mix to dampen the loss of monetary autonomy, with emphasis on exchange rate management.
3. Building of primary and secondary securities markets for monetary policy implementation and financial stability.
4. Enforcement of domestic competition to foster allocative and operational efficiency within the financial sector.
5. Strengthening of prudential regulation and supervision, legal and accounting systems to cope with systemic risks of financial systems.
6. Restructuring the domestic banking system to remove excessive bad loans, so enabling unfettered competition on level playing fields.
7. Reformation of the tax system to compensate for the loss of explicit and implicit taxes on financial intermediation.

All of those conditions, or prerequisites, should certainly be part and parcel of a capital account liberalization program. The question is should they come first? And, more importantly, at what point are the conditions deemed satisfied? That question is inherently difficult to answer. At a recent conference on the role of the International Monetary Fund on the subject, many expressed concern that by having too exhaustive a list of firm preconditions, reformers will balk due to the difficulty. Moreover, entrenched interest groups opposed to liberalization will *always* say the preconditions have not yet been met. Many of the preconditions listed above are subjective in terms of evaluating. It is likely that the correct answer will not be found in theory but in the empirics of individual cases. In the case of China, for reasons I outline below, I believe the historical record demonstrates that if

China waits for firm preconditions to be established, liberalization of its capital account will not occur for several decades.

The Case of the People's Republic of China

In December 1996, China liberalized its current account but its capital account remains closed. That allows only those enterprises with necessary trade documents to buy foreign exchange from designated foreign exchange banks. The rules stipulate that Chinese enterprises must sell all hard currency earnings to designated foreign exchange banks or hold them in foreign currency bank accounts after receiving approval to open an account. Foreign currency earnings cannot be held outside of China. Meanwhile, Chinese residents can hold foreign currency in banks or sell it to the banks on a voluntary basis but no private trading is permitted.

Foreign investors can remit profit, dividend, and interest earnings out of China from their foreign currency accounts, or can convert yuan earnings into hard currency at designated banks before sending money from China. With regard to China's fledgling stock exchanges, the market is still largely closed. Foreign investors can only invest in "B-Shares" on the stock exchanges, which are traded restrictively in a small portion of the market separated from the primary security market—the "A-Shares"—that can be traded by domestic investors.

This opening of the current account but closing of the capital account has served China well in some respects, notably in that it prevents speculators from instigating an exchange crisis. As one commentator noted:

> The absence of capital account convertibility also means that speculators, foreign or Chinese, have no way to act on a belief that the renminbi is overvalued and likely to depreciate. . . . Only buyers with a demonstrated need related to trade, tourism, repayment of previously approved foreign currency borrowing, or repatriation of profits derived from a prior direct investment are allowed to purchase foreign exchange. That thwarts would-be speculators from buying foreign exchange to sell in the spot market [Lardy 1998: 197–98].

Over the course of the past five years, the government has allowed the currency to fluctuate, but within a very narrow band. Right now, according to the government officials, conditions in China are not yet in place for introducing the free movement of capital across borders. Leaders from China routinely note that, "With China's accession to the World Trade Organization, we will press ahead with the capital account convertibility process gradually" (Kynge 2000b). Nevertheless, they also point out the need to further improve macroeconomic regulation and install an effective mechanism for controlling foreign exchange before moving to full convertibility. Chinese press reports often point out that China is not yet ready for an open capital account and that "there is no timetable for this measure now" (*People's Daily* 2000).

As expected, despite the tight controls, there is growing evidence that China's capital account is increasingly subject to leakage. A new study estimates that the amount of money leaking through China's supposedly closed—but infinitely porous—capital account amounted to $36.4 billion in 1997, $38.6 billion in 1998, and $23.8 billion in 1999. That contrasts with official reports of "errors and omissions" of $16.5 billion in 1997 and 1998 (Kynge 2000c). Moreover, Dong Fu of the Federal Reserve Bank of Dallas estimates that 40 percent of total foreign direct investment injected into China from 1991 to 1998 actually left the country (Dorn 2000: 10)

What is especially interesting is that most of the illegal capital flight is being conducted by SOEs, either through underreporting of export earnings or overreporting of import expenses. By underreporting exports, companies can keep significant foreign exchange revenues that they would otherwise have had to hand over to the State Administration of Foreign Exchange (SAFE), the body that manages China's $158 billion in reserves. By overreporting imports, companies are able to secure permission to change renminbi into U.S. dollars. The foreign trade partner will deposit the overpaid portion of the contract into a foreign bank account. Affiliates of state companies also overreport or overpay for raw materials and other inputs, falsely inflating their foreign currency expenses. Consequently, foreign affiliates of Chinese companies tend to perform suspiciously poorly. One SAFE study of 2,202 affiliates in 1998 found that only 36.6 percent were either making a profit or breaking even (Kynge 2000c). Consequently, it is clear that despite the best intentions of capital controls, the Chinese government can only stem or slow down capital flight, at best.

Since capital flight from China is now primarily conducted through diverting investment and through the fudging of import and export documents, expanded trade and investment opportunities will only foster those opportunities. Clearly, one impact of China's accession to the World Trade Organization (WTO) will be to accelerate and expand options for individuals who want to invest capital outside of the country illegally. That makes capital account liberalization all the more necessary.

There is also a strong case to be made that China's economic reform program, despite the best intentions of the leadership, is stalling. That implies that a credible commitment in terms of a date is in order. Waiting too long for preconditions to be established puts China on the fast path to nowhere in terms of capital account liberalization. The basis for this argument is drawn from the historical record of China's now two-decade-plus experiment with economic reforms. While it is clear that China's economic reforms are responsible for lifting millions of Chinese out of abject poverty, it is also clear that many of the most difficult reforms are yet to be undertaken. Indeed, there is a strong case to be made that much of the economic growth during the 1980s and 1990s was due to an increase in allocative efficiency and increases in productivity. Many have suggested that China is now entering a second, much more difficult stage of reform—one that will not be fully realized absent a stronger system of private property rights.[2]

The case of state-owned enterprise (SOE) reform is illustrative. Since 1984, the PRC government has quite literally announced every year in some declaration that the following year was the crucial or would be the breakthrough year in reforming the moribund SOE system. Most analysts would agree that much work remains to be done. I would go further and argue that there has been some backtracking, notably due to the government's encouragement of mergers and capitalization of SOEs and de-emphasis of bankruptcy as a viable option.[3]

The question that must be answered is whether or not pressure from above or outside works. While the jury is still out, there is some evidence to suggest that China's impending accession to the WTO, with its relatively firm timetables for implementation, is putting pressure on certain sectors to reform. It is noteworthy that just after China signed its bilateral agreement with the United States, it took the unprecedented step of elevating the importance of the private sector in official economic policy. State Development Planning Commission chairman Zeng Peiyan announced that the government would "actively guide and encourage private investment" and would "eliminate all restrictive and discriminatory regulations that are not friendly toward private investment and private economic development in taxes, land use, business start-up, and import and export" (Pomfret 2000:

[2]It is interesting to note when articles in China began formally calling for a stronger system of property rights. In the early 1990s, many articles appeared calling for property rights institutions to be strengthened. Not until the late 1990s, however, did the PRC government begin invoking the term "private" with regularity.

[3]This de-emphasis on bankruptcy was recently confirmed by a high level banking official as recently as June of 2000.

A1).[4] Just as important, Zeng declared that more private firms would have access to China's fledgling stock markets in Shanghai and Shenzhen, which are currently restricted almost exclusively to SOEs.

Just the prospect of foreign competition is also shaking up the Chinese financial sector. Top executives in China's state-owned banks are considering ownership changes to help brace the industry for change, particularly two years after WTO entry when all banks will be permitted to do business in the local currency with Chinese companies (Kynge 1999). Meanwhile, China's central bank governor, Dai Xianglong, announced a series of banking reforms including gradual interest rate liberalization and expanding the band within which the bank allows its lending and deposit rates to fluctuate (Kynge 2000a). Along related lines, China is breaking up its reinsurance market monopoly in preparation for WTO entry. Dai Fengju, head of the state-run monopoly, indicated that the reason to do so was because the entrance of foreign business rivals would bring competition as well as advanced management technology, which would compel Chinese firms to further improve management and service (*Journal of Commerce* 2000: 10).

That is not to say there are no risks involved from establishing a firm timetable. As Lardy (1998: 139) observes, "Since full convertibility would represent a dramatic expansion of the range of financial assets available to Chinese households, it poses the threat of disintermediation and thus could undermine the financial viability of domestic banks." That could potentially lead to a disastrous run on the Chinese banking system, which would also entail the closing of roughly one-third of Chinese SOEs. While some might argue that this is a good thing over the long term, there is the legitimate and palpable fear that such a result would lead to such chaos and turmoil that China's leaders would close up even further. If such a situation resulted, Chinese banks could create a massive hyperinflationary spiral by printing money, or they could restrict customer withdrawals. The first option would be disastrous; the second option, while preferable to the first, would erode confidence even further and result in more illegal capital flight.

A palatable solution to this problem is to distinguish between different types of capital flows such as borrowing and lending, securities, and foreign direct investment. As noted above, foreign direct investment is largely already liberalized. For securities, China should rap-

[4]To be sure, there are some sectors that will be limited. As Zeng pointed out in the same article, "Except for the areas that are related to national security and those that must be monopolized by the state, all the rest of the areas should allow private capital to enter."

idly expand the number of countries listed on the B-Share lists, and gradually eliminate it altogether. That would also serve the purpose of recapitalization. One positive step is that foreign companies can now apply for both A- and B-Share issuance. China's accession to the WTO will accelerate that process and provide an impetus for key reforms in the capital account if China wants to grow its fledgling stock exchanges. As Teng Tai of the Haitong Securities Company argues, increased investment in China's stock market "will require further opening up of China's capital account, and free outward remittance of investment returns by foreign-invested funds, as well as distribution of such returns to overseas shareholders. New changes will occur to the structure of China's securities markets" (Tai 1999: 7).

The trickier issue, of course, is with regard to borrowing and lending. In the case of interest rate deregulation, for example, China has already announced that it will follow a sequencing process of lifting interest rates on foreign currencies first, then the renminbi in rural areas, followed by a relaxation of control over rates in urban rates. Control over lending rates will be lifted first, followed by deposit rates. Such gradualism is the only politically feasible solution at this time, although pressure should be made for Chinese leaders to announce when the reforms will take place.

Far and away, the trickiest problem is strengthening the Chinese banking system. That will require a monumental mind shift on the part of the Chinese leadership, perhaps even at the top. Fundamentally, China has yet to embrace a full-fledged system of private property rights and insolvent firms are not allowed to exit the system through bankruptcy. Statism still pervades much of the Chinese economic policy. Even the new guidelines on elevating the role of the private sector talk about how the Chinese government will "guide" and "channel" investment to the private sector. This is critical to resolving both the banking and the related problem of insolvent SOEs. Progress must be made on both fronts. As my colleague Jim Dorn points out, though, this will require political change at the top of the Chinese Communist Party. It is not lost upon the leadership that "the party will lose substantial power if it depoliticizes investment decisions and lets the market allocate funds" (Dorn 2000: 10).

Conclusion

There is a saying in China that things will happen when the conditions are right ("taking fruit is best when conditions are ripe"—*guashu dailuo*). It is time for bolder thinking, however, in the case of China. The reform experience in China suggests that while there has been spontaneous market development in some sectors, the state is still firmly entrenched in many parts of the economy. The fruit will likely never get "ripe"—to continue the metaphor—absent a clear signal from the top as to when China will liberalize its capital account (with accompanying minor and limited controls if necessary).

Unfortunately, at this time, there appears to be little movement at the top on this issue. Zhu Rongji, Chinese premier and "economic czar" of the country, has publicly declared that there is no firm timetable for reform. In short, he subscribes to the belief that the closed capital account saved China from ensuing economic turmoil. While true in the past, China should recognize that prolonging would only increase the aggregate costs over the long-term. Thus, while Michel Camdessus of the IMF believes that capital account liberalization must be "bold in its vision, cautious in its implementation" (Camdesses 1998), there is a strong case in China that it should be bold in both vision and implementation.

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