China's WTO Accession as a Catalyst for Capital Account Liberalization

Fred Hu

The Asian financial crisis has led to questioning, in both academic and policy circles, concerning the wisdom of permitting free cross-border capital movements. Paul Krugman (1998a, 1998b) and Joseph Stiglitz (1998), for example, have both argued that unrestrained and volatile capital flows were the main factor in triggering and prolonging the 1997–98 Asian crisis. That crisis and subsequent debate evidently have had an impact on the thinking of Chinese policymakers. Not only has the official goal, established in the mid-1990s, of substantially abolishing exchange and capital controls by 2000 been quietly abandoned, the Chinese government has since been reticent about the whole issue of capital account convertibility. Many analysts have concluded that China has indefinitely postponed capital account liberalization.

This paper argues that, despite the absence of a publicly announced timetable, full capital account convertibility will take place within five years. The key catalyst for this accelerated transition to free capital mobility is China's imminent accession to the World Trade Organization.

Implications of WTO Membership for Capital Account Liberalization

Following 13 years of marathon negotiations, China and the United States reached a landmark trade agreement on November 15, 1999, paving the way for China's accession to the WTO. Since this crucial breakthrough, China has concluded bilateral agreements on WTO

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Fred Hu is Managing Director at Goldman Sachs in Hong Kong and Co-Director of the National Center for Economic Research at Tsinghua University.

membership with its remaining trading partners, including the European Union. It now appears almost certain that China will become a full-fledged member of the WTO this year.

While much attention has been paid to trade liberalization associated with WTO entry, equally important is the impact of the WTO membership on capital flows. First, under the terms of WTO accession spelled out in a series of bilateral agreements, China has committed to undertake sweeping trade reforms. Average tariff rates will be reduced from about 17 percent to less than 10 percent. Information technology (IT) products such as computers and telecom equipment, the fastest growing component of Chinese imports, will incur zero tariffs by 2005. More significantly, most of the nontariff trade barriers, such as quotas, licensing, and permits, are to be abolished. Today China is the world's ninth largest trading nation. Sweeping trade liberalization mandated by WTO entry will further increase China's role as a leading player in the global trading system, with foreign trade projected to reach $600 billion annually by 2005.

Reduced trade restrictions and increased trade flows will substantially complicate the task of enforcing existing exchange and capital controls, further eroding the effectiveness of such controls (see Table 1 for current capital controls in China). Since China formally moved to convertibility of current account transactions by accepting the IMF Article VIII in December 1996, there has been significant leakage in China's capital account via the largely open current account. Trade misinvoicing (typically overinvoicing of imports and underinvoicing of exports), noncompliance with foreign exchange surrender requirements, and evasion of official approval and surveillance over foreign borrowing (as shown in the collapse of the Guongdong International Trade and Investment Company [GITIC], smuggling, and rampant customs fraud and corruption) have been found to be important sources of leakage. Despite draconian control over capital movements, capital flight has remained a vexing problem. At least part of the errors and omissions in China's official balance of payments (Table 2) can be attributed to illicit capital outflows (Hu 1998b). Recent efforts to improve official BOP statistics have apparently failed to reduce the magnitude of the E&O item.

In view of China's recent experience with capital controls, it appears quite certain that rapid expansion in the volume of foreign trade after WTO entry will further curtail the effectiveness of such controls. The plain dilemma is that capital controls cannot be fully enforced once there is a freely convertible current account. The more open the trading regime, the more channels of leakage and evasion there will be. This stark reality will prompt pragmatic policymakers within the

TABLE 1

Capital Controls in China

Category	Controls
Any Form of Capital Control	Yes
Comprehensive Controls	Yes
On outflows	Yes
On inflows	Yes
Foreign Direct Investment	Yes
Of nonresidents	No
Of residents	Yes
Profit repatriation and capital liquidation	No
Taxes on capital transactions	No
Nonresident-controlled enterprise	No
Portfolio Investments	Yes
Of nonresidents	Yes
Of residents	Yes
Security issuance by nonresidents	Yes
Security issuance abroad by residents	Yes
Debt-to-equity conversion	Yes
Financial Transactions	Yes
Of nonresidents	No
Of residents	Yes
Trade-Related Financial Transactions	No
Deposit requirements for borrowing from abroad by residents	No
Deposit Accounts	No
Of nonresidents in foreign exchange	No
Of nonresidents in local currency	No
Of residents abroad	No
Of residents in foreign currency with domestic banks	No
Other Capital Transfers	Yes
Personal capital transfers	Yes
Blocked accounts	Yes
Real estate transactions	Yes
Of nonresidents	No
Of residents	Yes

Sources: IMF, *Annual Report on Exchange Arrangements and Exchange Transactions;* People's Bank of China.

Chinese government to relax or lift capital controls sooner rather than later. They will recognize that China's strict capital controls have failed to achieve their intended policy objectives and created large distortions in the allocation of resources.

TABLE 2

CHINA'S BALANCE OF PAYMENTS (BILLIONS OF DOLLARS)

	1995	1996	1997	1998	1999	2000
Trade Balance	18.1	19.5	46.2	46.6	36.2	34.5
Exports	128.1	151.1	182.7	183.5	194.7	249.1
Imports	110.1	131.5	136.4	136.9	158.5	214.7
Services Balance	–6.1	–2.0	–5.7	–4.9	–7.5	–5.6
Income Balance	–11.8	–12.4	–15.9	–16.6	–18.0	–14.7
Current Account	1.6	7.2	29.7	29.3	15.7	20.5
(% of GDP)	0.2	0.9	3.3	3.1	1.6	1.9
Foreign Direct Investment	33.8	38.1	41.7	41.4	37.0	37.5
Direct investment in China	35.8	40.2	44.2	43.8	38.8	38.4
Direct investment abroad	–2.0	–2.1	–2.6	–2.6	–1.8	–0.9
Portfolio Investment	0.8	1.7	6.8	–3.7	–11.2	–4.0
Other Investment	4.0	0.2	–25.5	–43.7	–18.1	–31.5
Capital and Financial Account	38.7	40.0	23.0	–6.3	7.6	1.9
Net Errors and Omissions	–17.8	–15.6	–17.0	–16.6	–14.8	–11.9
Overall Balance	22.5	31.6	35.7	6.4	8.5	10.5
Change in Reserves	–22.5	–31.6	–35.7	–6.4	–8.5	–10.5

SOURCE: China Economic Information Center.

Second, as part of the membership requirement, China will significantly liberalize trade in financial services in the coming five years. Foreign commercial banks will be allowed to conduct renminbi (RMB) business with local enterprises within two years of WTO entry and retail banking with Chinese households and consumers within five years. Foreign insurance companies will also be allowed to write both life and property insurance policies for resident firms and individuals with existing geographical restrictions to be phased out within five years. Foreign asset management companies will be allowed to form joint ventures (up to 33 percent equity ownership) with Chinese institutions in fund management. Similarly foreign securities firms will also be allowed to establish joint ventures with domestic institutions (up to 33 percent equity ownership) so as to participate in the underwriting, sales, and trading of RMB-denominated securities onshore. These measures aimed at partially liberalizing trade in financial services will have profound implications for the capital account. The opportunity for foreign financial institutions to provide services onshore as well as offshore to local residents (such as Chinese enterprises and households) and nonresidents (such as multinational corporations) will inevitably boost cross-border financial flows, rendering existing controls obsolete or ineffective.

These upfront liberalization measures aside, membership in the WTO involves acceptance of several agreements, including the Multilateral Agreements on Trade in Goods (of which the General Agreement on Tariffs and Trade [GATT] is the best known), the General Agreement on Trade in Services (GATS), and the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS). It is worth noting that the GATS includes provisions proscribing members from imposing restrictions on capital transactions related to the provision of services identified in such agreements. Although the primary objective of these agreements is the freedom to provide services and not the related capital movements, the GATS is the first agreement of universal (as opposed to regional such as within the OECD or EU jurisdictions) application that proscribes lifting certain restrictions on capital transactions as required to liberalize trade in services. The GATS therefore will put pressure on new members like China to review and relax those restrictions on capital movements that could effectively hinder market access by foreign financial institutions.

Finally, China's package of commitments for WTO entry also calls for opening up a range of sectors previously off-limits to foreign investment. These newly opened up sectors include telecommunica-

tions, external trade, domestic retail trade, and distribution. Access to other sectors—notably manufacturing, agriculture, commercial banking, and insurance—will be further increased. China's foreign direct investment regime, which already favorably compares to many other countries in terms of openness, will become considerably more liberal following China's accession to the WTO. Annual inflows of FDI will likely increase to $100 billion by 2005. Such a significant surge in FDI flows will dramatically increase attendant cross-border financial transactions such as equity and debt financing, interest and currency swaps as required by multinational corporations (MNCs) to hedge risks, and repatriation of earnings, dividends, interest income, capital gains, and principals. The penetration of FDI into all sectors of the Chinese economy and the proliferation of sophisticated financial transactions required by MNCs in their financial planning and risk management will pose a serious challenge to China's existing system of exchange and capital controls.

Capital Liberalization as a Natural Extension of the Reform Process

China's experience with capital controls has cast serious doubt on their effectiveness. Maintaining capital controls will likely run into growing difficulties following China's accession to the WTO, when the country implements significant measures to liberalize trade in goods and services, especially financial services. Furthermore, continuing capital controls is incompatible with the objectives of China's ongoing domestic economic restructuring, because controls cause distortion, provide incentives for capital flight, reduce transparency, increase corruption, and prevent efficient pricing and allocation of capital. Capital account liberalization would therefore be a natural extension of China's ongoing reform process. Early liberalization would help promote domestic restructuring and ensure that Chinese enterprises and banks become more efficient to meet the challenge of global competition following WTO membership.

To prepare for the WTO entry, China has accelerated the restructuring of state-owned enterprises (SOEs), with privatization as the centerpiece of the reform strategy. So far the government has chosen to list its largest SOEs in international capital markets, including such successful examples as China Mobile, China Southern Airlines, PetroChina, and China Unicom. But the sheer number of SOEs to be privatized implies China cannot rely on international capital markets

alone. Greater emphasis should be placed on developing its domestic capital markets in order to successfully accomplish the country's massive privatization agenda.

What accompanies privatization has been SOE downsizing, plant closures, and mass layoffs, imposing substantial pressures on China's labor market and on the fragmentary traditional social security system. In order to sustain social and political support for these wrenching reforms, the government has initiated reforms on social security, especially old age pensions. The long-term goal is to establish a system of fully funded private pension funds supplemented by a mandatory public pension scheme that provides minimum pension benefits for retirees. To finance the transition to such a new system from the current pay-as-you-go system, China would have to seek a combination of privatization proceeds and long-term public debt. It is hence essential to develop a deep, liquid capital market to absorb new privatization and allow the government to sell down equity stakes in listed (partially privatized) companies.

China's domestic stock market, while only 10 years old, now boasts a market capitalization of $590 billion. A high private savings rate and the public's appetite to hold risky securities have contributed to the stunning growth of the market. But it is largely a retail investor-driven market that suffers from poor liquidity, lack of depth, and high volatility. The huge backlog of pending supply of new issuance from the country's massive privatization program threatens to depress the market and spark social unrest. The solution is to introduce institutional investors—including mutual funds, pension funds, and insurance companies—to the market. With a nascent domestic fund management industry, the government is likely to introduce a scheme called qualified foreign institutional investors (QFII) to attract foreign investors to the domestic market.

The QFII scheme, expected to be in place within two years, will be a major step toward a more liberal capital regime. It will, for the first time, allow foreign access, albeit controlled, to RMB denominated domestic securities. Participation by foreign institutional investors will undoubtedly have a positive impact on the development of the domestic market and facilitate a number of critical reforms including privatization and pension reform.

In addition, a relaxation of capital controls will also help China attract more foreign investment to the country's fledgling IT industry that has experienced explosive growth and has enormous potential. Similarly, developing the country's vast Western region, another strategic policy objective of the government, can also be aided by freer flows of capital. As shown in the economic takeoff of China's coastal

provinces, foreign investment can act as catalyst in the catch-up process of China's underdeveloped Western region.[1]

Preconditions for Successful Capital Account Liberalization

If China's WTO membership will eventually undermine its capital controls, and China realizes capital liberalization carries large benefits for its ongoing economic reforms and development priorities, then the only remaining issue appears to be feasibility. That is, can China achieve full capital account convertibility within a reasonably short period of time while averting possible risks in light of the lessons from the recent Asian crisis?

It is on this point that most analysts remain deeply skeptical. The widely shared view is that it will take a long time for China to get itself ready for full-fledged capital account liberalization. Such a line of analysis, however, errs on two counts. First, it overstates the role of a closed capital account in shielding China from the recent Asian financial crisis. In fact, China's capital controls have been far less effective than generally believed as evidenced by well-documented capital flight. The real reason for China to escape from the worst of the Asian contagion is the country's earlier success in macroeconomic stabilization. Zhu Rongji's 1993–96 austerity program reduced runaway inflation and cured overheating and speculative bubbles in real estate. Tight monetary policy and fiscal consolidation since 1994 helped restore macroeconomic stability and corrected external imbalances, with a steadily improving current account and a rapid buildup in official foreign exchange reserves. These economic fundamentals, not capital controls, made a crucial difference to China's ability in coping with adverse external shocks and preventing RMB devaluation during the 1997–98 Asian crisis (Hu 1998a, 1998b).

The same set of macroeconomic conditions are required for China to move smoothly to an open capital account. Strong fundamentals and sound economic policies are essential if China is to reap the benefits of increased capital freedom while avoiding the potentially destabilizing effects of free capital flows.

A common obstacle (and risk) to capital account liberalization is a weak balance of payments position. China's export competitiveness and the prospect for significant FDI inflows following WTO entry, however, imply that China's payments position will remain strong in

[1]On the relation between capital mobility and economic growth, see Rodrik (1998).

the medium term. Modest external debt and substantial reserves also provide a cushion to withstand external shocks. The strength in external positions has fulfilled one of the key preconditions for successful capital account liberalization.

The second requirement for opening up the capital account is a sound domestic financial sector. This condition is probably the toughest for China to meet (Hu 1997, 1999). But the government has already embarked on financial reforms. It has swiftly closed insolvent institutions such as GITIC, Hainan Development Bank, and a large number of distressed smaller ITICs. It has taken steps to recapitalize the four largest state-owned commercial banks, and set up asset management companies to dispose of bad loans of these large banks. It has also made contingency plans for the large number of weak rural credit cooperatives. Lately, the government has signaled its intention to privatize state banks in a bid to strengthen their capital base and improve bank operations. The People's Bank of China has also stepped up efforts to improve its capacity in prudential supervision and to liberalize domestic interest rates in the next several years. The gradual opening up of the banking sector will introduce competition and international best practices, promoting the restructuring of China's domestic banking system. Nurturing the banking sector back to health is a time-consuming and difficult task, but China is already off to a good start. Sustained efforts to reform the domestic financial sector within five years would put that sector on a stronger footing and significantly increase China's readiness to lift capital controls.

Finally, in order to better cope with external shocks following WTO entry, China is already in transition to a managed float from its current, de facto peg. International experience suggests a rigid exchange rate regime may be unsustainable under a system of free capital mobility. Flexible exchange rates and prudent monetary and fiscal policies will sharply reduce the risk of currency and balance of payments crises frequently observed in countries with an open capital account. China's shift to a more flexible exchange rate regime will therefore likely facilitate capital account liberalization.

Conclusion

China's accession to the WTO will significantly liberalize trade in goods and services between China and the rest of the world, boost trade and financial flows, and increase the integration with the global

economy. As such, WTO membership will impose severe pressures on China's current system of capital controls, sharply curtailing the effectiveness of such controls. A freely convertible current account will accentuate the tensions between increased trade openness and continued restrictions on capital movements. Meanwhile, accelerating SOE privatization, pension reform, and development of the IT industry and of the Western region will increase the demand for both FDI and portfolio investment, hence providing strong impetus for significant relaxation of capital controls. Capital liberalization will become a natural extension of the country's domestic reform process. China's relatively strong balance of payments position, progress in domestic financial reforms, and the shift to a more flexible exchange rate regime will also facilitate the process of capital account liberalization.

Capital account liberalization, however, is unlikely to take place in a big bang. Rather, it will be phased in over an extended period that will likely last about five years. Nor will liberalization occur across all types of capital flows simultaneously. It will likely start with inward FDI, then outward FDI, then inward portfolio investment, then foreign borrowings, and finally extend to outward portfolio investment by residents.

While China's bid to join the WTO is unrelated to capital account convertibility, its imminent membership in the WTO has brought that issue to the fore. Accession to the WTO provides both pressures and incentives for China to liberalize the capital account sooner rather than later, despite the fact that the recent Asian crisis has made the Chinese leadership more cautious toward capital flows. In light of the lessons from the Asian crisis, Chinese policymakers will likely pay close attention to the sequencing of domestic financial sector reform and capital account liberalization. Without material progress in financial reforms, it would be premature to introduce full capital account convertibility. There also will be emphasis on monetary and exchange regimes conducive to free capital movements. In that regard, China has already begun its shift toward a more flexible exchange rate system to better cope with volatile capital flows and external shocks after entering the WTO.

The sweeping trade reforms China will undertake following WTO accession and the sooner than expected capital account liberalization will bring massive benefits to the Chinese economy—facilitating economic reform, improving efficiency, and boosting productivity and long-run growth. Clearly, a more liberal trade and investment regime in China will also have a significant positive impact on the global economy.

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