In recent years, there has been considerable discussion of the impact of globalization on the Chinese economy. The consequence of China’s entry to the World Trade Organization for capital mobility and exchange rates is a key issue. China’s controlled capital account system, although not fully effective, has helped the authorities conduct independent monetary policy, preserved public confidence in the domestic financial system, and served as a firewall during the Asian financial crisis. However, with Asian economies coming out of crisis, China’s economy posting a strong recovery, and accession to the WTO a certainty, financial liberalization and capital account convertibility have been placed back on the agenda.

The strengthening of market forces has important implications for macroeconomic policy management in general, and for monetary and exchange policy in particular. Domestic reform and deregulation lead to greater external openness, while external liberalization reinforces domestic reform and deregulation. In liberalizing cross-border capital movements, the links between the Chinese economy and the international economy will be tightened, thus accelerating China’s globalization process, with its embedded risks and opportunities. A set of closely associated questions about prudential norms, the regulatory framework, information disclosure, accounting standards, and risk management need to be addressed. The collapse of the Guangdong International Trust and Investment Company (GITIC) and other ITICs are sobering examples of the importance of prudent management of cross-border financing. Furthermore, opening the capital account in China requires addressing a number of pressing economic policy issues.
Improving the Allocation of Capital

China must build an effective channel to allow domestic savings to become productive investments. In recent years, China has suffered what appears to be a problem of oversaving, despite the fact that interest rates on deposit accounts were at historical lows. As in Japan, the return on capital is very unattractive. Under the current closed economic regime, the authorities are able to keep interest rates at a very low level and finance structural reform at a minimal cost. However, once the capital account is liberalized, free capital mobility abroad will be permitted so that excess domestic savings will be able to flow overseas and earn a higher return.

China’s oversaving problem is complicated. Many areas and projects are starved of capital and the rate of unemployment is at an historic high of about 8 percent. Therefore, the problem of a serious misallocation of capital has arisen due to the lack of any proper channel to mobilize savings into profitable investments and the absence of an environment and legal framework to foster private investment. Those problems must be put right before liberalizing the capital account.

Challenges for Monetary Policy

The second policy issue China must face is to establish a sensible interest rate policy. Under a closed economic regime, interest rates are an important policy tool to balance the demand and supply of domestic capital. When capital controls are lifted, the setting of interest rates will be subject to a further constraint—external consideration—to balance both the national and international economies. The interest rate differential between countries will be a major driving force behind any cross-border movement of capital.

One lesson of the Chinese economy in the mid-1990s must not be ignored. In 1994, official one-year deposit rates in China eclipsed 11 percent (nonofficial rates reached over 20 percent)—about 7 percent higher than in the United States. China’s foreign reserves increased by $30.4 billion, a 143 percent rise over 1993. However, the trade surplus for the year was $5.2 billion and utilized foreign direct investment was $33.8 billion, about half of which was in physical form (e.g., machines and equipment).

As can be seen, about $8 billion of the increase in official foreign reserves has not had any proper source. According to some sources, the real size of capital inflows entering the country without following the proper procedure during that period was much larger. The ob-
vious reason for that high volume of capital inflow was arbitrage, taking advantage of high interest rates or leaving money in the bank as collateral to borrow renminbi and earn hard currency interest. That large capital inflow, in part, resulted in a dramatic expansion in broad money and triggered hyperinflation of 24 percent in 1994. All of that happened when capital controls were more or less in place. When the capital account is opened, that sort of situation could be much more severe if proper control measures are not in place.

To take the point further, external complications could present policymakers with a serious dilemma. A typical scenario is the one that hit Asia during the economic crisis in 1997–98. Countries faced the dilemma of needing to lower interest rates to provide liquidity to troubled corporations. But in order to defend the currency and restore external balances, interest rates had to be kept at unprecedented high levels. The inevitable result was to prolong recession. The only exception was Malaysia where capital controls were reinstated, blocking capital from leaving the country and enabling interest rates to come down to a much more comfortable level. As a result, Malaysia was the first country to emerge from the crisis. But the capital controls have come back to haunt Malaysia—they turned out to be only a short-run palliative.

In brief, opening up the capital account would pose new challenges to the authorities in conducting monetary policy. The Chinese government is already planning to liberalize interest rates and introduce competition into the banking sector.

The Exchange Rate

Under a liberal economic regime, another important economic policy concerns the exchange rate. A necessity of achieving capital mobility is to have a more flexible exchange rate regime. Since 1994, China has imposed a rule that requires domestic firms to sell any hard currency they earn to designated state-owned commercial banks. The central People’s Bank of China (PBOC) imposes a quota on each commercial bank’s hard currency balance. When the hard currency balance is below or above the quota, the PBOC requires the commercial banks to take action to return hard currency holdings to the quota level through either interbank operations or the swap market.

From time to time, the PBOC has to step into the foreign exchange market to intervene in order to maintain the renminbi exchange rate’s stability. In recent years, there has been a large surplus in China’s balance of payments. Without the PBOC’s intervention, the renminbi would have appreciated much more. In China those interventions
cannot be sterilized easily, resulting in the augmentation of domestic money in circulation and the rising pressure of inflation.

There are indications that China has begun its transition to a managed float regime. It has been suggested that after China’s WTO entry, the country needs a flexible exchange rate to respond to increasing capital mobility. By allowing foreign companies to take over state-owned enterprises (SOEs) and open up many previously closed sectors such as telecommunications and the financial sector, and by permitting offshore funds to enter the domestic capital market by investing in A-shares and other offerings, China will inevitably experience a significantly increased inflow of capital. Under the circumstances, a more flexible exchange rate regime would be required to avoid real exchange rate appreciation and to achieve domestic monetary objectives.

Fiscal Policy

Once the capital account is opened and the foreign exchange value of the renminbi (RMB) is more flexible, achieving internal and external balance will become more challenging. Using Mundell’s assignment rule as a guide, China’s fiscal position would ideally be sufficiently robust to cushion negative external shocks to nonmonetary economic objectives, especially to the goal of full employment.

Making the RMB fully convertible and letting it float will mean that the People’s Bank of China will be constrained in its approach to monetary policy. As opposed to simply ensuring internal stability, monetary policy will shift to both the internal and external balances. While a floating exchange rate should address the external balance, many countries use interest rates as a tool to “manage” their exchange rate. A stable exchange rate would be extremely beneficial for China since its economy depends greatly on foreign trade and capital inflows.

Fiscal policy should be used in tandem with monetary policy to maintain full employment. To serve as a policy tool, China’s fiscal position must be improved. Although the country’s fiscal deficit is less than 3 percent of GDP, much needs to be done. China’s fiscal revenue last year was 14.2 percent of GDP, compared with some 40 percent in developed countries. Those revenues are insufficient to deal with the nonperforming loans of state banks, estimated to be at least 35 percent of all loans, and to meet the needs of the social security system. In sum, prior to capital account liberalization, China needs to have a more robust fiscal position.
Financial Policy

China’s financial sector needs to be further reformed and improved. With a weak financial system, both the pace of capital account liberalization and the design of prudential measures become more complex. Local financial institutions have limited ability to assess and manage risks associated with large capital inflows, and regulatory authorities have limited experience and capacity. For prudential purposes, China should develop a healthy financial system that includes financial institutions, a transparent capital market, and modern financial products before the capital account can be properly opened. In the early stages, China may have to adopt crudely designed measures to achieve legitimate prudential objectives, and those measures may have a restrictive impact on capital flows.

Particular attention will have to be paid to strengthening the banking sector. In many developing countries, banks are the major financial intermediaries for capital flows, thus becoming the most vulnerable part of the chain. For example, Thailand witnessed a large capital inflow before the Asian crisis, with the banking sector’s net external debt rising from 4 percent of GDP in 1988 to 20 percent in 1994. When the banks were flooded with liquidity, they lent money to borrowers with low credit ratings, or to speculators who participated in such activities as investing in property. Those loans dramatically increased the credit risk. Using the case of Thailand again, lending to the property sector took 30 percent of the total bank loans in 1996. When the economic boom started to cool, the riskier clients and sectors cracked first and immediately dragged the banks into trouble.

A related issue is that bank interest rates and credit policy can have a strong influence on capital flows. For example, wide deposit-lending spreads encourage firms to borrow overseas, just as underpricing of credit and maturity transformation risks may distort the yield curve. In China in 1994, the nominal lending rate fell below the inflation rate by about 10 percentage points, resulting in excessive borrowing by companies and an overheated economy. Situations like that would drive weak banks to expand their balance sheets and lead to a banking crisis.

To prevent those problems, more direct measures may need to be undertaken, such as placing limits on overseas borrowing by banks. More fundamentally, China needs to adopt an international standard of corporate accounting and timely disclosure of information. It is vital that systematic weakness be corrected, appropriate supervisory...
standards adopted, and concerns about moral hazard addressed before banks and corporations can access foreign finance.

**Conclusion**

Freeing up capital mobility will have benefits as well as costs, as the recent experiences of the Asian economies have demonstrated. Some of the economies experienced a long period of rapid growth, to some extent fueled by growing foreign capital inflows. At the same time, the flows were further attracted by strong economic performance. But then policy inconsistencies, institutional weakness (including a pegged exchange rate regime), and cyclical fluctuations surfaced and prompted an abrupt reversal in capital flows and economic hardship.

The key for the Chinese authorities is to be aware, before adopting such liberalization, that there will be a progressive divergence between political and economic boundaries once the process is started. The resulting cross-border externalities and spillovers will reduce both the scope and the effectiveness of government economic policy, autonomy, and power over economic activity. Therefore, there must be a gradual and orderly process that enables a lot of necessary measures and steps to be taken in a timely fashion. Failure to recognize this requirement will put China at great risk.