China’s Capital Account Liberalization: A ruby jubilee & beyond

Yanliang Miao & Tuo Deng
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Outline of Chapter

- Three debates that shaped China’s capital account liberalization
- Lessons learned: the good, the bad, and the “ugly”
- China’s capital account policy, through the lens of the three debates
Three Debates
1. How open is China’s capital account? What remains to be done?

- **De jure openness**: mixed
  - Chinn-Ito: *unchanged* since 1993!
  - Quinn: improving, but trails average EME

- **De facto openness**: substantially improved, but not complete
  - IIP: fast growing
  - Capital account: increasingly volatile
  - Long-term bond yields: co-moving
  - Incompleteness: portfolio flows remain scheme-based

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**De jure openness: Chinn-Ito vs. Quinn**

**De facto openness: China’s IIP (Tln. $)**

Source: Chinn & Ito, IMF AREAER.

Source: IMF.
## China’s IIP

### China's International Investment Position (Bil. $)

<table>
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### Assets

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<th>FDI</th>
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### Reserve Assets

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### FX Reserves

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### Liabilities

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</tr>
</tbody>
</table>
De facto openness cont’d

Composition of net capital flows (Bil. $)

10-year bond yields: China vs. US

Source: SAFE.

Source: Chinabond, Federal Reserve Board.
What remains to be done?

- **IMF’s AREAER**
  - Glass-half-empty: 80% types of capital transactions are subject to some control (Schipke 2017)
    - Least restricted transactions: FDI, ODI
  - Glass-half-full: 90% types are at least partially convertible (PBOC 2017)
    - 3 types of unconvertible transactions: foreigners’ equity & money market issuance in domestic markets, derivative transactions

- **Portfolio investment: low foreign penetration**
  - Foreigners hold 0.4% of China’s credit bonds, and 2% of A-shares

- **Individual investors: limited ways of investing abroad**
  - Available: QDII funds and Stock Connects
  - QDII2: under study since 2013, almost launched in 2015
  - Overseas insurance and home purchases still restricted

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**China’s capital account convertibility according to IMF’s AREAER classifications**

<table>
<thead>
<tr>
<th>Convertibility</th>
<th>2012</th>
<th>2016</th>
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<tbody>
<tr>
<td>Unconvertible</td>
<td>6</td>
<td>3</td>
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<tr>
<td>Partially convertible</td>
<td>19</td>
<td>20</td>
</tr>
<tr>
<td>Mostly convertible</td>
<td>8</td>
<td>9</td>
</tr>
<tr>
<td>Convertible</td>
<td>7</td>
<td>8</td>
</tr>
</tbody>
</table>

2. How committed is China to opening its capital account?

- Official: vocal commitments

- Skepticisms:
  - Deliberate slowdown, to resist inflows and keep RMB undervalued (Jeanne, Subramanian & Williamson 2011)
  - Tightening of controls in 2015-2016 reflects lack of commitment (Wharton 2016)
  - Fear of a massive capital flight and its stress on financial system (Yu 2017)
3. Is China ready to liberalize its capital account further, and how?

- **Cautions:**
  - Many preconditions have not been met (Lardy & Douglass 2011, Yu 2015)
  - External environment is not friendly (Zhang 2015)
  - Possible side effects (Zhang 2015)

- **Optimism:**
  - China’s financial system is becoming more robust (Sheng, Xu, Yan & Zhu 2012)

- **Subtle changes in policymakers’ view:**
  - Early 2010s: optimistic
    - PBOC’s proposition of studying of QDII2 in 2013
    - 3rd Plenary Meeting of the 18th CPC Central Committee: accelerating capital account convertibility
  - 2015-2016: cautious, focusing on risk
  - Since 2017: cautiously optimistic
    - Pan (2017): “The pace of capital account liberalization should be consistent with a country’s economic development, financial market and financial stability, and external conditions.”
Lessons Learned
The good: pick the right sequence, and proceed gradually

- Open up to FDI flows first
  - Long-term, stable, low financial risk
  - Brings in technological & managerial know-how

- Gradualism
  - FDI: pilot programs in the 1980s before fully embracing it
  - Portfolio: gradually raise the quotas of Q schemes, then introduce C schemes (no individual quotas)

### Capital inflows by type, 1982-2000 (Bil. $)

- **Source:** SAFE.

### Approved quotas of “Q” schemes

- **Source:** SAFE.
The bad: unevenly paced capital flow management reform

- Capital flow management reform has undergone a philosophical change since 2009
  - *Ex ante* review & approval → *ex post* monitoring & analysis
  - Positive list → negative list

- Why skepticism remains?
  - Reform focuses on *micro-level management*
  - *Macroprudential* framework has been slow to develop and implement
  - Result: continued reliance on administrative tools and discretion
  - 2015-2016: tightening of *de facto* outflow controls (without changing the rules)
  - Market impression: still discriminative, time-inconsistent, and opaque
The “ugly”: distorted financial system & inflexible exchange rate

- 2008-2013: sharp carry trade inflows
  - Financial misallocation at home: high marginal rate for private borrowers, hence large home-abroad interest gap (Song, Storesletten & Zilibotti 2011)
  - Overseas borrowing relaxed: sharp carry trade inflows
  - Amplification by inflexible exchange rate

- 2014-2016: carry trade unwinding
  - RMB became overvalued
  - Forced deleveraging of overseas debt by domestic enterprises
  - Sharp other investment and E&O outflows

Source: SAFE.
The great capital reversal

<table>
<thead>
<tr>
<th>The Great Capital Reversal (Bil. $)</th>
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<tbody>
<tr>
<td><strong>2008</strong></td>
</tr>
<tr>
<td>(in % GDP)</td>
</tr>
<tr>
<td>(in % GDP)</td>
</tr>
<tr>
<td>Δ Reserve Assets</td>
</tr>
<tr>
<td>(1+2+3)</td>
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FX Reserves
Overseas borrowing by Chinese corporates

- As the interest differential widened from 2008-2014, overseas borrowing by Chinese corporates totaled $1.1 trillion
- Since 2015, interest differential narrowed, causing the sharp external deleveraging

The August 11, 2015 exchange rate reform

- It was in fact long overdue
  - Greater exchange rate flexibility: could have dampened carry trade inflows *ex ante*, or reduce the loss of FX reserves by letting RMB fall

- In practice, China relied on FX reserves to counterbalance outflows

- A dangerous vicious cycle kicked in, costing $1 trillion in 18 months
  - Asymmetry: FX reserves can go up without limit, but are bounded from below at 0, at which the central bank is powerless in maintaining exchange rate
  - Market view FX reserves as the barometer of China’s financial strength (Miao 2018)
  - FX reserves fall → market worry more → FX reserves fall even further → …

中国外汇储备和USDCNY汇率

源：SAFE
China’s Capital Account Policy: Recent Developments
Opening up further: direct & collateral benefits

- Direct benefit: capital account liberalization as an end in itself
  - Open capital account offers better benefit-risk tradeoff for DMs than for EMs
  - “Threshold” effect: opening-up may be increasingly favorable for China over time (Kose, Prasad & Taylor 2009, Wei 2018)

- “Collateral” benefits: to other key reforms (Kose, Prasad, Rogoff & Wei 2009)
  - “Ratchet effect”: commitment device for domestic financial reforms (Zhou 2017)
  - Accommodate RMB’s internationalization
    - RMB’s inclusion in the SDR basket in 2015: China’s capital account opening-up has passed the point of no return (Zhou 2017)
Upgrading capital flow management: the dual pillars (Pan 2018)

- **Microprudential** regulation: even-handed & time-consistent
  - Focus: authenticity & legality of individual transactions
  - Equal & time-consistent treatments, regardless of type, direction, and timing

- **Macroprudential** regulation: targeted & countercyclical
  - Focus: overall financial stability
  - Targeting flows with the most threat: short-term, lending-related flows
  - Pre-emptive enforcement during inflow booms

- Macroprudential regulation complements FX reserves in capital account stabilization
  - Before exchange rate becomes sufficiently flexible, macroprudential regulation is even more important
Coordinating the reforms: a troika approach (Zhou 2017, Yi 2018)

- In theory: many views
  - The preconditions view
  - The sequencing view
  - The stability view

- In practice, the “troika” approach
  - Idea: pushing the backmarker forward to catch up others, so that all reforms gradually march ahead
  - Coordinating
    - Domestic financial reform: interest rate liberalization and beyond
    - Capital account liberalization
    - Exchange rate flexibility
  - Political economy
    - Helps to resolve bureaucratic deadlocks
    - Avoids rollbacks

- The built-in gradualism and opportunism
  - No preset schedules
  - Proceed faster under more favorable conditions
Adding up: China’s path on the Impossible Trinity

- From O → A: many possible paths
  - More aggressive: (c)
  - More conservative: (b) or (a)


中国路径的不可能三角模型

- 从O到A：许多可能的路径
  - 更加激进的：(c)
  - 更为保守的：(b)或(a)

资料来源：Miao & Tan (2018)。
Conclusion

- Substantial capital account liberalization in the past four decades

- Incomplete efforts: portfolio flows still somewhat restricted

- Good, bad & ugly lessons

- Going forward: committed to financial opening-up, with three principles (Yi 2018)
  - Pre-establishment national treatment + negative lists for foreign institutions
  - Coordinating capital account opening-up with financial and exchange rate reforms
  - Matching the degree of opening-up with regulatory capabilities

- The goal: a near-fully convertible capital account + flexible exchange rate + monetary autonomy
Thank you!