



中央财经大学 金融学院

Central University of Finance and Economics School of Finance

# Should China Accelerate Liberalization of Capital Account?

**Liqing Zhang**

**Professor and Dean  
Central University of Finance and Economics**

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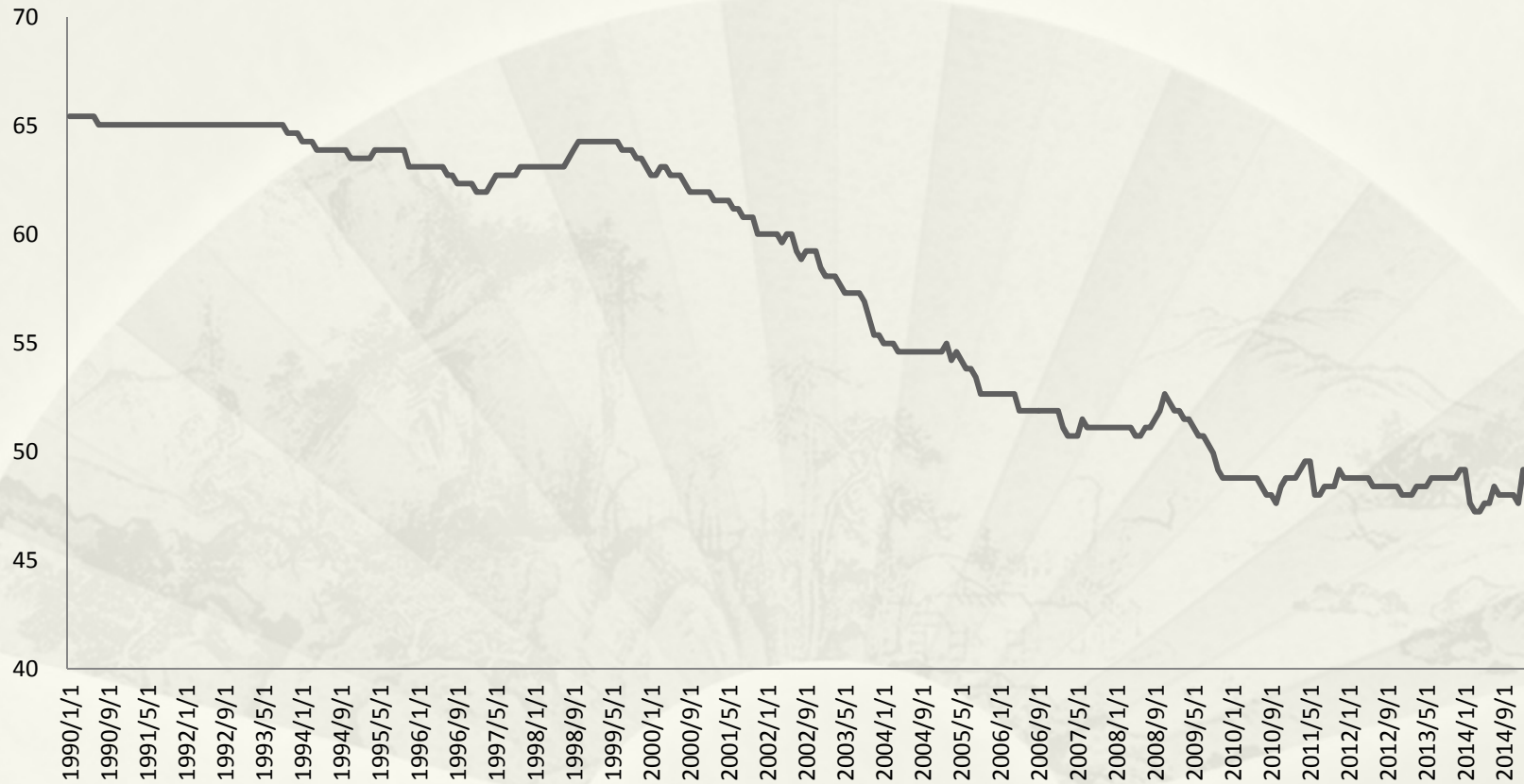


## 1. An Overview of China's Capital Account Liberalization

- \* China started to liberalize its capital account early this century. Over the past one and half decades, significant progress has been made.
- \* According to AREAER, among 40 items,
  - 14 items (35%) have been basically liberalized;
  - 23 items (57.5%) have been partially liberalized;
  - 3 items (7.5%) remain strictly restricted, mainly related to the controls on capital and money market instruments, and controls on derivatives and other instruments.
- \* Basically, restrictions on capital outflows are more than on capital inflows.



### China's Capital Control Index (de jure): 1990-2014 (Sept.)



Source: China SAFE.



## \* Some new developments in recent years:

- Revision of ***Foreign Investment Law*** (early this year): prior approval by the government has been removed, while reporting and monitoring is strengthened.
- The quota of QFII and QDII was increased after 2012. By June 29, 2015, QFII is USD 75.5 billion, and QDII is USD 90 billion.
- Launch of RQFII. By June 29, the quota is CNY 390 billion.
- Launch of Shanghai-Hong Kong Stock Connect program. A cross-border investment quota of CNY 550 billion is set.
- Foreign central banks, international organizations and sovereign funds are allowed to purchase bonds in inter-bank bond market.



## 2. Whether China should accelerate its CAL, mainly the further opening of capital market?

### Two Schools

- ◆ Some believe the timing for accelerating has come and China should fully liberalize its CA with 3-5 years or before 2020 ;
  - More reasons: (1) to help RMBI; (2) to reduce the BOP surplus; (3) to force domestic reform;.....
- ◆ Some believe that China needs more time to reach the goal, at least more than a decade, for avoiding financial risks and other problems.



## **Five Reasons for More Cautiousness in the Coming Five Years**

- ◆ First, fully liberalizing CA before the completion of domestic financial reform may cause serious financial risks.
  - We did a simulation study to find out the risks of different reform sequence. There two scenario conclusions: (1) China is likely to experience a financial crisis on a probability of 14.2% during 2016 to 2020, if it fully liberalizes CA in 2015 in the absence of sufficient domestic financial sector reform, especially bank reform. (2) Gradual reform of CA combined with advanced domestic financial reforms will reduces the probability of crisis to 5.66% during 2016 to 2020. (Zhang and Gou, 2015)



- ◆ Second, according to *Impossible Trinity* approach, the fully liberalizing CA before the completion of exchange rate regime will significantly reduce the independence of PBOC's monetary policy, which is very important to China, the second largest economy in the world. In addition, with the inflexible exchange rate regime, fully removal of capital control will cause severe currency speculation (carried trade).



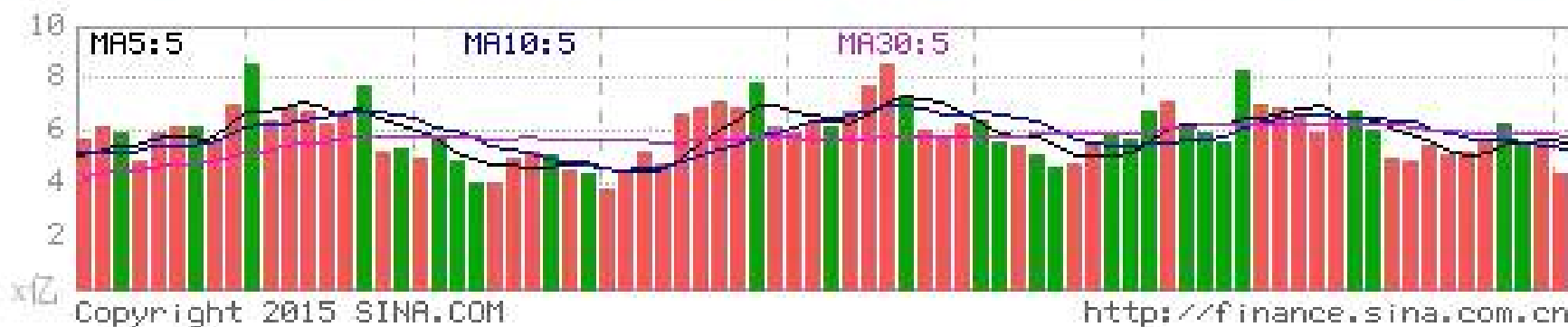
- ◆ Third, full liberalization of CA may cause serious financial risks if financial regulation is not adequate.
  - Within three weeks after mid of June 2015, the Shanghai stock index declined by more than 30%, some stocks over 50%, triggering a big crash. The chaos demonstrates that China's financial regulations are inadequate and immature.
  - Fortunately, there are limited foreign investment involved due to the strict restriction on cross-border capital flows in China's stock market. Otherwise, RMB may greatly depreciate.





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- ◆ Fourth, the full liberalization of CA may cause more market distortion if prices of key resources or production factors, including land, labor and natural resources, are strictly controlled by the government. If the domestic markets are distorted, CAL may become a new source of the over-capacity in some sectors, since investors may be guided by wrong price signal and make wrong decision.



- ◆ Fifth, the slowdown of the economic growth (structurally and cyclically), the continuous recovery of US economy and the expectation of the Fed's tapering of QE have caused capital outflow since the mid of 2014. The foreign exchange reserves has dropped USD 300 billion over the past year. Under such a circumstance, quick removal of the remaining capital control is very likely to trigger massive capital flight and eventually the serious instability of the Chinese economy.



***An interesting issue: whether China's partial liberalization of CA can facilitate the ongoing RMBI?***

**The answer is yes.**

- ◆ RMBI is determined by three factors: **size, liquidity and credibility**. CA mainly affects the **liquidity** of holding RMB denominated financial asset. Partially control (i.e. authorized inflows and outflows) only reduces the liquidity to some degree, not fully. Meanwhile, reckless opening may greatly hurt the **credibility** and even **size** if financial crisis happened.



- ◆ The US dollar's experience in 1950s till 1970s shows that offshore markets may play an important role when onshore market is not fully liberalized. So, RMBI may continue to develop through offshore markets (including special accounts in Free Trade Zone set in Shanghai and other cities).
- ◆ As to join the SDR basket, “freely used currency” should not be interpreted as “fully convertible currency”.



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Thanks!