

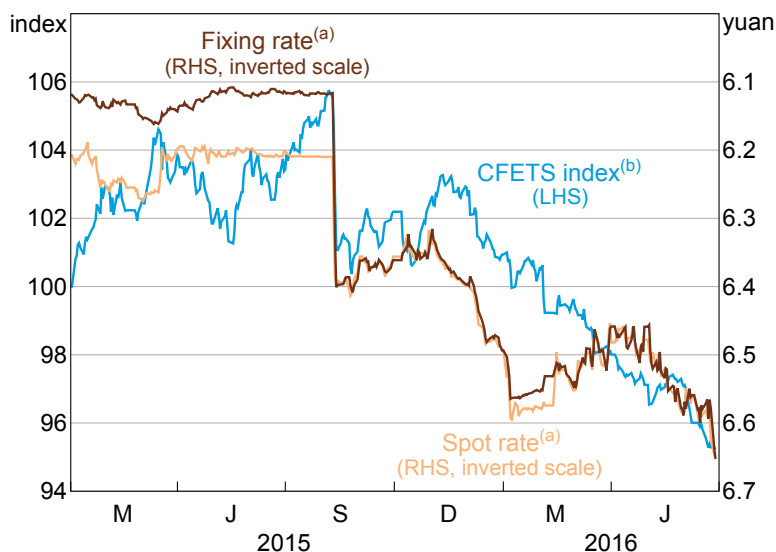
Capital Account Liberalisation and China's Effect on Global Capital Flows

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1. Introduction

In 1993, China announced a plan to fully liberalise its capital account by 2000. That plan was, however, disrupted by the Asian financial crisis. China's capital account liberalisation process has resumed over the past few years, raising the question about the sequencing of capital account liberalisation. The debate gained prominence following the renminbi depreciation in August 2015 and subsequent capital outflow pressures (Figures 1 and 2). This paper provides a brief overview of China's capital account liberalisation, evaluates the effect of a full liberalisation of the Chinese capital account and describes how China's liberalisation process compares with the International Monetary Fund's (IMF) institutional view.

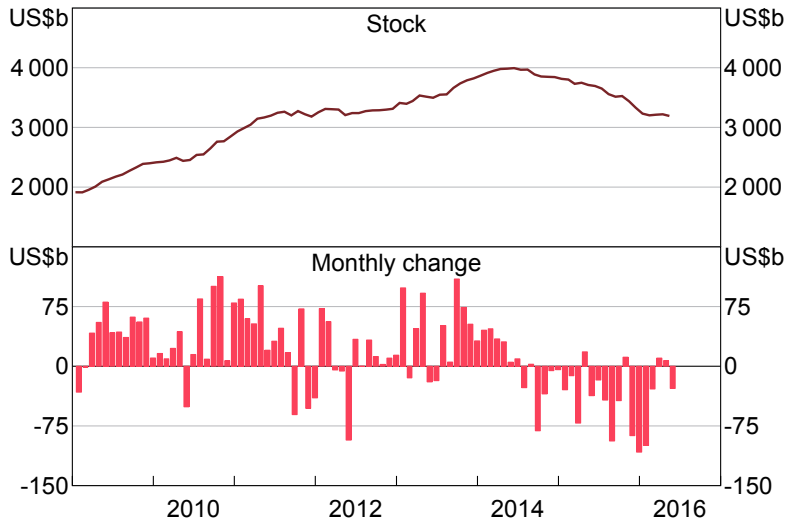
Figure 1: Chinese Renminbi



Notes: (a) Yuan per US\$
(b) 31 December 2014 = 100

Sources: Bloomberg; CEIC Data; China Foreign Exchange Trade System; RBA

* The author is from the IMF. The views expressed here are those of the author and do not necessarily represent the views of the IMF or those of its Executive Board. This paper is based on Bayoumi and Ohnsorge (2013) and Habermeier *et al* (forthcoming).

Figure 2: Foreign Currency Reserves

Sources: CEIC Data; RBA

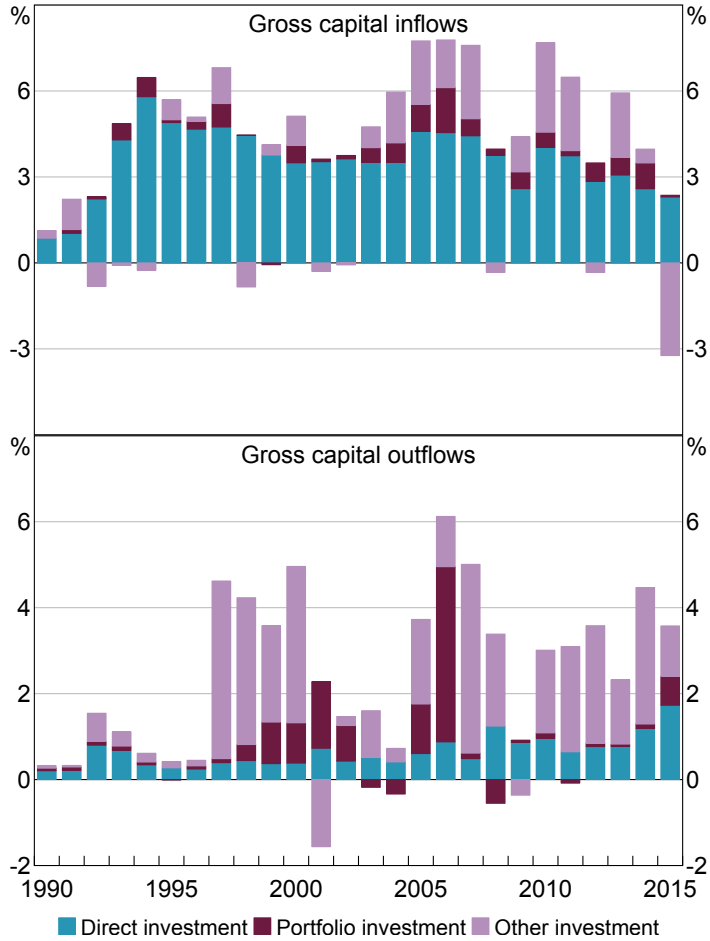
2. Capital Account Liberalisation in China

China has gradually opened its capital account, but considerable restrictions on capital flows remain in place. According to the IMF *Annual Report on Exchange Arrangements and Exchange Restrictions*, 52 out of the 58 items still have some degree of control (IMF 2015).¹ The different types of private capital flows – direct, portfolio investment and other – have been liberalised at different rates and restrictions on inflows have generally been eased before those on outflows. Despite formal restrictions, leakages have increased.

Foreign direct investment (FDI) has dominated capital inflows to China, in part because they have been less restricted than other forms of capital flows (Figure 3). The size of other flows, which are mainly banking related, have increased in recent years and have been a particularly important component of capital outflows. By comparison, portfolio investments remain limited, reflecting greater restrictions on these flows. While portfolio investors have generally been restricted by various schemes, the allowable quotas for these schemes have been gradually relaxed (Table 1).

¹ China's State Administration of Foreign Exchange (SAFE) measures suggest that, of the 40 items in the capital account, 5 are unconvertible and 18 are partly convertible.

Figure 3: Capital Inflows and Outflows
Per cent of GDP



Notes: Gross inflows are defined as the sum of inward foreign direct investment, portfolio liabilities and other investment liabilities in the balance of payments statistics; gross outflows are defined as the sum of outward foreign direct investment, portfolio assets and other investment assets

Source: Thomson Reuters

Table 1: Summary of China's Schemes to Ease Controls on Portfolio Investments

Scheme	Target flows	Start year	Quota limit	Total quotas allotted	Cap on individual quota	Cap on total quotas	Minimum investment required	Currency
QDII	Portfolio outflow	2006	Yes	US\$90b	No	No	No	Any
QFII	Portfolio inflow	2002	Yes	US\$79b	US\$1b	US\$150b	US\$2m	Any
RQFII	Portfolio inflow	2011	Yes	CNY412b	No	No	No	CNY
SHKSC ^(a)								
Southbound	Equity outflow	2014	No ^(b)	na	No	CNY250b ^(b)	CNY0.5m	CNY
Northbound	Equity inflow	2014	No ^(b)	na	No	CNY300b ^(b)	No	CNY

Notes: QDII denotes Qualified Domestic Institutional Investor, QFII denotes Qualified Foreign Institutional Investor and RQFII denotes renminbi QFII

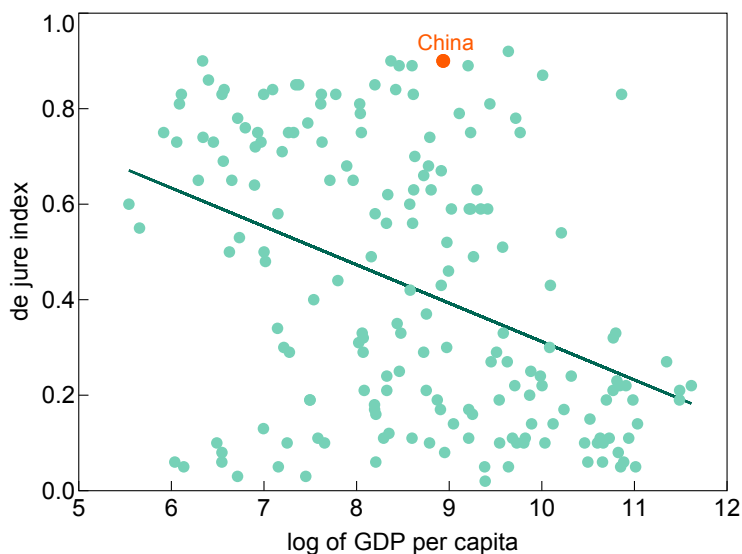
(a) Southbound refers to investment flows from Shanghai (mainland) to Hong Kong SAR, northbound refers to investment flows from Hong Kong SAR to Shanghai (mainland)

(b) Though Shanghai–Hong Kong Stock Connect (SHKSC) investors are not subject to individual quota limits, they are subject to a daily limit and an aggregate quota on total flows; net southbound flows are capped at CNY10.5 billion per day and net northbound flows are capped at CNY15 billion per day

Source: IMF

To gauge the direction of future reforms, it is useful to consider where China stands relative to other economies. Internationally, higher income per capita tends to be associated with a more open capital account (Figure 4). China appears to be an outlier, with a more closed capital account than other countries that have a similar income per capita. Similarly, China has a low level of integration with the global financial system (as measured by the sum of its external assets and liabilities as a share of GDP) given its per capita income. This could suggest that China is likely to become more open and financially integrated with the global economy in the coming years.

Figure 4: De Jure Financial Account Restrictiveness and Income Level



Notes: 185 IMF member countries, including their territories where data are available; data as at 2014 or latest available
Sources: IMF; World Bank, World Development Indicators

3. Recent Developments

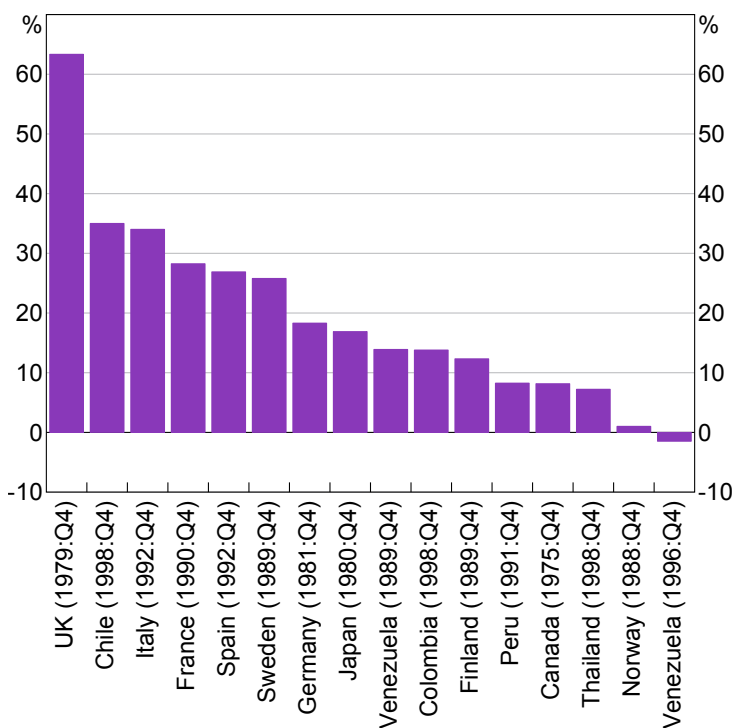
The volatility in foreign exchange markets, capital outflows and the associated decline in foreign currency reserves in late 2015/early 2016 prompted the Chinese authorities to better enforce existing capital account controls and impose some additional measures (such as the 20 per cent unremunerated reserve requirement (URR)).

Nevertheless, the authorities remain committed to capital account liberalisation and the process has continued to move forward. In February 2016, the quota for individual institutions to invest under the QFII program was relaxed and the minimum investment period was reduced from one year to three months (SAFE 2016). Also in early 2016, access to the interbank bond market was expanded for international investors (PBC 2016).

4. Implications of Full Liberalisation

Given that parts of the capital account remain closed, the question arises of what would be the impact of fully opening the capital account in one go. The size and direction of those capital flows could have important implications domestically and internationally. In the past, countries that liberalised their capital account generally experienced a significant increase in both inward and outward capital flows (Figure 5). However, with a few exceptions, outflows were larger than inflows as domestic investors sought to diversify their savings.

Figure 5: Change in Gross International Assets
Five years following capital account liberalisation, per cent of GDP



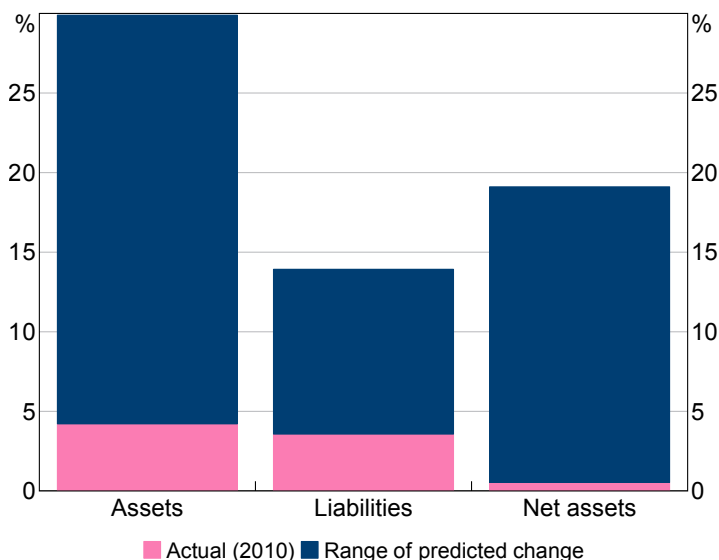
Source: Thomson Reuters

For China, for example, Bayoumi and Ohnsorge (2013) use a portfolio allocation model and data from countries that liberalised their capital account over the past 30 years to estimate the size of capital flows following liberalisation. The authors use a partial equilibrium model that does not take into account other changes in the macroeconomic environment that would occur if the capital account were to be fully opened in one step. Nevertheless, the model's estimates provide a useful starting point to think about what to expect following capital account liberalisation in China. Based on this exercise, capital account liberalisation may be followed by a one-time stock adjustment of Chinese assets of 15–25 per cent of GDP and a smaller adjustment for foreign assets in China (2–10 per cent of GDP; Figure 6). This would imply a net capital outflow of around

11–18 per cent of GDP. He *et al* (2012) and Saadi Sedik and Sun (2012) come to similar results, estimating that net capital outflows would occur following capital account liberalisation in China.

Figure 6: Predicted Impact of Capital Account Liberalisation on China's International Portfolio Assets and Liabilities

Per cent of GDP



Note: Portfolio assets and liabilities exclude official reserve assets
Source: Bayoumi and Ohnsorge (2013)

5. A Roadmap for Further Capital Account Liberalisation

To date, the sequencing of China's capital account liberalisation has been broadly in line with the IMF's institutional view (IMF 2012) (Figure 7). The liberalisation process has proceeded gradually. China initially implemented quotas focused on specific investor groups with experiments in certain parts of the country and over time these experiments have been expanded. Going forward it would be good to move from quantity-based to price-based restrictions (e.g. Nishizawa 2016).

The process of capital account liberalisation should occur alongside supporting reforms, including reforms to the domestic financial sector. For China, this would involve the ongoing modernisation of the monetary policy framework, imposing hard budget constraints and state-owned enterprise (SOE) reform. Because none of these goals are easily defined, it is difficult to determine the optimal timing of further capital account liberalisation. As a result, further opening up of the capital account is likely to occur gradually and in parallel with other reforms.

Figure 7: Capital Account Opening

Source: IMF

6. Conclusion

China has made considerable progress in opening the capital account in recent years; however, it continues to formally maintain significant capital controls and remains more closed than other economies at a similar level of development. In the future, one would expect China to integrate further into the global financial system.

If China's capital account were to be fully opened, there would be both sizable inflows and outflows. Previous studies suggest that on net there would initially be a capital outflow. In recent years, China has continued to open its capital account and has indicated that its goal is to move toward 'managed convertibility' (Zhou 2015).

So far, China has opened up its capital account in a way that is broadly in line with the IMF institutional view. As this process moves forward, China should move from quantity- to price-based restrictions, and then also from administrative controls to currency-based regulation and supervision. One of the challenges going forward is the increasing difficulty of enforcing the remaining restrictions as the capital account becomes more open and there are more opportunities to circumvent the rules.

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