Discussion

1. Lillian Cheung

I think the presentation provides a good overview of the progress on capital account liberalisation in China so far and offers a sense of likely portfolio investment flows upon further opening.

The key messages I took from the paper were that:

- So far, China's capital flows have been driven by foreign direct investment (FDI) flows and banking flows. Portfolio flows have faced more restrictions, but are also being liberalised gradually.
- The author predicts that net foreign portfolio assets could increase by 11–18 per cent of GDP upon capital account liberalisation, up from 0–1 per cent of GDP in 2010. Both portfolio inflows and outflows are predicted to increase significantly. Additionally, both foreign portfolio assets and liabilities are projected to increase from less than 5 per cent of GDP in 2010 to 15–30 per cent of GDP after the capital account is liberalised. Net outflows from China after liberalisation would have significant global effects.
- Going forward, strengthening the policy framework is necessary to further support capital account liberalisation. For example, further development of capital and liquidity buffers and the micro and macroprudential frameworks would facilitate capital account liberalisation.

I think these are all fair points and I tend to agree with most of them. I will supplement these with some comments on the implications for the resulting international investment position (IIP) in China that are likely to flow from capital account liberalisation.

I would like to focus on the composition of the IIP in China as I believe it provides additional insights beyond those gained from looking at the direction or size of capital flows. To date, the foreign asset position has been dominated by official reserves, whereas outward FDI and portfolio assets are still small. Having said that, the percentage of official reserves among total foreign assets declined from 66.5 per cent in 2008 to 60.8 per cent in 2014. Total foreign liabilities also increased significantly, but mostly through inward FDI, and total liabilities remain smaller than total assets. As a result, the private sector has a net foreign liability position. But because of the huge official reserves, mainland China holds a net foreign asset position with global markets.

Despite having a net foreign asset position, the rate of return on investment from abroad has been lower than the rate of return owing to foreign investors. This is because foreign assets, in the form of official reserves, are mostly invested in foreign government bonds, which have low rates of return. Conversely, foreign liabilities were mostly in the form of inward FDI, which would usually have a high rate of return.

So what would happen if China further liberalised its capital account? Here, I would like to point to a piece of research work that my colleagues and I did on China's capital account liberalisation in 2012 (He *et al* 2012). We found similar results to the current paper. In our work, we projected that

net foreign portfolio assets would increase from 0.6 per cent of GDP in 2010 to around 8 per cent of GDP after China's capital account liberalisation is complete, so it is close to the lower bound of the author's estimate (of 11–18 per cent of GDP).

We projected that both inward and outward portfolio investment would increase. We also expected net portfolio outflows, reflecting relatively faster asset accumulation due to Chinese residents' desire for global portfolio diversification. Our research work also made projections on FDI flows. Given the already large inward FDI position, built up in the past three decades, outward FDI would likely increase by more than inward FDI flows. This would happen as Chinese corporates go abroad, for instance, to facilitate both upgrades along the value chain and to tap overseas markets.

Together such factors would lead to more capital flows coming out of mainland China through direct investment and portfolio investment channels, instead of the current one-way traffic going into mainland China. The result is that the private sector would turn its net liability position into a balanced position and the official sector would reduce its net asset position significantly as a share of GDP. Because of such changes in the composition of the IIP, China would be able to earn higher net investment income from abroad. Overall, we expect China would continue to be a net creditor, with the net foreign asset position as a share of GDP remaining largely stable.

Interestingly, the recent decline in China's foreign exchange reserves is consistent with this shift of foreign asset holdings from the official sector to the private sector. In fact, the recent renminbi (RMB) depreciation and the associated RMB outflows mainly reflected asset-liability rebalancing by mainland residents, rather than cross-border capital outflows by foreign investors.

Over the past few years, the trend of RMB appreciation provided a strong incentive for residents to hold most of their assets in terms of RMB, while Chinese firms increased borrowing in US dollars to benefit from the low interest rates. Now with increased volatility and depreciation expected, mainland residents have been prompted to reallocate their assets by holding more foreign currencies and less RMB. This has been achieved not only by a rebalancing of the portfolio on the asset side, but Chinese corporates have also reduced their foreign currency liabilities by paying off their foreign currency and external debt.

One proxy for the trend of US dollar borrowing by Chinese enterprises is the change in mainland domestic foreign currency bank credit. The latest available data show that the size of outstanding mainland domestic foreign currency bank loans to non-financial enterprises peaked in the March quarter of 2014 and then declined in the second half of the year, following the strengthening of the US dollar (USD). The significant RMB depreciation since late 2015 resulted in another noticeable decline in these borrowings, with the size of outstanding foreign currency loans dropping by another 23 per cent between mid 2015 and January this year. Since the Bank for International Settlements data on external claims and liabilities for all countries are not yet available for the December quarter of 2015, another proxy is the USD loans of Hong Kong banks extended to the non-financial sector of mainland China (excluding loans extended by their mainland subsidiaries), which decreased by about 12 per cent in the second half of 2015.

The listed company data in China also paint a similar picture. For the 52 firms where data for the December quarter of 2015 are available, the size of outstanding USD loans came down by about 45 per cent in the second half of 2015. Meanwhile, mainland Chinese firms listed in Hong Kong

redeemed a total of US$3.4 billion USD bonds before maturity in the December quarter of 2015, which was one of the largest early redemptions of bonds in recent years.

Finally, to illustrate how mainland China can potentially affect capital flows globally, we can make use of Hong Kong as a case in point. Hong Kong's bilateral capital flows with mainland China have increased at a fast pace and have become more balanced across the different types of capital flows. Although direct investment flows still account for most of the cross-border flows, portfolio investment and banking flows have been catching up. Cross-border banking flows have also increased, along with rising mainland-related lending of banks in Hong Kong.

References

He D, L Cheung, W Zhang and T Wu (2012), 'How Would Capital Account Liberalisation Affect China's Capital Flows and the Renminbi Real Exchange Rates?', Hong Kong Institute for Monetary Research Working Paper No 09/2012.

2. General Discussion

Discussion began with questions on the speed and sequencing of financial liberalisation in China. One participant noted that, while Chinese authorities appear to have a preference to take a gradual approach to capital account liberalisation, due to the risks associated with opening up too quickly, there are also costs associated with keeping the capital account closed in terms of distortions to the domestic allocation of capital. On the other hand, several participants questioned whether the liberalisation of the capital account had proceeded too fast relative to the liberalisation of the domestic financial system, thereby increasing domestic risks and volatility.

Alfred Schipke responded by noting that the liberalisation process was largely in line with the IMF institutional view. However, he emphasised that a large amount of the liberalisation process was characterised by experimentation and it was important to pause if required. He highlighted three areas of reform that would be expected to move together: reform of state-owned enterprises (SOEs); financial sector liberalisation; and capital account liberalisation. He noted that financial sector and capital account liberalisation had moved hand in hand, but that SOE reform had progressed at a slower pace. He also stated that there can be beneficial effects from volatility in markets for corporates and policymakers, for example, because it aids the development of hedging practices.

Discussion then turned to the measurement of the openness of the capital account. Several participants suggested that China's capital account was already relatively open. For example, the exchange rate appears to have responded to changes in interest rate differentials since the currency was unpegged in 2010. Along these lines, participants pointed to anecdotes of Chinese investors using cash to buy property in other countries as evidence that the official measures understate capital outflows. Several participants noted that some parts of the capital account have been closed again since August 2015, with both Chinese residents and multinational corporations finding it more difficult to move money offshore. Dr Schipke agreed with participants that the official data only told part of the story. He also emphasised that China is highly integrated into

the global trading system and, with an increasing number of global companies and investment abroad, the ability of authorities to control capital flows is limited since many flows can be hidden.

Other participants discussed possible price-based policy measures which could be implemented by the People's Bank of China (PBC), such as a Tobin tax or unremunerated reserve requirements. One participant noted that these measures could limit the negative effects of short-term capital flows, which recent research has suggested have tended to be driven by market volatility. The participant noted that this contrasts with previous conventional wisdom that short-term capital flows are important in price discovery. Dr Schipke agreed that the movement away from quantity measures to pricing measures are warranted.

Participants also discussed the recent movements in the exchange rate and policy changes by the PBC. One participant questioned whether the recent change to a reference basket of currencies in the PBC's commitment to a basically stable exchange rate was a sustainable approach. In response, Dr Schipke noted it is important to keep in mind that policy is generally not made by a single institution in China. This arrangement typically results in ambiguous statements given for policy changes, although he noted that there had been improvements in communication recently. He also noted that the move to reference a basket of currencies, in addition to the US dollar, is more sustainable. This approach provided the authorities with more flexibility, particularly given the possibility of further tightening of monetary policy in the United States. He also emphasised that the policy of a basically stable currency against a basket of currencies is likely to be an intermediate step, given the long-term goal of an effective flexible exchange rate system.

Other participants asked whether the renminbi is currently at fair value. It was noted that a small depreciation of the renminbi in August 2015 triggered enormous capital outflows and a spike in financial market volatility. Participants suggested this could be interpreted as a policy mistake, an overreaction by the market or as a sign that the currency had been mispriced. Another participant questioned the authorities' focus on managing the exchange rate, rather than domestic interest rates and independent monetary policy.

Several participants focused on the recent decline in China's official foreign currency reserves. One participant questioned whether the PBC is more concerned with the level of reserves or the pace of decline in reserves. Another participant noted that declining official foreign reserves and increasing private foreign assets was consistent with capital account liberalisation. Dr Schipke indicated that the IMF conducts an exercise for many countries to determine the appropriate level of reserves. While this is an estimate, it is lower than the current level of official reserves in China. He also noted that the PBC has indicated that it is not concerned by the decline in reserves, given that it also reflects rebalancing of assets and liabilities by Chinese residents rather than genuine capital outflows.

One participant noted that resident capital outflows were likely to be persistent given the high saving rate in China and benefits of diversification. The participant noted that this may be balanced by continued efforts to attract capital inflows, such as the recent reforms to the bond market and opening up of the equity market. Another participant questioned the effect of the exchange rate on longer-term projections of the net IIP for China.