

Net Positive Non-FDI Capital Inflows in China

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Abstract

1. Since 2002, both the net non-FDI capital inflows and the “error and omission” have turned positive. Reversing the pattern of the last decade. The positive “error and omission”, which usually can explain the most part of the capital inflow volume out of the state supervision, does not give a satisfactory explanation to what happened since 2002. The “double positives” should be partly contributed to the hidden inflow of speculative capital driven by the expectation of RMB appreciation.
2. As non-FDI capital inflow have grow quickly, the government’s failure to stop the tide of speculative capital inflow has been accelerating the accumulation of foreign reserves in China. If this trend continues, China could not be able to sustain the existing peg regime.
3. Though the Chinese leadership has expressed that the exchange rate formation of RMB would be “gradually perfected”, its slow pace to bridge the huge gap between the real market rate and official rate of RMB has strengthened people’s expectation of a stable and well-controlled forex floating mechanism with a band of 5% or less. Unfortunately, this situation would make the capital inflow—both FDI and non-FDI—to China a long-drawn development, which will further make the foreign reserve accumulation a sustained phenomenon.
4. No evidence indicates that the speculative capital or the so-called “hot-money” has been driven mainly by foreign players. Most likely, the repatriation of Chinese offshore capital plays a role; or at least it is the result of money by manoeuvring by the Chinese entities.
5. Despite China imposes a strict control over the capital movement, as a matter of fact, many effective conduits still exist for cross-border capital movement. This is restricted by that the speculative capital inflow caused the unexpected quick accumulation of FX reserves.
6. Facing this problem, the Chinese government has taken some strategy as during Asian crisis, that is to maintain the stability of basic exchange rate long enough in order to make it impossible for speculative capitals with long position to sustain.

- 7. The increasing multiplicity of conduit for the non-FDI capital movement has increased the difficulty of Chinese authorities to regulate financial activities and to control capital flows. Therefore, it has become a central issue under the consideration of Chinese leadership to seek international cooperation and coordination as well as to introduce new measures for monitoring capital flow. For example, these measures may include accrediting the qualified domestic and foreign institutions for supervision.**

- 8. In the past, facing the pressure of RMB depreciation, the Chinese government adopted a policy of “being relaxed on entry and strict on exit” for capital flow. Now facing the serious threat of speculative capital inflow flood and the ensuing appreciation pressure relaxed, close scrutiny over inflow capital will be introduced.**

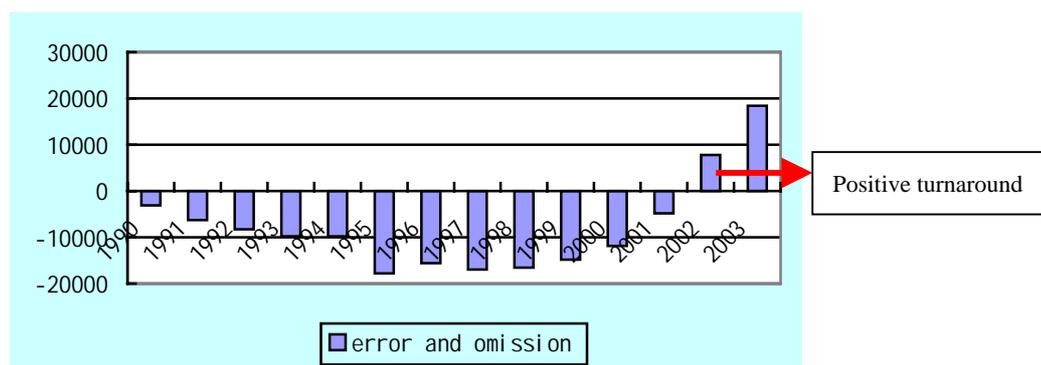
- 9. The approach to managing capital account has gradually shift from rigid control to a more open regulatory system. This shift will proceed under the following guiding principle: the opening-up process will firstly shift with easier items, long-term account, real transactions, and the authorized financial institutions, then it will apply to the more complex items, short-term account and those non-financial institutions.**

1. The Turning Net Positive Non-FDI Capital Flows and “Error and Omission”

Since the last quarter of 2001, according to the monthly data, the negative “error and omission” of China’s balance of payment (BOP), which had been existed at least over ten year, has converted into the positive (Chart 1). It is believed widely that some foreign capital has not been accounted into regular non-FDI capital inflow in state statistics, or out of the supervision of Chinese authorities. The problem is that so far the positive error and omission has been not only continued but also increased quickly even after 2004.

What have happened in China’s BOP and particularly at capital flow? One of explanations by professionals that such capital movement would be motivated by the RMB’s appreciation expectation as China is under the much heavier pressures than before from the main advanced economies. Among the pressures, certainly the main one from American before Bush’s competing for president election in 2004. As we have heard for several years, the main complain is based on the fact that China’s FX regime of RMB’s managed peg to US dollar many years, particularly narrowed band since Asian financial crises.

Chart 1 the “Error and Omission” in China’s BOP (1990-2003)



Source: Drawing based on BOP data from SAFE website, China, June 25, 2004

Compared with RMB convertible transaction under the current account of China’s BOP, the control of non-FDI capital inflow has long been strictly regulated. The inconvertibility of RMB under the “capital and finance account” should not have huge unaccountable inflow of capital, but is estimated over 30 billion US\$ for about one year from July, 2002 year¹. Where does foreign capital come from? How can they inflow? what kinds of channels or ways have the capital taken for the money movement?

As Chinese monetary policy has been burdened with the huge foreign reserves recent years (Chart 2a and 2b), PBC (People’s Bank of China) does hope the gradual reducing over reserves of FX. Hereby some important measures have been taken during recent months. Among them, the

¹ <http://finance.sina.com.cn>, August 27, 2003, and <http://www.people.com.cn>, August 15, 2004. The investigation for hot money inflow by SAFE is started from September 2003 while the public media reported the volume was estimated about US\$30 bn and then said over US\$ 50 bn during the last quarter of 2003.

steps aimed at deterring speculative capital inflows will be of course the first exercisable choice.

Chart 2a Foreign Reserve (100 Million US\$)

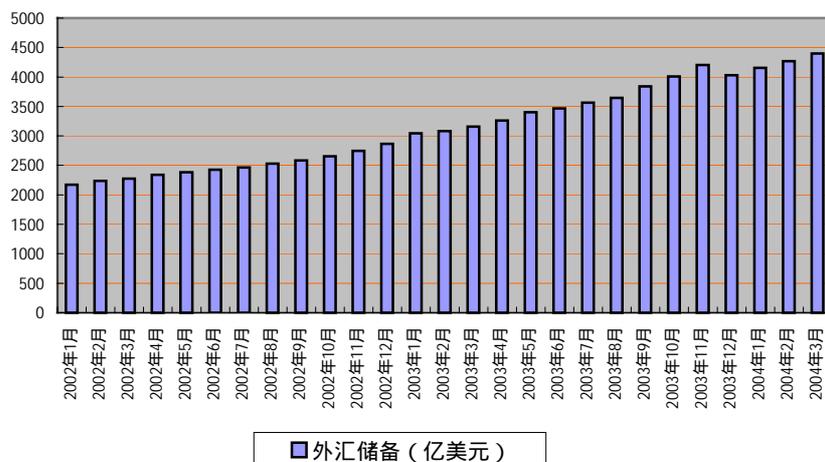
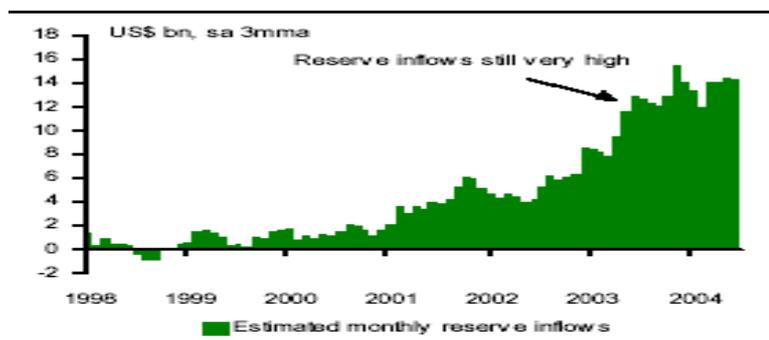


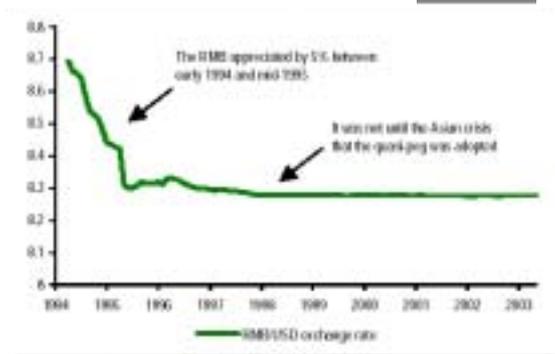
Chart 2b FX reserve monthly since 1998²



Source: CEIC, UBS estimated³.

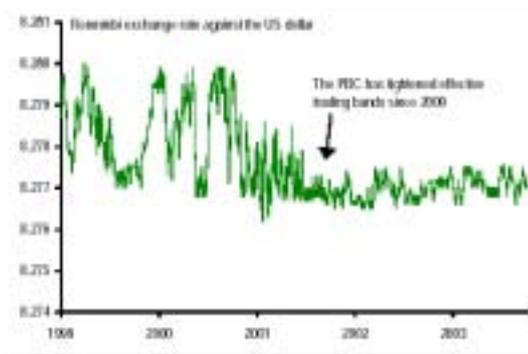
Chart 3a and 3b the “peg” and narrowed band of floating

Chart 3a China under the “peg”



Source: CBC

Chart 3b The PBC has been tightening Exchange Policy



Source: CEC

² The monthly updated data during second quarter of this year are 449 in April, 458.6 in May and 470.6 in June by SAFE, increase continued.

³ Jonathan Anderson, “China: Capital Inflows Stabilizing”, UBS Asian Economic Comment, July 16, 2004). The charts below in PDF are mostly come from reports of UBS Investment Research.

3. The foreign capital inflow and FX reserve in China

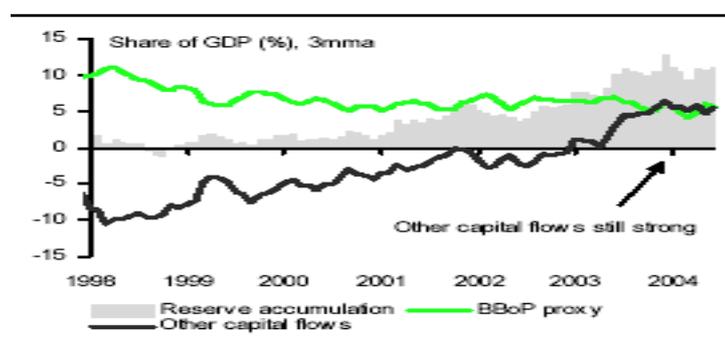
In Asia and also in this world, China, only after Japan, has had the impressive huge and increasing FX reserves (Chart 4). Even during the second half of 2003, China was still on second one with its FX reserve. On average, Japan had accounted for 50% of regional FX reserve accumulation, with China taking another 25% (Chart 4). But it is worthy note that a little difference from recent 12 or more months, the increased FX reserve in China before was mainly resourced from the surplus of current account and FDI inflows.

Chart 4 Japan and China have 90% of Asian Foreign Reserves



Source: CEIC, UBS estimates

Chart 5 “Hot” Capital inflows in China



Source: CEIC, UBS estimated.

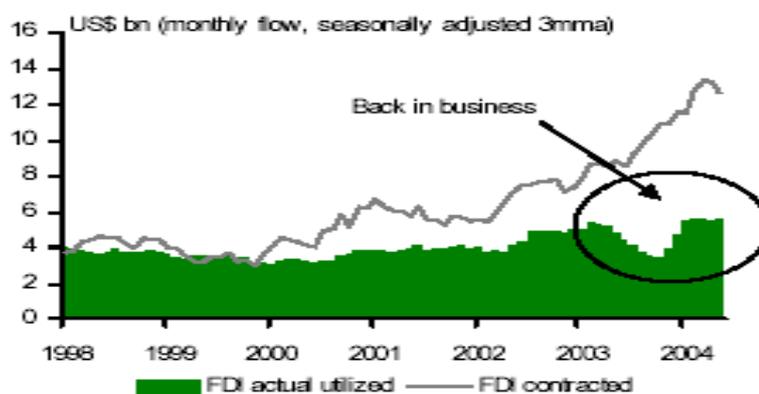
It is well known that China has long been the negative non-FDI capital flows, which was resulted from the massive circulation of China’s national currency in China’s neighboring economies. However, significantly from the fourth quarter of 2002, China has being started the positive net non-FDI capital inflow and more interesting positive “Error and Omission” (Chart 1). It indicates that the capital flows, under the widely expectations on RMB appreciation, have taken over from trade surpluses as the main driver of China FX reserve growth for the first time since the Asian crisis⁴.

⁴ In January 2004, net capital inflows outpaces the Asian current account surplus by a significant margin. Once again, Japan and China were the most important destination countries for capital inflows, together accounting for nearly 90% of the total.

We think the main factors behind the positive turnaround error and omission or the opposite regular direction of “hot money”, are at least five.

- (1) The first, as the external force, is the strong expectation on RMB’s appreciation within one year. The foreign investors in the financial market seems believed that this time Chinese government could persist on the existed FX regime under growing external pressure from advanced economies;
- (2) The second, as the internal force, is the narrow band floating regime reform expectations⁵ based on China’s government on promise of “perfecting RMB exchange rate formation”, which have lead to continued growing capital inflow, not only offshore hot money, but FDI. Last year, just after SARS, the real FDI has been back soon to its business and the contacted FDI has grown surprisingly (chart 6);

Chart 6 Updated FDI inflows in China



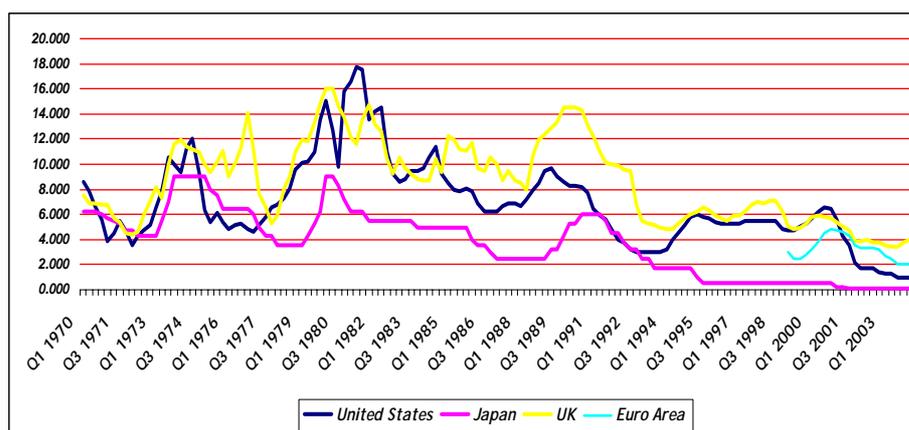
Source: CEIC.

- (3) The expectations of trend US dollar weakness going forward. Recent years, the deposit rate differences between RMB and four main foreign currencies have being positive in all commercial banks in China⁶. (Table 1). Under the appreciation expectation on RMB official revalued and the positive of domestic deposit rate difference, the individuals and institutions have recently preferred to hold RMB assets rather than foreign currencies, which is the main reason why the FX deposits in the domestic commercial banks have been down obviously while the official holding FX is increased. In China, it is well known that the rate return of assets in foreign currencies, except some special cases, are always followed with the benchmarks of FEB, ECR, Bank of England etc, which are all actually in the downing trends during the recent years. (Chart 7)

Chart 7. The downing trends of benchmarks in the main advanced economies

⁵ The public have been looking forward the 3% or 5% floating band.

⁶ The big amount of deposit in foreign currency could be negotiated with the banks but usually still lower than the deposit rate issued by PBC. The updated rate is being 1.44% (<http://www.bank-of-china.com/rate>). All the RMB deposit rates have been available since Feb. 21, 2002 and FX rates have been announced since Jan.19, 2004.



Sources: FEB, ECR, Bank of England and Bank of Japan. June 2004

Table 1 before tax annual rates (%) of deposits in RMB and foreign currencies

Interests of deposits	RMB	US\$	Euro	JP	HK\$
Current Account deposits	0.072	0.0750	0.1000	0.0001	0.0001
Seven days call deposits	1.62	0.1250	0.3750	0.0005	0.0010
One month	⁷	0.2500	0.7500	0.0100	0.0025
Three month	1.71	0.4375	1.0000	0.0100	0.0050
Six month	1.89	0.5000	1.1250	0.0100	0.0200
One year	1.98	0.5625	1.2500	0.0100	0.1000
Tow year	2.25	0.6875	1.3125	0.0100	0.1625

Source: BOC website July 22, 2004

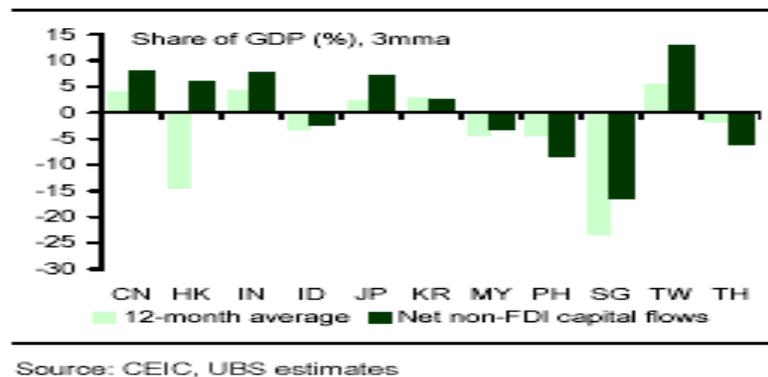
- (4) The longstanding of higher economic growth and other quite good economic developing performances in China have created much more opportunities of business and investment, which are considered as the better timing of capital inflow with expected higher returns in the future. The chart 8 shows net portfolio or more accurate capital flows (considered as main source of positive “errors and omissions” at least in China) for individual countries as a share of each country’s GDP⁸.
- (5) An increasingly active domestic debate on the existed foreign exchange regime has been seen in both academic circle and public society. More and more people have believed now their national currency is truly undervalued. Some of scholars even

⁷ Chinese commercial banks have no long one month deposit product so far.

⁸ As before, Japan, PRC, India and Taiwan are the largest inflow recipients on a relative basis, with Hong Kong recording a very sharp positive turnaround over the last few months.

think former premier Zhu Rongji lost the best opportunity for changing China's FX regime after 1997.

Chart 8: Net portfolio capital inflows/GDP



In PRC, even during the peak period of capital outflows, it is always a difficult questions either for outside observers or Chinese authorities. There is a typical year we can see such conundrum. 1999 just after Asian crisis, China had the combined value of the external trade surplus and FDI inflows reaching USD70bn. However, headline FX reserves rose by only US\$9bn during the entire year. It was very interesting that compared 2002 of 83.11 bn US\$, total earnings from the trade and FDI surplus in 2003 were almost at 79.04 bn US\$, but FX reserves this time leapt so much from 286.407 bn in 2002 to 403.251 bn in 2003, almost 116.844 bn⁹.

4. The main explanations to the net positive capital inflows in China's BOP

Under the very strict capital control regime, we can't image massive non-FDI capital cross-board movement, no matter whether either positive or negative. That is reason why non-FDI capital movement, in particular portfolio capitals in developing host economies, including China, is usually mixed or got along with legal FDI for cross-board moving. We have been accustomed to the massive capital outflows in foreign currencies in China but the recent reverse flow. Thus a question here is, under the similar regulation framework, why non-FDI capital flows becoming easily than before. And furthermore, why has non-FDI outflow been instead of inflow with huge amount and particularly so quickly?

Based on our information and knowledge, some explains are tried to be given below.

- (1) **The gradual internationalization and regionalization of RMB.** The course of RMB partial convertibility, no matter of active or passive of Chinese authorities, in Southeast Asia¹⁰, particularly as Chinese central government' promise of keeping prosperity of Hong Kong economy, has impacted the efficiency of current control regime on foreign

⁹ SAFE, China, June 2004.

¹⁰ The authorized currently Offshore RMB changing market in Hong Kong and tolerating NDF transaction on RMB in East and Southeast Asia.

capital in China. The gradual flexible regulation of cross-board capital movement make RMB exchanges with direct and indirect costs lower.

- (2) **The much more channels existed after over twenty years economic reform.** Along with the more opening to outsiders, more available business channels and other exchange ways such as QFII, overseas investment, the hidden “tubes” serviced to various capital movement have been “innovated” so actively that China’s supervision institutions with limited budget can’t sustained the increasing detective costs.
- (3) **Encouraging rational FX usage by the public with offering some effective outflow channels.** Aiming at more effective operation of monetary policy, less net purchasing of over supply of foreign currencies¹¹ in Chinese FX market¹², less accumulation of FX reserve, Chinese authorities have encouraged institutions and the public to increase their FX holdings for their international activities. Thus during recent years, more conveniences or channels have been given to the society for the foreign currencies outside using. However, it is so pity that out of the imagination and the effective control from the supervisions, the channels, not merely subterranean tubes, now have been used for non-FDI capital inflows¹³.
- (4) **China is lacking of modern FX market network with fair information, high efficiency and good transparence, wide openness.** A lots of FX transactions are carried out directly by dealers and end-users in OTC market. So the database from trading platform, which is the main source of state statistics, is often confused. At the same time, China is still lack of functional national financial center, which could be connected well with some global financial centers. We herewith thought the real vision behind of “errors and omissions” in Chinese BOP would be much worse than the disclosed by data.

5. Who would be main players turned non-FDI capital inflow to the postive?

Similar to the situation during the period of net negative capital outflows, we don’t think that the main players for making both net positive capital inflows and “error and omission” are foreign sources. We think the foreign institutions in China have now virtually been at increasing RMB exposure, including a limited channel of existed QFII¹⁴. The case during Asian crisis indicates that usually the foreign big players carry speculative attacking operation with great risk exposure only when the worse imbalance of host economy accumulated to such extent that “big bang” is inevitable. China is believed not to yet reach such degree and its currency, after all, has not been

¹¹ So far there are four foreign currencies, US\$, Euro, HK\$ and Japanese Yuan for transaction in China’s FX market. Euro is relative new one starting trade from June 2002.

¹² Referring to Zhang Jikang and Liang Yuanyuan’s working paper in English titled with “Structural Analysis on Chinese Foreign Exchange Market”, The Financial Studies Institute, Fudan University. Forthcoming of next month, 2004.

¹³ The volume was estimated over 50 billion US\$ for last 12 months.

¹⁴ Possibly just for this exposure, Nomura Securities, as one of first QFII in China, has been criticized for no action for Chinese A share purchasing as their application originally.

fully convertibility.

As all of us know that there has been an active RMB NDF market to all players, the foreign capitals would exactly only need the market for their speculative operation. Therefore we would suppose that quite volume of actual non-FDI inflows into the mainland are most probably a Chinese game, driven primarily by reallocation of asset holdings in favor of domestic currency (including the repatriation of Chinese offshore capital). Existing capital controls make it much more difficult to borrow abroad at will-and much more difficult for foreign institutional money to move in and out of the mainland.

As the UBS researcher said¹⁵, “we think the ‘revaluation trad’ from China has fueled a very pronounced correction in the external balance, with net outflows turning to large net inflows. The main contributors have been the repatriation of offshore holdings, further conversion of domestically-held assets, and more recently a move to leveraged positions; to the extent possible, banks and firms borrowed abroad and held RMB long”.

Thus, for the point, the considerable share or maybe the lion’s share of flows would be from Chinese sources and even most probably from offshore Chinese institutional sources. We think the regulations on capital account is not quite effective or even ostensible, but at least in keeping out the potential attacking from “big guns”, the existed supervision and control of capital movement is strong enough as we saw in Hong Kong during Asian crisis. However, faced with domestic source rather than foreigners, the Chinese authorities are still embarrassed that locally rooted firms and institutions with the different international business background as they have a much easier time distinguishing capital flows and keeping themselves under the strictly supervision.

6. What channels or tubes could be used for ongoing speculative flows in China?

Experienced on our research to RMB outflows before, the main channels of non-FDI capital inflows could be summarized briefly below.

- (1) Cash smuggle. The individuals or families as the tourists, business tour and even private visit could now carry cash in foreign currency or RMB to go abroad or enter China;
- (2) Cross-border deposit exchange. For example, in order to encourage sightseeing tour to Hong Kong, the Chinese tourists have been permitted to use RMB international credit cards for consumption and then the financial institutions in Hong Kong have also been authorized to offer the cross-border currency exchange services;
- (3) The cross-board portfolio investments, such as local B share investment or offshore H share investment have been more easily done with the help of unauthorized local or

¹⁵ Mainly from the UBS investment research reports recently on China’s economy by economist Jonathan Anderson.

overseas intermediate institutions. In 2003, only US\$1 bn permitted investment volume to local securities issued by PBC to QFII, but the real portfolio capital inflow is absolutely exceeded the quota. Currency swap, parallel loan as well as private remittance on half of overseas Chinese are believed the main tubes.

- (4) The non-FDI capital movement hidden under FDI project. As more and more FDI capitals recently in China have focused on market seeking projects and expectation on RMB appreciation, each year the FDI capitals are requested more to change into local currency. Before July 2002, the real and registered capital input under FDI project for Changing RMB has to be approved by SAFE. But after that, as the convenience offering to foreign invested firms, the local commercial banks can deal the transaction directly on behalf of SAFE. So “Leads & Lags”, in particular the input capital and superadded registered capital asking for earlier exchange with RMB under capital account, instead of traditional under current account, have recently become the important methods for capital inflow.
- (5) From this new century, except the sectors not yet opened to foreign share majority, more projects approved in China are wholly foreign owned, which means the more freedom and less watching from locals. It is truly not difficult now for foreign investors borrow money directly from international market and take some capitals to make other investments, such as A-share, bond, portfolio fund, insurance fund and even real estate assets. Under the current FDI policy, the financial operation inside the foreign invested project is almost no supervision, or changing the word, RMB under FDI related could be almost supposed as fully convertibility. So far the usage and movement of foreign project capital, no matter of outflow from or inflow to the project, are only needed booked into the special account at authorized commercial banks. The movement and transaction are monitored loosely by the local and foreign commercial banks accredited by SAFE.
- (6) The transactions under the current account of BOP are still considered as main and effective source of cross-board capital flows. Before this RMB appreciation expectation, by using either illusive invoices or black market, it was so popular for Chinese institutes’ to escape overseas or domestic incomes from the mainland. Now the direction has been changed but the method is still more effective.
- (7) There are more and more local and foreign financial service institutions, authorized or unauthorized locally, as the growing intensive competitions in China, give the various services to their customers legally or illegally. Even some state-owned or shared financial institutions with the authorized overseas branches, as disclosed by authorities or public medias, did the same capital movement services to their big customers, typical ways including traditional swap, currency swap, parallel loans.

The growing multiplicity of channels or tubes for the movement of non-FDI capitals potentially increases the difficulty of Chinese authorities financial regulation and control of capital flows. Along with the more opening to integrated global economy, the government has

to cost more and more to detect the bulk of covered-up business activities unless it has to give up some targets. Looking for international cooperation and coordination, accrediting the qualified institutions and so on for stakeout, as the new ways of capital flow regulation in China, has therefore had a source of great concern by Chinese authorities.

7. The measures have been taken by Chinese authorities

Aimed at making control of non-FDI capital inflow, keeping in the existed peg regime with a period, lowering the growing speed of official foreign exchange reserves and reducing RMB appreciation pressure, Chinese government has adopted some series measures recently along with the structured tightening policies for so-called soft landing of international imbalanced economy and up growing CPI trend. The main measures taken are listed in summary as follow.

(1) Opening some capital account items firstly for encouraging outflow of capital supervised

Chinese government recently announced that more items under capital account are being opened recent months, which would be partly for encouraging outflows of capital, increasing demand of FX for reducing pressures of exchange rate, and supporting PBC's sterilizing operation as well. For instance, a number of steps to loosen capital restrictions in an attempt to promote capital outflows have been carried out: (1) Exporters are no longer required to convert the bulk of their export earnings into RMB; (2) Some institutional investors, such as the social security fund and insurance companies who have been the great exposures of market interest varies several years, are to be allowed to invest in overseas markets though the detailed rules have not yet been worked out; (3) Some special portfolio foundations, are to be granted greater access to overseas bonds, as well as new domestic dollar-denominated issues by the policy banks; (4) More and more Chinese companies, even if they are private owned, are almost literally being pushed out the door, with expedited approvals for overseas direct investment (which averaged around US\$5 bn per year from 2001-2003) as well as full retention of overseas income earned.

And just last month, the senior official in SAFE has also announced other measures: (1) the local private assets owned by immigrants to abroad and non-residents, if its reality and validity is confirmed, are allowed to transfer to abroad. But before this measure, only the returns on the assets can be moved out of mainland; (2) Opposite the direction of QFII, the QDII system would be established and exercised very soon, which is obviously also expected to reducing the FX reserves; (3) OPI (Overseas Portfolio Investment) to global capital market by the funds from Society Guarantee and Insurance Foundation has been approved by the State Council. As the SAFE said, it would be in practice soon.

It is obviously that China seems to open further some items at its capital and finance account. However the progress is to be carried carefully as it is related to the sensitive FX rate issue and the steps selected. Supposing if China does go for a significant gradual capital opening as said, it

would have to firstly move to a flexible exchange regime. Otherwise, China could go the same path as the Asian crisis economies, facing “one way bets” with large inflow pressures under a perceived guaranteed return, which can then turn to debilitating capital outflows when the markets begin to worry about the strength of the peg. Indeed, nearly every emerging market financial crisis in recent memory was associated with a fixed or quasi-fixed exchange rate, which is recently described as the main exchange regime in emerging Asian economies, before the final blowup occurred.

(2) Increasing marketable demand for foreign currency

Chinese authorities are increasing the marketable demand for fostering the capital outflow. One of the typical measures is to deal with the competitive applications by domestic financial institutes for strengthening and fasting QDII. The measure is also aimed at guiding domestic capital outflows for higher capital returns while under the effective control of FX transaction by authorities. The idea, actually very similar to rules of QFII, is trying to concentrate non-FDI inflows to the limited number of authorized qualified foreign investment Institutions. Hence the authorities could focus their supervision on limited QFII. Thus the authorized QFII have had then the obligation for indirect monitoring while offering legal business services to their customers domestic and abroad.

Another measure attracting public concern recently is that Chinese government is encouraging local enterprises to investment abroad. Different from strictly approving procedure before and mostly limited to qualified state enterprises, the local shared and private firms are now aroused to go abroad with flexible foreign currency exchange quotas. Such stimulated demands for foreign currency are not requested on traditional self-balance and are accordingly expected to increase the FX demand in Chinese foreign exchange market.

Unfortunately June data on FX reserve growth is sticky highly, which means we should have to wait for longer the real growing demands for foreign currencies. Anyway, the increasing money has not flooded into the banking system since the PBC is continuing to sterilize domestic liquidity.

(3) Keep the interest rates, in particular the deposit rate lower level than America for deterring non-FDI inflow.

Chinese money market is again rife with concerns and possible scenarios about Chinese interest rate hikes, in particular just after FEB arising rate last month which is considered as Mr. Greenspan gave Chinese colleague a flexible space for monetary operation. Under the pressure of RMB appreciation expectation, and possible interest rate arbitrage speculation on rate gap, such benchmark up moving, even with only 25bp, is absolutely beneficiary deterring hedge capital further inflow. At least we think that PBC has now more time given by FEB to postpone rate hike, in other word, Chinese central bank would herewith stress “broadly stable” interest rates and instead keep using other monetary policy instruments such as liquidity management, reducing the overall pace of credit growth, stopping lending to targeted real estate sector and raw material manufacturing sector.

However, even if the rates are changed as expected during the fourth quarter of this year, we still believe that Mr. Zhou Xiaochuan will hike deposit rates within this year mainly for compensating household depositors for CPI inflation¹⁶. Referring to the level up, deposit rates should be at most raising 100bp and regarding to lending rate, should be less than 100bp or preferring further liberalized. These imply that the central bank will have to care seriously about the very high level of capital inflows motivated by wide rate gap. Remember that the PBC is already buying up FX reserves of US\$10 bn to US\$15 bn a month, as Chinese companies and banks take advantage of the positive interest spread between RMB and USD assets, as well as continued expectations of a RMB appreciation.

No matter whether the measures are effective, a massive further acceleration in non-FDI inflow volumes could be happened if the appreciation expectation is strongly preserved. However, on the other side, China still maintains a higher closed capital account, and portfolio activity is mostly limited to domestic firms and banks which are relatively adept in working within the current framework of regulatory restrictions. Meanwhile the PBC has been successfully tightening monetary policy to date, but wouldn't a rising tide of speculative inflows eventually overwhelm the authorities' ability to sterilize the domestic liquidity impact, effectively forcing China off the peg.

(4) Raising exit barriers to the speculative hot money outflow

As we have seen in several cases, the "hot" money usually can't sustain longer than one year for their speculative movement as increasing financing costs, opportunity costs and other related costs. What China has successfully done during the Asian crisis is just keeping FX rate stable enough or even fixed while making strict control of capital outflows. China's experience was surely based on its large economy but uncertainty for other small host economies with pegged or quasi-pegged regime. Regarding the strategies to the speculative capital inflows, Chinese authorities would increase the hot money exit barriers like closely monitoring financial transactions, increasing supervision to business of domestic and foreign commercial banks and other financial institutions while (1) keeping the FX rate unchanged so that no near future return expected; (2) Strengthening the supervision to the targeted institutions on illegal money transferring and business transaction irregularity. (3) Inspecting the transferred investment such as portfolio and real estate investment.

Concluding the recent over hot economy came from the real estate sector and related others like its upstream sectors, Chinese government's soft landing policies have recently targeted at the investment on luxury apartments located in large municipal cities like Shanghai, Beijing and Guangzhou. The governments have considered that these kinds of assets would mostly absorb transferred hot money. As the part of reasons, the current structural measures calming down economy, as we have seen, would be placed to the targeted sectors. Actually also as we have noticed, the hard landing bank loans have resulted in a series of expected bankruptcies and losses.

¹⁶ June data on the cost-push CPI has reached to 5% though the GDP growth rate is a little down.

(5) Making FX reserve at adequate level

Monitoring non-FDI capital inflow growth with a view to expectation on RMB value. The second half of last year, faced with net positive both non-FDI capital inflow and “error and omission”, PBOC and SAFE did the investigation on about US\$50 bn other capital inflows in coastline areas and particularly at Guangdong province. The state council has appraised the actions as (1) the flooding capital inflows have been deterred successfully; (2) the appreciation pressures to RMB have also been released obviously as well as (3) the growing of FX reserves has been slowed effectively.

Except the measures aimed at control of foreign capital inflows, the authorities have gradually loosen the foreign currency regulation. For example, let enterprises keep holding more foreign currencies no matter whether they have already had international business, giving firms with overseas business more FX quotas no matter what kinds of ownership, permitting enterprises more freedom on FX purchasing if they have the real demand for import.

All of above measures are actually not only proposed to controlling FX reserve growth, but also strategically for creating effective volume of marketable FX demands, which is planned to perfecting exchange rate formation mechanism as soon as possible¹⁷.

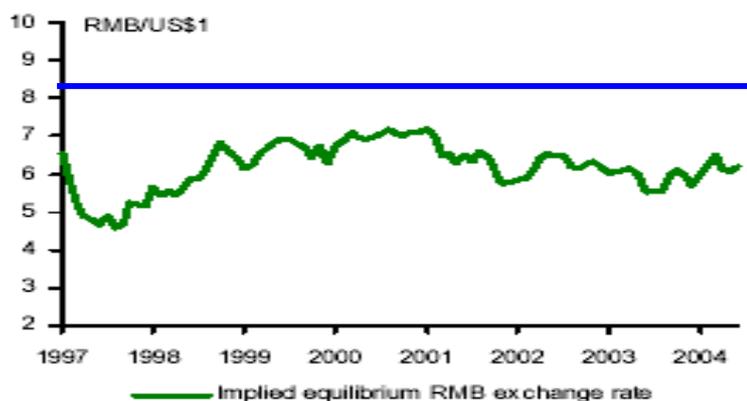
(6) Stabilizing FX rate.

The Chinese government has taken the similar relative long timing strategy as during Asian crisis, that is to maintain “basic exchange rate stability” long enough while speculative capitals with longer position can’t be sustained. The measure, usually could be understood and accepted by advanced economies, is to maintain “basic exchange rate stability” while “perfecting the exchange rate mechanism”. As we can image, this standard formulation suggests that the authorities are not interested in a large RMB exchange rate adjustment at all but continue to leave the door open for the gradual introduction of limited flexibility. Such action was done against the RMB depreciation expectation made the global speculative capitals in China and Hong Kong with huge losses during Asian crisis.

The government is well advised more that a flexible change regime is much more suitable in the medium term, as it would allow the economy to avoid long-term speculative pressures and adjust dynamically to future structural changes in trade and capital flows. From the experiences in so many economies, at least in medium term the estimated impacts of exchange rate movements on exports, economic growth and FDI are quite small. Actually both from a theoretical standpoint and historical record, while a more flexible rate might encourage speculative flows in the near term, a fixed exchange rate regime would be also the target for speculative attacking when the economy, as we observed in Thailand in 1997, has the fundamental imbalance of international payment.

¹⁷ Zhang Jikang, “Establishing marketable demands and supplies of foreign currencies to foster function of Chinese FX market”, *Journal of Chinese Money Market*, Feb. 2004.

Chart 10 RMB Valuation Estimate



Source: CEIC, UBS estimates

Except all above, other measures directly or indirectly related to the objectives under the both current account and capital account have been or to be adopted by the supervision authorities under the commitments to WTO, such as

- (1) Encouraging increasing imports of commodities;
- (2) Pushing state-owned enterprises for ODI (overseas direct investment);
- (3) Arousing the local firms with good business performances for international financing instead of traditional international debt;
- (4) Lifting restrictions on foreign financial institutions by CBRC (China Banking Regulatory Commission) for RMB business to foreign invested firms and forex business to local invested enterprises;
- (5) Increasing the percentage of share in the joint-ventured financial institutions, allowing foreign investors to join local financial institutions and so on.

Anyway, it should note that since China opened its current account in 1996, so far the authorities said that they have lifted control over about half of 43 capital account items.

Short points as conclusions

As the conclusions, we would stress two points for the measures above and more broadly on related policies.

The first is that the effectiveness of all above measures are beyond of our foreseen, however, the updated data of “hot” capital inflows during June is still strong though momentum has basically peaked since the last quarter of 2003 (Chart 5). Maybe we need the longer time to observe the tendency;

The second, as a speech delivered by Mr. Wei Benhua, vice-director of SAFE in a business conference in New York, is that in opening the capital account, the financial authorities would use

a phased approach and follow the principle of doing the easy parts before the hard ones. For every move financial authorities take to open the capital account, Chinese government would make sure that “the risks are controllable and there is room for manoeuvre.” Specifically, controls over transactions concerning capital inflow would be relaxed before outflow, long-termflow before short-term flow, transactions with real background before ones with no real background. Control of financial institutions would be loosened before that of non-financial institutions and private individuals.