Should China Accelerate its Liberalization of Capital Account[1]?

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Ⅰ. Benefits and costs of financial globalization: a brief review

***Benefits*:**

- Equalizing the capital returns among difference countries, which means the efficiency of the capital usage may be improved
- Inter-temporal trade benefit, which means countries with less saving may consume more at present while consuming less in the future.
- Diversification of the investment risks on a global base, which may help reduce risks more effectively and then reduce the external and internal shocks.
- FDI's spillover effect of technology.
- Improvement of financial deepening and efficiency of resource allocation.
- Strengthening fiscal discipline.

Some empirical studies on the correlation between "liberalization of capital account and economic growth"

Studies	(Countries) Sample	Year	Correlation
Alesina, Grilli, and Milesi-Ferretti (1994)	20	1950–89	no
Grilli and Milesi-Ferretti (1995)	61	1966–89	no
Quinn (1997)	64	1975–89	yes
Kraay (1998)	117	1985–97	no
Rodrik (1998)	95	1975–89	no
Klein and Olivei (2000)	92	1986–95	yes
Chanda (2000)	116	1976–95	yes
Arteta, Eichengreen, and Wyplosz (2001)	59	1973–92	unclear
Bekaert, Harvey, and Lundblad (2001)	30	1981–97	yes
Edwards (2001)	62	1980s	yes

Source：IMF（2001）

How to interpret the empirical studies? If the methodology is not a big problem, then the costs behind the capital account liberalization will matter.

Costs:

- The financial instability

[1] Outline for Manchester Conference, June 25-26, 2008

- Boom-bust circles over the past three decades in emerging markets
- Interpreting the boom-bust circle: market failure
  - Imperfect information and excessive capital inflows
  - sudden stop and capital flight
- Some empirical studies

- More distortion if domestic good and factor markets are distorted
- Decrease of independence in monetary policy
- Accelerating the global imbalance

Policy Implication:

- Capital account liberalization should be a luxury good for emerging market countries if they are unable to manage the costs.
- Elimination of the market failure should be the most important preconditions of capital account liberalization.
- Capital account liberalization should be a gradual process.
- The global cooperation of regulation on capital flows should be very important. Why not *Tobin Tax?*

Ⅱ. China's integration into financial globalization: overview and some issues

- Overall financial openness and recent policy adjustments

  - How many capital transaction items had been freed by the end of 2004?

Table 1: China's Capital Account Openness by the End of 2004

capital transaction items[1]		number	Percentage	
No restriction or few restriction	no restriction	11	25.58%	51.16%
	few restriction	11	25.58%	
Partial or strict restriction	partial restriction	15	34.88%	48.83%
	Strict restriction	6	13.95%	

Note：Based on the IMF' classification appeared in its annual publication *Exchange Rate Arrangement and Exchange Restriction*, capital transactions can be divided into 43 items in total.

Source：IMF，*Exchange Rate Arrangement and Exchange Restriction* ,2004.

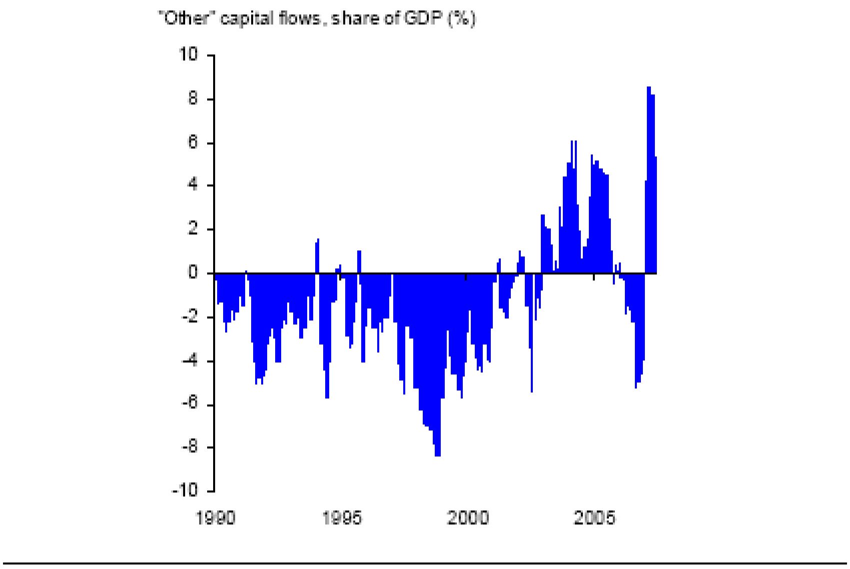
- Latest development in expending capital account liberalization.

Table 2: Some policy changes in capital control since 2001

- Since 2001, China has gradually reduced its foreign exchange control on overseas direct investment by Chinese enterprises. On July 1, 2006, restriction in this regard was completely removed.
- Since May 24, 2001, State-owned enterprises have been allowed to do hedging operation in international financial markets.

- Since Jan 1, 2003, with a ceiling control, the qualified foreign institutional investors have been allowed to buy A-share stock in Chinese securities markets.
- Since Feb 18, 2005, international development banks have been allowed to issue Renminbi-denominated bonds in the China.
- Since June 17, 2005, insurance companies have been allowed to buy securities and stocks issued by Chinese listed companies abroad. Two years later, the liberalized arrangement was extended to all foreign portfolios.
- Since May 1, 2006, individuals have been allowed to buy upmost US $ 20,000 for overseas portfolio investment through the entrusting arrangement with qualified commercial banks and fund managements.
- Since May 10, 2007, commercial banks have been allowed to use the funding entrusted by individuals to buy structural products overseas.

- Some policy issues
  - Has China had the preconditions for accelerating its capital account liberalization?
  - Should China encourage capital outflow for reducing its external imbalance?
  - How to deal with the large hot money inflows?
    - Estimated amount



Source: CEIC, UBS estimates

    - Main channels
    - Challenges for the macroeconomic stability and risks of reversal
    - Policy mix: capital control, more flexible exchange rate and other instruments.

Conclusion