Capital Account Liberalization: International Experiences and Implications for China

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China is opening up, especially in the field of finance, since 1878 when the reform of "opening up" started. The capital accounts have moved from a closed manner to a strict regulation to its current liberalizing state.

China has a floating exchange rate (0.5 to 2.0% band). The foreign rate of RMB has increased and has been ranked in the 5th place of settlement currency. The capital account liberalization is an important one, which has two schools of thought: (1) China has to speed up the pace of capital account liberalization. This belief is that it should follow the trends of the world, major economies have done so and China wants to join the SDR basket of currency, so it must do so as well. The benchmark for this action is the level of capital liberalization. (2) A lot of developing countries began to liberalize their capital accounts at an early time and as a result a lot of bad conditions such as financial crises occurred. If China, liberalizes the capital accounts, it will have to face the shock of foreign economies and markets. This is a controversial topic. Some people believe that the time is not right for China to fully liberalize its capital account and should be cautious in its liberalization.

The Experiences of Latin American Countries about Capital Account Liberalization, Mr. Jose Antonio Ocampo

- Title of presentation: "Latin America's Lessons from Capital Account Liberalization"
- Full liberalization is a very difficult issue. Gradualism is the essence of good policy.
- When the SDR was created, no currency was completely liberalized.
    - So China should keep this in mind.
- The major issue is managing the medium term cycles (6-10 years) of the capital accounts. Short-term volatility is very easy to manage.
- In case of Latin America the first medium-term cycles of capital flows to emerging markets was in 1975-81 as a result of the recycling of petrodollars.
- The two medium term cycles ended up in crisis
- Third cycle started in 2003-2007, due to new capital flows into developing countries. In 2008, this was interrupted by the Lehman Brothers collapse and the North Atlantic Crisis.
    - The crisis had no long-term implications for Latin America, only less than one year.
- First cycle was severe, the second cycle was less severe, and the third cycle has been the mildest of all cycles
- The intensity of the cycles has become less intense and its due to how the cycles are managed.
- There has been a tendency to liberalize during capital booms. "Not a good guide to policy"
- First cycle, 1975-1981, capital account liberalization in Argentina, Chile, and Peru joining Mexico and Venezuela. Colombia and Brazil are the two countries that kept restrictions on capital flow.
    - Saw a severe crisis in the two countries that liberalized the most Argentina and Chile.

- 1982-89, reversal of liberalization of capital accounts
- Second cycle, in 1990-1998, broad-based capital account liberalization.
    - Chile and Colombia, unremunerated reserved requirements, put a reserve requirement on capital inflows, had a significant cost.
- The Colombian system was the most stable, does not allow a currency mismatch. Forces all banks to have a positive net position in foreign currency.
- Argentina and Peru moved to semi-dollarized system due to hyperinflation. Brazil did experience hyperinflation also, but did not semi-dollarize.
- Third boom, 2000-2006, further liberalization.
    - In Chile and Colombia, this occurs because of the FTA with the United States.
    - There was a reversal of liberalization in Argentina and Venezuela.
- Peru manages capital inflows implicitly by managing reserved requirement on deposits in dollars.
- Colombia used unremunerated reserve requirements (URR) prior to FTA with the U.S.
- First lesson: surges in capital flows results in a lot of pressure to liberalize the accounts and the financial systems. Reflected in two major crisis.
- Not all booms end in crisis. Depends on current account deficits and associated currency appreciation.
- Using foreign capital to increase construction has disastrous events in the long-term
- Using foreign capital for investment has much better effects.
- In terms of capital account crisis, Latin America is not likely to have a crisis despite current issues.
- Recovery for Latin America was quite substantial in terms of investment ratio.
- However, Latin America overspent the commodity boom.
- Bonds are about three times the price before the North Atlantic Crisis.
- Countries with better access to financial markets do have costs, but they are smaller than they were before the North Atlantic crisis
- Latin America is much more indebted than it used to be.

The Experiences of Japan about Capital Account Liberalizations, Mr. Kenji Aramaki

- Post WWII, the legal framework in Japan was very tight. Totally controlled trade and foreign exchange.
    - Foreign exchange banks were used as an effective tool to control the exchange rate.
- The whole process may be divided into three stages.
    - 1. Liberalization of Trade and current account transactions. (beginning 1960 with passing of act to liberalize)
    - *2.* Gradual relaxation and framework shift to a generally liberalized system (latter half of 1960s to end of 1970s)
    - *3.* Completion of Liberalization (1980s-1990s)
        - *1997, COMPLETE LIBERALIZATION OF CAPITAL ACCOUNTS, 4 restrictive elements after the war were eliminated or substantially modified.*
- Main Characteristics of Japan's liberalization:
- 1. Cautious sequencing taking into account the type of transactions.

    - Liberalization of direct investment generally preceded to liberalization of other types of transactions.
- 2. Use of Foreign Exchange banks as effective mechanism for foreign exchange control
- 3. Frequent use of direct control measures to deal with the unstable short-term capital flows
- 4. Neutral stance for internationalization of the yen.
    - Allowed the use of yen in free non-resident accounts and in foreign payments. Resulted in open channels for inflows.
- Capital account liberalization took 40 years.
- Quantitative control measures were frequently used to manage volatile capital flows
- Implications to China:
    - much like Japan it had complete control of the capital account inflows and began gradually liberalizing the 1990's (Japan did so in 1964)
    - Most important thing is to control the risk when liberalizing the capital account.
    - To promote internationalization of RMB, necessary to allow holding and free disposal of RMB by non-residents.
        - Would lead to abrupt rise and fall of capital accounts
- Impossible trinity
    - Stability, free flow, and independent monetary policy. Can't do all these three at the same time, must choose two.
- The international community does not have effective tools to deal with capital outflow driven by international financial crisis

The Experiences of Middle and East European Countries about Capital Account Liberalizations, Ms. Daniela Gabor

- The Eastern European developing countries were very heavily affected by the North Atlantic Crisis.
- Countries after collapse of central planning, two waves.
- 1) Fast wave—within 6 years time, they liberalized everything. The reason for doing so, the EU promised membership but one of the conditions was to open up the capital account.
    - First FDI, then at the end the hot interest-sensitive flows (non-resident access to money market instruments)
- By 2008, almost all Eastern European countries had very large capital inflows
    - Fueling consumption by borrowing abroad.
    - Some of these were FDI, but they were also degenerating and portfolio inflows.
- When Lehman Brothers collapsed, all the countries had a crisis and some countries in the EU asked for IMF support.
    - Opened the door for other countries to do so, Ex. Greece
- Foreign ownership of banking sector has a balance of risks and benefits that are not very clear.
- Lessons:
    - Ask, who intermediates capital inflows and how? Liquidity issues
        - A lot of the hot inflows in Eastern Europe were from loans and help from foreign banks, resulted in the sterilization games with the central bank. This might be a problem.

        - When non-residents have access to currency, there needs to be a counterpart for domestic liquidity
    - Once you open up economies to capital inflows, there is financialization of currency and interbank money markets.
        - Structural surplus of liquidity is asymmetrically distributed.
        - Sterilizations become an asset class
            - Central bank activities aren't for inflation control but for capital inflow management.
    - There is no framework to understand how to deal with global financial frameworks.
        - IMF does not have the right answer to global financial cycles.
- Eastern Europe has stopped being an attractive asset class for foreign investors.

US-China Bilateral Investment Treaty: Implications for China's Capital Account, Mr. Kevin Gallagher

- Very concerned with the negotiations for the US-China bilateral treaty
- May make it harder for China to regulate the capital account management.
- Urge China to negotiate to have the policy space to regulate the capital flows properly.
- If follow US model bilateral treaty, it will require the full and immediate opening of the capital flows
    - Unlike WTO, there are no exceptions for the liberalization of capital flows.
- US bilateral treaty vs WTO treaty
    - WTO has a good balance between opening capital accounts and being able to regulate flows under circumstances.
    - Capital flows are only covered under financial services, not as broad a definition under the US bilateral treaty where all forms are covered in liberalization.
    - Under the WTO, countries can put a limit to the liberalization of assets to the ones that you choose to liberalize, the US treaty, it's a negative list and you decide only what is not liberalized.
    - US treaties privatize the dispute propositions and allow private firms to take care of parts of agreement and file complaints against the nation-state.
- Under a US treaty, an investment is every asset that an investor owns or controls, directly or indirectly. The scope of investment is that all transfers relating to a covered investment have to be made freely and without delay into and out of its territory
    - URR, short-term tax, etc. would be seen as an interruption of this, and would be actionable under the agreement.
    - Will allow private firms to file a claim and have a dispute against a government.
        - Problem because the US government has no power or presence in these disputes.
- WTO has exceptions for when to regulate capital outflows under balance of payments circumstances and inflows due to prudential exceptions.
    - US treaties do not have balance of payments exceptions.
    - The United States does have prudential exceptions, prudential reasons restricted to just financial people and organizations.

- With Chile and Colombia, The US treaties gave a grace period for the private firm disputes with their governments after measures are used.
- South Korea insisted that they won't sign the agreement with a carve out of that piece of legislation with some limits
- Under the TPP, Malaysia is trying very hard to getting a balance of payment exceptions
    - US considering it but with five conditions.
        - Will only allow outflow regulations, "US is shortsighted when giving exemptions only to outflows"
        - They exempt equity markets from exemptions
        - Any regulations that occurs is a price-based not quantity-based regulation.
        - Necessity test of whether the regulation was the right one under dispute
        - Regulations can only last up to one year.
- IMF has new safeguards on regulating capital flows
    - Agreements and treaties do not provide the appropriate safeguards and sequencing for liberalization and very important for reform.
- In bilateral treaty, very important that China ask for a reform of the prudential exception to allow for proper sequencing of capital account opening, and allow for regulation of inflows to prevent instability.
    - Include a strong balance of payments safeguard to explicitly allow for regulation of outflows to mitigate instability.
    - China has more leverage than Malaysia, Japan, etc. in TPP to get exceptions that US is considering to give it to Malaysia.

Why China should still be Cautious in Capital Account Liberalization?, Mr. Zhang Ming

- 2012, the central bank published a report that they should accelerate liberalization of capital accounts.
- It is very dangerous to accelerate the liberalization of capital accounts.
- Q3 outflow is predicted to increase.
    - Out of types of capital, other investment, credit has been consistently going out of China
- Current capital outflow is closely related with change of RMB exchange rate expectations.
- In the past few years, there has been a difference between the opening price and closing price of the RMB in comparison with the US.
- Two weeks ago, the central bank adjusted downwards the medium price, and there has been a devaluation.
    - Why? Because RMB effective exchange rate appreciated too quickly since 2014.
    - The capital outflow will continue for some period of time.
- Central bank has had 4 comprehensive reductions of interest rates and two comprehensive reductions of reserve requirements.
- Global demand is contracting, so over the four years deleveraging is the trend
    - Will cause an increase of financial crisis
    - In the next four years, there will be a new wave of nonperforming loans.
- Interest rate liberalization has been accelerating, and will have an impact on commercial banks.
    - There is an adjustment in real economy.
- Labor productivity growth determines the growth of exchange rates.

- Problem with Stock Market regulators: there are many regulators and they do not coordinate with each other.
- Uncertainty in various sectors will accelerate capital outflow liberalization.
- Due to US economic recovery, normalization of US monetary policy is certain, though the pace is not.
  - The Fed may increase interest rates
- Persistent stagnation
  - Developed countries are growing very badly
  - International trade is growing at a very low level
  - Increasing risk of currency war, more pressure of devaluation of currencies
  - Euro zone will continue to be on the verge of a crisis.
- Capital outflow may impair financial liquidity and stability
  - Will accelerate corporate sector deleveraging.
- Bank faces dilemma:
  - if it doesn't regulate capital outflow while liberalizing capital accounts, it might help capital accounts.
- Acceleration of liberalization, may help accelerate the inclusion of RMB in SDR basket, but will this promote long-term economic growth in China? "I don't think so"
- Large short-term capital inflow has negative externality, so capital flow management might be desirable.
- No significant evidence between free capital flow and economic growth.
- Policy recommendations:
  - Government should put domestic structural adjustments on the top of its agenda
  - Chinese government should speed up RMB exchange rates and interest rate reform and mitigate negative impacts of reforms.

Comments:

Mr. Huang Yiping:

- Common understanding of caution in liberalization of capital accounts. More and more people in China think this way.
- If the market is not stabilized now, then after liberalization it will be even more unstable.
- Human expectations play a very substantial role.
- Three questions:
  - Do we need a reform or not? Caution is relative. Is a reform necessary? There is no possibility that we evade such a reform, but we are still affected by significant market volatility and are concerned about the inflow and outflow of hot money.
  - Can we cautiously carry out reform? To what extent do we act cautiously and what consequences will it entail? The reform will be slow and a lot of problems will occur in China. Scholars believe if you liberalize the market many of the underground banks with the large debt will pose a significant problem.
  - When we liberalize the market, we can't avoid financial crisis, we have to think in advance and make preparations. Need to make preparations to get the conditions ready

    for reform. For some things you need to move cautiously, but for others you need to move faster such as investment for individuals.
  - Capital inflow search is the start of the financial crisis for any emerging country.
  - We are over assessing the intention of the central bank to push forward the capital account liberalization.

Mr. Zhang Bin:

- Cost-benefit analysis for liberalization: in different countries and different times, the analysis is different for each country.
  - Benefit of liberalization is that the residential sector will have more channels for asset allocation and optimization.
  - But in emerging countries, these benefits are problematic. Income distribution may be very extreme, rich people have most of the wealth, enterprises are highly monopolized
    - If capital accounts are liberalized, then benefits will not be seen only. The rich people will have many opportunities but the poor can't take advantage of it.
- Sequencing is very important. There is a belief that with liberalization comes interest rate regime, this causes much resistance. Liberalization in any area is progressive. Most people don't worry about trade, but about Chinese companies with a lot of debt in foreign currency. If the exchange rate is liberalized, then these companies will be highly affected.
- Economists believe that transparency and rules are good. But, in China there are strict regulations on capital accounts. But look at the execution, some companies doing arbitrage aren't following the rules and countries don't do anything because they believe it helps with the foreign risks of transactions. Cross-border capital flow has a limited role in macroeconomics. Want something flexible that can change according to the environment
- Suggestion: companies have a lot of external debt, households do not. China has a liability mainly in the government but not in private hands. Liberalization of capital accounts and then also let the normal people benefit. If you do this it can help to optimize the market allocation.

Closing Remarks: Mr. Yu Yongding

- Long-run there is a problem of growth structure
- Short-term China is still suffering from over-capacity, and Chinese economy is suffering from negative CPI in terms of PPP
- China has entered into a state of deflation in his view.
- This deflation perhaps started since 2012.
- Most serious problem is the deflation spiral. Problem is not public debt but corporate debt of Chinese.
- Corporate debt is 120%
  - China's situation in this is the worst in the world. China has the biggest steel industry in the world. There is a huge overcapacity, thus the profitability of the industry is extremely poor (negative or even 0)
    - So natural there is a sort of spiral.
- Simulations show that China's corporate debt will continue to rise.

- “We have to try to stabilize the stock exchange”, and later China’s exchange rate.
- China’s household savings deposit ratio is very high
    - If diversify the assets, then the capital outflow can be very huge
- So must fix problems, before you open the accounts up.
- Currently, there are restrictions. Foreigners are not allowed to buy money free.
- China should allow the devaluing of the RMB in a gradual way.
- Does not like the movement towards liberalization of capital accounts