

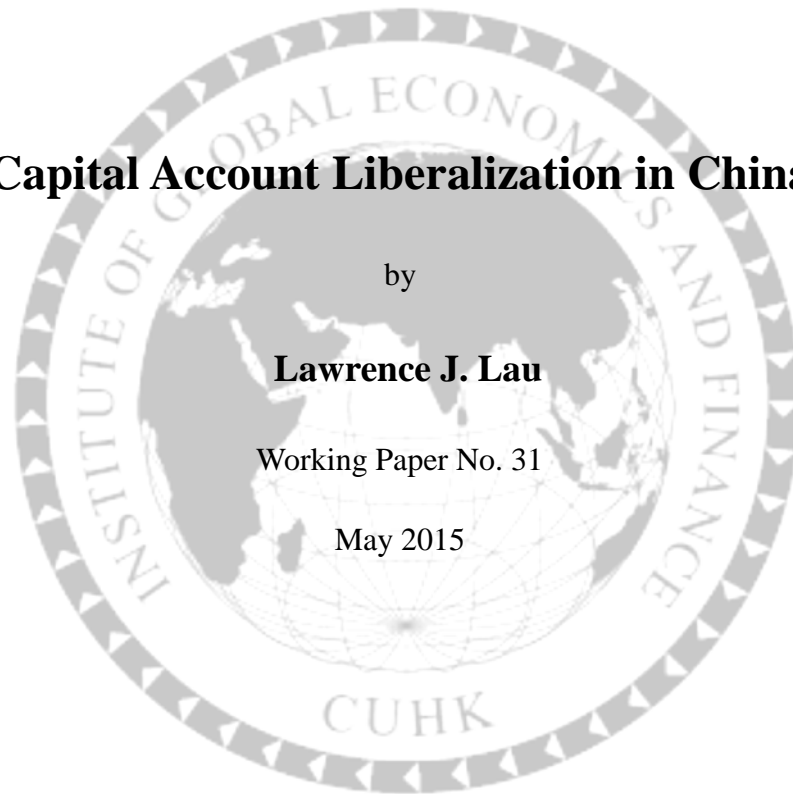
Capital Account Liberalization in China

by

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1. Introduction

China has a goal of achieving capital account convertibility (and a market-determined exchange rate) for the Renminbi by 2020. Capital account convertibility means the absence of controls on capital account inflows and outflows (although they may still be regulated). The Renminbi is now completely current account convertible but is only partially capital account convertible.

Capital account convertibility is a prerequisite for a market-determined exchange rate for the Renminbi. If capital flows are restricted, the demand and supply for Renminbi for capital account purposes will not be fully reflected in the foreign exchange market, and the Renminbi exchange rate determined in such a market will therefore not represent the true equilibrium Renminbi exchange rate.

2. The Costs and Benefits of Short-Term Capital Flows

Economic theory tells us that free international trade flows are beneficial to trading partner countries. Long-term capital flows in the form of direct investment or long-term portfolio investment are also known to benefit both the investor and the investee countries. However, there is no theory to support the hypothesis that short-term capital flows are beneficial to either the economy of origin or the economy of destination.

¹ Ralph and Claire Landau Professor of Economics, The Institute of Global Economics and Finance, The Chinese University of Hong Kong, and Kwoh-Ting Li Professor in Economic Development, Emeritus, Stanford University. This is a revised version of a presentation made at the Economic Summit, China Development Forum 2015, Beijing, 21 March 2015. All opinions expressed herein are the author's own and do not necessarily reflect the views of any of the organizations with which the author is affiliated.

International trade flows are relatively stable. Foreign direct investment flows, both inbound and outbound, are basically long-term in nature and hence also relatively stable on the whole. The same is true of long-term portfolio investment flows.

However, short-term cross-currency international capital flows are susceptible to abrupt changes in magnitude and direction (e.g., hot money) that can greatly destabilize the financial markets of a country, including its foreign exchange market, credit market and capital market, impacting the real economy negatively.

But the most compelling argument against such short-term cross-currency international capital flows is that, with the exception of short-term trade-related financing, they are not socially productive. Short-term cross-currency capital inflows cannot be usefully deployed in the destination country. When they are used to finance long-term investments in the destination country, they invariably lead to trouble because of the maturity mismatch, and further exacerbated by the currency mismatch. The 1997–1998 East Asian currency crisis is basically the outcome of massive maturity and currency mismatches in the loans taken out by enterprises in the East Asian economies.

Moreover, as short-term capital flows in and out of the destination country, it causes the exchange rate and/or the interest rate of the destination country to become excessively volatile, inhibiting not only the flows of its international trade and long-term investment but also the development of the domestic real economy. Thus, it is desirable to be able to differentiate between long-term capital flows, which should be welcomed and encouraged, and short-term capital flows, which should be discouraged.

3. Regulation of Short-Term Capital Flows with a Tobin Tax

A Tobin tax, originally proposed by the late Professor James Tobin, Nobel Laureate in Economic Sciences, can be an effective means of differentiating between short-term, mostly speculative, capital flows and long-term capital flows such as direct investment and long-term portfolio investment and their repatriation. Moreover, a Tobin tax can actually make possible simultaneously the “Impossible Trinity”.

For the sake of the present argument, a Tobin tax may be taken as a tax of, say, 0.5% on all spot conversions of a foreign currency into Renminbi or vice versa that are not related

to underlying current account transactions. Thus, foreign currency transactions related to the exports or imports of goods and services will be completely exempted from such a tax. In practice, even capital account transactions below a certain threshold level, say 0.5 million Yuan (approximately US\$83,500 at the current exchange rate), should probably also be exempted in order to simplify and facilitate effective enforcement without imposing undue burdens on relatively small capital account transactions.

Such a Tobin tax is intended to impose a penalty on short-term purely financial round-trip excursions from a foreign currency into the Renminbi or vice versa and thereby discourage short-term cross-currency capital flows into or out of China. If every time a foreign currency is converted into Renminbi or vice versa, a tax of, say, 0.5% of the amount being converted is levied, then a round trip within a month would amount to an effective cost of more than 12% per annum, whereas for a direct investment with a long time horizon of, say, 5 years, the tax will amount to a cost of only 0.2% per annum, virtually nothing. Thus, a Tobin tax on capital flows will help to differentiate between short-term and long-term capital flows and to discourage the former.

4. Enabling the “Impossible Trinity”

The “Impossible Trinity” (sometimes also referred to as the Trilemma) is a theorem in international economics which states that it is impossible to have simultaneously all three of the following supposedly desirable outcomes:

A stable exchange rate;

Free capital flows (both inbound and outbound);

An autonomous interest rate policy.

However, as mentioned above, the imposition of a Tobin tax on capital flows in both directions can make all three seemingly simultaneously impossible outcomes simultaneously possible.

Suppose that the one-month Renminbi rate of interest is 3% per annum and the one-month USD rate of interest is 0.5% per annum. (We assume that these are the rates on government bonds or government-insured bank deposits so that they are risk-free.) There is then in principle a risk-free return of 2.5% to reward capital inflows from the U.S. into China.

Given a fixed exchange rate between the USD and the Renminbi, and free capital flows, funds will flow into China until there is so much liquidity in China that the Renminbi interest rate falls and so little liquidity in the U.S. that the U.S. interest rate rises. The capital flows will stop when the Chinese and the U.S. interest rates are equalized at somewhere between their initial rates of interest. In the case of a small economy, the rate of interest of the small economy will fall or rise until it is equal to the U.S. interest rate. It is in this sense that an autonomous interest rate policy is not possible for a small open economy with a fixed exchange rate and free capital flows.

Now, suppose a 0.5% Tobin tax is levied on all capital inflows and outflows. With such a tax, a round-trip capital flow into China within one month will incur a cost of 12% per annum, which is much higher than the 2.5% per annum interest rate differential. Even a round-trip capital flow into China of one-year duration will only earn an additional return of 1.5% (2.5% - 1%) per annum. (Of course the one-year interest rate differential may be different from the one-month interest rate differential.) However, it is clear that interest rate arbitrage is unlikely to be very profitable, even with the use of leverage. For example, with a 0.5% Tobin tax, the interest rate differential between China and the U.S. on one-month bank deposits can be as high as 12% per annum without triggering massive capital inflows or outflows, and the interest rate differential on three-month bank deposits can be as high as 4% per annum. Thus, it is possible to have simultaneously a fixed exchange rate, free capital flows (subject to a 0.5% Tobin tax on both inflows and outflows) and a significant interest rate differential with the rest of the world.

5. Towards Capital Account Convertibility (and a Market-Determined Exchange Rate)

By discouraging short-term capital inflows and outflows, China can avoid having the Renminbi exchange rate become an object of gambling and speculation by the hedge funds of the world, which is not in the best interests of China. The average daily volume of foreign exchange transactions worldwide in 2013 was approximately US\$5.3 trillion. This is equivalent to approximately US\$1.325 quadrillion per year, on the basis of 250 working days per year. The total annual volume of international trade, including trade among countries and regions that do not require currency conversions such as within the euro zone, is approximately US\$45 trillion in 2013, which is only 3.4% of the total volume of foreign exchange transactions.

Since both exports and imports are included in total world trade, they require at most one currency conversion, e.g., a Chinese importer will need to convert from Renminbi to USD to pay the Indonesian exporter, and the Indonesian exporter will need to convert from USD to Indonesian rupiah. It is possible that some exporters or importers may require some currency hedging, but altogether they cannot amount to more than twice the underlying trade transactions and therefore cannot account for more than 6.8% of the foreign exchange transactions worldwide. There are also cross-currency direct investment and portfolio investment that require foreign exchange transactions, but they cannot amount to that much. Average annual international direct investment flow is probably no more than US\$2 trillion.

The bulk of the foreign exchange transactions consists of short-term gambling and speculation, causing unnecessary volatility in the exchange rates of many currencies, which generate no benefits to real economies but create large profits for banks handling these transactions. These banks are in effect operating “legal casinos”, so to speak (and there have been allegations of price fixing in foreign exchange markets by the major multinational banks). Moreover, the volatility of the exchange rates caused by such speculation further increases the demand for foreign exchange hedging and hence foreign exchange transactions. This volatility also discourages international trade flows in goods and services and long-term direct and portfolio investment flows. However, the U.S. Dollar turns out to be the major beneficiary of this volatility as the dominant international reserve currency and the only safe haven currency in the world.

The imposition of a Tobin tax on capital account transactions by China can greatly reduce potential short-term capital inflows and outflows and hence the potential volatility of the Renminbi exchange rate under capital account liberalization. The reduction in volatility can be most beneficial to international trade and cross-border direct and long-term portfolio investment. Freed of short-term speculative capital flows, the Chinese foreign exchange market can be allowed to play a more decisive role in the determination of the Renminbi exchange rate. Moreover, by increasing the cost of capital inflows from other countries, the imposition of a Tobin tax by China also helps to retain the liquidity in the monetary easing countries where it is supposedly intended and needed.

6. Concluding Remarks

Capital account convertibility of the Renminbi, in the sense that both inbound and outbound capital controls will be effectively lifted, is expected to be achieved by 2020. It can occur sooner if short-term speculative capital flows (hot money), both inbound and outbound, which do not benefit the real economy of any country, can be appropriately regulated through the imposition of a Tobin tax. With short-term speculative capital flows successfully discouraged under such regulation, the market can be allowed to play a much more decisive role in the determination of the Renminbi exchange rate.