

**A Safe Approach to Convertibility for the  
Renminbi**

by  
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# **A Safe Approach to Convertibility for the Renminbi**

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## **Introduction**

1. Capital account convertibility for the renminbi is an important subject matter in the further development of the international monetary system, which has not been functioning in a manner conducive to achieving global financial stability. The currency of an economy that is likely, within twenty years, to become the largest in the world has a role to play in the international monetary system, both as a medium of exchange or as a store of wealth. The road to capital account convertibility for the renminbi has, however, not been clearly mapped out, understandably perhaps in view of the risks to monetary and financial stability this would pose to China at a time when financial authorities of developed as well as developing economies are finding it difficult to harness the increasing potency of international capital. This paper examines the subject matter,

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<sup>1</sup> The author wishes to thank Ms Vivian Wong and Ms Ceara Hui of the Institute of Global Economics and Finance at the Chinese University of Hong Kong for their assistance in background research.

makes the important distinction between full convertibility and free convertibility, and recommends a strategy for achieving capital account convertibility for the renminbi.

## **The Policy Intention**

2. Although currently not a sharp focus of international or domestic attention, China seems committed to moving gradually towards capital account convertibility for the renminbi. Current pre-occupations on the monetary and financial fronts are to curb inflation and dampen inflation expectation, shift monetary policy stance from “suitably easy” to “stable”, control effectively “the liquidity gate”, refine further the mechanism for the determination of the exchange rate and interest rate liberalization.<sup>2</sup> These are pressing issues and, understandably, are given much higher priority. But the commitment to capital account convertibility is clear, as articulated in a detailed description on the framework on the administration of foreign exchange published on the website of the State Administration of Foreign Exchange (SAFE).<sup>3</sup> Work in the area of foreign exchange administration “in the next stage” will aim to: “orderly and in a controlled manner expand the channels for capital inflow and outflow to gradually achieve convertibility for the renminbi in the capital account” (有序可控地拓宽资本流出入渠道, 逐步实现人民币资本项目可兑换). The 12<sup>th</sup> five-year (2011-2015) plan repeated the intention “gradually to realize capital account convertibility for the renminbi” (逐步实现人民币资本项目可兑换).

3. There is, however, a lack of explanation on why China should go for convertibility in the capital account. There is, in the same document from SAFE, a reference to “taking the initiative to further deepen reform in foreign exchange administration to continue to refine convertibility in the current account, steadily move towards capital account convertibility and facilitate trade, so as to meet the challenges in

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<sup>2</sup> See for example the statements issued by the People’s Bank of China (PBC) on 27 December 2010 after the fourth quarterly meeting of its Monetary Policy Committee and on 6 January 2010 after the Working Meeting of the PBC on that day.

<sup>3</sup> For a detailed account of the framework on the administration of foreign exchange, see the History Section of the SAFE website. Available at: [http://www.safe.gov.cn/model\\_safe/whjjs/whjjs\\_detail.jsp?id=1&ID=160500000000000000](http://www.safe.gov.cn/model_safe/whjjs/whjjs_detail.jsp?id=1&ID=160500000000000000).

relation to joining World Trade Organization in 2001 and embracing globalization” (外匯管理主动順應加入世貿組織和融入经济全球化的挑戰, 進一步深化改革, 繼續完善经常項目可兌換, 穩步推進資本項目可兌換, 推進貿易便利化). Insofar as capital account convertibility is concerned, this seemed to be a voluntary initiative on the part of China, as it is not a formal requirement for joining the World Trade Organization (WTO), as in the case of convertibility in the current account, although some capital account convertibility is necessary to facilitate the liberalization of trade in services, in particular financial services.

### **Capital Account Convertibility – Theory and Practice**

4. The benefits of capital account liberalization, at least on the theoretical level, are clear, to the extent that capital account convertibility is generally and globally taken for granted as something desirable. The theoretical argument runs as follows: capital account convertibility makes it possible for the risk appetites of those who have surplus money in any jurisdiction to be more fully satisfied by investing and diversifying risk exposures overseas. Fund raisers are also given alternative sources of funding, as their risk profiles may find a less expensive match with risk appetites overseas. Capital account convertibility therefore enhances, on an international dimension, the efficiency in the allocation and use of capital and therefore the efficiency of financial intermediation, which better promotes economic growth and development.

5. There is, however, a dearth of empirical evidence specifically attributing economic success to financial liberalization, in particular capital account convertibility. What seems clear is only that the globalization of financial markets made possible with capital account convertibility has greatly enhanced the profitability of the international financial intermediaries, at least for a long period before the onslaught of the sub-prime crisis that originated in the United States. The empirical evidence on the benefits of capital account convertibility is so lacking that academics and international financial institutions like the International Monetary Fund (IMF) could not find themselves in a position to advocate it with commitment and consistency.

6. Fischer (1998) argued that, similar to trade liberalization, “capital mobility promotes an efficient global allocation of savings and a better diversification of risk”.<sup>4</sup> But this is not an idea shared by all. Joseph Stiglitz won a Nobel Prize with others in 2001 for proposing an economic theory that elicits negative impacts of capital market liberalization, pointing out that market driven optimal allocation of resources is theoretical, as long as the phenomenon of asymmetric information continues to prevail.<sup>5</sup> Instead of encouraging capital flow to economies with the highest return and generating real economic growth, short-term speculative capital flows in and out of the country is often volatile and disruptive, with a pro-cyclical nature and possibly weakening the economy and creating financial instability.

7. Though Fischer and Stiglitz disagreed on the issue of capital account liberalization, they both highlighted the importance of financial regulation in the management of capital flows. Garber (1998) even asserted that financial deregulation and opening up of the capital accounts together is a magnet for financial crisis.<sup>6</sup> It is also stated in an IMF policy paper that: “... it is necessary to approach capital account liberalization as an integral part of more comprehensive programs of economic reform, coordinated with appropriate macroeconomic and exchange rate policies, and including policies to strengthen financial markets and institutions”.<sup>7</sup>

## **Position of the International Monetary Fund**

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<sup>4</sup> Fischer, S. 1998. “Capital Account Liberalization and the Role of the IMF”, in *Should the IMF Pursue Capital Account Convertibility?* Princeton University, International Finance Section, Essays in International Finance, May, 207, pp.1-10.

<sup>5</sup> Stiglitz, J. E. 2000. “Capital Market Liberalization, Economic Growth, and Instability”, *World Development*, Vol. 28, No. 6, pp.1075-1086.

<sup>6</sup> Garber, P. M. 1998. “Buttressing Capital Account Liberalization with Prudential Regulation and Foreign Entry”, in *Should the IMF Pursue Capital Account Convertibility?* Princeton University, International Finance Section, Essays in International Finance, May, 207, pp.28-33.

<sup>7</sup> International Monetary Fund, Monetary and Exchange Affairs Department, “Developments and Issues in the International Exchange and Payments System – Background Studies”, SM/98/172, Supplement 2, 8 July, 1998.

8. Correspondingly, the stance of IMF on capital account convertibility remains an ambiguous one to date, although over the years it has attempted on several occasions to bring the issue of capital account convertibility under its wings. In 1995, an amendment to the 1977 Surveillance Decision defined the role of the IMF with respect to capital account issues, giving it the responsibility to monitoring member countries' capital account policies and providing technical guidance, but not the authority to impose a standard of capital account convertibility.<sup>8</sup> The Asian financial crisis extinguished any excitement in the early 1990s over the possibility of further amending the Articles for the IMF to assume jurisdiction over restrictions in the capital account.

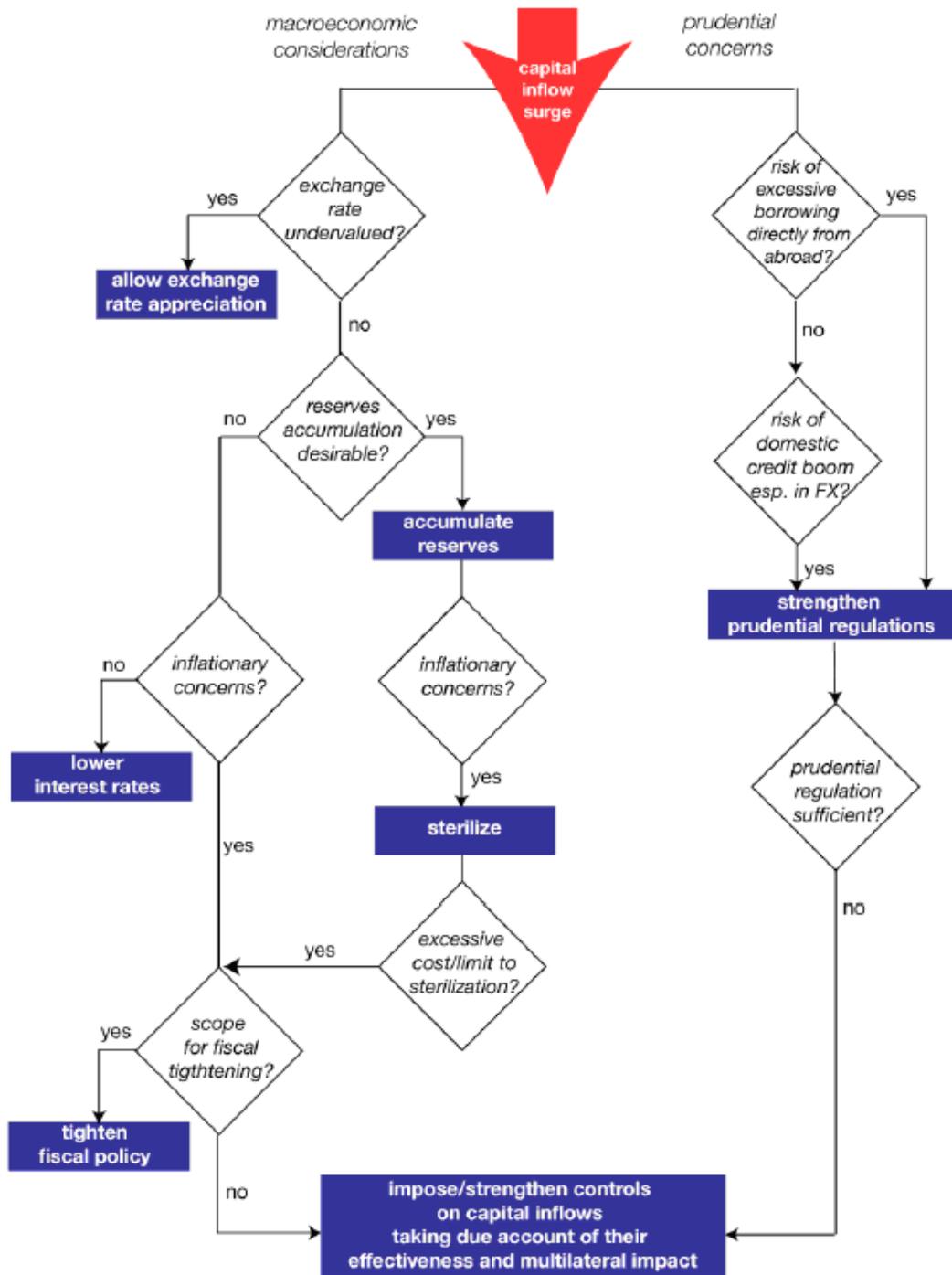
9. Interestingly, the IMF has more recently recognized the destabilizing effects of volatile capital flows, to the extent of lately (February 2010) incorporating capital controls in a stylized package of policy recommendations for coping with surges in capital inflows, reversing an earlier position (2005) against their use. In a staff position note published in February 2010, the IMF justified the imposition of capital controls under certain circumstances and highlighted that certain types of capital (debt and some financial foreign direct investment) might be negatively related to economic growth.<sup>9</sup> The use of traditional policy measures on the fiscal, monetary and exchange rate fronts in responding to capital inflows is still preferred, but if all else fails, then capital controls are to be considered, as illustrated in Figure 1. But users are still reminded to take account of the effectiveness and the multilateral impact of capital controls.

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<sup>8</sup> International Monetary Fund, Independent Evaluation Office, "Report on the Evaluation of the IMF's Approach to Capital Account Liberalization", SM/05/142, Chapter 2, 20 April, 2005.

<sup>9</sup> International Monetary Fund, Research Department, "Staff Position Note – Capital Inflows: The Role of Controls", SPN/10/04, 19 February, 2010.

**Figure 1: Coping with Surges in Capital Inflows: Macroeconomic and Prudential Considerations**



Source: IMF Staff Position Note – Capital Inflows: The Role of Controls, February 2010

10. IMF's support or acquiescence on the imposition of capital controls to cope with surges in capital inflows, of course, is not synonymous with it having the same pragmatic attitude towards capital account convertibility. But, having regard to the downside risks that capital account convertibility presents to monetary and financial stability, cautiousness in moving towards it is without doubt a defensible position. Thus there have not been noticeable political pressures on China on this front, unlike on the exchange rate front, where concern over the sustainability of the external imbalance features prominently, and China is able to proceed on capital account liberalization very much free from the glare of a strong international spotlight.

### **Policy Considerations for China**

11. It is a fact though that the age of globalization of financial markets coincided with impressive global economic growth, although at the same time, the frequent occurrence of financial crises in the last two decades has also demonstrated quite clearly the risks that unbridled capital account convertibility can pose to monetary and financial stability. China is clearly aware of the pros and cons of capital account convertibility, the lack of empirical evidence of the benefits notwithstanding. It is, to China, probably a question of carefully finding a modality of capital account convertibility that ensures that the potency of international capital is well harnessed for the benefit of the economy, having regard to the special and unparalleled characteristics of its socialist, market economy.

12. There is, nevertheless, an important consideration for China, and this is the crucial and thankfully recognized need for an adjustment in its growth model in the form of a relative shift from being export-led to domestic consumption led. This has many benefits, not least enhancing the sustainability of economic growth and development of China. The prospects of China more meaningfully contributing to correcting the global imbalance would also be enhanced, which at the same time would shift attention away from the misguided and politically inspired remedy (through exchange rate appreciation) that many have been promoting.

13. It is not clear whether there is adequate recognition in China that one important element in the strategy to enable the necessary adjustment in its growth model to materialize is a judicious relaxation of capital account convertibility. This can be illustrated by looking at the national accounting identity, which can be expressed as  $S - I = X - M$ , where  $S$  is national savings;  $I$  is gross domestic fixed capital formation or, put simply, investment;  $X$  is exports; and  $M$  is imports. The fairly large balance of trade surplus of China is reflected in the excess of savings over investment, even though there has already been concern of over-investment in China. The reason why savings (the savings rate is estimated to be around 50% of GDP) is so high reflects the need for the community to self-insure, given the relative lack of social security benefits.<sup>10</sup> Yet the less than well developed financial system does not provide diversified avenues for achieving a rate of return for savings that is big enough to obviate the need to save even more. Exchange rate appreciation notwithstanding, capital account convertibility, in a form that allows domestic savings to be invested also overseas to achieve a higher and more stable risk-adjusted rate of return would contribute to lowering the saving rate and boosting consumption expenditure.

### **Current Position on Capital Account Convertibility**

14. Whether or not this is in the minds of policy makers in China, it is interesting to note that China's position in respect of capital account convertibility is still a clear and positive one, as articulated by SAFE. Also interesting is that, while there have been an abundance of market predictions on timing, there is no official timetable for achieving capital account convertibility. Presumably, there is no need for one and this is not an area in which there is political pressure. If anything, the potency of international finance resulting from financial liberalization calls for caution. So, on capital account convertibility, China's attitude, as described quite clearly by SAFE, is that it is an area of reform characterized by emphasis being placed on "gradualism, coordinated planning,

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<sup>10</sup> The estimated annual savings rate expressed as a percentage of GDP can be obtained from the World Development Indicators of The World Bank.

tackling easier areas before more difficult ones and reserving grounds” (循序漸進, 統籌規劃, 先易後難, 留有余地).<sup>11</sup>

15. China’s attitude on convertibility has been very consistent over the years.<sup>12</sup> The beginning was the decision taken at the Third Plenum of the Fourteenth Session of the Party (黨的十四屆三中全會) on 14 November 1993 in relation to “certain questions concerning the establishment of a socialist, market economic system” (中共中央關於建立社會主義市場經濟體制若干問題的決定). The important requirement, among other things, was then laid down to “reform the system of foreign exchange administration; establish a managed floating exchange rate system on the foundation of market supply and demand, and a unified and regulated foreign exchange market; and gradually allow the renminbi to become a convertible currency” (改革外匯管理體制, 建立以市場供求為基礎的、有管理的浮動匯率制度和統一規範的外匯市場, 逐步使人民幣成為可兌換貨幣).

16. Almost immediately in 1994, conditional convertibility was introduced to current account items. Then quickly by December 1996 all restrictions on current account convertibility were lifted, thus satisfying and observing Article 8 of the IMF and achieving full convertibility in the current account. Until then, however, capital account convertibility was still strictly controlled. It was not until after China’s accession to the WTO in November 2001 that significant action was taken to “steadily move towards capital account convertibility” (穩步推進資本項目可兌換). By the end of 2004, looking at China’s position in respect of the 43 items of transactions in the capital account specified by the International Monetary Fund, a self-assessment by SAFE indicated that 11 items were convertible, another 11 items were subject to relatively few restrictions (較少限制), 15 items were subject to relatively more restrictions (較多限制) and 6 items were strictly controlled (嚴格管制).

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<sup>11</sup> A detailed description on the framework on capital account convertibility can be found in the History Section of the SAFE website. Available at: [http://www.safe.gov.cn/model\\_safe/whjjs/whjjs\\_detail.jsp?id=1&ID=160500000000000000](http://www.safe.gov.cn/model_safe/whjjs/whjjs_detail.jsp?id=1&ID=160500000000000000).

<sup>12</sup> For a detailed account of the developments over the years, see the History Section of the SAFE website. Available at: [http://www.safe.gov.cn/model\\_safe/whjjs/whjjs\\_detail.jsp?id=1&ID=160500000000000000](http://www.safe.gov.cn/model_safe/whjjs/whjjs_detail.jsp?id=1&ID=160500000000000000).

17. The IMF publishes an Annual Report on Exchange Arrangements and Exchange Restrictions (AREAER). Table 1 summarizes the position on capital account restrictions in respect of major capital account items based on the information provided in AREAER 2008. The special arrangements for residents investing abroad through Qualified Domestic Institutional Investors (QDII) schemes and non-resident investing in China through Qualified Foreign Institutional Investors (QFII) schemes are examples of the cautious moves taken by China in recent years in enhancing capital account convertibility. By the end of 2010, there were 88 QDIIs approved, involving a total amount of overseas investment of US\$68.361 billion; and 97 QFIIs approved, involving a total amount of investment in China of US\$19.72 billion.<sup>13</sup>

**Table 1: Brief Summary of Restrictions on Major Capital Transactions in China (by 2008)**

		<b>Inflow*</b>	<b>Outflow*</b>
<b>Stock market</b>	<b>nonresidents</b>	<ul style="list-style-type: none"> <li>- purchase B shares (USD/HKD) listed on the Chinese Securities Exchange (also available for domestic investors)</li> <li>- QFIIs purchase A shares subject to a set of limitations</li> </ul>	<ul style="list-style-type: none"> <li>- sell A and B shares listed on the Chinese Securities Exchange</li> <li>- nonresidents issue A or B shares with no restrictions</li> </ul>
	<b>residents</b>	<ul style="list-style-type: none"> <li>- issue H shares abroad with CSRC approval</li> </ul>	<ul style="list-style-type: none"> <li>- domestic companies repurchase shares issued abroad with SAFE approval</li> <li>- QDIIs purchase shares and other investment instruments abroad subject to a set of limitations</li> </ul>
<b>Bonds and</b>	<b>nonresidents</b>	<ul style="list-style-type: none"> <li>- QFIIs are permitted to</li> </ul>	<ul style="list-style-type: none"> <li>- international development</li> </ul>

<sup>13</sup> Figures are obtained from a paper by the Director of SAFE published on the SAFE website on 18 January 2011.

<b>other debt securities</b>		purchase treasury bonds, convertible bonds and corporate bonds locally	agencies are permitted to issue RMB denominated bonds with the approval of the MOF, the PBC, and the National Development and Reform Commission  - foreign-funded enterprises are permitted to issue bonds with approval
	<b>residents</b>	- prior approval by State Council for Examination	- insurance companies, securities firms, qualified banks and groups are permitted to purchase foreign bonds that meet rating requirements, subject to the approval of the China Insurance Regulatory Commission (CIRC) and the SAFE
<b>Money market</b>	<b>nonresidents</b>	- QFIIs may purchase locally	- no permission
	<b>residents</b>	- issue money market instruments with SAFE approval	- insurance companies, securities firms, qualified banks and groups are permitted to purchase money market instruments that meet rating requirements, subject to the approval of the CIRC and the SAFE
<b>Collective investment securities</b>	<b>nonresidents</b>	- QFIIs may invest in closed-end and open-end funds locally	- no permission

	<b>residents</b>	- issue collective investment securities with SAFE approval	- insurance companies, securities firms, qualified banks and groups are permitted to purchase collective investment securities that meet rating requirements, subject to the approval of the CIRC and the SAFE
<b>Derivatives and other instruments</b>	<b>nonresidents</b>	- no permission	- no permission
	<b>residents</b>	- regulated financial institutions with the approval of the Chinese Banking Regulatory Commission (CBRC) may sell for the purposes of hedging, gaining profit, and providing transaction services for clients  - derivative operations are subject to prior review by regulatory agency and restriction on open foreign exchange position	- regulated financial institutions with the approval of the CBRC may purchase for the purposes of hedging, gaining profit, and providing transaction services for clients  - derivative operations are subject to prior review by regulatory agency and restriction on open foreign exchange position  - regulated financial institutions that meet risk management requirements may trade in gold futures on domestic market
<b>Direct Investment</b>		- approved (by the Ministry of Commerce) nonresidents are free to invest in China	- permitted only after examination of the sources of foreign exchange funds, approval of the related authorities and completion

			of offshore investment foreign exchange registration
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Note: Inflow represents purchase locally by nonresidents and sale or issue abroad by residents, whereas outflow represents sale or issue locally by nonresidents and purchase abroad by residents

Source: IMF AREAER 2008

18. On 18 January 2011, there was a paper by the Director of SAFE published on the SAFE website, summarizing, in the area of foreign exchange administration, achievements in the period of the 11<sup>th</sup> Five Year Plan and laying out work for the period of the 12<sup>th</sup> Five Year Plan.<sup>14</sup> In relation to capital account convertibility, there it was mentioned that: “as of now, according to the classification by the IMF of the total of 40 capital account transaction items falling into seven categories, those that remain strictly controlled mainly relate to cross-border transactions of financial derivatives; the other items are all, to a significant degree, convertible, the extent of renminbi convertibility in the capital account has been noticeably raised” (截至目前, 按照國際貨幣基金組織劃分的 7 大類共 40 項資本項目交易中, 我國實施嚴格管制的主要是跨境金融衍生工具交易等, 其他項目已實現一定程度的可兌換, 人民幣資本項目可兌換程度明顯提高).

19. Looking ahead into the period of the 12<sup>th</sup> Five Year Plan, the SAFE statements relevant to capital account convertibility include: “further promote trade and investment facilitation” (進一步推進貿易投資便利化) and “steadily relax the restrictions on cross-border capital transactions; refine the monitoring and analytical system on cross-border funds; and, on the foundation of effective and timely monitoring of information, and risks being kept manageable, realize step by step renminbi convertibility for capital items” (穩步放寬跨境資本交易限制, 健全跨境資金監測分析體系, 在信息監測及時有效、風險可控的基礎上, 逐步實現人民幣資本項目可兌換). Thus, with the necessary caution, China confidently continues to move towards capital account convertibility.

<sup>14</sup> The paper is available at:  
[http://www.safe.gov.cn/model\\_safe/news/new\\_detail.jsp?ID=9000000000000000,864&id=3&type=1,2](http://www.safe.gov.cn/model_safe/news/new_detail.jsp?ID=9000000000000000,864&id=3&type=1,2).

20. The reference to a monitoring and analytical system on the cross-border movement of funds is quite interesting. This suggests the existence of a sophisticated system for monitoring capital flows and conducting analysis. This type of management information system is an essential element of risk management in this delicate area and China seems to have taken advantage of modern information technology to have such systems built, along with taking steps to reform the financial system generally and liberalize the capital account in particular. In other communications from PBC and SAFE, there are, for example, references to an RCPMIS, which stands for RMB Cross-border Payments & Receipts Management Information System (人民币跨境收付信息管理系统) and a “direct investment foreign exchange administration information system” (直接投資外匯管理信息系統). The close attention given to monitoring and analyzing developments mirrors the philosophy in the management of reform that has been articulated repeatedly by Chinese leaders, particularly the Premier, that places much emphasis on “controllability, gradualism and the ability to take the initiative” (可控、漸進、主動). Objectively speaking, having regard to the tremulous developments in international finance seen in the last two decades, this seems to be a prudent approach to capital account convertibility.

21. SAFE in July 2010, presumably in response to the concern over the rapid accumulation of foreign reserves and for these to be held in assets that may be deteriorating in quality as a result of the financial crisis in the developed markets, made an interesting attempt to explain China’s policy in the management of foreign exchange. SAFE emphasized that it pays “a lot of attention to communicating with the public” and that it is “proactive in adopting various means to enhance transparency of policy and management so as to facilitate the familiarization and understanding of foreign exchange management by the community”.

22. The explanation took the form of 28 questions and answers (Q and A) published in five articles appearing on the website of SAFE covering a wide variety of subjects on foreign exchange management: from generally the role of foreign reserves and how they were being managed, to specifically the exposure to Fannie and Freddie, and the impact of the sovereign debt crisis in Europe, and to philosophical issues in further taking

forward reform and liberalization. The 23<sup>rd</sup> Q and A articulated “five changes in the approach to foreign exchange management in China” (外汇管理理念的五个转变) as “specific realization of the need to press ahead with the philosophy of scientific development” (贯彻落实科学发展观的具体实践).<sup>15</sup> The five changes were articulated as follows:

- (1) From emphasizing examination and approval to emphasizing monitoring and analysis (從重审批轉變為重监测分析);
- (2) From emphasizing pre-event regulation to emphasizing post-event management (从重事前监管转变为強調事后管理);
- (3) From emphasizing conduct management to emphasizing institutional management (從重行为管理转变为更加強調主体管理);
- (4) From “presumed guilty” to “presumed innocent” (从 “有罪假设” 转变到 “无罪假设”); and
- (5) From “positive documentation (prohibited unless specified in law)” to “negative documentation (allowed unless prohibited in law)” (从 “正面清单” (法無明文受权不可為) 转为 “負面清单” (法無明文禁止即可為)).

23. Although these are statements of intentions, they are rather bold indeed, to the extent of giving the impression of placing too much trust in the integrity of those dealing in the foreign exchange market. But, read with the further elaborations provided in Answer 23 (A23), these statements perhaps presage a modus operandi for foreign exchange management, or a form of convertibility, possibly a new paradigm for the foreign exchange market, that provides an interesting (and perhaps the optimal) balance between the need for the market to serve the demands of the economy and the need to

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<sup>15</sup> The five articles are all available from the SAFE website. In particular, the 5<sup>th</sup> article comprising the 23<sup>rd</sup> Q and A is available at:  
[http://www.safe.gov.cn/model\\_safe/news/new\\_detail.jsp?ID=9000000000000000,810&id=3&type=2](http://www.safe.gov.cn/model_safe/news/new_detail.jsp?ID=9000000000000000,810&id=3&type=2).

ensure financial safety – a balance that has been so elusive in the recent history of international finance. It would be interesting to observe how these five changes will be brought into effect. Rightly so, as also emphasized in A23, there is a need for a longish period for implementation, during which the five changes will be continuously refined.

### **The Foreign Exchange Market**

24. The function of the market in price discovery is perhaps something that has been so much taken for granted that the efficiency with which market performs that function is seldom discussed, let alone questioned. This is particularly so in financial markets, where so much is at stake in even the slightest of price movements, churning out, or destroying, millionaires in every twist and turn. Market players live on volatility, and, as if volatility in the market price in whatever is being traded is not large enough to provide opportunities for profit, derivatives betting on the change in the price have become almost a standard feature of financial markets nowadays.

25. Those familiar with the history of Hong Kong before the resumption of sovereignty in 1997 will remember that popular term “the maintenance of stability and prosperity” used repeatedly in statements from the Sino-British Joint Liaison Group tasked then with working out the transitional arrangements for Hong Kong in the lead up to 1 July 1997. The repeated use of the term annoyed observers, particularly those in financial markets in Hong Kong then, who understandably were keen to see developments in those talks, so much that they, perhaps jokingly, betrayed the sentiment that, in their opinion, “in finance, stability and prosperity cannot go together”. Jokingly or not, such sentiment regrettably features prominently in how financial market participants behave. When financial markets turn quiet for a while and prices remained stable, there would be complaints on the lack of “vol”, which stands for volatility (or perhaps volume as well).

26. One question that perhaps regulators should ask is whether the financial markets they regulate are discovering price efficiently enough to serve the original purpose

justifying their existence in the first place. Or is there instead too much price volatility and market distortion that financial markets are actually serving the private interests of those making a living in the markets, instead of serving the needs of the economy – the all important public interest? Furthermore, does volatility, which market participants like so much, threaten to undermine the robustness of the financial system and its ability to support the economy? Is there a better and more cost-effective way of harnessing the potency of the market in resource allocation that presents less risk in harming the public interest?

27. In the foreign exchange market, according to statistics published by the Bank for International Settlements (BIS) and the United Nations Conference on Trade and Development (UNCTD), 97% of turnover represents trading and position taking obviously in anticipation of significant movements in the exchange rates of currencies and in the hope of making a profit.<sup>16</sup> There is hedging as well, representing the legitimate need of managing foreign exchange risks arising from exposures, speculative or otherwise, that have been built up. The other 3% represents the foreign exchange needs arising from actual economic activity such as trade and foreign direct investment. Without laboring the point further, there is at least doubt as to the need of the 97% in discovering a price that serves the need of the 3%. The empirical evidence, in the form of sharp, short term volatility that has been highly destabilizing and characterized by occasional predatory behavior, seems to suggest the contrary. There is a need to tame that 97% and reminding it of the purpose of its existence, even if this means cutting it down to size and cutting jobs.

### **Determinants of Financial Vulnerability**

28. The experience with the Asian financial crisis of 1997-98 and the sub-prime crisis of the developed markets of 2008-09 drew international attention on how best authorities

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<sup>16</sup> By using 2007 world data obtained from the BIS and the UNCTD, the foreign exchange turnover arising from actual economic activities can be approximated by dividing the sum of annual total trade in merchandise and services and annual foreign direct investment flows by annual total foreign exchange turnover, assuming the number of trading days per year to be 250.

can deliver financial stability. There is an abundance of literature on the subject, particularly by the international financial institutions and the standard setting bodies. It is not the intention of this paper to survey these. Rather, as a necessary step in addressing the subject of convertibility of the renminbi, an attempt is made here to articulate from a macro perspective three determinants of financial vulnerability, as learnt from the first hand experience in actually dealing with the two financial crises. They are of course not exhaustive, but at least two of them have not been the focus of attention in other studies in the subject.

29. The first determinant is an obvious one. This is the credibility of macroeconomic policies. Not a lot needs to be said about it. There is often a popular explanation for the onslaught of a financial crisis, as the international financial institutions are always at pains to point out, and this is that macroeconomic policies have been less than prudent. Over-indebtedness or over-dependence on borrowing overseas and in foreign currencies; large balance of payment deficits, large budget deficits, too rigid exchange rates, ineffective monetary management, etc, are common themes. But prudent macroeconomic policies do not guarantee financial stability. The macroeconomic numbers of individual Asian economies in 1997 were a lot more robust than those of many developed markets nowadays. Yet they were brutally “punished” by the market. This differential “treatment” by financial markets seems to impose an almost unfair macroeconomic discipline on different jurisdictions, and this can be explained by the other two determinants of financial vulnerability.

30. The second determinant is size, or more specifically, the size of the financial markets of a particular jurisdiction relative to the volume of international capital, which has ballooned over the years of economic prosperity before the sub-prime crisis and sustained, if not enlarged, by quantitative easing being pursued by central banks of a few developed markets as a response to the crisis. While waves made by the movement of international capital are normally just waves on the shores on the developed markets of largest countries, they could be tidal waves for smaller markets. But the relationship between financial vulnerability and size is not a linear one. The smallest of financial markets are not big enough meaningfully to attract the international capital always

searching for quick and handsome profit. Macau, for example, with its currency linked to the Hong Kong dollar was not subject to currency attack in 1997-98, while Hong Kong, a market with adequate liquidity to attract international capital, but regrettably small enough to be tossed around, got the worst of it. So did the medium sized emerging markets in the Asian region.

31. A remedy for financial vulnerability arising from the size factor is perhaps for medium sized financial markets to achieve quantum growth through the use of common currencies. For Asia, this would mean monetary union, following the (now doubtful in the absence of close fiscal coordination) example of Europe. But it is difficult to envisage individual jurisdictions in Asia willing to concede their sovereign right over monetary policy (and fiscal policy). While the future of monetary arrangements in Asia, and therefore of the international monetary system, is a subject of great importance, it is intended for discussion in other papers.

32. The third determinant of financial vulnerability is openness of financial markets, not just the openness to international capital, which is relevant to China in achieving convertibility for the renminbi, but also to financial innovation, which more often than not presents sources of financial instability. Focusing in the former, the fact that quite a number of jurisdictions opted for imposition of capital controls, however temporary they may be, in coping with or in pre-empting financial instability clearly supports the thesis. It is also the high degree of openness and freedom in financial markets in Hong Kong – mandated in the Basic Law – that made the maintenance of financial stability in Hong Kong such a challenging task, necessitating the self-imposition of very firm discipline in the management of its macroeconomic, monetary and financial affairs. As pointed out earlier in this paper, there is no consensus in academic literature on the benefits of capital account liberalization. Thus, for jurisdictions contemplating the liberalization of the capital account, such as China, the question of the optimal degree and the form of openness should be carefully addressed.

### **Full versus Free Convertibility**

33. There is a need perhaps to distinguish between full convertibility and free convertibility for a currency, a distinction that is not normally made in international discussion on convertibility. The usual meaning attached to the word convertibility seems to be the freedom to convert between a domestic currency and foreign currencies, with no questions asked, no forms filled in, no approvals needed and no reporting requirements. As long as, for example, the bank is satisfied with the counter-party risks, including settlement risk, of the customer, and subject to know-your-customer and anti money laundering requirements, it is free to deal with or for the customer. This is the case in Hong Kong and in the majority of capitalist, free market economies. Indeed, for Hong Kong, Article 112 of the Basic Law specifies that “No foreign exchange control policies shall be applied in the Hong Kong Special Administrative Region. The Hong Kong dollar shall be freely convertible. Markets for foreign exchange, gold, securities, future and the like shall continue. The Government of the Hong Kong Special Administrative Region shall safeguard the free flow of capital within, into and out of the Region”.

34. Full convertibility can be assessed against the many items in the current and capital accounts, as articulated by the IMF. Very simply, if all the items in both the current and capital accounts are convertible, then there is full convertibility. But full convertibility does not necessarily and should not mean total freedom to convert, without, for example, the need to seek approval from any authority or to report. It is quite legitimate for any jurisdiction to impose requirements to go through procedures that are essential for safeguarding financial stability, having regard to the circumstances specific to individual jurisdictions. It is also quite legitimate, if it is felt necessary, for the authorities to impose the condition that approval for conversion for a specific purpose is subject to the converted amount being used for the purpose for which it is sought.

35. In any case, it is not clear if convertibility, with or without approval, for all the 43 items in the capital account is at all times beneficial. One has yet to see full and convincing justifications on how convertibility for the trading of certain complex financial derivative products would enhance the efficiency of financial intermediation on

an international dimension. Instead, there is no lack of examples on how these products unmistakably played a significant role in eroding the robustness of financial systems actively engaged in originating and distributing them, and, for some, in buying them.

36. It is encouraging to note that in official statements on the subject of convertibility, China uses the term “可兌換”, which can be translated as “allowed to convert”, rather than “自由兌換”, or “free to convert”. It is, of course, important to promote the ease of conversion in order to facilitate the efficient conduct of desirable economic and financial activities, but, as articulated in A23, at the bottom line are the controllability of risks and financial safety (以风险可控、金融安全为底线). To hold that bottom line, there is a need for a mechanism exhaustively to monitor and analyze cross border capital flows (对跨境资金流动全口径监测分析), however desirable it may be to gradually shift from ex ante approval to emphasizing on ex post monitoring and management (逐步减少事前审批, 重点加强事后监测管理).

### **A Recommended Strategy**

37. Having regard to the arguments in this paper, it is recommended that the following strategy be adopted in achieving capital account convertibility for the renminbi.

- (1) The approach to reform in relation to convertibility of the renminbi in the capital account should, as for other areas of reform, continue to emphasize on “controllability, gradualism and the ability to take the initiative”;
- (2) A clear distinction, as articulated in this paper, should be made between full convertibility and free convertibility, with full convertibility being adopted as the goal for reform in foreign exchange management;
- (3) A critical examination should be made on the risks and benefits of convertibility for each of the many items in the capital account, involving the appropriate international standard setting bodies, focusing on the risks to financial stability and the benefits to

financial efficiency, and emphasizing at all times that the role of finance is to support the economy rather than to enhance the profitability of financial intermediaries;

- (4) In terms of individual items in the capital account, convertibility should be introduced only after it has been convincingly demonstrated that doing so is clearly in the public interest of enhancing financial efficiency and that the risks to financial stability can be prudently managed;
- (5) A mechanism to facilitate efficient conversion for the legitimate transactions on the one hand and effective monitoring on the other should be established;
- (6) The relevant financial intermediaries, notably the banks with access to the wholesale foreign exchange market, should, in line with the requirement to know-your-customers, be given the responsibility to understand the conversion needs of their customers and ensure that the conversion proceeds are mobilized to meet those legitimate needs;
- (7) The authorities should reserve the right to impose sanctions, either in the form of penalties or in the form of tax, against abuses in conversion.

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