World Bank China Office Research Paper No. 4

External Liberalization and the Evolution of China's Exchange System: an Empirical Approach[1]

Min Zhao

The World Bank Beijing Office

Abstract:

China's external liberalization has been experimental and gradual, making it evolutionary rather than revolutionary. The empirical approach has allowed China to draw lessons from experiments, and subsequently establish or adapt the institution and administration system that are appropriate for the particular stage of liberalization. China's success suggests that the empirical approach is a useful and pragmatic approach to handle systemic reform in a complex and diversified economy. This paper provides a detailed description of China's external liberalization and the evolution of exchange control system in the context of the overall reform during the period between 1978 and 2005. This paper draws four conclusions from China's experience: (1) maintaining the first priority on foreign direct investment; (2) strategically timing the liberalization to smooth the capital flows; (3) carefully sequencing external liberalization; and (4) strengthening capacity in supervising and monitoring risks associated with liberalization. Looking ahead, China is likely to accelerate capital account liberalization and outward investments in near future, though in a prudent and controlled manner. This move will have far-reaching implication for the world financial market.

[1] Comments are appreciated. Mzhao1@worldbank.org
I thank Bert Hofman for encouragement and comments and Tao Wang, Xin Wang and Chongeng Bai for comments on an earlier draft. I also would like to thank Xu Nuo for his very able research assistance and Niu Zijing for editorial assistance.

Glossary of Abbreviations

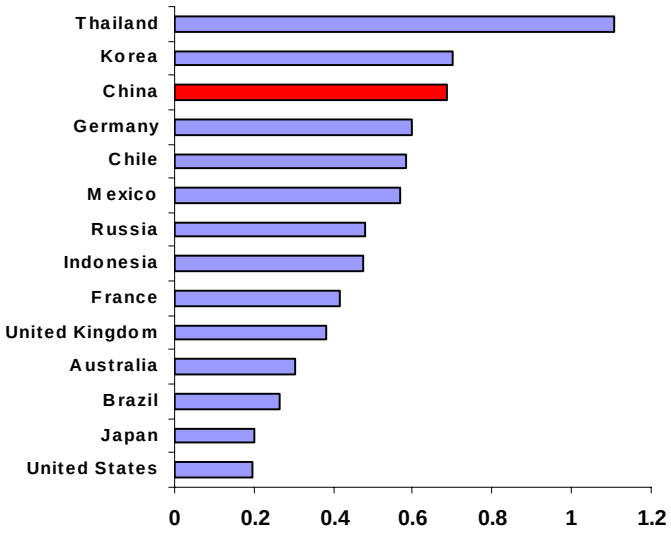
ABC	Agricultural Bank of China
BOC	Bank of China
CBC	Construction Bank of China
CFETS	China Foreign Exchange Trading System
EDZs	Economic Development Zones
EDSA	external debt specified account
EDPSA	external debt payment specified account
FDI	Foreign Direct Investment
FEACs	Foreign Exchange Adjustment Centers (swap centers)
FEDBs	Foreign Exchange Designated Banks
FERQs	Foreign Exchange Retention Quotas
FESPS	foreign exchange surrender and purchase system
FFEs	foreign funded enterprises
FTCs	foreign trade corporations
ICBC	Industrial and Commercial Bank of China
ITICs	International Trade and Investment Corporations
MOFERT	Ministry of Foreign Economic Relations and Trade
MOFTEC	Ministry of Foreign Trade and Economic Cooperation
MOC	Ministry of Commerce
MNC	Multi-National Corporate
NBFIs	Non-bank financial institutions
NFEAC	National Foreign Exchange Adjustment Center
NDRC	National Development and Reform Commission
OTC	over-the-counter
PBC	People's Bank of China
QFII	qualified foreign investment institutions
QDII	qualified domestic investment institutions
RMB	Renminbi (China’s currency)
SAFE	State Administration of Foreign Exchange
SEZs	Special Economic Zones
SOEs	State-owned enterprises
TICs	trust and investment corporations

I Introduction

Prior to 1978, China was practically a close economy, with very limited trade and no financial interaction with the rest of the world. In 1978, China initiated economic reform and started opening up to the rest of the world. In December 1978, the Third Plenum of the Eleventh Central Committee of the Communist Party announced to shift the principal task of the government to reform the economic system.

Over the two and half decade since the start of the opening up process, China has become one of most open economies in the world in many prospects. Trade volume reached 64 percent of GDP in 2005. The run-up to the WTO accession in December 2001 saw a major reduction in trade barriers, with average tariffs falling from over 40 to 15 percent. The un-weighted average tariff rate was reduced to 10 percent in 2005, and key commitments with respect to banking services and trade and distribution rights have also moved forward. China's degree of openness is rare among economies with similar size of population or GDP (Figure1). China has also been very successful in attracting foreign direct investment (FDI): the country received about a quarter of all FDI to developing countries over the last 10 years, and a record $60.6 billion in 2004, some 9.9 percent of total global FDI. (See Annex 1, selected economic indicators)

Figure 1. Comparison of Trade Openness[2]



Data source: International Financial Statistics and Staff calculation

China has successfully managed the process of the transition from a closed to an open economy. During this period, China maintained an average economic growth rate of 9.7 percent. Growth has also been relatively stable over the reform period: the standard deviation of economic growth rate is only 2.8 percentage points, or 29% of the period mean. Growth only faltered in the aftermath of the Tiananmen events in 1989, and growth slowed in 1997/98 after the Asian crisis affected the rest of the region.

During the external liberalization process, China developed a comprehensive exchange control system covering all balance of payments transactions. The role of the exchange system has been evolving over time to adapt to the extent to which China economy is integrated with the global economy. Descriptions of the evolution of China's exchange

[2] Trade openness is calculated as the share of exports and imports in gross domestic product in 2004.

control system are rare. Tseng et al (1994) summarize the main elements of the trade and exchange system in 1992-93 and China's reform program in 1994. Mehran et al (1996) describe the development of China's exchange system in early stage till 1993. Since late 1990s, most economists focused their studies on the effectiveness of China's capital control (see ex. Hu, 2004; Luo, Huang & Jiang, 2005; Ma & McCauley, 2005) and few analyzes the developments of the exchange system and its evolving role in macroeconomic management.

This paper reviews the process of China's external liberalization with particular focus on the role of the exchange control system, describes the achievements so far and provides prospects for the future. Section II provides an overview of the external and exchange reform process since 1978 against the background of the overall economic reform, and gives a detailed account of the reform developments of external liberalization and exchange control system. Section III draws experience from China's reform experience. Section IV discusses the outlook for further reform, and the main conclusions of this paper are presented in Section V.

II External liberalization and Developments in the Foreign Exchange Management System

At the outset of the reform and opening up process in 1978, China was a close and central planning economy. China traded little with the rest of the world, and total trade volume in 1978 was $20.7 billion, or 9.8 percent of GDP. External trade was carried out by a handful of foreign trade corporations (FTCs). All foreign exchange transactions were carried out by the Bank of China, a state-owned bank specializing in foreign banking transactions. All foreign exchange receipts had to be sold to the State, and all foreign exchange payments were subject to a compulsory foreign exchange plan. China did not borrow from other countries, nor received foreign direct investment. Since the 1978 Third Plenum of the Eleventh Central Committee of the Communist Party, which initiated Deng Xiao Ping's reform policies, China has gradually opened up to the rest of the world as a part of the country's reform strategy. In less than three decades, China has become a predominantly market-based economy that is highly integrated into the global economy. Trade volume increased by 70 times, the share of trade in GDP five-folded, and the country's share in world trade increased from 0.8 percent to 7.7 percent during 1978-2005. Foreign banks have spread all over the coastal China, and China has become the largest recipient of FDI in the developing world, attracting a quarter of all FDI to developing countries. This section reviews this external liberalizing process from 1978 to the present. It first summarizes the main characteristics of the process and then describes how the foreign exchange control system evolved over time in line with the liberalization in the rest of the economy. A chronology of external liberalization and the evolution of China's exchange system is presented in Annex 3.

2.1. Characteristics of external liberalization process

In mid-1978 the China Communist Party reviewed the lessons of the culture revolution. The review established a philosophy that "*Practice is the sole criterion to test truth*", which helped the authorities to overcome the obstacle of doctrinarism—communist ideology in economic management. This basic philosophy has guided the decision making in the whole reform and liberalization process. Following this philosophy, external liberalization has been experimental and gradual, making it evolutionary rather than revolutionary. The empirical approach has allowed China to draw lessons from experiments, and subsequently establish or adapt the institution and administration system that are appropriate for the particular stage of liberalization. The empirical approach has been supported by a strong political commitment to reform and opening up. Over time, China has developed a comprehensive exchange control and monitoring system, which allows for a deep integration in the world economy in terms of trade and investment, but which has shielded China from external crisis in the process.

Empirical Approach

Many economists and observers describe China's reform and opening up process as gradualism. Merriam-Webster's Collegiate Dictionary (tenth edition) defines gradualism as "the policy of approaching a desired end by gradual stages". By this definition, the term *gradualism* does not capture the characteristic of China's reform and liberalization process very well. The reasons are twofold. The first is that China's reform and liberalization never followed any blueprint. At the on-set of the reform, no one knew where the reform would end. The second is that almost all liberalization measures were first tested, either in a location or in one industry, before the experiment, if successful, was expanded nationwide. When the empirical evidence from experiments helped build strong political will, the liberalization process has sometimes been radical, rather than gradual. The current account convertibility introduced in 1996 and service sector liberalization under WTO commitment in 2001 are examples of radical reform. Likewise, disappointing results from an experimental reform slowed down the liberalization process. Two periods (1987-1991 and 1997-2000) are such cases of slowdown. An "empirical approach" therefore is a better alternative to describe China's liberalization process—truth from facts. As Deng Xiaoping said in 1985, the reform and opening up is a very big experiment and one can not learn from books.[3]

Examples of the empirical approach in external liberalization are numerous, including liberalizing FDI in four SEZs in 1980, the opening of foreign exchange swap centers in selected cities in1986, the opening of the banking sector to foreign banks in Special Economic Zones (SEZs) first and the opening of the domestic capital market for selected foreign institutional investors in 2002, as well as the opening of investment abroad for selected domestic financial institutions in 2005. In all cases, restrictions were relaxed after the authorities had confidence that these experiments were successful.

[3] P. 130, The 3rd volume, Selected Works of Deng XiaoPing, 1993, People Publishing House

Figure 2 policy cycle of empirical approach

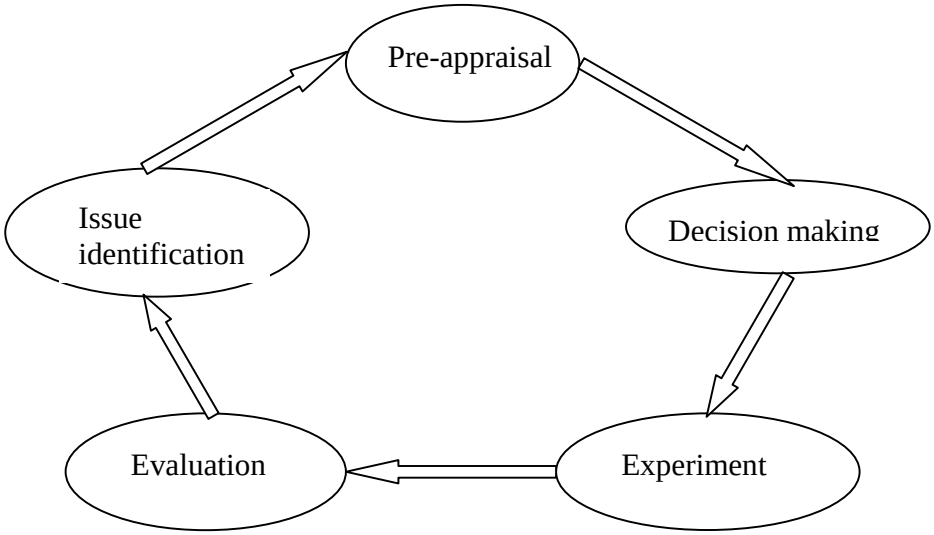
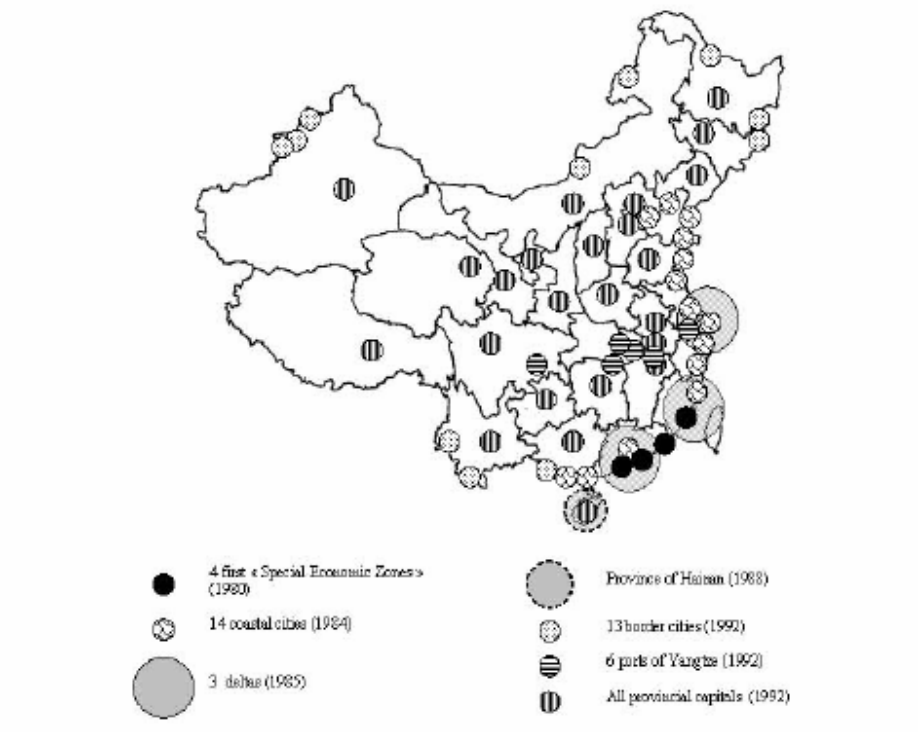


Figure 2 depicts the policy cycle of the empirical approach. The cycle often starts when an issue or problem emerges. The authorities collect proposals and carry out a pre-appraisal of these proposals. A preliminary policy is formed based on the result of pre-appraisal. Then the policy will be tried in a selected location or in a specific industry. Subsequently, the findings of the experiment are evaluated, and problems with the experimental approach identified. An appraisal will be carried out to judge whether the modification is needed. Then the authorities decide whether to discontinue the policy, or further experiment in more locations, or extend the policy nationwide.

The evolution of FDI policies is the most striking example of this approach. In 1980, the first SEZs were established in four coastal cities (Shenzhen, Zhuhai, Shantou in Guangdong and Xiamen in Fujian) in the provinces Guangdong and Fujian, hometowns of many oversea Chinese investors, with the aim to promote exports and economic growth. These zones were given the freedom to offer special advantages to attract foreign investors. Within four years between 1981 and 1984, the trade volume of Shenzhen SEZ has increased by 60 times. To scale up the success of these zones to the entire coastal region, the open-door policy extended to 14 coastal cities in 1984 and to the deltas of the Yangtze, Pearl and Minnan Rivers in 1985. In 1988, the policies were expanded to Hainan Island and another 140 coastal cities and counties including Nanjin, Hangzhou and Shenyang in 1988. After the coastal regions took-off in the 1980s, the open-door policy was gradually extended to the inland region in the 1990s. A big leap was made in 1999 when the whole western region was opened for FDI (Catin, Luo and Huffel, 2005).

Figure 3 Spatial Gradualism of the open-door policies in China



Source : Luo (2003).

Credibility with strong political commitment

China's success suggests that the empirical approach is a useful and pragmatic approach to handle systemic reform in a complex and diversified economy. However, as the empirical approach is subject to policy reversals, foreign investors were concerned about the continuity of reform and opening up policy. In view of this concern, the China Communist Party (CCP) and the authorities made strong commitment to protect foreign investors' interest in China and to reform and opening up policy. Evidence of this commitment includes:

- The 1979 Law on Sino-Foreign Joint Venture Enterprises (JVEs) which stipulates that the state shall not nationalize or expropriate JVEs.
- The fourth Constitution passed on 4th December 1982, which stipulates that foreign funded enterprise' legitimate rights and interests are protected by China laws and regulations.
- Deng Xiaoping's 1984 commitment that the reform and opening up policy wouldn't be changed for the next 50 to 70 years.
- The 1986 Law on Foreign Funded Enterprises enacted, which stipulates that foreign investors' investment, profits and other legitimate rights and interests are protected by China laws.
- The 1992 revision of the China Communist Party's Constitution, which included reform and opening up.

- The 1993 revision of China's Constitution, which anchored reform and opening up policy in the Constitution.

Since then, the reform and opening up has been adopted as an essential state policy.

2.2. Evolution of foreign exchange control system and the external liberalization process

During the process of external liberalization, China developed a comprehensive system of foreign exchange management, which governs foreign exchange receipts and payments, purchase and sales, borrowing and lending, cross-border transfer, international settlement, and foreign exchange market. The external control system performs multiple functions, including: (1) maintaining balance of payments equilibrium and keeping exchange rate stability; (2) keeping monetary policy independent of the influence of international developments; and (3) preventing firms and financial institutions from taking excessive external risks. The restrictive control measures helped cushion the impacts and mitigate the risks emanating from the external liberalization. The roles that the foreign exchange control system plays is of particular importance at a time when the authorities have only limited indirect tools to manage the business cycle, and when the open economy and firms and banks lack the capacity to assess and manage foreign exchange and financial risks. China's relatively closed capital account has been considered by some commentators as an important element in its success in maintaining its commitment to a stable exchange rate during the Asian crisis, and subsequent Russian crisis in 1997-98. (Ariyoshi et. al, 2000)

The decision making concerning external liberalization is highly centralized. All major policies in this area have been decided by the State Council (cabinet), but policy initiatives may come from ministries. China's exchange system involves four departments (in the current government institutional setup): the National Development and Reform Commission (NDRC), the State Administration of Foreign Exchange (SAFE), the Ministry of Commerce (MOC), and the People's Bank of China (PBC). Other line ministries may be involved in policy discussion and implementation when needed. NDRC, the successor of the State Development Planning Commission (SDPC), is in charge of economic plan including foreign exchange plan and foreign capital utilization plan, and supervision of investment activities including foreign direct investment. MOC, the successor of the Ministry of Foreign Economic Relations and Trade (MOFERT) and the Ministry of Foreign Trade and Economic Cooperation (MOFTEC), supervises all trade activities and policies, the setup of foreign investment firms and international negotiations on economic issues. SAFE is responsible for controlling and monitoring cross-border exchange flows and all businesses in foreign currency. PBC plays a key role in forming the policies on exchange rate and financial sector reform.

The current foreign exchange control system was not built over night, but has evolved with the developments of China's external liberalization. Although China has implemented its policies of reform and opening up since 1978, the reform process has not

been linear. The liberalization process can be broken down into five phases. The first phase from 1978 to 1986 can be called the "early liberalization period," during which the liberalization is carried in selected regions with particular focus on attracting FDI in manufacturing industry. The second phase from 1987 to 1991 can be dubbed the "regulation period," during which an initial foreign exchange control and monitoring system was set up. During the third phase from 1992 to 1996 the reform and external liberalization gained pace, and China achieved current account convertibility in late 1996. During the Asian financial crisis (1997-2000), the pace of external liberalization slowed and control over outward capital flows was strengthened. In the post WTO era (2001-persent), China implemented an all-round liberalization, with striking progress in financial industry's liberalization and opening. In the remaining of this section, we will deliberate the developments of external liberalization and how the exchange control system evolves in each phase.

Phase 1 (1979-1986) early stage of opening up

The most distinctive opening-up policies during the period from 1978 to 1986 are trade liberalization and opening up of the economy to FDI. The aim of the opening-up policies was to use foreign capital to fill the saving-investment gap and to attract foreign technology to promote exports growth and import substitution.

The 1978 third Plenum of the 11th central committee of the communist party made a decisive break with the legacy of the Cultural Revolution and focused the party's work on economic development in order to achieve substantial, sustained gains in output. To achieve this objective, the Plenum decided to adopt market-oriented reforms and opening up (*Gei Ge Kai Feng*). In 1980, the first Special Economic Zones were established in four coastal cities (Shenzhen, Zhuhai, Shantou in Guangdong and Xiamen in Fujian) in the provinces Guangdong and Fujian, origin of many oversea Chinese investors with an aim to promote exports and economic growth. These zones were given the authority to offer special advantages to attract foreign investors, including profit tax exemptions and reductions, import tariff exemptions and licenses to conduct foreign trade in specified products. To scale up the success of these zones to the entire coastal region, the open-door policy extended to 14 coastal cities in 1984 and to the deltas of the Yangtze, Pearl and Minnan Rivers in 1985.

At the start of reform, the Bank of China was the only bank that was allowed to conduct business in foreign currency. To attract FDI, foreign banks were allowed to set up branches in SEZs, but they were not allowed to conduct business in Renminbi, China's domestic currency (RMB). The first foreign owned bank, Nanyang Commercial Bank, started operations in 1982. By 1986, all domestic banks were allowed to conduct foreign exchange business in order to increase competition and to revitalize the banking industry. China started to borrow abroad in 1980 and invested overseas as banks built up foreign exchange assets by taking foreign exchange deposits from firms and individuals.

Trade liberalization also took off. At the onset of the reform, foreign trade was carried out by 14 national foreign trade corporations (FTCs). In 1979, the state council decided

to break down the state monopoly over foreign trade, allowing Guangdong and Fujian provinces and later all provinces to set up their own FTCs. In 1983, MOFERT tried out granting some big state owned enterprises (SOEs) the license to conduct foreign trade of specified products on a trial basis. In 1984, MOFERT released a list of products whose import was subject to approval—a negative list. FTCs import goods not on the list were free from approval from then on. By 1984, the number of FTCs ran into over 1000.

The authorities allowed domestic firms and local governments to retain part of the quota of the foreign exchange earnings starting 1979. Domestic enterprises had to surrender all foreign exchange earnings to the state and received RMB at the official exchange rate. At the same time, the firm also received—and could retain or sell in the swap market—retention quotas equivalent to a share of the foreign exchange surrendered. This share varied over the time and also depended on the source of the exchange earnings. The remaining retention quotas were allocated directly by the SAFE to the local governments' retention quota account, to the central government quota account and to be purchased by the PBC at the prevailing swap rate. The RMB proceeds from the PBC purchase went to the firm. Entities could use their foreign exchange retention quota to buy foreign exchange at official rate and to import products with prior approval from MOFERT (the approval requirement was later relaxed). The remaining foreign exchange proceeds beyond those needed for the approved imports had to be sold to a FEDB. The share of foreign exchange retention quota was gradually increased. By end of 1993 when the retention system was abolished, total foreign exchange retention had reached 80% of export proceeds.

A dual exchange rate system was also used for motivating firms to generate foreign exchange earnings. In parallel to the official exchange rate, the authorities set a trade settlement exchange rate at 10 percent above the average break-even point (a PPP equilibrium exchange rate) as of 1981, while the official rate was much lower than the equilibrium rate. At the on-set of the introduction of the dual exchange rate, the settlement rate was 2.8 yuan/dollar while the official rate was 1.5 yuan/dollar. Although the dual rate system promoted exports, its implementation was difficult. The authorities depreciated the official rate gradually and eventually unified the two rates on January 1, 1985. The unified rate was set at 2.8 yuan/dollar initially. In 1986, swap centers were established in some cities where Chinese enterprises with retained foreign exchange or retention quota and FFEs in SEZs were permitted to trade foreign exchange at a rate that is higher than official rate.

Additional exchange control measures were used to maintain foreign exchange balance. There are two parallel mechanisms: foreign exchange plan for domestic entities and foreign exchange balancing requirement for FFEs.

SDPC and MOF compiled a foreign exchange plan for the usage of foreign exchange within the limit of the retention quota that was made available to the governments. Firms who received retention quota according to the foreign exchange plan could purchase foreign exchange from a FEDB at the official exchange rate and paid for the specified transactions such as imports of specified goods. The foreign exchange plan was

supplemented by a trade plan and a foreign capital utilization plan. Through the trade plan, MOFERT managed the exports target and allocation of foreign exchange for imports. SDPC compiled the foreign capital utilization plan in which SDPC set the target for FDI, imposed quota on external borrowing and other financial activities.

Each FFE was expected to generate sufficient foreign exchange income, mainly through exports, to cover its own foreign exchange expenditure, such as imports, expatriate salaries and expenses, and profit remittances. In 1986, the balancing requirement was broadened to apply to the FFE sector as a whole (rather than to an individual FFE) by allowing FFEs with a shortage of foreign exchange to purchase foreign exchange from other FFEs with a surplus through the swap centers, subject to approval by the local SAFEs. As more domestic enterprises started to participate in the swap markets, the foreign exchange balancing requirements were gradually relaxed.

The early liberalization and opening up measures propelled economic growth and trade expansion. By 1986, China has attracted more than $4.9 billion FDI cumulatively, and external debt outstanding had reached $21.5 billion. The ratio of foreign trade to GDP was about three times of that of 1977, reaching 25.3 percent. The external liberalization and opening up together with reforms in the rest of the economy had contributed to a high GDP growth rate, which averaged 10 percent during this period.

Phase 2 (1987-1991) establishing exchange regulation and monitoring system

With an aim to promote exports growth and import substitution, the experiments of opening up to FDI and trade liberalization further expanded. In 1988, the FDI policies were expanded to Hainan Island and another 140 coastal cities and counties including Nanjin, Hangzhou and Shenyang. In 1988 most cities had established foreign exchange swap centers. The swap rate was allowed to float. The trading volume in swap centers steadily increased and more firms were allowed to trade in the swap market. The official exchange rate was adjusted several times in line with the change of purchase power parity of exports products. But the adjustments of official exchange rate always lagged price increase. Effective 9 April 1991, the official exchange rate regime was changed from a periodical adjustment to a managed float, which allows the authorities adjust the rate more frequently. In February 1988, The Ministry of Foreign Trade and Economic Cooperation (MOFTEC) carried out an experiment with an export contracting system among its affiliated FTCs. Under this system, each FTC became responsible for achieving the targets of the volume, cost and profit of exports set by MOFTEC. Meanwhile, MOFTEC granted some big manufacturing firms foreign trade licenses with the objective to promote export processing. MOFTEC granted all provincial bureaus authority to approve FTCs. FTC became profit oriented. Fiscal subsidies to FTCs were repealed.

However, in the context of the distorted domestic price system, the experiment in trade liberalization led to a faster expansion of imports than exports growth. FTCs mushroomed to 4000 by 1988. The current account balance shifted from a surplus of 2% of GDP in 1982 to a sustained deficit from 1984 to 1989 (3.7% of GDP in 1985). The

fierce competition among FTCs worsened China's term of trade, and contributed to high inflation. Consumer price inflation rate hit 18.8% in 1988. Early 1988, in the wake of a bout of inflationary pressures, a stabilization program was introduced (the "rectification program"), in which structural reforms were given lower priority than stabilization and administrative measures were used to supplement nascent indirect instruments of macroeconomic control.

Against this backdrop, some rules and regulations were introduced to strengthen supervision and monitoring of external transactions, which formed a rudimental comprehensive exchange control system.

The 1989 Regulation on FFE's foreign exchange account in China. All receipts of foreign funded enterprises in foreign currency would be deposited in domestic bank, and all expenditures in foreign currency would be paid from the account. When a FFE's product substituted imports or was sold to SEZs or other FFEs, the firm could settle the trade in foreign exchange with the approval of the State Administration of Foreign exchange (SAFE). This implied a relaxation of the foreign exchange balancing requirements in place previously.

The 1989 Regulation on Foreign exchange Management related to Overseas Investment. A domestic enterprise could invest overseas with its own foreign exchange earnings and SAFE had to examine the source of its foreign exchange earnings. The investing enterprise had to deposit 5% of the investment in a special account of a bank designated by SAFE. The profits and other foreign exchange earnings should be repatriated home and surrendered to the state. The firm could retain 100% of the foreign exchange quota within 5 years from the investment and 80% afterwards.

The 1989 State Council's Notification on Strengthening Management on Borrowing International Commercial Loans. The authorities imposed a ceiling on the outstanding short-term external debt of each financial institution. Issuing debt in overseas market was subject to the foreign capital utilization plan. SAFE improved the external debt registration system. Both direct borrowing and on-lend had to be registered with SAFE.

External guarantee. Enterprises could extend external guarantees within the limit of their own foreign exchange proceeds. Non-bank financial institutions could extend external guarantees, but the total of external guarantees and external debt could not exceed the ceiling set by PBC. Government departments and administrative entities were not allowed to provide external guarantees.

Verification of export receipts. This was to enforce firms to repatriate foreign exchange earnings from exports. All firms conducting foreign trade were required to submit to SAFE a copy of export contract, custom declaration form and cash voucher. SAFE could launch investigation and impose punishment on firms who failed to provide these documents verifying repatriation of exports proceeds.

In trade sector, the rectification program laid out a level play field for FTCs and reduced interference of local governments in FTCs' operation. All FTCs were required to re-registered with MOFERT in 1989; the unqualified FTCs were shut down; local governments were prohibited from interfering FTCs' operation; FTCs approved by local authorities could only conduct foreign trade within the region. In December 1990, MOFERT resumed the authority to approve the setup of FTCs, and the State Council articulated that no commercial firm should be granted license to do foreign trade.

The rectification program in trade sector, opening up to FDI and enhanced capital control significantly strengthened China's external balance. By 1991, the trade volume increased to 33.4% of GDP. The imports growth was successfully contained and the trade balance turned surplus. China accumulated $21.7 billion foreign exchange reserve, equivalent to 9.4 months imports of goods and services. The rectification program ended in 1991. The strong external position allowed relaxation of some measures of exchange outflows. Starting November 1991, individuals were able to purchase foreign exchange in the swap market for overseas study, tourism, emigration and financial support to elders, though the amount was limited, up to $60 for an oversea tour per head. Enterprises in pillar/strategic industries were allowed to buy foreign exchange to pay external debt. 10% tax on FFEs' repatriated profits was repealed. The strong external performance also paved the way for accelerating reform and opening up process.

Phase 3 (1992-1996) re-accelerating liberalization and opening up process

In early 1992, senior leader Deng Xiaoping during his famous "tour through the south" called for an accelerations of reform and opening up. His view was soon endorsed by the CCP. In October 1992, the Fourteenth National Congress of the Communist Party adopted the goal of establishing a "socialist market economy" and accelerating the pace of opening up. In November 1993 the Third Plenum of the Fourteenth Central Committee outlined and approved a comprehensive reform strategy in which foreign exchange management reforms were mentioned as a key element for a market-oriented economy. A market-based unified floating exchange regime and current account convertibility were accepted as ultimate goals of the exchange reform.

Between 1992 and the onset of the Asian crisis, significant progress was made in opening up to FDI. More regions were opened to foreign investment, and ownership requirement for FDI in most industries was relaxed. The authority to approve FDI projects was assigned to local governments. From 1995, FFEs could engage in State Owned Enterprises (SOE) reform through purchasing equity or injecting capital. Joint ventures with foreign ownership exceeding 25% could enjoy the same advantages as FFEs. Services industries' including retail, distribution, insurance and securities, were opened up for foreign investment, though on a trial basis. American International Insurance, the first foreign insurance in China, started operation in September 1992, and the authorities formally announced an experiment of opening up of insurance industry in Shanghai in 1993. China International Capital Corporation, the first foreign funded investment bank, was established in 1995. Meanwhile, the geographic restriction and business scope restriction on foreign banks were gradually relaxed. In 1992 foreign banks were allowed

to open branches in an additional seven coastal cities and in 1995 a further 24 cities were opened to foreign banks. Effective 1996 foreign banks could become foreign exchange designated banks and act as agent for foreign currency trade for FFEs. Foreign investors were allowed to set up joint venture foreign trade corporations in Shanghai and Shenzhen.

Other than FDI, China started exploring more channels to utilize foreign capital. In 1992 the B-share market was launched in Shenzhen and Shanghai, on which domestic corporations could issue foreign currency denominated shares, and only non-residents were allowed to buy. On July 15, 1993 the first Chinese firm, Qingdao Beer, listed in Hong Kong Stock Exchange.

Restrictions over domestic financial institutions were also relaxed. By 1992, the elements, if not the practice of a modern financial system had formed. In 1993, non-bank financial institutions were allowed to conduct business in foreign currency. This policy covered trust and investment corporations, financial leasing corporations, finance company, security firms, and insurance companies. In 1996, financial institutions were allowed to issue bonds in international market, but restrictions remained on the use of proceeds from bond issuance.

Trade liberalization accelerated as more entities could engage in foreign trade. Manufacturing enterprises as of May 1992 and research institutes and state owned commercial corporations as of 1993 could acquire foreign trade license for specific products. Also, the procedures for the approval of enterprises' engagement in foreign trade were liberalized. Effective 1994, all remaining mandatory foreign exchange plan for trade had been eliminated. The quantitative target was limited to a few products subject to guidance planning, which entailed that import ranges rather than specific targets were established and administered flexibly. Meanwhile, the authorities tried to build a level playing field for all trading corporations. The subsidization of loans to FTCs was stopped; FTCs were no longer required to surrender profits to the authorities but pay income tax instead. In 1992, a ceiling was imposed on the volume of FFE's imports that were exempted from import tariff, up to the amount of total investment. Later in 1996 imports of equipment for export processing was no long exempted from import duties. From mid 1992, to promote exchange generation activities including export in services and investment earnings, MOF allowed firms to retain part of foreign exchange earnings from non-trade transactions. PBC started selling the quotas that it had bought at the market rate to importers through the swap market at the prevailing swap market rate.

Accelerated reform and liberalization in external and financial sector led to economic overheating in 1992 and 1993. GDP real growth rate hit 14%. Price increase accelerated from about 5% in 1992 to 24% in 1994. The current account balance turned from a surplus $13.3 billion in 1991 to a deficit 11.9 billion in 1993. The high inflation and deteriorated current account performance drove the expectation of RMB depreciation. RMB in the swap market at one point depreciated to over 10 yuan/dollar in mid 1993, while the official rate was 5.8 yuan/dollar. With PBC's intervention in the swap market, the swap rate fell to 8.7 yuan/dollar at the end of 1993.

On January 1, 1994, the official and swap market exchange rates were unified at the prevailing swap market exchange rate, 8.7 yuan/dollar. The unified exchange rate regime was a market-based managed floating rate with a band, +/- 0.3% in one trading day. The China Foreign Exchange Trade System (CFETS) became operational, creating an integrated system of foreign exchange trading centralized in Shanghai. A two-tier trading system was established. Firms traded foreign exchange with banks. Banks traded their net foreign exchange position in CFETS. Swap centers phased out and eventually were shut down in 1998. As exchange rate flexibility increased, FEDBs were allowed to offer RMB forward products for firms to hedge exchange risk.

Associated with the exchange regime change, the foreign exchange control system underwent a large change. In 1994, the foreign exchange retention and quota system was repealed. The foreign exchange plan was abolished. A foreign exchange surrender and purchase system (FESPS) was put in place, under which firms were generally not allowed to retain foreign exchange for current account transactions. They should surrender their foreign exchange earnings from current account transactions at the official rate, and purchase foreign exchange from a FXDB when a payment in foreign currency is needed. Initially only domestic enterprises were subject to the FESPS, later in July-1996 FFEs were included in the system. But FFEs may retain foreign exchange in account with a FXDB. SAFE sets the ceiling on the account. The foreign exchange proceeds from capital account transactions were not allowed to be converted in RMB, unless SAFE approves.

With the exchange reform and success in containing the credit growth and thus overheating, the external account significantly improved since 1994. Current account resumed surplus in 1994. RMB gradually appreciated from 8.7 yuan/dollar at the onset of regime unification to 8.45 at end-1994, or by 11% in real term. The foreign exchange reserve increased sharply during 1994, by $30.5 billion to $51.6 billion, as a result of PBC’s effort to slow the pace of RMB appreciation. The strong international balance of payment triggered speculative capital inflows on expectation of RMB appreciation. The massive capital inflows and the current account surplus partially offset the government efforts to contain the overheating.

To cushion the impact of capital inflows on macro economy in 1994-96, measures were taken to relax restrictions on outward exchange flows and to enhance controls over sales of foreign exchange from capital account transactions. In 1995, the profit repatriation deposit for overseas investment was reduced to 5% of the investment paid in cash or 2.5% of the investment paid in kind. Investor could deposit either in foreign exchange or equivalent RMB. The foreign exchange proceeds from capital account transactions such as external borrowing were required to be deposited in a specified account, and should not be converted in RMB unless being approved by the SAFE. Domestic entities providing guarantee for FFEs and international leasing of plane were subject to SDPC's guiding foreign capital utilization plan and were required to be registered as external debt. In 1996 foreign exchange account holders were allowed to remit foreign exchange from their own account to abroad. The ceiling on individual’s purchases of foreign exchange

for private use was raised in mid 1996 and again in early 1997. The exchange balance requirement for FFEs was repealed in 1996. FFEs were allowed to convert profits in RMB into foreign currency and remit outside of China. The remaining restriction measures on current account transactions were repealed. Effective from December 1, 1996 China accepted the obligation of the Article VIII[4], Sections 2, 3, and 4 of the International Monetary Fund and announced that it had achieved current account convertibility.

While China was making significant progress in liberalizing current account transactions, SAFE strengthened the supervision and monitoring of exchange flows. SAFE launched the authenticity examination of current account transaction. The so-called import payment verification system was launched in 1994. Under this system, all importers should file their custom declaration form and exchange payment certificate at the SAFE, with an aim to prevent unauthorized capital outflows. All FEDBs were required to check the authenticity of the receipts and expenditures under current account transactions on behalf of SAFE. The export payment verification system that was launched in 1991 was further strengthened. But its aim was shifting from ensuring timely repatriation of export receipts to stopping hot money inflows.

SAFE also implemented strict restriction on foreign exchange account. There were two types of foreign exchange accounts: settlement account for current account transaction and specified account for capital account transactions. SAFE set the limits on the settlement account. FFEs and later some domestic firms were allowed to retain their foreign currency earnings in the settlement account within the limit. The surplus over the limit had to be surrendered and be sold to a FEDB. Firms were allowed to pay from their own account or purchase foreign exchange to pay for current account expenditures. Opening specified accounts required the approval from the SAFE. The receipts from capital account transactions including external borrowing, IPO and bond issuance had to be deposited in the specified account and be used on specified expenditures. Receipts were generally not allowed to be converted into RMB.

Except for FDI, all capital account transactions were to be approved by SAFE case by case. One of key qualification to incur an external liability was the capacity to generate sufficient foreign exchange earnings to pay off the liability. Take an example of external debt. SAFE evaluated the firm's capacity to pay off the debt before allowing it to borrow. After borrowing, the firm had to open two specified accounts in a FEDB, one was external debt specified account (EDSA), and other was external debt payment specified account (EDPSA). The proceeds from borrowing had to be deposited in the EDSA and be used for the previously specified expenditures, such as imports of equipments under a project. The earnings in foreign currency from exports had to be deposited in the EDPSA, and be used only for paying the principal and interest of the debt.

[4] IMF members accepting the obligations of Article VIII undertake to refrain from imposing restrictions on the making of payments and transfers for current international transactions or from engaging in discriminatory currency arrangements or multiple currency practices without IMF approval.

Phase 4 (1997-2000) Asian financial crisis period (strengthening capital control and monitoring)

In the aftermath of the Asian crisis, capital outflows became an increasing problem in late 1997 and early 1998, driven by concerns about a devaluation of the RMB and the falling differential between domestic and foreign interest rates. The current account remained in surplus and foreign direct investment remained strong, but the capital account deteriorated sharply and errors and omissions in the balance of payments, a proxy for capital flight, remained high. As a result, the overall balance of payments surplus fell sharply, from $36 billion in 1997 to $6 billion in 1998. In response to these developments, the authorities intensified enforcement of exchange and capital controls, and moved to reduce circumvention to prevent illegal capital outflows and, ultimately, maintaining a stable exchange rate.

These measures involved enhanced screening of capital account transactions, and severe penalties, such as imprisonment, for fraudulent behavior. In 1997, the qualification of financial institutions and enterprises that could provide external guarantees was significantly tightened. In 1998, domestic FEDBs were prohibited from issuing long-term letter of credit not related to trade. Banks issuing letter of credit with maturity more than one year were required prior approval from SAFE. Domestic FEDBs extending RMB loans to domestic entities could not accept foreign exchange guarantees (including stand-by letter of credit) issued by foreign banks or overseas entities as collateral. In addition, in June the authorities restricted overseas RMB transactions by prohibiting domestic banks from accepting inward remittances in RMB. NPC revised the Criminal Law, stipulating that the fraud, evasion and circumvention of foreign exchange among other illegal exchange transactions were subject to criminal punishment.

The implementation of export receipts and import payments verification system was improved to plug up the loopholes of disguised capital transactions. In 1998 SAFE launched a targeted examination of import payments. The examination revealed foreign exchange purchase with fraudulent documents over US$10 billion, equivalent to about 7 percent of imports (Ren, 2001). While the enhanced verification reduced illegal activities, there were widespread reports that legitimate transactions have also been adversely affected. By 1997, the trade volume had reached 34% of GDP. SAFE was short of hands to implement the verification. In an effort to reduce financial risks, support the development of a sound business environment and cut the administrative cost, the authorities took measures to facilitate a more efficient operation of exchange management. These included steps to increase the transparency of the regulatory framework and explore the use of information technology to speed up screening of documentation for imports. On January 1, 1999, a web-based export and import verification system was launched, which integrated the database of the Customs Administration, FEDBs and the SAFE. This system facilitated verification and reduced the burden on foreign trade enterprises of stricter enforcement of exchange control. In May 1999, SAFE started to evaluate the exporters' performance by the indicator of export receipts ratio, and provided firms with differentiated treatment so as to motivate them to timely collect export receipts.

Following the introduction of the measures, transactions reported as imports in the balance of payments showed an increasing trend in January 1999. Possibly owing to a substitution of recorded for unrecorded imports, foreign exchange reserves showed small increases in the second half of 1998; and the authorities reported stronger fiscal performance in the most recent period.

In the aftermath of the Asian crisis, the external liberalization has been skewed toward activities that generate foreign exchange inflows. The preferential treatment was extended to FDI in energy, transportation and infrastructure industries, and to promote the western region development, FFEs in western region could enjoy reduction in profit tax. The restrictions on extending external guarantee, issuing bonds in international market and FFEs' borrowing in RMB were relaxed. Domestic banks could conduct off-shore banking businesses. Trade liberalization also continued. Non-manufacturing firms in SEZs could get license of foreign trade in 1997 and private firms in 1999. And major exporters and importer were allowed to engage in future transactions of specified products at abroad.

The opening up of the banking industry to foreign investment was also noteworthy. In 1997, 13 cities were opened for foreign banks to conduct business in RMB, making the total of open city 18. In 1999, the geographic restriction on foreign banks was repealed, but geographic restriction on foreign banks' conducting business in RMB remained. Foreign banks were allowed to invest in domestic bank with an aim to improve these banks' corporate governance. In 1997, Asian Development Bank invested in China Everbright Bank. In September 1998, International Finance Corporation (IFC) acquired 5% equity of Bank of Shanghai. In 2001, IFC acquired 15% share of Nanjing Commercial Bank; HSBC invested in Shanghai Bank.

The increasing competition from foreign banks was of concern to the domestic banks. Against this background, measures were taken to create level playing field. These measures include: (1) foreign banks had to surrender required reserve to PBC; (2) foreign banks allocate non-performing asset reserve; (3) foreign banks outside of SEZs no longer enjoyed the profit tax exemption and reduction; (4) foreign financial institutions in SEZs were no longer exempt from business tax (8%) after the 5 years preferential period. Meanwhile, domestic financial and insurance companies' business tax was raised from 5% to 8%.

Phase 5 (2001-present) Post WTO period

In December 2001 China joined the World Trade Organization (WTO). This event marks a new era for China's external liberalization. In addition to tariff cut, China has promised to eliminate over the next few years most restrictions on foreign entry and ownership, as well as most forms of discrimination against foreign firms. Over the space of some six years, China, one of the most closed services markets, has promised to become one of the most open ones. By 2008 a large number of key services will be fully or almost fully open to foreign entry—including important business services, courier services, wholesale

trade, franchising, tourism services, rail and road transport, and freight forwarding services. In many other services, substantial foreign entry will be allowed—including in telecommunications, audiovisual services, construction, retail trade, insurance, banking, securities, and maritime transport. (Mattoo 2002)

Since China access to the WTO, significant progress has been made. In the banking sector, more cities were opened to foreign banks to conduct business in RMB, and by end 2005, the number of open cities reached 25, two more than scheduled. In 2001 foreign banks were allowed to provide foreign exchange services to all firms and individuals, no longer just to FFEs. Foreign banks were allowed to provide RMB service to domestic firms in open cities effective 2003. From 2002, foreign banks could buy equity of domestic banks, but the share of ownership could not exceed 20% for a single foreign investor or 25% for total foreign ownership. Meanwhile, unfavorable treatments of foreign banks were repealed. The required reserve ratio for foreign exchange deposits were unified to 3%, before that, it was 2% for China funded financial institutions and for foreign institutions 5% for deposits up to 3 months maturity and 3% for deposits more than 3 months maturity.

China also made a breakthrough in capital market liberalization. Since 2001, domestic investors including individual residents are allowed to invest in B-share with self-owned foreign exchange earnings. Starting from 2002, qualified foreign financial institutions (QFII) are allowed to invest in the domestic capital market (bond and stock markets). Since 2004, insurance companies are allowed to use their own foreign exchange to invest in international capital market. In 2005, the first foreign company was listed on the Shanghai Stock Exchange. In the same year, domestic firms were allowed to set up corporations with special purpose at abroad to facilitate overseas listing, mergers and acquisition.

Since China joined the WTO, the country has enjoyed a sharp increase in both current account surplus and capital inflows. By end-2005, the foreign exchange reserve increased to $818.9 billion, equivalent to 12 months imports of goods and services, up from 165.6 billion at end-2000. The rapid buildup of foreign exchange reserve has complicated monetary policy, and increased pressure for RMB appreciation.

In response to these developments, the authorities have taken measures to discourage capital inflows and facilitate capital outflows. The measures that are aimed at discouraging inflows, particularly the hot money inflows, include: (1) enhancing the enforcement of export receipts verification to stop the disguised capital inflows. In August 2003, the SAFE carried out a special examination on the foreign exchange receipts and sales among all FDXBs; (2) stricter screening process of non-residents purchase and sales of foreign exchange; (3) expanding the right of firms to hold foreign exchange earnings at abroad or in bank account. The qualifications for domestic firms retaining foreign exchange in a bank account were lowered and the ceiling on the account was raised several times during the period. Effective Feb 2005, the deadline for repatriation for foreign exchange proceeds raised by resident shareholders from overseas IPO was extended to six months after the funds are collected; and (4) imposing limits on

FFEs and foreign banks' external borrowing. Restrictions on purchasing foreign exchange to repay domestic debt denominated in foreign currency or external debt were repealed. Big SOEs were encouraged to repay external debt before the maturity date.

In 2003 the provisional regulation on external debt further limited capital inflows. The long-term external debt quota was extended to foreign banks in China. In 2004, foreign banks in China issuing guarantees to non-residents were subject to external debt regulation, and a ceiling was imposed on foreign banks' outstanding short-term external debt. Domestic entities issuing guarantee for residents to foreign banks in China were subject to domestic guarantee regulation. In 2005, import payments due maturity over 6 months or amounting to over US$200 thousand had to be registered as external debt. Ceilings were imposed on the scale of the external debt of foreign invested companies.

The measures that facilitate capital outflows include: (1) In October 2002, a pilot program was launched in six coastal provinces to allow provincial authorities to approve firms' purchase of foreign exchange for overseas investment. This policy was extended to 14 provinces in 2003, to 24 provinces in 2004 and eventually to the nationwide in 2005. In 2004, the approval requirement for overseas investment was changed to verification requirement. (2) The ceilings on residents' carrying of foreign bank note across border and on residents' purchase of foreign exchange for purposes of tourism and overseas study were raised in 2003 from US$2000 to US$3000, or US$5000, if one stays at abroad over 6 months. In 2004, the restriction on transferring assets overseas was further relaxed. (3) The ceiling on firms' settlement account balance was raised from previous 20% of their foreign exchange proceeds to 30-50% in 2004 and further raised to 50-80% in 2005. (4) Multi-national corporations were allowed to lend to their overseas affiliates in 2004. The proceeds from overseas IPO or bond issuance were allowed to be deposited abroad for 2 years, up from half year.

Despite these measures, the overall balance of payments surplus remained. The trade surplus with major industrial countries triggered increasing trade conflicts. The RMB exchange rate has been the focus of dispute. To increase exchange rate flexibility to give the authorities more room for maneuver in conducting independent monetary policy, on July 21, the PBC announced a change in the exchange rate regime. The de facto US dollar peg was replaced by "a managed floating exchange rate regime with reference to a basket of currencies." The initial move entailed a 2 percent appreciation against the US dollar. The new arrangement uses a basket of currencies as a "reference", rather than a precise determinant, for the central parity that will be announced at the end of each previous trading day. The +/- 0.3 percent band has existed since 1994, but has not been used since the Asian crisis, when China decided to implement the de facto peg against the dollar that existed until recently. The band allows for the RMB to appreciate or depreciate a maximum of 0.3 percent per day. The PBC announced it would "readjust the exchange rate band when necessary.

Since the exchange rate regime change of July 21, further reforms have been implemented. Wider interbank market spreads allow the banks more room to price risk; wider spreads vis-à-vis clients allow the development of 2-way quotation; and wider

trading bands vis-à-vis currencies other than the US$ remove unhelpful arbitrage. The PBC has also accelerated foreign exchange market reform. Introduction of derivative products including forwards allowed banks and firms to manage their exchange rate risks, and an RMB swap market was also planned to be introduced in 2006. Market makers were allowed in both the spot and forward exchange market, and restrictions on banks' open foreign exchange positions have been relaxed. With the introduction of the market maker quotation system, the determinant of the central rate was changed from the closing rate to the weighted average of market maker banks' quotations.

However, as Chinese economy is integrated with the world economy and the economic openness increases, exchange control effectiveness is inevitably weakened. To cope with these developments, the exchange authorities are changing the control system to a market friendly monitoring system by increasing regulatory transparency and streamlining the administrative approval procedures. The new system under development has the following features.

*Changing from prior approval to ex post examination***.** SAFE nullified 20 approval requirements on November 1, 2002 and additional 6 approval requirements on February 27, 2003. The foreign exchange risk assessment requirement and profit repatriation deposit were repealed in 2003. Instead, the ministries concerned carry out a joint annual examination of overseas investment corporations. In 2004, the approval requirement for firms' overseas investment was completely repealed. In 2005, the methodology of supervision over the domestic banks' guarantee to overseas companies was changed from case by case approval to one that limits the outstanding balance.

*Shifting focus on market sentiment***.** Information disclosure was enhanced. In April 2002, China joined the general data dissemination system (GDDS) making the data and statistic methodology more transparent. As the control measures are significantly relaxed, SAFE has shifted their efforts to monitor the most vulnerable capital flows and the market sentiment. A high-frequency external debt monitoring system and a market expectation survey system have recently been put in place.

Extensively apply information technology whenever possible. Information technology has been extensively used, ranging from collecting, processing to analyzing data. In August 2001, an E-port supervision system was launched which collects electronic data of custom declaration, bank payment and firms' reporting data. Based on this centralized database, SAFE developed an auto-verification system to check the authenticity of exports and receipts so as to cover the loophole of disguised capital flows.

III Experience from China's success in managing external liberalization

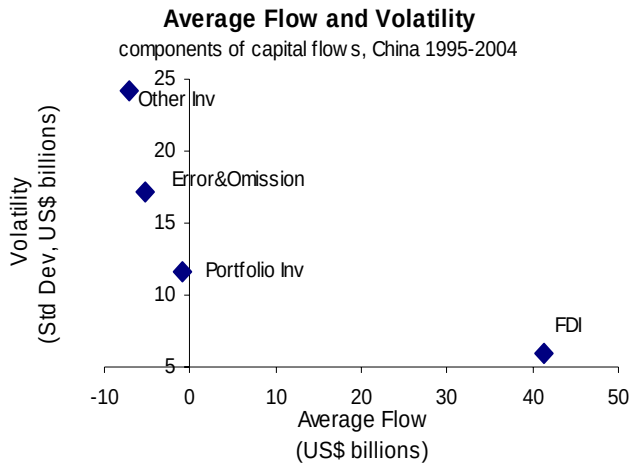
China now has successfully transited from a close economy to an open economy. The following lessons from China's success in managing the process of external liberalization can be drawn.

1) Maintaining the first policy priority on FDI

From the onset of opening up, China has generally favored FDI over other capital inflows. Foreign direct investment accounted for 118 percent of the cumulative net inflows recorded in the financial account between 1982 and 2005. The bias toward FDI has helped to reduce the vulnerability of the economy to external shocks, such as the regional crisis in 1997-98.

In addition to finance investment and smooth consumption, FDI also promoted economic growth by transferring technology, market access and marketing skills, and management know-how. And foreign investment has catalyzed China's economic reform through participating in restructuring SOEs and increasing market competition. Together, these contributions have supported China in maintaining a record-high 9.5 percent economic growth rate during 1980-2005. China's success in utilizing FDI, in expanding external trade is perhaps most striking. China's trade is now *thirty-seven* times that of 1980,[5] and more than half of trade is due to foreign invested enterprises. In 2005, these enterprises accounted for 58 percent of exports, 59 percent of imports and 84 percent of processing trade.

Figure 4. Flow and Volatility: Components of Capital Flows



Source: Based on China's Balance of Payments Data.

2) Strategically timing the liberalization to smooth capital flows

Capital flows in China are pro-cyclical. They increase during a boom and recede during a recession. Capital flows have exaggerated a boom-bust cycle of domestic economy. China has strategically timed the liberalization to smooth capital flows so as to minimize the disturbing effects. China accelerated the liberalization of inward foreign exchange flows and enhanced controls over capital outflows when overall balance of payments surplus shrank or turned deficit, and enhanced controls over inward exchange flows and liberalizes exchange outflows when there was excessive external surplus. The foreign exchange policy was consistently designed as a part of a comprehensive macro management framework. This tactic may have contributed to maintaining a stable economic growth, especially since late 1990s, when the monetary authorities juggled with multi-objectives.

3) Sequence of external liberalization

[5] Data source: CEIC

China's external liberalization process reveals a clear sequence. Liberalization of FDI was carried out at an early stage and first experimented in manufacturing industry and in coastal region where state share of the economy was relatively low. The opening coincided with the efforts to build market infrastructure and SOEs' reform. When China had built market infrastructure and introducing modern corporate governance in SOEs in mid 1990s, liberalization of FDI was extended to inland regions and to more industries. When China has built a comprehensive banking system and accumulated high exchange reserve to fend off reversal of capital inflows, China started liberalizing financial industries and capital flows. At the same time, the authorities have paid great efforts to clean up domestic financial industries. These measures include establishing prudential regulation, strengthening internal control, improving the corporate governance, taking away the non-performing assets and injecting capital. The liberalization of capital flows was also carried out in parallel with the reform in domestic capital market. As the domestic capital market is still weak, the liberalization of capital market has been taken in a controllable manner, QFII, which gives leeway for the authorities to control the magnitude of capital inflows and to draw back when necessary.

Through the careful sequencing of liberalization policies, China has mitigated some of risks associated with capital inflows and maintained financial stability. It is noted that this sequence was not planned, but through trial and error. China has learned lessons from some premature liberalization experiments. For instance, the liberalization of overseas bond issuance of trust and investment corporations led to a wide default in the mid 1990s. These trust and investment corporations are owned by the state and are perceived by the international financial market to be explicitly or implicitly guaranteed. Monitoring by lenders for these corporations is prone to be insufficient. Since then, China has become more prudent in financial liberalization.

4) Strengthening capacity in supervision and monitoring risks associated with exchange flows

In the process of financial liberalization, China has made great efforts to establish a prudential supervision system. It helps to reinforce private incentives for banks and other participants in financial markets to recognize the risks that they are taking. Their consciousness about risks can constrain the capital inflows at an appropriate level. The prudential supervision system can also help reduce the risks associated with capital flows by strengthening the ability of the financial system to withstand volatile market conditions. However, it takes time to build a well-functioning system. Before the prudential supervision system works, China has developed a comprehensive exchange control and monitoring system. The exchange control and monitoring system has evolved over time to fit China's integration in the world economy. Such a system has also enabled the authorities to monitor potential threats to systemic stability. Responding to the singles, the authorities have taken corrective measures promptly.

Although experience so far indicates that Chinese government is responding well to the challenges of liberalizing financial flows, they will have to continue their policy reforms

and adjustments. Moving forward, China's past experiences may be more relevant for some developing countries that are undergoing or will undergo external liberalization, but less applicable for China itself to deal with future risks emanating from further external liberalization.

First, it will be increasingly difficult for China to implement the empirical approach as labor and capital become mobile and all entities can engage in foreign trade and external financial transactions.

Secondly, with the successful introduction of market economic system, there are a large number of stakeholders and each of them has own specific interest. The lobbying of stakeholders will make it difficult for the authorities to objectively make economic evaluation and take prompt actions if without an institutionalized evaluation framework in place.

Finally, using exchange control system to control risks of individual entities is inevitably difficult, if not impossible, in a highly open economy. Shielding China from external risks emanating from liberalization eventually relies on the capacity of each sector (public, private and banking sectors) to properly manage risks. Effort to enhance the authorities' control over individual entities' risk, for instance, risks from SOEs' overseas derivative transactions, may send a false signal to market that these entities are implicitly guaranteed by the government. Moral hazard resulted from such a perception would magnify risks against the benign will of the authorities.

In all, China is still confronted with great challenge in further advancing external liberalization despite great success achieved so far. The exchange system is now evolving in the right direction—increasing the availability of necessary information to officials and investors so that capital markets can function effectively. But the role of exchange system should not be over-emphasized. More efforts need be devoted to building a sound financial system and a strong prudential supervisory system.

IV The prospects of external liberalization in near future

China is now shifting its focus of economic work from growth to equity and environmental concerns. The aim is to build a harmonious society through increasing public investment in agriculture and public expenditures on rural population so as to promote income growth of rural residents. This shift won't derail China from reform and liberalization. President Hu Jintao reaffirmed recently in March 2006 that China would stick to reform and opening up policy, and at the same time would pay attention to safeguarding national economic security. China's experience in last two and half decade demonstrates that reform and opening up is China's own interest and benefit. Looking forward, we expect China will continue its external liberalization and will gradually relax all restrictive measures over capital account transactions.

Fulfilling its WTO commitment and opening up the service sectors. By end 2006, the ownership restriction on FDI in tax consultation, management consulting, city planning will be repealed, as well as the geographic restrictions on FDI in mobile telecommunication, data service, international trade, banking business in RMB, insurance, tourism and railway transportation. The market of distribution service of chemical, refined oil and crude oil will be opened for foreign investment. By end 2007, geographic restriction in all industries will be repealed, and the ownership restriction on FDI will remain in only few industries including education, telecommunication, life insurance, asset management and securities.

Continuing FDI promotion, but discontinuing fiscal incentives. China will continue to attract FDI. China has an array of tax incentives to promote foreign investment in general and regional and industry-specific investment. These incentives played a role in the early days of China's transition to a market economy, when domestic enterprises were seen to have an advantage over foreign ones. These advantages to domestic firms that in part motivated the FDI are being eroded by China's WTO entry. Moreover, FDI is increasingly aimed at production for China's growing domestic market, not for export processing industries that are arguably more footloose, and more sensitive to tax advantages. Against this background, unifying corporate profit tax rates between FFEs and domestic firms is now on the agenda. Equalizing domestic and foreign income tax rates will be done through merging the two existing tax codes. Senior finance officials declared that the government would submit the proposal of merging the two existing tax codes to NPC in August 2006. If the proposal is passed, the corporate profit tax rates will be unified no later than 2008. The unified profit tax rate is likely lower than the current 33 percent rate on domestic enterprises, but higher than the 15 percent for foreign investors.

Advancing capital market liberalization. Promoting the development of direct finance, particularly the stock market is key to improve the efficiency of the financial system in allocating resources to promote economic growth, but also critical for the sound development of banking industry. China is experimenting on the use of foreign investment to revitalize the stock market through the QFII mechanism. This experiment will be further extended, more quotas will be allocated. But this policy is not likely to be accelerated before the pressure of massive balance of payments surpluses is alleviated.

Capital account convertibility and liberalization of outward investments. In further advancing the external liberalization, China will continue to follow the empirical approach and the tactics we summarized above. Taking into account the current macroeconomic developments—high economic growth, large exchange reserve, big balance of payment surplus, massive capital inflows and market expectation on RMB appreciation, China will very likely accelerate liberalization measures that lead to capital outflows. These measures include capital account convertibility, facilitating outward direct investment and relaxing restrictions on other outward investment.

Capital account convertibility will be implemented in a gradual manner and be supplemented with efforts to strengthen capacity in monitoring capital flows vulnerability.

The outward direct investment will be directed in processing industry, in natural resource industry and construction projects, as specified in the 11th plan. Relaxation of other overseas investment will be through a controllable mechanism—qualified domestic institutional investor (QDII), which allows the authorities to cushion the impact on external balance and financial market and gives a leeway to the authorities to withdraw when needed. Very recently in April 2006, SAFE allowed individuals to invest in overseas capital market, and the investment had to be conducted through a domestic financial institution. A quota for buying foreign exchange for overseas investment will be assigned to each qualified financial institution. Till now, the sum of the assigned quotas is a small number, but is expected to increase over time.

V Conclusions

In the past two and half decade, China has successfully managed the transition from a close to an open economy following a unique empirical approach. China's success suggests this approach can be useful in dealing with a complex systematic reform in such a big country as China. China will soon complete the opening of domestic market to foreign direct investment as all commitments to WTO are fulfilled. By end 2007 all geographic restrictions will be abolished. Only ownership restrictions will remain, but in very few industries. But restrictions still remain on other types of capital flows.

China is likely to accelerate the liberalization measures that lead to outward investments in near future. Such measures include capital account convertibility, facilitating outward direct investment and allowing qualified institutions to invest in international capital market. Managing capital flows and the associated risks will be a great challenge for China in the next decade. China will have to continue policy reform and adjustment. For the rest of the world, China will not only be a receiver of international capital, but also be a big investor in international financial market. China will make direct contribution to the world economic growth by sharing its high savings. Nevertheless, other countries' exposure to China will go beyond the trade channel. Financial flows will be a significant channel of contagion for the rest of the world some time down the road.

List of References

Ariyoshi et. al, 2000, Capital Controls: Country Experiences with Their Use and Liberalization, IMF Occasional paper No. 190, Washington

Bank for International Settlement (a), 2003, China's Capital Account Liberalisations: International Perspectives, BIS Papers No. 15, Basel, Switzerland

Bank for International Settlement (b), 2005, Foreign Exchange Market Intervention in Emerging Markets: Motives, Techniques and Implications, BIS Papers No. 24, Basel, Switzerland

Catin, Maurice, Xubei Luo & Christophe van Huffel, 2005, Openness, Industrialization, and Geographic Concentration of Activities in China, World Bank Policy Research Working Paper WPS3706, Washington D.C.

Hu, Fred, 2004, Capital Flows, Overheating, and the Nominal Exchange Rate Regime In China, present in a conference on a liberal agenda for the new century: a global perspective," cosponsored by the Cato Institute, the Institute of Economic Analysis and the Russian Union of Industrialists and Entrepreneurs, April 8-9, 2004, Moscow, Russian Federation.

Luo, Robin Huang & Chun Jiang, 2005, Currency Convertibility, Cost of Capital Control and Capital Account Liberalization in China, *Journal of Chinese Political Science*, vol. 10, no. 1, April 2005

Luo X., 2003**,** *Impact des investissements en infrastructure sur la croissance régionale: le cas des provinces chinoises*, Thèse de Doctorat, Université d'Auvergne Clermont 1.

Ma, Guonan & Robert N. McCauley, 2005, Are China's Capital Controls still Binding? Presented in a Joint RIETI/BIS/BOC conference "Globalisation of financial services in China: implications for capital flows, supervision and monetary policy", Beijing, 19 March 2005

Mattoo, Aaditya, 2002, "China's Accession to the WTO: the Service Perspective", the World Bank Policy Research Working Paper 2932

Mehran et. al, 1996, Monetary and Exchange System Reforms in China: An Experiment in Gradualism, IMF Occasional paper No. 141, Washington

Hui Ren, 2001, Reveal the Secret of Capital Flight in China, Economic Daily, July 10, 2001, Beijing China

Tseng et.al, 1994, Economic Reform in China: a New Phase, IMF Occasional paper No. 114, Washington

Zhao, Min, 2005, Policies for the 11th Foreign Capital Utilization Plan, internal policy note of the World Bank Beijing Office.

国家外汇管理局，《中国外汇管理体制的沿革》
http://www.safe.gov.cn/0430/js_tzyg.htm

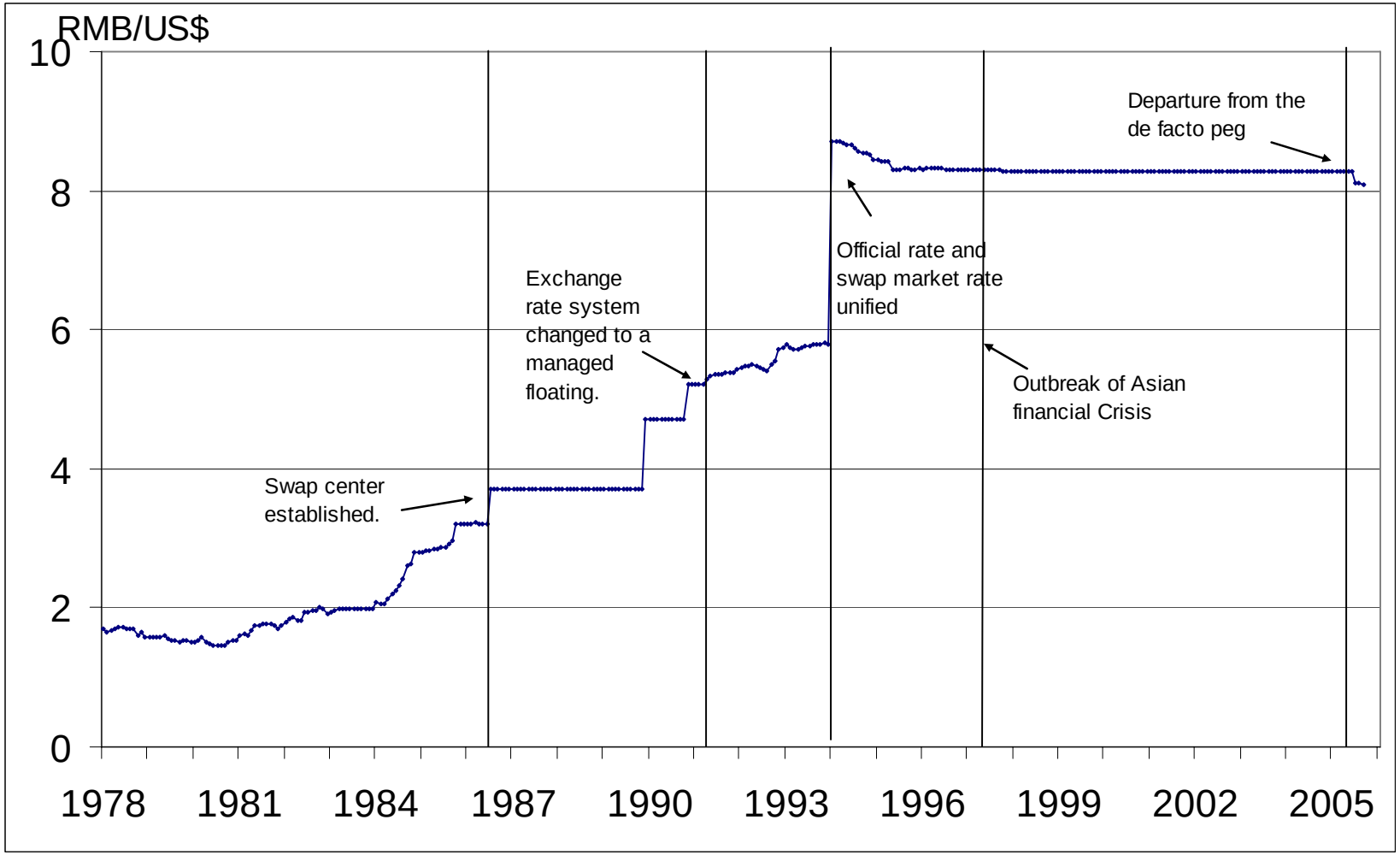
任惠，2001，《中国资本外逃揭秘》，《经济日报》2001 年 7 月 10 日六版

Annex 1. Selected economic indicators, China 1978-2005

Year	GDP Growth Rate %	CPI %	Exports billion US$	Imports billion US$	Trade Balance billion US$	FDI billion US$	Foreign Exchange Reserve billion US$	External Debt billion US$
1978	11.7		9.8	10.9	-1.1		0.2	
1979	7.6		13.7	15.7	-2.0		0.8	
1980	7.8		18.1	20.0	-1.9		-1.3	
1981	5.2		22.0	22.0	0.0		2.7	
1982	9.1		22.3	19.3	3.0		7.0	
1983	10.9		22.2	21.4	0.8		8.9	
1984	15.2		26.1	27.4	-1.3	1.3	8.2	
1985	13.5	9.3	27.4	42.3	-14.9	1.7	2.6	15.8
1986	8.8	6.5	30.9	42.9	-12.0	1.9	2.1	21.5
1987	11.6	7.3	39.4	43.2	-3.8	2.3	2.9	30.2
1988	11.3	18.8	47.5	55.3	-7.8	3.2	3.4	40.0
1989	4.1	18	52.5	59.1	-6.6	3.4	5.6	41.3
1990	3.8	3.1	62.1	53.3	8.7	3.5	11.1	52.5
1991	9.2	3.4	71.8	63.8	8.1	4.4	21.7	60.6
1992	14.2	6.4	84.9	80.6	4.4	11.0	19.4	69.3
1993	14.0	14.7	91.7	104.0	-12.2	27.5	21.2	83.6
1994	13.1	24.1	121.0	115.6	5.4	33.8	51.6	92.8
1995	10.9	17.1	148.8	132.1	16.7	37.5	73.6	106.6
1996	10.0	8.3	151.0	138.8	12.2	41.7	105.0	116.3
1997	9.3	2.8	182.8	142.4	40.4	45.3	139.9	131.0
1998	7.8	-0.8	183.8	140.2	43.6	45.5	145.0	146.0
1999	7.6	-1.4	194.9	165.7	29.2	40.3	154.7	151.8
2000	8.4	0.4	249.2	225.1	24.1	40.7	165.6	145.7
2001	8.3	0.7	266.1	243.6	22.6	46.9	212.2	170.1
2002	9.1	-0.8	325.6	295.2	30.4	52.7	286.4	168.5
2003	10.0	1.2	438.2	412.8	25.5	53.5	403.3	193.6
2004	10.1	3.9	593.3	561.2	32.1	60.6	609.9	228.6
2005	9.9	1.8	762.0	660.1	101.9	60.3	818.9	

Data Source: CEIC

Annex 2. RMB official exchange rate, end of period



Annex 3 Chronology of external liberalization and exchange reform

1979-1987: early stage of opening up

[December 1978] Third plenum of the central committee of the communist party makes a decisive break with the legacy of the cultural revolution and resolves to focus the party's work on economic development in order to achieve substantial, sustained gains in outputs. To achieve this objective, it is decided that market-oriented reforms and opening up will be adopted.

Financial Liberalization		Exchange Rate Regime	Restriction on Current Account Transactions
banking system	**capital market**		
1979 Bank of China is the only bank that is allowed to conduct business in foreign currency. The Bank of Tokyo, the first foreign bank, is approved to set up a representative office in China.		1980 An experimental trading system is established by the BOC in a few cities, where domestic enterprises are permitted to sell retained foreign exchange to other domestic enterprises at the internal settlement rate. The BOC acts as broker. 1981 A dual exchange rate regime is established. An internal settlement rate, calculated as the exporters' average break-even point multiplied by 1.1, applies to goods exports and imports. The official rate, peg to a basket of currencies but adjusted occasionally, is used for non-trade related transactions.	1979 To promote exports, the national monopoly of trade is broken. FFEs are allowed to conduct trade of specified goods. SEZs and Guangdong and Fujian provinces are allowed to set up FTCs with central government approval. International transactions are based on a foreign exchange plan, prepared by various ministries. BOC is responsible for implementing the plan, and all transactions are performed in accordance with it. Local governments and firms are allowed to retain part of their foreign exchange proceeds from trade and non-trade activities, but approval is required to use the retained foreign exchange and quota. The non-retainable foreign exchange should be sold to BOC.
1982 Foreign financial institutions are allowed to set up branches in SEZs, but are not allowed to conduct business in RMB. The first foreign bank starts to operate.			1982 BOC starts to extend foreign exchange credit to exporters. 1983 The license of foreign trade is granted to some big SOEs. 1984 MOFTEC releases a list of commodities forbidden from import. Approval is no-longer required for FTCs to import non-forbidden commodities. BOC and CBIC start to extend loans to importers.
		1985 The use of the internal settlement rate is discontinued. The official rate applies to all currency trade.	1985 Firms are allowed to freely use up to 50% of their retained earnings.
1986 All domestic banks can conduct business in foreign currency.		1986 Swap centers are established where Chinese enterprises with retained foreign exchange or quota and FFEs are permitted to trade foreign exchange at freely negotiated rates.	The State Council grants the Guangdong and Fujian provinces with the authority to approve the setup of FTCs.

Direct investment		External Debt, Guarantee and Derivatives	Cross-Border Transfer
Inward	**Outwards**		
1979 Four SEZs (Shenzhen, Zhuhai, Shantou and Xiamen) are set up.			
1980 FDI is allowed with the central government's approval. FFEs are required to deposit all foreign exchange proceeds in BOC. Profits can be remitted out of the country, but repatriated profits are subject to 10% tax. FFEs are required to keep foreign exchange balance.	1980 Outward direct investment is permitted only after examination of the source of the foreign exchange funds, approval of the authorities concerned with foreign direct investment, and completion of offshore investment foreign exchange registration. Profits from overseas investment should be repatriated home and surrendered to BOC.	1980 Domestic entities to borrow external debt are required to fill in the annual external debt plan and be approved by the State Council. SAFE and SDPC are responsible for compiling the external debt plan.	1980 Transfer across the border must be implemented through a FEDB. Carry-in foreign bank note, valuable minerals or financial instruments are not restricted, but carry-out of these items is generally not allowed.
1984 14 coastal cities are opened for FDI. Shanghai city government are granted with authority to approve FDI up to US$10 million. FFEs in open cities are exempted from profit tax in the first two years and 50% reduction in the following three years. FFEs in open cities are free from import duties when importing equipment, raw material, parts and components. Profit repatriation of FFEs in open cities is no longer subject to tax.			
1985 Foreign investors can invest in port construction. Four regions are opened to foreign investment. Restriction on setting up joint-venture in Shanghai is relaxed. Foreign investors can invest in oil and gas exploitation projects in 10 provinces.			1985 Domestic residents are allowed to retain all proceeds from overseas remittances and deposit them in BOC.
1986 JVEs can pay in foreign currency for purchase from firms outside of SEZs and ETDZs.			

1987-1991: setting up foreign exchange controlling and monitoring system

[Early 1988] In the wake of a bout of inflationary pressures, a stabilization program is introduced (the "rectification program"), in which structural reforms are given lower priority than stabilization and administrative measures are used to supplement nascent indirect instruments of macroeconomic control. China reinforces exchange control system, and at the same time stick to reform and opening up policies.

Financial Liberalization		Exchange Rate Regime	Restriction on Current Account Transactions
Banking system	**Capital Market**		
	1987 Domestic entities are allowed to issue bonds in international market with the State Council's approval.	1988 Part of FERQs from export proceedings are made available to domestic exporters. By October 1988, 80 swap centers have been established. Bank of China is allowed to agent spot and forward foreign exchange trade. The swap rate is allowed to float. Governments are allowed to sell self-owned FERQs in swap market. All firms are allowed to trade retained foreign exchange and FERQs in swap market for specified use. 1988-89 Official rate is applied for the foreign exchange plan, the surrender of proceeds in foreign currency, and purchases associated with FERQs.	1988 The State Council decides to propel the trade responsibility system nationwide and further accelerate and deepen external trade system reform. The authority to approve the setup of FTCs is assigned to provincial governments.
1990 Shanghai, the first city outside of SEZs, is opened for foreign financial institutions.	1990 The Shanghai Securities Exchange is officially recognized. The PBC regulates inter-bank market rates and promulgates new measures to regulate inter-bank markets. 1991 The Shenzhen Stock Exchange is officially recognized.	1991 The official exchange rate is changed from one of pegging to a basket to a system of managed floating. Individuals are allowed to buy foreign exchange in swap markets to pay for overseas tourism, overseas study and emigrants with the approval of SAEC. But the ceiling on the purchase is low.	1991 Export receipts verification system is implemented. The State no longer provides subsidies to support exports.

Direct investment		External Debt, Guarantee and Derivatives	Cross-Border Transfer
Inward	**Outwards**		
		1987 Financial institutions with license and non-financial institutions with foreign exchange earnings are allowed to be engaged in foreign exchange guarantees.	
1989 FFEs are allowed to earn foreign exchange from sales to firms in SEZs, EDZs or other FFEs, or from sales of products that substitute imports to domestic enterprises.	1989 Notification on overseas direct investment is released by SAFE. Domestic investors are required to deposit 5% of investment amount in a special account with a FEDB for profit repatriation. Domestic firms are not allowed to provide guarantee to overseas investment firms.	1989 Upper bound is imposed on the outstanding short-term external debt. PBC sets the national upper bound and SAFE sets the upper bound for each financial institutions. Short-term debt is forbidden to be invested in long-term project. Issuing international bonds is included in the nation's foreign capital utilization plan. The external debt registration and monitoring system is further improved. Both direct external debt and on-lend debt are to be registered with SAFE. The qualification for engaging in external guarantee is raised. Government departments and administrative units are forbidden from providing external guarantee.	
1990 The administrative procedures for setting up a FFE is streamlined. Pudong (Shanghai) sets up EDZs. Foreign investors are allowed to invest in land and real estate development projects. 1991 Profit Tax Code for FFEs is enacted. 10% tax on FFEs' profit repatriation is repealed.	1990 Only enterprises that have own foreign exchange can invest overseas. The profits from overseas investment should be repatriated home and surrendered. The investing enterprises can retain FERQs up to 100% of the repatriated profits in 5 years and 80% afterwards.	1990 Non-financial enterprises (non FFEs) are allowed to borrow from foreign banks or jointly owned banks in China with SAFE's approval. 1991 Enterprises in pivot industries can buy foreign exchange to repay external debt.	

1992- 1996 accelerating liberalization

[November 1993] Third Plenum of the Fourteenth Central Committee outlines and approves comprehensive reform strategy in which foreign exchange management reforms are mentioned as a key element for a market-oriented economy. A market-based unified floating exchange regime and current account convertibility are targets of the reform.

Financial Liberalization		Exchange Rate Regime	Restriction on Current Account Transactions
Banking System	**Capital Market**		
1992 The rectification program ends. The authorities announce their intention to accelerate the reform process. Gradually, more commercial banks, mostly of regional scope, are licensed. Seven more coastal cities are opened to foreign banks.	1992 B-share market is launched.	1992 Part of the FERQs made available to the state are purchased at a premium equal to the monthly weighted average of the rate in the swap market. The PBC starts selling the quotas that it has bought at the market rate to importers through the swap market at the prevailing swap market rate.	1992 Some inland cities and border regions are opened for border trade and investment. Import adjustment tax is nullified. Some qualified big SOEs are allowed to conduct foreign trade in specified products. Part of the FERQs from non-trade proceedings are made available to firms.
1993 Shanghai, as a pilot city, is opened to foreign insurance companies. The first foreign insurance company is in operation in September 1992.	July 15, 1993 The first Chinese firm, Qingdao Beer, lists in Hong Kong Stock Exchange.	1993 The State Council decides that the SAFE should function under the guidance of the PBC. The SAFE issues regulation on licensing, capital, operation, control, and risk limits for financial institutions' foreign exchange operations. 1994 The official and swap market exchange rates are unified at the prevailing swap market exchange rate. The unified exchange rate regime is a managed floating system. The CFETS becomes operational, creating an integrated system of foreign exchange trading centralized in Shanghai. A two-tier trading system is established. Firms trade foreign exchange with banks. Banks trade their net foreign exchange position in CFETS. Swap centers phase out and eventually shut down in 1998.	1993 Research institutes and state owned commercial corporate can conduct foreign trade in specified products. . 1994 Most exchange restrictions on current account transactions are removed. The foreign exchange retention quota system is repealed. The foreign exchange plan is nullified. A foreign exchange surrender and purchase system is applied to all proceeds and expenditure under current account transactions. An import payment verification system is launched. FTCs are not required to surrender profits to the authorities but pay profit tax instead.
1995 24 cities are opened to foreign banks. The first joint venture investment bank is established.			
1996 Foreign banks are allowed to be foreign exchange designated banks, and trade foreign currency with FFEs. The first non-state owned bank-Mingshen bank is established. Domestic banks can extend loans in foreign currency and issue credit card in foreign currency. Inter-bank foreign currency market is in operation.	1996 Except for buying B-share, non-residents should not buy, sell or issue any note and bonds in monetary market. Financial institutions can issue bonds denominated in foreign currency in international market with the State Council's approval. The foreign exchange proceeds from overseas IPO or bond issuance are not allowed to be converted in RMB nor be used to invest in foreign bonds or other foreign financial instruments.		1996 China announces achieving current account convertibility. Imports of equipment for export processing are no longer free from import duties. Foreign investors are allowed to set up joint owned foreign trade corporate in Shanghai and Shenzhen.

Direct investment		External Debt, Guarantee and Derivatives	Cross-Border Transfer
Inward	**Outwards**		
1992 Retail and Distribution services industries are opened to foreign investment with ownership restriction. More regions are opened to foreign investment, and ownership requirement for FDI in most industries is relaxed. Imports of FFEs that are free from import tariff are up to the amount of total investment.			
		1993 FFEs, private enterprises and individuals are allowed to trade futures. SOEs and JVs are allowed to trade futures for hedge purpose only.	
1995 SOEs and collective owned enterprises are allowed to be converted as FFEs through selling equity to foreigners, issuing B-shares or acquiring foreign investment with foreign ownership no less than 25%.	1995 The profit repatriation deposit is reduced to 5% of the investment paid in cash or 2.5% of the investment paid in kind. The deposit can be in foreign exchange or equivalent RMB.	1995 Domestic financial institutions are not allowed to trade derivatives in overseas market. Government entities are forbidden from providing external guarantees. Only qualified financial institutions and enterprises are allowed to provide external guarantee with SAFE's approval. FEDBs are allowed to trade RMB forward with firms.	
		1996 FFEs' providing guarantee for a domestic entity is subject to SDPC's guiding plan and is required to be registered as external debt.	
1996 As of July 1996, the foreign exchange surrender and purchase system is extended to FFEs. FFEs may open foreign exchange account in bank. SAFE sets the ceiling on these foreign exchange accounts. The foreign exchange proceeds from capital account transactions are not allowed to be converted in RMB, unless SAFE approves. Foreign exchange balance requirement for FFEs is repealed.	1996 When domestic entities make overseas investment, SAFE checks the source of foreign exchange earnings. The foreign exchange proceeds from capital account transactions are not allowed to be converted in RMB unless being approved by the SAFE.	Foreign exchange proceeds from external debt are not allowed to be converted in RMB. International leasing of plane is subject to national external debt plan.	1996 Foreign exchange account holder can remit foreign exchange in the account abroad. Individuals can carry up to US$4000 foreign banknote out of the border.

1997-2000 strengthening supervision on outward flows

In December 1996 China becomes a member of IMF's Article 8 of Articles of Agreement, achieving current account convertibility. The breakout of Asian financial crisis makes China be cautious about financial liberalization. The monitoring system over external transactions is significantly strengthened.

Financial Liberalization		Exchange Rate Regime	Restriction on Current Account Transactions
Banking System	**Capital Market**		
1997 Reserve requirement is extended to the foreign exchange deposits of foreign banks. Foreign bank should allocate non-performing asset reserve. 18 cities are opened for foreign banks to do business in RMB. Foreign banks outside of SEZs no longer enjoy the profit tax exemption and reduction. The foreign financial institutions in SEZs are not free from exemption of business tax (8%) after 5 years preferential period. Domestic financial and insurance companies' business tax is raised from 5% to 8%. Banks are allowed to do off-shore business with SAFE's approval. Foreign investors can invest in domestic banks.	1997 Financial institutions are allowed to issue bonds in international market with SAFE approval.		1997 Non-manufacturing firms in SEZs can be engaged in foreign trade. Domestic entities should repatriate foreign exchange proceeds from current account transactions home, and surrender them to a bank or deposit them in a FEDB if being approved.
		Dec 1998 The swap centers are shut down. FFEs can trade foreign exchange with FEDBs.	1998 Individuals purchasing foreign exchange below the ceiling no longer requires SAFE approval. Citizens can deposit in banks or convert in RMB their foreign exchange proceeds from current account transactions or overseas remittance.
1999 The geographic restriction on foreign banks is repealed.	Feb 1999 The first private firm is listed abroad.		1999 Private firms can do foreign trade.
2000 Effective May 2001, foreign financial institutions in SEZs no longer enjoy the preferential business tax. The business tax rates of domestic and foreign financial firms are unified to 8%, and will be reduced to 5%, one percentage point a year from 2001 to 2003.	2000 Qualified institutions are allowed to issue bonds in overseas market. SDPC, PBC and other departments evaluate the institutions' qualification and the State Council approval is required.		

Direct Investment		External Debt, Guarantee and Derivatives	Cross-Border Transfer
Inward	**Outwards**		
1997 The industrial guidance for foreign direct investment is released. Seven ministries start to exercise a joint annual examination over foreign funded enterprises.		1997 Only qualified financial institutions and enterprises can provide external guarantees with SAFE's approval.	
Jan 1998 FFEs in encouraged category are free from tariff, consumption tax and VAT for imports of equipment. 1999 The preferential policies are extended to FDI in energy, transportation and infrastructure industries. The authorities encourage foreign investment in western region. FFEs in western region can enjoy a lower profit tax rate, 15% in the first three years. The restriction on FFEs borrowing in RMB is relaxed. 2000 Foreign enterprises should buy insurance products from domestic insurance company. Railway, water transportation and gasoline mining are opened for foreign investment. Medical care is opened for foreign investment, but ownership restriction remains.	1998 Residents can deposit or convert in RMB their foreign exchange proceeds from capital account transactions with SAFE's approval.	1998 Domestic FEDBs should not issue long-term letter of credit not related to trade. Banks issuing letter of credit with maturity more than one year requires prior approval from the SAFE. Domestic FEDBs extending RMB loans to domestic entities should not accept guarantees in foreign currency issued by foreign banks or overseas entities (including standby letter of credit) as collateral. 1999 Major exporters and importers can trade futures of specified commodities at abroad.	

2001- accelerating financial liberalization in context of accession to WTO

China accesses to WTO as of December 2001, committing to liberalizing its service industries including banking, securities, insurance among others.

Financial Liberalization		Exchange Rate Regime	Restriction on Current Account Transactions
Banking System	**Capital Market**		
2001 Foreign banks are allowed to provide foreign exchange services to all firms and individuals. Four cities are opened for foreign banks to do RMB businesses. In December 2001 foreign insurance companies are allowed to operate in China. Seven are approved.	2001 Domestic residents can invest in B-share with self-owned foreign exchange.	On July 21, 2005 RMB exchange rate regime changes from a de facto peg to US dollar to a managed floating system with a reference to a basket of currencies. Non financial institutions are allowed to participate in inter-bank spot foreign exchange market. RMB forward and swap are allowed to trade. Foreign banks are allowed to do forward trade. On Jan 4, 2006 OTC trade is introduced in inter-bank spot foreign exchange market.	2001 FFEs are allowed to do foreign trade.
2002 Opening security industry to foreign investment. The first jointly owned fund company is approved. The first jointly owned life insurance company is in operation.	2002 Foreign financial institutions can invest in domestic capital market within specified quota after being approved by the authorities. (QFII)		2002 Current account foreign exchange settlement account and specified account are combined as current account. The ceiling of current account is raised to 20% of foreign exchange proceeds from current account transactions in previous year. Individuals are allowed to purchase up to US$20000 for overseas study per year.
2003 Foreign owned insurance companies are allowed to participate in foreign exchange inter-bank market. The foreign ownership restriction in future corporate is repealed. Foreign investors can buy equity of domestic banks. But the foreign ownership can not exceed 25% of total equity or 20% for any single foreign investor.			2003 RMB, hard currency or currency of neighboring countries are allowed to be used in border trade. The maximum amount that individual can purchase for tourism is raised to US$3000 per transaction, or US$5000 if staying overseas for more than 6 months.
2003 Four more cities are opened to foreign banks to do RMB businesses. Foreign banks are allowed to provide RMB service to domestic firms in open cities.			
2004 PBC provides settlement service for Hong Kong banks that are engaged in RMB deposits, currency exchange, credit card and remittance businesses.	2004 Insurance companies can use their own foreign exchange to invest in international capital market.		2004 The ceiling of foreign exchange current account is significantly raised. The procedures for firms to buy foreign exchange are simplified. The Law of External Trade is revised. No approval is required for firm or individual to do external trade.
2005 The geographic restriction and ownership restriction to foreign insurance companies are repealed. Foreign insurance companies are allowed to provide health insurance, group insurance, pension and annuity services. Seven more cities are opened for foreign banks to do RMB business. The total number of open cities reaches 25. The required reserve ratio for foreign exchange deposits are unified to 3%. Before that, it is 2% for China funded financial institutions, 5% for deposits up to 3 months maturity in foreign financial institutions, 3% for deposits more than 3 months maturity in foreign financial institutions.	2005 The first foreign company is listed in Shanghai Stock Exchange. Effective Feb 2005, the deadline for repatriation for foreign exchange proceeds raised by resident shareholders from overseas IPO is extended to six months after the funds are collected.		2005 Enterprises in export processing zones can use foreign exchange to settle trade with enterprises in the zones. SAFE significantly raises the ceiling on the current account again. Firms can surrender their foreign exchange proceeds at their own discretion. The ceiling of individual purchase of foreign exchange for tourism or overseas study is raised again. Individuals are allowed to buy foreign exchange to pay for overseas expenditures paid via credit card.

Direct investment		External Debt, Guarantee and Derivatives	Cross-Border Transfer
Inward	**Outwards**		
2001 The business tax rate that finance and insurance companies pay is lowered from 8% to 5% in three years, one percentage point a year.	2001 The restriction on purchasing foreign exchange for overseas investment is relaxed. Firms are allowed to purchase foreign exchange to repay debt before it matures.	2001 The restrictions on purchasing foreign exchange to repay domestic debt denominated in foreign currency is repealed. The restrictions on purchasing foreign exchange to repay the external debt or domestic debt in foreign currency before the debt matures are relaxed. All firms that are engaged in foreign trade can trade futures and other hedge instruments in overseas market.	
2002 A new four-tier classification system is introduced, defining activities in which foreign investment is encouraged, permitted, restricted, or banned. FDI in encouraging category can enjoy duty exemption of imports of equipments. .Many industries, that are previously closed to foreign investment, particularly in public utilities and services industries such as insurance, banking, commerce, tourism, accounting, telecommunication, transport, accounting, legal service are opened. The sub-sectors in restricted category are reduced from 112 to 75.	2002 A pilot program is carried out in six provinces to grant local SAFE authority to approve the purchase of foreign exchange for overseas investment.	2002 Restrictions on buying foreign exchange to repay the debt in foreign exchange are repealed. Big SOEs are encouraged to repay external debt before the maturity date.	
2003 Foreign investors are allowed to open foreign exchange account in China to facilitate their M&A activities.	2003 The requirements of foreign exchange risk examination and profit repatriation deposit for overseas investment are repealed. The joint annual examination of overseas invested companies is launched.	2003 The provisional regulation on external debt is issued. The long-term external debt quota is extended to foreign banks in China. Domestic entities are forbidden from issuing guarantee to non-operational overseas entities. Government departments and other quasi-government entities are not allowed to borrow external debt or provide external guarantee without the approval from the State Council.	2003 Individuals, residents or non-residents, are allowed to carry up to US$10,000 cash across-border. There is no limit on other financial instruments denominated in foreign currency.
2004 Multinational corporate, irrespective domestic owned or foreign owned, are allowed to lend to their overseas affiliates or subsidiaries.	2004 Firms investing overseas is no longer required to get approval from authorities.	2004 External debt quota management system is extended to foreign owned banks. A ceiling is imposed on the foreign banks' outstanding short-term external debt. Foreign banks in China issuing guarantee to non-residents are subject to external debt regulation. Domestic entities issuing guarantee for residents to foreign banks in China are subject to domestic guarantee regulation.	2004 The maximum amount of RMB banknote that is allowed to be carried across border is raised from RMB6000 to 20,000. Mainland residents are allowed to use RMB bank card for overseas tourism. SAFE imposes strict screening process on non-residents purchase and sales of foreign exchange. The restriction on transferring assets overseas is further relaxed.
2005 Domestic residents are allowed to set up companies at abroad to facilitate round-tripping investment or overseas financing (issuing bonds and stocks). The industrial guidance to foreign direct investment is revised.	2005 Authorities over some capital account transactions are assigned to local SAFE bureaus. The pilot project to allow selected provincial and regional SAFE to authorize purchase of foreign exchange for outward investment is rolled out nationwide, with the total volume being raised from US$3.3 billion to 5 billion.	2005 The due import payments with maturity over 6 months and more than US$200 thousand is required to be registered as external debt. Ceilings are imposed on the scale of the external debt of foreign investment companies. Supervision over the domestic banks' guarantee to overseas companies is changed from approval by transaction to annual outstanding balance management.	2005 The approval procedures for individual assets transfer is simplified.