

# **Capital Controls in China: Recent Developments and Reform Prospects**

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## **Keywords:**

Capital controls, Currency convertibility, Financial liberalisation, Economic reforms, the Chinese Economy

## **Abstract**

Capital controls proved useful for the central planning system, but the growing adverse effects make the reform inevitable. Early reform efforts were focused on relaxing restrictions on foreign exchange availability and embracing for market forces, which led to the establishment of Chinese currency's convertibility on the current account in 1994. The Asian financial crisis disrupted this process.

China recently has quietly re-launched this reform. The new measures are directed at loosening up controls over capital account transactions to achieve so-called "fundamental convertibility" with full convertibility on the current account but conditional convertibility on the capital account that allows free long-term capital flows but restricts short-term capital flows.

The recent reforms feature a strategy of selective liberalisation and China is making progress in reducing the intensity of controls, particularly controls on capital outflow. A new regime has emerged under which transactions in most international assets are freed though a number of capital transactions remain regulated. Meanwhile, China has pro-actively promoted international use of Chinese currency. These developments suggest the beginning of the end of capital controls in China.

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## **I. Introduction**

More than two decades of economic reforms have fundamentally transformed the Chinese economy. However, in transition to a market economy China is still faced with many outstanding tasks. One of these, and perhaps the most serious, is how to

deal with the continual existence of capital controls that frustrate capital movements across China's border.

The merits and demerits of capital controls have been well debated in the literature (Dooley, 1996, Eichengreen and Mussa, 1998, Dooley and Walsh, 2000, Dornbusch, 2001, and Gourinchas and Jeanne, 2004). Historically, capital controls allowed China to fend off disruptive capital movements, set the exchange rate independently and mobilise scarce resources of foreign exchange to national development projects (Yin, et al., 1991). Further, in recent years, China has greatly benefited from the protection provided by capital controls in avoiding mayhems of the Asian financial crisis (Han, 2002). However, as the Chinese economy becomes mature and opens its door ever wider to the rest of the world, the effectiveness of the control regime is diminishing and the administrative costs rising (Zhong, et al., 2004). As a result, calls for reforming the control regime steadily become stronger (Yu, 2001).

But, for a country like China, it is no simple matter to revoke such a regime. The capital controls regime has long been an integral part of the economic system. Its reform will radically change the functioning of the whole economy and requires many other supportive policies with formidable complicity. International experience has shown that freer capital movements are on the whole welfare enhancing, but premature liberalisation is everywhere a recipe for financial crisis (Gao, 2000). So what is really at issue for China is how to handle the liberalisation process (Zhang, 2004).

China is aware of the immensity of the tasks involved and has pondered deeply over the management of the process of capital account liberalisation (Yu, 2001; Guan 2002). Quite contrary to general belief, this process has already begun. Despite ups and downs, a lot has actually been achieved with promising results. All the indications are that China is committed to establishing an open capital account, and that reform of China's capital account policy is likely to quicken in the years to come.

For China as a world trading nation, lifting capital controls for a full convertible Chinese currency will change the way that nation deals with the rest of the world and perhaps also the landscape of international finance. The implications are simply enormous. It will then take an increasing interest in finding out what China has achieved and what will happen.

As a successful reformer, China is noted internationally for its sensible handling of general economic transformation. So far, many other countries have plunged into crisis when liberalising their capital controls. It is yet to be seen how China will fare. Good or bad, the Chinese experience in establishing capital account convertibility will prove to be valuable.

The rest of the paper is organised as follows. The next Section will give a brief account of the history of capital controls in China prior to the reforms. Section Three introduces the evolution of China's capital account regime in the early reform period up until 1994. Section Four analyses the framework of the current Chinese capital controls regime. Section Five concerns recent developments of the reform of capital controls in China, especially the reform measures taken by the Chinese authorities

after the Asian financial crisis. Section Six goes on to analyse China's policy goals and the reform strategy. The last Section concludes.

## **II. A Brief History of China's Capital Controls**

Capital controls in China are shrouded in an extensive system of "Foreign Exchange Management". According to official articulation, the foreign exchange management system covers all aspects of foreign exchange transactions including organisation, coordination and restriction of foreign exchange purchases, sales, settlements, prices and marketing (Wu, 2001).

Historically, this control regime was developed out of the need for the collection of limited resources of foreign currency available to the country for the after-war economic rehabilitation (Yin, et al., 1991). Shortly after the foundation of the new People's Republic, the central authority in 1950 promulgated the Temporary Methods for Foreign Exchange Distribution and Utilisation. A Central Financial and Economic Committee was set up, empowered, among other things, to execute exchange controls in China. Foreign exchange income was required to be sold to or deposited with state banks while users had to seek approval from the People's Bank of China (PBOC) for obtaining foreign currency needed for imports or other non-trade activities. Only with a permit, could a user purchase foreign exchange from designated state foreign exchange banks, 53 in total (Zhang, 2002). The overarching mission of the regime at this stage was to achieve financial stabilization by restricting destabilising movements of foreign capital. Meanwhile, the regime was also designed to plug up leakage of foreign exchange revenues from central controls and mobilise all foreign exchange available into government hands (Chen, 2001).

After 1956, the regime was further centralised according to the principle of “centralised controls and unified transactions”. A compulsory planning system was instituted, turning China’s exchange controls into a strict command system. The state monopolized allocation of foreign exchange, the setting of the exchange rate, and related regulations. All foreign exchange business was to be conducted solely by the state bank, the Bank of China (Wu, 2001).

In parallel with the master trade plan, the national foreign exchange plan was formulated by the State Planning Commission (SPC) after consultation with the Ministries of Trade and of Finance, and the People’s Bank of China. All foreign exchange for trade or non-trade purposes by central, provincial or local government, or by public or private agents, were to be approved and then listed in the plan. The plan was mandatory and exchange controls were enforced accordingly. With that, all foreign exchange proceeds would be surrendered to the state and every demand for foreign exchange had to be approved by the state and be allocated according to the plan (Lardy, 1995). Furthermore, there was a rigid separation of income and expenditure. They had to be kept in separate accounts and subject to different controls (Chen, 2001).

Exchange controls were the mechanism designed and applied to ensure the matching of imports and exports in financial terms. In addition to the roles of preventing disruptive capital movements and mobilising foreign exchange resources within the country, the regime was now granted a new mission to ensure a smooth functioning of the central planning system as far as foreign exchange availability was concerned.

The regime worked by way of plugging up leakage of foreign exchange revenues from central controls and mobilising foreign exchange flowing into the country to promote national development projects that required financing in foreign exchange (He and Xu, 1997).

Capital controls in China featured a dual regime that restrained quantity as well as price of foreign exchange. In addition to the imposition of quantity controls, the exchange rate was strictly regulated. The RMB exchange rate played only an accounting role, translating foreign trade transactions into domestic counterparts. Economically, the RMB exchange rate was relevant only to non-trade transactions, such as foreign tourism, remittances from overseas Chinese, etc. With regard to institutional arrangements of the exchange rate, China had a managed floating system during 1945-55. From 1955, it operated a fixed regime with the RMB exchange rate being frozen for almost 17 years. When the world entered the era of general floating currencies in 1973, China pegged the RMB to a basket of international currencies (Zhang, 2000).

In short, the Chinese capital controls regime in the pre-reform years was a dual institution that controlled both quantity and price of foreign exchange. The main functions it performed included fending off disruptive international capital movements, mobilising foreign exchange resources for national development projects, and ensuring foreign exchange availability for the functioning of the central planning system. On the whole, this regime worked reasonably well in performing its designated roles. However, as the country gradually opened its doors to the outside world in the reform years, the adverse effects of the regime such as ineffective

allocation of foreign exchange resources, irrational exchange rates, and the increasing cost of administrative management have raised the stake of the reform to this regime.

### **III. Evolution in the Early Reform Period**

Since 1979, when economic reforms were launched, China's capital and exchange controls have undergone sweeping changes. First among these was the establishment of a supervisory body. In March 1979, the State General Administration of Foreign Exchange (SGAFE) was created within the Bank of China to supervise all inflows and outflows of foreign exchange across the country. In August 1982, the SGAFE ended its association with the Bank of China to become a bureau of the People's Bank of China (PBOC, the Chinese central bank), renamed the State Administration of Foreign Exchange (SAFE). In July 1988, the SAFE was put under the direct control of the State Council, with organisational affiliation to the PBOC. In December 1989, the SAFE was promoted to vice-ministerial level. With this status, it was merged with the PBOC in 1990 by a resolution of the People's Congress (Liu, et al., 1997).

The creation of this single supervisory institution has helped reduce bureaucracy and has improved informational and institutional efficiency. For, prior to this, despite the extensiveness of capital controls, the administration of the regime was carried out by different ministries, each concerned with a particular aspect of the controls.

Confusions, overlapping of responsibility, and infightings among officials were an inevitable occurrence.

Along with this institutional improvement came legal changes helpful for the establishment of a rule-based environment. In December 1980, the State Council promulgated the Preliminary Regulations on Foreign Exchange Management (amended in April 1996). Later, several bylaws and rules were issued by the SAFE. These cover foreign exchange utilisation by individuals, Sino- foreign joint ventures, special methods for Special Economic Zones, foreign debt registration, outward investment, tourists' foreign exchange, and foreign exchange guarantees (Wu, 2001).

The old controls system was based on rule by man. Unpublished internal policies and bureaucratic expedient were the main media through which all foreign exchange within the country was controlled. The system was thus prone to bureaucratic abuse. The effort of trying to regulate the controls with a legal framework represents a welcome break from this tradition.

The third reform concerns the liberalisation of foreign exchange allocation that led to the emergence of some form of foreign exchange market in China (Khor, 1993, Lu and Zhang, 2000). In 1979, China introduced foreign exchange retention schemes to encourage export enthusiasm. The schemes tried to link import entitlement with export performance by allowing domestic units (including producers, trading organisations and provincial governments) to retain some share of the foreign exchange they earned through export. When domestic agents surrendered their foreign exchange proceeds to the government, in addition to receiving domestic money at the official exchange rate, they could obtain entitlements to a proportion of foreign exchange. The proportion or the retention ratio was specified by the government, and was called the foreign exchange quotas in China (He and Xu, 1997). The retention

ratio was generally between 10 and 50 per cent in its early stages and averaged about 44 per cent overall for the whole period (Khor, 1993). Initially only applicable to above-target exports, from 1988 the system was based on actual foreign exchange receipts. In the early version, priority regions enjoyed higher retention ratios. For Special Economic Zones and minority regions (such as Tibet), the retention ratio was as high as 100 per cent. For economic and Technological Development Areas in coastal cities, the ratio hit 80 per cent. Guangdong and Fujian provinces were each given a retention ratio of 30 per cent because of their special policy status, while other provinces could only claim a ratio of 25 per cent. Later, priority products and sectors were given preference. From 1991 to 1994 when the retention schemes ceased, all regions and sectors were given a uniform ratio of 80 per cent, though in minority and less-developed regions preferential treatments were maintained (Shang and Yan, 1995, Ba, 1999).

While the usages of retained foreign exchange were specified by the government, imports financed by such retention quotas required no planning permit in general cases. As a result, imports under the schemes were fairly free. Given the strict import rationing in China at the time, this was a significant liberalising step (Ba, 1999).

The quotas, or foreign exchange entitlements in their true nature, were initially not transferable, which limited their inducements. They became marketable in October 1980 when the Bank of China launched a swap business in 12 cities, which provided some intermediary services for holders of foreign exchange entitlements and the demanders. From August 1981, these notional quotas could be sold to the bank directly. In the beginning, the price of such notional quotas was at the Internal Rate

for Trade Settlement (the IRTS rate), with a margin of up to 10 per cent added or deducted. As of October 1985, this was changed to be priced at one RMB yuan more than the official exchange rate with a ceiling of 4.20 yuan per dollar. In October 1986, Foreign Invested Enterprises (FIEs) were allowed to swap foreign exchange among them, with the price to be decided freely by the parties involved. This gave rise to the emergence of swap centres exclusively for FIEs, separate from the swap market for domestic enterprises where the price was restricted (Zhang, 2002).

Further liberalisation occurred in April 1988. With the introduction of the contract responsibility programmes in the foreign trade sector, the barrier segmenting domestic enterprises and FIEs on the swap market was lifted and the swap rate was allowed to move freely. Meanwhile, controls over the amount of retained foreign exchange that could be actually spent in a year were dropped. From 1 September 1989, private residents were gradually allowed to sell foreign currency on the swap market, resulting in total freedom in selling foreign exchange on the swap market (Wu and Chen, 1992).

On the demand side, restrictions on the purchase of foreign exchange remained, reflecting China's cautious approach to foreign exchange liberalisation. Domestic buyers had first to be eligible to import, and then had to obtain foreign exchange approval from local offices of the SAFE. For licensed imports, enterprises had to obtain the licence in the first place. For non-licensed imports, SAFE approval was based on a "Priority List" compiled in conformity with the national industrial policy. For products outside the list, mostly consumer goods, the restrictions applied were less stringent although this varied between regions.

With the free pricing of retention quotas and an increased amount of foreign exchange that could be retained by Chinese agents, the swap market expanded dramatically. In 1988, amid an increased number of authorised local swap centres, a national swap centre was created in Beijing to deal with swap business between ministries and between regional swap centres. By the end of 1993, there were 119 swap centres in China, with at least one swap centre in every province (Wang, 2003a).

The dramatic development of the swap market was a milestone in China's exchange reform. The swap market itself entailed liberalisation of foreign exchange allocation. As the foundation of this market, foreign exchange retention schemes granted exporters easier access to foreign exchange, and hence lower costs due to reduced bureaucracy. Also, the schemes made it possible for exporters and local governments to readily import for their own needs that were not necessarily high in the central government's priorities.

The swap market furthered the beneficial effects of retention schemes. The transferability of the retention quotas at a depreciated rate gave an implicit subsidy to exporters. As a result, the swap market provided--at least partially-- compensation for the general anti-export bias of the trade system. More fundamentally, it allowed interactions between demand and supply, leading to the introduction of the essential elements of a market system into China's foreign exchange allocation and so providing gains in terms of allocative efficiency.

On top of these, it also contributed to the reform of the exchange rate. There is evidence that the authorities had used the movements of the swap rate to gather information about changes in the domestic cost of foreign exchange. Such information was then used by the authorities to assess the prevailing exchange rate policy and to decide possible adjustment of the official exchange rate. As a result, the Chinese exchange rate policy became largely market-driven.

Thus, the rigid Chinese regime of capital controls was shaken to its foundations. The relatively free supply of and demand for foreign exchange at a market-driven rate spelt the beginning of the end of a regime that relied on quantity and price controls to insulate the domestic economy.

However, the liberalising experiment was not without its problems. The most intractable was a multiple exchange rate regime that emerged when a swap rate existed in parallel with the official exchange rate. The authorities tolerated the existence of a more depreciated swap rate to redress overvaluation. But the multiple rate regime did lead to unpredictable discrimination, rent-seeking activity and corruption, which gradually made the swap market a matter for wide concern and finally an object of further reform.

Further liberalising reforms were adopted by the Chinese government. Entry and usage controls were progressively relaxed, the retention ratio increased, and a national swap centre was created to reduce market fragmentation. Finally, the government unified the exchange rates and established partial currency convertibility on the current account in 1994 (Lu and Zhang, 2000).

The liberalisation process continued after 1994 (Wu, 1997). In preserving the swap business for FIEs, the 1994 reform programme caused some resentment. Compared with the freedom granted to domestic enterprises, FIEs felt that they were discriminated against because they still had to obtain SAFE's approval for access to swap centres and pay a fee. It was also feared that the government might tighten the requirement for individual FIEs to balance their foreign exchange account. In response, the government abandoned the arrangement in July 1996 and allowed FIEs to buy foreign currency freely on the inter-bank market.<sup>1</sup>

Furthermore, from 1995 individuals can buy \$1000 for one overseas trip (\$600 to Hong Kong). Starting on 1 January 1997, authorised foreign banks may provide financial services in RMB in Shanghai, and later on in Shenzhen. With most current account transactions freed, China on 1 December 1996 officially notified the IMF of RMB's convertibility on the current account<sup>2</sup>.

It was only logical that China's next move would be to allow RMB's convertibility on the capital account. However, because of the Asian financial crisis, the process was disrupted. To many Chinese economists, the crisis was largely due to volatile movements of international capital. This belief persuaded the Chinese government to be more cautious about liberalising capital controls. Despite this, convertibility of the RMB on the current account has significantly reduced the extensiveness of capital control in China (Song, 1999). The once all-inclusive system of foreign exchange management has now given way to a mixed system in which the current account is

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<sup>1</sup> People's Daily, 21 June 1996.

<sup>2</sup> People's Daily, 1 December 1996.

free while the capital account remains restricted. As a result, whereas the general term of foreign exchange management is still used in China, what one may now hear is the term capital account management.

#### **IV. The Current Regime Framework**

At present, the framework of China's capital controls consists of three pillars, i.e. controls over foreign debts, international portfolio investment and foreign direct investment (Yu, 2001).

The control over foreign debt covers Chinese government's liability, long- or short-term, to foreign governments, international organisations, international banks, and companies. The control operation involves the size, structure, maturity and repayment of debts. Planning permission and registration are also required. The types of debt subject to control extend to international loans, project financing, external collateral, and risk management.

In theory, both inward and outward investments are the remit of the control over international portfolio investment. However, as private Chinese residents are prohibited from buying foreign securities, the current regime centres on controlling overseas issuance of bonds by government bodies, the listing of Chinese company shares in overseas stock exchanges (including that in Hong Kong), and the issuance and transactions of B shares, which are a special type of Chinese shares denominated in US dollars and used to be traded only among non-Chinese residents in China.

The third pillar of China's capital controls is the management of foreign direct investment (FDI). China has been particularly successful in attracting FDIs. Controls in this field were traditionally focussed on inward FDI, including the amount of investment capital to be paid in, operational expenditures and receipts in foreign currency classified as capital account transactions, and external borrowings by FDI firms. But, recently, this focus on inward FDIs is being gradually replaced by China's concern with outward FDI, especially outward FDI by Chinese companies, which we will discuss later.

Throughout the mid-1950s to the 1970s, the principle adopted by the Chinese government for capital controls was that of centralised management with unified operations. In the early reform years, this was modified as being centralised management of foreign exchange, uniform requirements for all units to balance foreign exchange expenditure and income, ensuring availability of foreign exchange for key projects, and allowing retention of foreign currency proceeds from trade and non-trade activities (Wu, 2001, Guan, 2002).

These policy principles had a strong flavour of stressing the importance of balancing foreign exchange books at all levels. With plenty of foreign exchange reserves now being held by China, it is no longer necessary for China to stringently require all agents to balance their foreign exchange accounts. The establishment of convertibility on the current account thus brings in a change to the policy approach.

China's new policy stance now is that, having achieved convertibility on the current account, the emphasis of foreign exchange management should change to that of capital account (Wu, 2001). However, there is no rush to seek an open capital account.

International experience has repeatedly shown that premature opening of the capital account is a recipe for financial crisis. At the current stage of China's economic preparedness, capital controls may have to remain in place to ensure adequate availability of external funding, maintain stability of the RMB exchange rate, promote restructuring of the domestic economy, protect the national economy especially the state sector, and safeguard financial stability (Yu, 2001, Wang, 2003a).

The present principle for China's capital controls is therefore reduced to concern the capital account only. Specifically, the new principle calls for capital account transactions to be subject to strict controls. Stringent examinations, approvals, and registration procedures are required for all inward and outward investment, though FDIs are to be encouraged. The total amount of foreign debts will be restricted to an appropriate size and structure be timely adjusted. Attention will be paid to economic efficiency in using foreign capital to ensure repayment of the principal and interest. Outward investment by Chinese enterprises is to be promoted with a view to further developing China's external sector (Guan, 2002, Han, 2002).

## **V. Recent Developments**

### ***5.1 Developments in the General Policy Regime***

### *Policy Goal*

The official objective of China's foreign exchange liberalisation policy has been to gradually make its currency fully convertible. But, despite its early progress in liberalising the foreign exchange system, China waited until 1993 to formally announce this intention, reflecting its cautiousness in dealing with the liberalisation of exchange controls.<sup>3</sup>

The success of the 1994 foreign exchange reform programme boosted Chinese confidence to some extent. As a result, China's reform initiative briefly became bolder. In 1995, China again confirmed the convertibility plan, adding that positive measures would be taken to create conditions for making the RMB convertible (Wang, et al., 2002). Then, in 1996, China confidently notified the International Monetary Fund of RMB's partial convertibility on the current account.

According to Chang (1998), the 1996 announcement was actually several years ahead of its original target date. Moreover, given the reform measures that China has taken such as abolishment of foreign-exchange balancing requirements and export quotas for FIEs and its rapidly growing foreign exchange reserves at the time, Chang (1998) suggested convertibility on the capital account was perhaps a realistic goal for the year 2000. Chinese researchers also mentioned such a plan to open China's capital account by 2000 had there been no disruptions due to Asian financial crisis (Yi. 2001). The full RMB convertibility was only to be halted by the breakout of the Asian financial crisis in 1997. Quite unexpectedly, China's success in shielding the RMB exchange rate from speculative attacks generated a view within the country that

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<sup>3</sup> Resolution of the Central Committee of the Chinese Communist Party on Several Issues Concerning Building a Socialist Market Economy, People's Daily, 15 November 1993.

capital controls were not bad and even desirable. Exchange controls were consequently tightened after 1997, making a fully convertible Chinese currency a distant prospect.

This was relieved when the Asian financial crisis was over. And especially, after 1998 when China intensified its bid for the WTO membership, were calls for liberalising the foreign exchange system rekindled (Hu, 2001). Since accession to the WTO in 2001, China has restated again that it will push for capital account convertibility.

On 21 October 2003, the powerful Central Committee of the Chinese Communist Party passed a resolution on building a market economy in China. The resolution declared that “Provided that risks can be effectively guarded off, we should selectively, and in steps, deregulate restrictions on cross-border capital transactions and gradually establish RMB’s convertibility on the capital account.”<sup>4</sup> This was the first time that China mentioned specifically the capital account convertibility as an official goal.

One aspect often missing in the study of China’s liberalising attempt is the definition of currency convertibility. What is really meant by convertibility could be quite different in China than is conventionally understood. Chinese government economists at the central bank have talked about an intermediate plan for the “fundamental convertibility of the Chinese currency” (Jing 2001). This plan aims to achieve “total convertibility on the current account but conditional convertibility on the capital account” for RMB, meaning that some long-term capital account transactions will be

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<sup>4</sup> People’s Daily, 22 October 2003.

allowed freedom but short-term capital movements will be prohibited, with all types of current account transactions being convertible. It is likely to be a favoured definition by the Chinese authorities of China's capital account convertibility.

### ***Reform Speed***

Concerning the speed of China's move toward an open capital account, Chang (1998) believes that China used to have an aggressive timetable for making the RMB a fully convertible currency by the year 2000. Groombridge (2001) also believes in the existence of such a plan. As mentioned before, the Asian financial crisis had disrupted the process of China's financial liberalisation including any possible reform timetables. In any case, even if this aggressive timetable had ever existed, it is likely that the Chinese government, alerted by the Asian financial crisis, had abandoned it. Indeed, despite some international urge for a bold convertibility programme (Groombridge, 2001), China has recently confirmed that any move to an open capital account will be gradual.<sup>5</sup>

### ***Reform Timetable***

Publicly, the Chinese authorities have never officially committed to a specific timetable for opening the capital account. However, some officials have suggested a timetable for the RMB to become fully convertible by 2015.<sup>6</sup> Wu (2000) believes China will more likely be ahead of, rather than later than 2015 to achieve an open capital account. An even more enthusiastic estimate, as reported in Wang (2003b), suggests China will establish a basically open capital account in 5 years from 2003. It

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<sup>5</sup> People's Daily, 22 October 2003

<sup>6</sup> Voice of China, 2 November 2001. The newspaper reported that Dr Yi Gang, Deputy Secretary of China's Monetary Committee, gave such a timeline.

is perhaps reasonable to put the time-frame for China's achievement of fundamental convertibility around 2010 (Jing, 2003).

### ***Reform Sequence***

Discussions on the sequence of decontrolling China's capital account are still ongoing within China. It is generally agreed that convertibility of capital account should start with conditional convertibility, then moves to full convertibility. The official guidelines used to be "proactive, sure-footed, easy things first, relaxed on inflows and tough on outflows". In 2004, the Chinese exchange authority has changed the policy of being soft-on-inflow and tough-on-outflow to one that emphasises on promoting capital outflows, while keeping other parts of the guidelines intact.<sup>7</sup>

The preferred sequence by Chinese authorities seems to be one that first opens across-the-border investment in the real sector (direct investment), then frees portfolio investment in the second stage, and finally liberalises the whole financial sector to complete the reform course (Wu, 2001). Specifically, the liberalisation sequence features such a set of orders: first relaxes inflows then outflows; first relaxes restrictions on long-term capital movements, followed by liberalisation of short-term capital flows; first relaxes restrictions on foreign direct investment, then allows indirect investment; loosens controls on overseas fund-raising before allows fund raising within China by non-residents; first deregulates controls on financial institutions, then relaxes controls on non-financial institutions and non-resident

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<sup>7</sup>See <http://www.safe.gov.cn/News/N352.htm>, as accessed 2 February 2005.

individuals, first allows transactions based on real business, then allows for transactions with no real business basis (Yi, 2001).<sup>8</sup>

### *5.2 Developments of Specific Policy Measures*

Efforts have been made to enhance the transparency of the controls regime. In May 1999, the SAFE went online, carrying publications of various laws, regulations, and decrees on foreign exchange management.

On the market, from 1 January 1997, forward foreign exchange transactions through banks have been once again permitted.<sup>9</sup> Some commercial banks such as The Bank of China, Bank of Construction, Industrial and Commercial Bank, and the Agricultural Bank have already started operations in forward foreign exchange business.

Meanwhile, the foreign exchange market, money market and bond market are to be gradually open to foreign dealers on the basis of national treatment. It is proposed that joint money dealers between Chinese and foreign firms can be set up and related regulations are being formulated (Zhou, 2004)

On 21 September 2000, China freed interest rates for foreign currency lending and for large amount foreign exchange deposits. For small foreign exchange deposits, their rates are to be determined by the Banking Association, which is a step forward towards marketisation of the interest rate (Hu, X. 2002).

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<sup>8</sup> “State Administration of Foreign Exchange: China will further open restrictions on capital account”, <http://finance.sina.com.cn/g20040704/1420849650.shtml>, as accessed 31 January 2005.

<sup>9</sup> See the notice issued by the Chinese State Administration of Foreign Exchange at <http://www.safe.gov.cn/law/law529.htm>, as accessed on 31 January 2005.

The China Foreign Exchange Trading Centre has started process of launching inter-bank transactions in dollar against other major currencies and to provide for payment and settlement facilities for transactions of foreign to foreign currencies among financial institutions. It will also gradually introduce into the inter-bank foreign exchange market the market makers mechanism (Guan, et al., 2004).

More international participations are in the sight. The China Foreign Exchange Trading Centre has launched substantial collaboration initiatives with the Chicago Commodity Exchange for China to introduce foreign exchange derivatives. Further collaborations will be promoted in the areas of product design, system development, market expansion and personal training. The two parties has signed Letter of Collaboration Intent in December 2003, and signed Memorandum for Collaboration in June 2004 (Zhou, 2004).

As early as October 1997, the SAFE granted permission for some qualified Chinese enterprises to open foreign exchange settlement accounts. In these accounts, some proportion of proceeds from current account transactions may be kept. However, qualifications required for opening such accounts at the time were so prohibitively high that most enterprises were unable to meet them. On 1 December 2001, qualifications for opening such accounts were relaxed, but small and medium enterprises were still excluded from the scheme (Han, 2002).

Then, in October 2002, further reform was launched allowing all types of enterprises qualified to undertake external business or having regular foreign exchange incomes from current account transactions to open foreign currency accounts. All qualified

enterprises can hold up to 20% of their last year's foreign exchange income in this account. From 1 May 2004, this proportion has been raised to 30-50% (Zhou, 2004). This represents a radical departure from China's current system that requires compulsory surrender of foreign exchange to the State. Meanwhile, from May 2004, Chinese enterprises and multinational companies can make overseas investment using their retained foreign exchange.<sup>10</sup>

Meantime, foreign invested businesses are also allowed to retain some proportion of foreign exchange proceeds from current account transactions for payments under the current account and for approved capital account transactions. Branches of foreign banks within China may lend to or take deposits from foreign invested enterprises or approved Chinese state-owned enterprises (Xu, 2004).

From August 2001, in some localities, experiment has been carried out for foreign invested enterprises to directly pay to banks rather than the SAFE foreign currencies earned from capital account transactions.<sup>11</sup> Although only a first step, this marks a radical change in SAFE's capital account policy, in that it breaks with the tradition of controlling capital account transactions using direct and administrative means and turns to indirect and market based regulations. From late 2002, this experiment has spread from limited cities to become applicable to all the country.

Starting from the fourth quarter of 2001, Chinese banks are now allowed to purchase foreign exchange to supplement their capital funds or for their operational needs. By

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<sup>10</sup> See <http://www.safe.gov.cn/News/N352.htm>, as accessed 2 February 2005.

<sup>11</sup> International Commercial News, 6 November 2001.

the end of 2002, purchased foreign exchange for these purposes was as high as 30 billion US dollars.

Since October 2001, China has relaxed restrictions on foreign exchange funding for outward foreign direct investment by Chinese enterprise. Chinese firms can buy foreign exchange with RMB for investment projects that are of national strategic importance. They can also buy foreign currency for overseas processing projects using Chinese materials and for overseas development assistance projects. As a result of this policy, the amount of foreign exchange purchased for outward FDIs has grown rapidly, increasing twofold from January to September 2001 as against the same period the year before. From 1 October 2001, using Zhejiang province as an experiment station, all restrictions on purchasing foreign exchange for outward FDIs by Chinese enterprises have been lifted. Also abolished are the SAFE's verification on possible foreign exchange risks involved in such outward FDIs and schemes of using deposits as a bond for securing profits repatriation from such FDIs. Meanwhile, enterprises are allowed to spend the profits or other incomes generated from outward FDIs. A delayed registration rather than a prior approval system for foreign exchange expenditures for the purpose of outward FDIs is being instituted.<sup>12</sup> By the end of 2004, this experiment was adopted in 24 provinces.<sup>13</sup> An interesting development in this field, Chinese private firms now are also allowed to make such international investments.<sup>14</sup>

On 1 June 2002, with the approval of the SAFE, the China National Foreign Exchange Transaction Centre started undertaking intermediary services for financial

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<sup>12</sup> International Commerce Daily, 5 November 2002.

<sup>13</sup> See <http://www.safe.gov.cn/News/N352.htm>, as accessed 2 February 2005.

<sup>14</sup> Finance and Economy Times, 20 January 2003.

institutions. This gives rise to a national and unified inter-bank market for foreign exchange. Before that, inter-bank transactions in foreign exchange were conducted by individual banks, leading to a segmented and inactive market with limited size. Banks wanting to borrow short-term funds from overseas institutions were restricted according to the total size of such short-term foreign debt (Guan, et al., 2004). The establishment of a national transaction centre enables banks to trade away these restrictions. All financial institutions qualified to undertake inter-bank foreign exchange transactions can enter this market. The borrowing and lending rates on this foreign exchange market are determined freely by the involved parties. The transactions may be conducted in the US dollar, the Japanese Yen, and the Euro, with the maturity being one year or less.

It was in the early 1980s that Chinese residents were allowed to open foreign currency deposit accounts. Now, foreign currency deposits that originated from overseas remittances can be remitted out of the country with no restrictions. Funds originating from the resident's own holdings of cash foreign currency can also be remitted out of the country on presenting valid documentation to banks. When more than 2,000 US dollars are involved, approval from local SAFE offices is required. Residents can now hold foreign exchange in cash, sell foreign exchange to banks, and buy and sell with and between foreign currencies through banks. Private residents can have more foreign currency available to them for overseas trips. Whereas one could previously buy \$600 for an international visit, in 1996 this was raised to \$1,000. In 1997, \$2,000 per overseas journey was allowed. Since 1 September 2003, this quota has risen to \$5,000 for every overseas trip. For studying at foreign universities, students can now

buy up to \$20,000 plus tuition fees effective on 1 January 2005. Also from 2005, Chinese citizens can bring up to 20,000 Chinese yuan out of the country.<sup>15</sup>

From April 2001, Chinese citizens have been permitted to deal in B shares that are dollar denominated shares of Chinese companies and to be traded in dollars. This trading right was a privilege previously enjoyed only by foreign passport holders. Now, for the first time, Chinese citizens are able to buy and sell foreign currency dominated securities, leading to free capital flows between domestic and foreign currencies within China (Takeshi, 2002). All these clearly indicate that China is making radical departure from the previous policy by way of quietly reducing controls on capital outflows. This is the most challenging part of China's endeavour of opening its capital account (Icard, 2002) and some promising progress seems to have been made.

Another exciting recent development in China's capital account policy is the introduction of the scheme of QFIIs (Qualified Foreign Institutional Investors). Originally tried in Taiwan and other emerging markets, this scheme provides an avenue for introducing foreign portfolio investment into China when capital controls are still in place ((Neoh, 2000, Green and Wall, 2000). Effective on 1 December 2002, a QFII is defined as either a foreign funds management firm, a foreign securities company, a foreign insurance company, or any other asset management house that (1) has been approved by the Chinese Securities Regulatory Committee (CSRC) to invest in Chinese securities, and (2) has obtained a quota from the SAFE to remit foreign exchange into China to make portfolio investments (Earnshaw, et al., 2005).

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<sup>15</sup> See <http://www.safe.gov.cn/law/law544.htm>, as accessed 1 February 2005.

QFIIs can invest in Chinese A-shares (but not the B shares), debt securities and other financial instruments as permitted by the CSRC. Previously, A-shares were reserved only for domestic investors. The introduction of the QFIIs opens the market of nearly 1200 A-shares to foreign buyers and so significantly expands the horizon of investment opportunity for international investors.

Strict restrictions are currently in place on qualification requirements, operational procedures and the outbound remittance of foreign currency funds by QFIIs (Wang, 2004). Curbs on early repatriation s are particularly tight. For example, a QFII that manages closed-end China funds has to wait for three years before it can start to remit the principal out of China and each remittance must not exceed 20% of the total capital, with the interval between two remittances being at least one month. This is another reflection of China's cautious and experimental approach to capital account liberalisation.

International institutions have welcomed the opening as a long-term opportunity (Chow, 2003). For China, this programme is likely to have a positive impact on its capital market development over the medium to long-term, and on the way Chinese listed companies handle corporate governance issues (Kim, et al., 2003). It is also a significant step toward capital market liberalisation in China, which indicates the Chinese government is taking real measures opening up China's capital markets (Kim, et al., 2003). As a result, capital controls tend to be considerably relaxed – since a large amount of foreign capital for investment purposes is now allowed to flow out of the country from institutions resident in China.

With these developments, China has now to say the least established partial convertibility on the capital account. There are no restrictions on foreign debts incurred by foreign invested enterprises. No approval is required for short-term and trade-related financing (three months or less). Non-residents can purchase both A shares and B shares, government bonds, commercial papers, H shares and N shares. Foreign investors in China are allowed to repatriate to their home countries profits from direct investment and other investment. There are no restrictions on loans to foreign establishments by their parent or affiliated firms. And neither is international lending by foreign invested enterprises in China subject to restrictions.

## **VI. The Emerging Reform Strategy**

The recent developments of China's capital account policy suggest that reform of China's capital controls is entering into a new stage. With a halting start, liberalisation of international capital movements across the border of China is under way and is gaining momentum. Although the pace may not be radically fast, the direction of the reform is well established, which is to go for a fundamental or basic convertibility rather than a completely free currency. With this aim, China is taking steps towards a total lifting of controls on all capital transactions except for movements of short-term speculative capital.

From these recent policy moves there has emerged a distinctive reform strategy, which may be characterised as one of selective liberalisation. Under this strategy, China has carefully chosen one area at a time for reform while keeping other restrictions untouched rather than deregulate all controls in one-go. The first chosen areas are usually those that may have more beneficial effects if reforms proceed well

and less adverse effects if things go wrong. For example, the first area of China's capital account reform concerns the inward foreign direct investment. In most cases these can make a positive contribution to the economy. However, having flowed into the country as economic conditions became worse; these investment projects will not usually suddenly exit the country and hence will be less disruptive.

Once liberalisation of foreign direct investment had met with success, China moved to decontrol portfolio investment. Initially, international investors were allowed only to trade foreign currency dominated shares among themselves. This was designed to attract hard currency funds into China while preventing depletion of official foreign exchange reserves should some international investors suddenly withdraw. Later on, this market is gradually opened wider to allow access by domestic residents. Next, barriers between investments by residents and non-residents were reduced and outflow of capital allowed. This is the real significance of the emergence of the QFII scheme. Thanks to this scheme, foreign investors can fully engage the Chinese capital market as they can now have access to both the domestic and foreign currency segments. More importantly, under this scheme portfolio investment funds are now entitled to flow out of the country. Previously, foreign capital inflows were almost totally free while the outflow of foreign capital was strictly regulated. This new established freedom for capital outflow, though it has to be orderly, shows the old policy regime has started to crumble.

Although Chinese domestic residents can now fully participate in the domestic capital market, their international investment opportunity is limited. They can only trade dollar-denominated B shares within China --no investment beyond the national border.

However, granted that China's object is to achieve full convertibility, it is almost inevitable that permission will be given for qualified domestic institutional investors (the QDII scheme) to invest in foreign stock markets. Above all, foreigners being allowed the freedom to buy Chinese securities when Chinese residents are not able to invest in foreign markets would be illogical. In effect, in the Chinese policy circle, further reform by way of the adoption of QDII schemes is already being pondered, which leads to widespread discussions in the Chinese press on the possibility of the QDII schemes.

Another distinctive aspect of China's emerging strategy is the reform's gradualist nature. The strategy to target selected areas of reform practically prescribes China to open its capital account gradually. This selective reform strategy entails the potential for the reform to expand from one area to another when conditions are ripe and the government has the courage to move forward. But selection also means that it will take some time for reforms to take place.

Such a gradualist strategy tends to enable China to avoid the clustering of reform measures in a single period, so that their shocking effects -- if any -- can be spread out. This is much in line with China's long-standing and successful strategy to general economic reforms that directs the reforms along the way of least resistance and minimum cost. It also takes in the fact that China's regulatory institutions are underdeveloped. This process is going to be slow and possibly protracted, but will not be infinite. The strategy of selective and gradual liberalisation entails the potential for the reform to expand from one area to another, so long as conditions are ripe and the reformers in the government have the courage to move forward.

Closely related to selective reform is the sequencing issue. China is noted internationally for its approach to phase in reforms. Although reforms may not be blueprinted *ex ante*, the phase-in approach to reforms has allowed China to achieve *ex post* consistency of economic transformation (Naughton, 1994). The reform of China's regime of capital controls comes as no exception. It has been revealed that the Chinese authorities will phase in the capital account liberalisation via three stages, which also spells out the sequencing of the reform. In the first stage, foreign direct investment is to be liberalised. The second stage focuses on liberalising international portfolio investment. The third and final stage sees the overall liberalisation of China's financial sector (Wu, 2001). China today has almost passed the test of the first stage and is well in the middle of the second. Currently, there are virtually no restrictions on inward foreign direct investment, and restrictions on outward FDIs are being relaxed. As for the main task of second stage reform, i.e. the liberalisation of portfolio investment, recent developments as revealed in the previous section indicate that only outward portfolio investment by Chinese citizens is still subject to restrictions. However, if the QDII schemes are to be instituted, which is widely tipped to be so in the near future, liberalisation in this area will essentially be accomplished.

China has also made progress in the third stage tasks of opening up the whole banking system. There is a growing presence of international banks in China. As a result of China's commitment to WTO membership, foreign banks will soon be allowed to do all types of banking business, including deposit and loan transactions in Chinese currency. Foreign securities firms will be fully functioning on the Chinese capital markets as well. Indeed, according to the Bank of International Settlement's research (McCauley and Mo, 2000; Icard, 2002), China's banking market is relatively open. In

terms of foreign currency deposits as a percentage of broad money, China is actually more open than has generally been recognised (Ma and McCauley, 2002).

The final distinctive aspect of China's reform strategy is the promotion of a two-way flow of capital, i.e. not only is foreign capital free to flow across the Chinese border, Chinese currency is also to be allowed free flow to the international market. Radically different to the conventional opening up of the capital account that essentially gives foreign capital free entry into and exit from the home country, this is about increased use of the Chinese currency internationally. Heated debate has been going on within China about the possibility of the RMB becoming a currency that is internationally acceptable in trade and investment (Zhao, 2003, He and Li, 2004, Li, et al., 2004).

Some economists from governmental think-tanks have further refined the notion of a hard Chinese currency. It is argued that, while foreign capital is allowed to flow freely into and exit China, more efforts should be made to promote the outflow of capital by Chinese investors seeking overseas investment opportunity. Preferably, the Chinese currency and capital can dominate this two-way traffic (Research Group, 2001). The Chinese government has already taken steps in this direction. Notable examples include encouragement of outward Chinese FDIs, increased allowance for the Chinese currency being brought out of the country by Chinese residents (for a trip to Hong Kong, an individual can now take 30,000 RMB yuan out of the country while previously this was only 6,000 yuan), provision of government-sponsored facilities for using the RMB in border trade transactions with China's neighbours. The newest development in this regard is the announcement by the Chinese government on 13 March 2003, which formally gave permission to allow China's foreign trade to be

denominated in RMB.<sup>16</sup> This carries the eventuality that the Chinese currency will become a vehicle currency for international trade and a currency for international settlement. As a result, it will soon emerge that the overseas RMB balance in the accounts will be held by international business and perhaps also be used for investment purposes. These are all essential elements of an international currency.

## **VII. Summary**

Capital controls in China take the form of an extensive system of foreign exchange management that covers all transactions involving the use of foreign currency. It is a dual institution that controls both quantity and price of foreign exchange through highly centralised management. The control regime has served roles of fending off disruptive international capital movements, mobilising foreign exchange resources for national development projects, maintaining an independent exchange rate policy, and ensuring foreign exchange availability for the functioning of the central planning system. On the whole, the regime has worked reasonably well for China.

However, the adverse effects of the regime are also substantial and rising. It has led to ineffective allocation of foreign exchange resources, irrational exchange rates, and increasing costs of bureaucratic administration. Hence, while the country has been steadily opening its doors to the rest of the world in the reform years, reform of this regime becomes inevitable.

In the early reform period, reform was first concerned with institutional improvement and the establishment of a regulatory framework. But the most important development

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<sup>16</sup> People's Daily, 14 March 2003.

during this period was the emergence of the secondary foreign exchange market that considerably relaxed restrictions on the availability of foreign exchange and introduced market forces into China's exchange rate policy.

The climax of the early reform was the establishment of convertibility on the current account in 1994, which was officially notified to the IMF in 1996. China was believed to have an aggressive reform agenda for opening its capital account afterwards. However, the breakout of the financial crisis in Asian and other emerging market economies in 1997-1998 disrupted this process.

Recent events indicate China to be re-launching reform of its capital controls. Given the fact that current account transactions in China are for the most part free, the centre of the recent reform campaign is reform of controls over capital account transactions. China's policy goal is to achieve fundamental convertibility of the Chinese currency, that is, total convertibility on the current account but conditional convertibility on the capital account. Conditional or partial capital account convertibility means freedom for long-term capital flows and restrictions on speculative short-term capital movements. China has already achieved total convertibility on the current account. Along this line, important reforms are taking place in China.

With a strategy of selective liberalisation, China is making progress in reducing the intensity of capital controls, especially controls on outflow of capital. Gradually and piece by piece, the old total institution of capital controls is crumbling away and a new regime has emerged, which features free transactions in most international assets, including direct and portfolio investment, while keeping controls in a declining

number of areas under the capital account. Meanwhile, two-way capital flows, particularly outflow of domestic as well as international capital, are gradually gaining more freedoms. In this process, a notable new development is that China has started to increase the international use of Chinese currency. This is an experiment unseen in any other similar countries that pursue an open capital account and could be a Chinese innovation in economic reforms.

Recent developments in China's capital account policy spell the beginning of the end of capital controls in China. This reform will fundamentally change the structure of the Chinese economy and the landscape of international finance. Early consequences of this reform have already started to emerge. As a result, China today is more open than generally perceived in terms of restrictions on capital account transactions. The reform of China's capital controls regime is no longer a halfway house, but a process that perhaps has passed the three-quarter mark of the reform journey on the Chinese scale, i.e. the Chinese definition of fundamental convertibility. A capital account that is free for most long-term capital transactions while some restrictions are kept on short-term, speculative capital movements is not in the distant future for China.

Reform of China's capital controls represents a quantum leap in China's integration into the world economy. The world with China having strict capital controls will be a fundamentally different place from a world with China allowing free movements of capital across its border plus Chinese money being a major international currency. We do not know precisely what the repercussions of this huge event will be. But we do know that we are witnessing perhaps the most important policy development in the recent economic history of the world.

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