Towards Full Convertibility?
China's Foreign Exchange Reforms

TSANG Shu-ki

Department of Economics
Hong Kong Baptist College
224 Waterloo Road
Kowloon
HONG KONG

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Towards Full Convertibility? China's Foreign Exchange Reforms

Tsang Shu-ki*

1. Introduction

Like most developing countries, China has adopted a multiple exchange rate regime in its attempt to maintain control while liberalizing transactions in the spheres of trade, non-trade and cross-border fund flows. From a very rigid, highly centralized system in 1979, China has progressed to one with a relatively high degree of flexibility. The tight control on international fund transfers has also been continually relaxed, as different parties (including individuals) gain increasing freedom to acquire. foreign currency.

A pledge to unify the multiple rates within five years was made in early 1993 by high-ranking government officials, in a bid to speed up China's re-entry to GATT. In the second half of 1993, the possibility of merging the official and the swap market rates in 1994 was raised. Strictly speaking, only the exchange rates on trade transactions are relevant for GATT purposes, and I would argue that unification of exchange rates should not be a pre-requisite for GATT membership. Nevertheless, unification would help to dispel the suspicion that China was manipulating the dual rates to subsidize unfairly her exporters and discriminate against foreign investors. Then in late 1993, China unveiled a relatively radical reform package for its foreign exchange system, whose major features included, among others, the unification of exchange rates, the enhancement of the degree of current account convertibility, and the transformation of the foreign currency trading system into a bank-based market.

Although it did not constitute a "big bang", like the approach adopted by Poland, Russia, or Bulgaria, this "three-in-one" reform package turned out to be more radical than most had recommended or expected. There are concerns as to whether China would have sufficient foreign exchange reserves and possess the necessary macroeconomic instruments to stabilize a unified and liberalized Renminbi in a bank-based trading system, particularly in an overheating environment. On the other hand, while signs are that some of the leaders in Beijing have, for

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*The author is a senior lecturer in the Department of Economics of the Hong Kong Baptist College. He is grateful to Dr. Chan Man-hung for a detailed and critical reading of the first draft. Versions of the paper have also benefited from comments and suggestions by Prof. Y.Y. Kueh, Prof. Jonathan Unger and Prof. Keith Griffin, amongst others. All remaining errors and omissions are his own.

various reasons, lost their patience or nerve over the gradual process of piecemeal reforms and have urged a bold attempt to achieve full convertibility for the Renminbi by 1997, others are still holding to a cautious approach. It appears that the government has not made up its mind about the pace of reform. Back-tracking is therefore possible as the tactic of "two steps forwards, one step backwards" could serve as a safety valve that guards against any potential crisis, particularly as the need for economic caution became increasingly important in 1994 because of cyclical considerations. Some "watering-down" of the reform was clearly observable by April-May 1994.

This paper provides a detailed historical and institutional analysis of the evolution of China's foreign exchange system in the reform period and addresses some of the contentious issues. It is organized as follows. In Sections 2 to 6, changes in the exchange rate mechanism and the control arrangements on trade, non-trade, as well as foreign investment in the past thirteen years are summarized. Developments in the swap centres are discussed in Section 7. The paper then goes on to assess the relevance of China's re-entry to GATT to her plans of foreign exchange liberalization (Section 8), summarize the mainstream reform proposals before 1994 (Section 9) and the major constraints (Sections 9 and 10), clarify the concept of unification and convertibility, and finally speculate about the prospect of the reform package recently launched (Section 12 onwards), which turned out to be more radical than most had expected, although it did not constitute a "big bang". In any case, despite all the worries, I do not foresee a crisis as bureaucratic back-tracking is always possible and has already been resorted to (Section 16). Because of cyclical and other considerations, the leadership seems to have slipped back to a more cautious approach concerning full convertibility (Section 17). Finally, some concluding remarks are offered in Section 18.

2. Evolution of China's Exchange Rate System

China's foreign exchange system has been closely tied to the country's strategy of conducting external economic relations. Before 1979, when international capital transactions were minimal, China's foreign trade was highly monopolized. Trade served only a residual function in balancing supply and demand in the domestic economy, and the government generally resorted to a policy of over-valuing the Renminbi.[1] In the reform period, the situation

[1]See Woo Tun-oy and Tsang Shu-ki, "Comparative Advantage and Trade Liberalization in China", *Economy and Society*, Vol.17, No.1, 1988, pp.21-51; and Wu Nianlu and Chen Quangeng, *Renminbi huilu yanjiu* (Studies on the Exchange Rate of the Renminbi), Zhongguo Jinrong Chubanshe (China Finance Publishing House), 1989, pp.15-35. The latter reference gives some interesting arguments on the proposition that the Renminbi might actually have been "under-valued" in the pre-reform period. We adopt in this paper the conventional definition of the exchange rate of the Renminbi, i.e. it is stated in the form of the amount of yuans per unit of

began to change, as China shifted towards a path of export-oriented growth, consciously or led simply by unfolding circumstances. Attracting foreign capital has also become an important objective since 1992, after the country emerged from the 1989-1991 doldrums and embarked on an infrastructure-driven and heavy-industries-led growth trajectory. Changes in the foreign exchange system have reflected these developments.

From 1979 onwards, the government has tried to modify the foreign exchange system to accommodate the country's changing external economic relations. The general trend has been to devaluate the Renminbi, but the authorities have been quite pragmatic in dealing with the issue of liberalizing the arrangements and enhancing the convertibility of the currency. From 1981 to 1984, a dual exchange rate system was adopted: the official rate depreciated gradually while the secondary rate, i.e. the internal settlement rate applied to trade transactions, was fixed at a lower rate of Rmb 2.8 per US$. The latter rate was apparently arrived at by adding a 10% premium to the average cost of exports in 1979.[2] Basically it was a mechanism to encourage exports, as exporters could earn more domestic currency per US dollar of money by selling goods in overseas markets. It was also a way to deal with the problems of financial losses due to increasing subsidies to the export sector.[3] The two rates were unified at 2.80 in January 1985, after the official rate slipped near that level.

However, dual exchange rates reappeared with the experimentation of foreign exchange adjustment centres (FEACs) or "swap" centres in some cities in 1985-86. The 1988 trade reform saw the official endorsement of the expansion of the FEACs. In general, the administered official rate was used for foreign trade and other external transactions embodied in the annual foreign exchange plan. A second, lower rate was determined at the FEACs, where enterprises were permitted to buy and sell foreign exchange as well as retention quotas which could be used to acquire foreign exchange at the official rate to finance primarily trade transactions not included in the plan.

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foreign currency. So if the amount goes up, say from ¥1.50/US$ to ¥2.80/US$, a "devaluation" (or "depreciation") of the Renminbi against the US dollar occurs. A "revaluation" (or "appreciation") refers to the opposite phenomenon of a fall in the amount.

[2]See Nicholas R. Lardy, *Foreign Trade and Economic Reform in China, 1978-1990*, Cambridge University Press, 1992, p.67. He quotes a Chinese source that the average domestic cost of earning one US dollar in exports was 2.40 yuan in 1979. Excluding crude oil, which was vastly underpriced internally, the cost was 2.65 yuan. The internal settlement rate of 2.80 was derived by averaging the two figures and then adding a 10% premium as an incentive to exporters.

[3]*ibid.*, p.67.

From 1985 to 1991, the official rate of the Renminbi was devalued significantly several times. On July 5, 1986, it was lowered to Rmb 3.70/US$. It was adjusted to 4.70 on December 15, 1989, and further devalued to 5.22 on November 17, 1990. Since April 9, 1991, the government had officially adopted a "managed float" system (*you guanli de fudong huilü zhidu*) under which the official rate was to be adjusted "continuously" and "in small steps". This mechanism was regarded as superior to the discrete large adjustments taken in the previous "fixed" rate system.[4]

The system held pretty well in 1991, with the official rate ending the year at 5.43 against the US dollar. In the ten major swap centres (Beijing, Tianjin, Shanghai, Guangzhou, Hangzhou, Nanjing, Shenzhen, Xiamen, Dalian, and the National centre in Beijing), the weighted average price of the retained US$ quota hovered around Rmb 0.50 for the whole year, implying a depreciation of the official rate of less than 10%.[5] Indeed, there were reports that in Shanghai, the largest FEAC, the government had to intervene to shore up the swap rate by buying foreign currency (selling Renminbi). The motivation was to provide incentives to exporters by giving them a better rate. The black market rates were quite close to the level of the swap rates. With hindsight, that provided a *golden* opportunity for the country to unify its multiple exchange rates, which unfortunately was not made use of, a point that many economists and officials now lament. To some, all the government needed to do then was one relatively but not exceedingly large devaluation of the official rate, and declare the convertibility of Renminbi overnight. Of course, the matter was, and is, not that simple. We shall return to this point later.

In any case, the good times did not last long. The exchange rate system came under pressure in 1992 when the economy began showing signs of overheating. The Renminbi fell sharply in the swap markets, touching a low of Rmb8.80/US$ in early 1993 before the government introduced a cap of 8.135 in March-May. In June 1993, the authorities tried to float the swap rates, only to see them slip in step-like fashion.[6] Eventually, the swap rates stabilized at the 8.70 level as a result of the macroeconomic adjustment programme introduced in late June 1993 and an apparent re-enforcement of administrative restrictions. Then talk arose of unifying

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[4] *Zhongguo Jinrong Nianjian (Almanac of China's Banking and Finance)* (hereafter ZGJRNJ), 1992, p.57.

[5] *ibid.*

[6] See Tsang Shu-ki, "Zhongguo dangqian de jinrong xingshi" (Recent Trends in China's Financial Sector), paper presented at a seminar organized by CERD Consultants Ltd., Hong Kong, 15 June 1993.

the official and the swap market rates within a short period of time. In reality, of course, the two rates were unified, through the abolition of the former, on 1 January 1994.

The exchange rate represents the price of a currency vis-à-vis other monies of the world. Other than controlling the price, a central bank can control the quantity of exchange transactions through restricting the access of various parties to foreign exchange and/or limiting their rights to buy or sell foreign exchange at various "prices" in a multiple-rate situation. China's exchange control system has been closely tied to its strategy of conducting external economic relations, which can be classified into trade and non-trade subsystems. Within the trade subsystem, export and import have received differential treatments. The trade subsystem is important, because more than 80% of China's foreign exchange revenue has come from external trade. So let us turn to it first.

3. The Exchange Control System on Export Trade

So far as exports are concerned, the Chinese government maintained an export plan up to 1991. Exports have been classified into Category I and Category II items, which were subject to mandatory planning. The 1991 reform formally abolished mandatory planning. However, the government has continued to exercise influence over exports by assigning the rights to export Category I and II goods to foreign trade corporations (FTCs)--a practice which is called *canalization*. It is essentially achieved through the *licensing* system. In early 1992, it was estimated that about 15% of China's exports were either Category I or Category II.[7]

With regard to the foreign exchange system, the dual-rate regime in 1981-84 was meant to encourage exporters by giving them a more favorable rate. Traditionally, the exporters were required to turn over all their foreign exchange receipts to the Bank of China in exchange for domestic currency.[8] In 1979, the government launched the retention scheme whereby local authorities, departments and enterprises were allowed to retain the rights to buy back a certain proportion of their foreign exchange earnings from the central authorities, the actual foreign

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[7]The World Bank, *China, Foreign Trade Reform: Meeting the Challenge of the 1990s*, A World Bank Country Report, 1994.

[8]Actually the Chinese also practiced a foreign exchange retention system in 1958-68 for trade and non-trade transactions. It was abolished in 1968, and between 1968 and 1978, a rationing system was implemented. See Wu Wei and Sung Gong-ping, (ed.) *Zhongguo waihui guanli (Chinese Foreign Exchange Administration)* (hereafter ZGWHGL), Zhongguo Jinrong Chubanshe (China Financial Publishing House), 1991, pp.245-246.

exchange having been remitted to the latter in the first place. In 1984-85, local authorities and enterprises retained rights to about 25% of their planned export earnings.[9]

Over time, the government modified the foreign exchange retention system for achieving industrial policy objectives. A differentiated retention system was started in 1985. From early 1988 onwards, corporations trading in priority sectors--light industries, arts and crafts, clothing, machinery, and electrical products were--permitted to retain between 70% and 100% of their quotas. A higher retention rate was allowed on foreign exchange earnings above planned targets. Higher retention rates also applied to certain provinces such as Guangdong and Fujian, several of the autonomous regions, and the special economic zones (SEZs), with the latter enjoying retention rates of up to 100%.

In 1988, reform in the exchange rate system gained further impetus when the No.12 Document of the State Council gave official blessing to the establishment of FEACs over the entire country.[10] The reform was of course concurrent with that in the trade contract system, as the government, in its effort to reduce fiscal subsidies to exports, gave a greater degree of freedom to trade units to compensate for their deficits in the swap centres. Under the contract system, provinces were obliged to achieve three annual targets (export volume, amount of export revenue to be earned, and an efficiency indictor mainly in the form of export cost), and the total amount of export subsidies was fixed at the level of 1987. The extension of the swap markets was intended to give exporters access to a more favorable exchange rate.

In 1991, the scheme was further revamped. The retention system had given rise to considerable distortions and provided an unfair advantage to some coastal provinces. Hence, in February 1991, a uniform rate was in general set throughout the country for the same product. For general commodities, the retention rate above the contracted amount of foreign exchange to be submitted to the central government was set at 80%. Of the 80%, 10% accrued to local government, 10% to the producing firm, and the remaining 60% to the foreign trade corporation. Special rates for some sectors were adjusted upwards. For crude oil and petroleum derivatives which were in effect monopolies of the State, the retention rate was very low, at 3% in 1992. As to fees from processing contracts, the rate was set at 90% in 1991, significantly up from the 30% prevailing in 1985. Regionally, the three coastal provinces of Guangdong, Fujian and Hainan enjoyed a 100% retention.[11]

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[9]See Lardy, *Foreign Trade and Economic Reform...*, pp.52-57.

[10]See Wu Wei and Sung Gong-ping, *ZGWHGL*, p.273.

[11]Zhongguo guoji maoyi xinxi yanjiu zhongxin (China Intric Ltd.), *Duihua jingmao zhinan*

At the same time, however, the central government reserved the right to purchase at the prevailing swap rate additional amounts of foreign exchange from units which retain them. For general commodities, a further 30% of foreign exchange was callable--20% from the FTCs and 10% from the export producers. All indications were that the central government has fully exercised its right since 1991. Hence, in general, 50% of the overall exchange earnings of local authorities and enterprises were appropriated by Beijing.[12]

4. The Exchange Control System on Imports

Imports into China have been and are subjected to administrative control. In the earlier stages of the reform, the control mechanism was composed of three elements: (1) a mandatory plan for key materials handled by designated foreign trade corporations (FTCs); (2) a system of foreign exchange rationing; and (3) an import licensing system for non-centrally funded imports. The import plan has been scaled down since 1988. It is estimated that in 1992, less than 20% of the imports were subject to mandatory planning. Overall, however, the World Bank estimates that more than 50% of China's imports were still subject to some form of non-tariff administrative control in that year.[13]

Before the reforms of 1994, importers of items included in the import plan were allotted foreign exchange quota accounts by the State Administration of Foreign Exchange Control (SAEC). Other importing units could obtain such quotas or cash through retention, the swap centres, or other channels. The key mechanism with which China controlled uses of foreign exchange was through the requirement that any user-unit should open either a foreign exchange quota account or a cash account with the SAEC, the utilization of funds in which was supervised.

While foreign exchange quotas were obtained through retention or swap, legitimate entries to the cash account included donations, receipts from loans and bonds in foreign currencies, operational receipts in foreign exchange, and foreign exchange in cash from swap centres etc.[14]

(China Business Guide Book) (hereafter DHJMZN), 1993.

[12]The World Bank, *China, Foreign Trade Reform: Meeting the Challenge of the 1990s*, A World Bank Country Report, 1994.

[13]The World Bank, *China, Foreign Trade Reform.....*

[14]Wu and Sung, *ZGWHGL*, p.233.

The uses of funds from the two types of accounts were subject to the import restrictions mentioned above. Other than importing goods, funds in the cash account could also be used to pay for external service expenditure and domestic bills that had been approved to be settled in foreign currency, as well as to repay foreign currency loans. There was moreover an upper limit on the total balance in the cash account, beyond which the surplus had to be converted back into Renminbi.[15]

5. The Exchange Control System on Non-trade

Foreign exchange receipts and payments in non-trade activities cover those of foreign institutions in China, transactions in areas such as transportation, communications, tourism, financial services, import and export of labor services, and aids and donations etc., as well as the foreign exchange needs of organizations and individuals when they travel abroad.

Before 1994, the government also implemented the retention system for foreign exchange earnings generated from non-trade activities. In 1992, the retention rate was 40% for tourism, 30% for friendship stores, ocean shipping companies, and arts and crafts corporations, 50% for magazines and journals publishing advertisements for foreign firms, 30% for companies offering labor services abroad etc. In principle, retained non-trade foreign exchange was to be used mainly for the expansion or upgrading of projects that earn foreign exchange.[16]

Like the control system for trade, quota and cash accounts had to be opened for non-trade foreign exchange.

Individuals receiving foreign exchange remittances from abroad were also subject to submission requirements. Initially, the retention rate was as low as 6%.[17] It was raised to 10% for remitted amount over Rmb3,000 in the *Rules for the Implementation of Control of Foreign Exchange Relating to Individuals*[18] promulgated on December 31, 1981. The rate was later increased to 40%-60%. The non-retained portion had to be sold to the authorities at the official

[15]*ibid*., p.235.

[16]*DHJMZN*, p.265.

[17] ZGWHGL, p.262.

[18]See The State Administration of Exchange Control, *Compilation of Regulations and Rules for Foreign Exchange Control of the People's Republic of China*, China Commerce Publishing House, 1990.

rate. In compensation, individuals would receive special coupons which entitled them to goods which were rationed or restricted.

Over time, the control on individual foreign exchange revenue was relaxed. Even Chinese residents could open the so called "type-C" foreign currency deposit or cash account with the Bank of China from 1984 onwards, which allowed for the normal freedom in withdrawal and remittance abroad.[19] A new regulation which took effect in December 1991 also gave individuals access to the swap market. As to the individual uses of foreign exchange, domestic holders of foreign exchange cash or deposit could remit it abroad or sell it for Renminbi to the swap market at the swap rate through a bank. The swap rate was also used to sell foreign exchange to residents to pay for international travel, visits, membership and examination fees and other petty expenses. In practice, the Renminbi price of foreign exchange offered by banks was usually more expensive than the actual swap rate.

Moreover, since March 1993, each individual has also been allowed to take an amount of Rmb 6,000 out of the Chinese territory, a move which immediately led to the legalization of the black market of freely traded Renminbi in Hong Kong. Hence any Chinese resident travelling abroad (to Hong Kong at least) can obtain a reasonable amount of foreign exchange (HK$) outside, without having to put direct pressure on the foreign exchange markets inside the country.

6. The Treatment of Foreign-funded Enterprises

In August 1983, the Chinese government promulgated the *Rules for the Implementation of Exchange Control Regulations Relating to Enterprises with Overseas Chinese Capital, Foreign-funded Enterprises and Sino-Foreign Joint Ventures*.[20] Over the years, effort has been made to give more flexibility to the foreign-funded enterprises, in a bid to attract more overseas investors.

In general, a foreign-funded enterprise has to open a foreign currency account with the Bank of China or other approved financial institutions. Permission is required to have more than one bank account or to open one abroad. All foreign exchange receipts are to be deposited into

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[19] *DHJMZN*, p.318-321.

[20] See The State Administration of Exchange Control, *Compilation of Regulations and Rules for Foreign Exchange Control.......*

the account.[21] In principle, China has kept to the requirement of self-balance in foreign exchange for foreign-funded enterprises. A World Bank discussion paper in 1991[22] commented,

> "There are only a few countries (Egypt, Mexico and Yugoslavia) that allowed FDI but imposed a balancing requirement for foreign exchange. The requirement has worked very badly in these countries, having been abandoned in Egypt and Mexico and frequently modified, without success, in Yugoslavia." (p.25)

One has to remember, of course, that the inconvenience of the balancing requirement may well be compensated by the high profitability, actual or prospective, of investing in China. Moreover, China's policy is not as outlandish as the author of the above, Zafar Shah Khan, makes it appear. Vietnam, for example, has imposed the same requirement.[23]

On January 15, 1986, the Chinese government promulgated the *State Council Regulations on Joint Ventures' Balance between Foreign Exchange Revenue and Expenditure*,[24] which laid down the foundation for related policies. Over the years, key measures to help enterprises to achieve such balance have evolved and included:

1. 100% retention in cash for export earnings;
2. permission to settle in Renminbi payments regarding domestic labor remunerations, material costs, and taxation;
3. permission to sell products of advanced technology and quality in foreign currency in the domestic markets;

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[21] See Zhang Benzheng et al., *Waishang Touzi Qiyei Waihui Guanli Zhinan* (Guidebook for Foreign Exchange Management of Foreign-invested Enterprises), Zhongguo Jinrong Chubanshe (China Finance Publishing House), 1992.

[22] Zafar Shah Khan, "Patterns of Direct Foreign Investment in China," *World Bank Discussion Paper* 130, September 1991.

[23] Laurence J. Brahm, *Banking and Finance in Indochina*, Woodhead-Faulkner, 1992; and Singapore Trade Development Board, *Trade and Investment Guide: Vietnam*, in collaboration with KPMG Peat Marwick, 1993.

[24] The State Administration of Exchange Control, *Laws and Regulations Relating to Exchange Control of the People's Republic of China*, China Foreign Economic Relations and Trade Publishing House, 1988, pp.77-81.

4. comprehensive compensation to foreign-funded enterprises under which they could purchase China-made products and re-sell them abroad;

5. preferential treatments to reinvestment of renminbi profit by foreign partners in domestic enterprises which can generate foreign exchange earnings, including partial refund of paid income tax and permission to remit abroad their lawful share of the increased earnings.

6. permission to raise Renminbi loans mortgaged with foreign exchange when a foreign-funded enterprise faces a surplus of foreign exchange but a shortage in Renminbi. The funds raised can be used as working capital or for investment in fixed assets. No interest is payable to the mortgaged foreign exchange and the Renminbi loan.

7. access to the swap markets for foreign-funded enterprises. They are allowed to sell their foreign exchange revenue from non-trade deals, investments and foreign currency loans and buy foreign exchange for production and profit remittance.

8. permission to sell a portion of their processed products in the domestic market and receive Renminbi or, when approved, foreign currency.[25]

With the proliferation of swap centres and the privileged access to them by foreign-funded enterprises,[26] it may be fair to say now that to fulfil the balancing requirement, these enterprises do not face any intrinsic difficulties. Basically, they can meet any shortfall in foreign exchange by buying from the swap market, provided of course that they are prepared to pay the price, which may fluctuate.

7. Liberalization of Foreign Exchange Transactions and the Swap centres

The swap of foreign exchange retention quotas was allowed from 1980 onwards. At the beginning of 1981, the official rate was Rmb 1.50/US$, compared to the internal settlement rate of Rmb 2.80/US$. The swap rate was allowed to "float" within a 5%-10% margin on top of the internal settlement rate, i.e. a price cap of 2.8 + 2.8 x 10% = 3.08 was imposed on it. Given the demand for foreign exchange and the shortage in its supply, the swap price for trade retention quotas stayed at Rmb 0.28 (3.08 - 2.8) in 1981-1984, while the swap price for non-trade retention

[25] See Laurence J. Brahm, *Foreign Exchange Control in China: A Strategic Guide for Corporate Survival*, Longman, 1993, for a detailed operational description of the practical mechanisms.

[26] The swap centres were supposed to be abolished on April 1, 1994 as part of the latest reform package. The government then changed its mind and retained them for the use of foreign-funded enterprises only, while domestic enterprises and units had to buy and sell their foreign exchange through designated foreign exchange banks. See below.

quota fell from the level of Rmb 1.58/US$ in 1981 to about Rmb 0.28 by the end of 1984 as the official rate gradually depreciated to the level of the internal settlement rate.[27]

At the same time, transactions in the swap markets were liberalized. In 1986, the SAEC formally took over the swap business, and the Bank of China concentrated only on accounting and settlement. In February 1986, the price cap on retention quotas (trade and non-trade alike) was raised to Rmb 1.0/US$.[28] In October 1986, the cap on the swap rate of transactions by foreign-invested and foreign-funded enterprises, which were transactions in cash rather than quotas, was lifted. Prices in the swap centres in the four SEZs and Hainan were also liberalized.[29] Transactions were apparently stimulated and the swap volume was reported to be US$ 4.2 billion in 1987.[30] The 1988 and 1991 reforms gave further impetus to the expansion of the number of swap centres as well as total volume of transactions. By 1993, the number of swap centres had exceeded 100. Trading volume was reported to be US$6.3 billion in 1988, $8.6 billion in 1989,[31] 13.1 billion in 1990,[32] US$20.5 billion in 1991,[33] and US$25.1 billion in 1992.[34]

Participation in the swap markets remained asymmetrical. Selling of foreign exchange at the swap rate had become virtually unrestricted since December 1991 when all domestic residents were allowed to unload their foreign exchange holdings through designated banks into the swap market. The major portions of sales were in the form of transfer of actual foreign exchange by foreign-funded enterprises and of retention quotas by Chinese enterprises. It is estimated about 70% of the sales in the swap markets was in the form of retention quotas.[35]

[27]Wu and Sung, *ZGWHGL*, pp.269-270.

[28]*ZGWHGL*, p.270.

[29]See Hultman, Charles W., "China's Regional Foreign Exchange Transaction Centers: Market Orientation in a Modified Planned Economy," *Journal of Asian Economics*, Vol.1, No.2, pp.309-317, 1990.

[30]*ZGWHGL*, pp.269-270.

[31]ZGJRSWDQ, p.1022.

[32]*DHMYJN*, p.266.

[33]*ZGJRNJ*, 1992.

[34]Citibank, "Towards a Freely Convertible Renminbi", *Citibank China Monitor*, premier issue, July 1993.

[35]*ibid.*

In contrast, buying of foreign exchange from the swap market was much more restricted. As mentioned above, individuals with foreign exchange could acquire it through a designated bank at the swap rate to pay for international travel, visits, membership and examination fees and other petty expenses. The typical amount involved was however small. Foreign-funded enterprises could purchase actual foreign exchange for approved purposes including operating needs, debt repayments and remittances. Domestic enterprises and units which were given permission to import could acquire retention quotas in the swap market, which must then be used within six months to purchase foreign exchange from the government at the prevailing *official* rate. Financial institutions which could engage in foreign exchange business were apparently also permitted to be buyers in the market. Authorization by SAEC of the use of swapped foreign exchange was in general subject to a *priority* list. In 1992, the list classified items into three sub-groups: (1) Priority imports for which swapped foreign exchange could be used; (2) Priority items for which swapped foreign exchange could be used if conditions permitted; and (3) Uses for which swapped foreign exchange were not allowed.[36]

Theoretically, potential buyers whose use of the foreign exchange acquired violated the above prioritization scheme were excluded from the swap markets. However, there were many grey areas in what was and what was not a legitimate item for which foreign exchange could be swapped. When demand exceeded supply in the swap centre, the question of how to prioritize the bids was also a touchy issue. In practice, the local branch of the SAEC had the say and many have attributed the unruly movements in the swap rates in 1992-93 to the lack of discipline on the part of SAEC branches and the activities of unscrupulous speculators admitted to the swap markets. As an example, the clampdown in Shenzhen in July 1993 led to the discovery that 11 major participants in the city's swap centre had violated regulations by falsifying the uses of purchased foreign exchange and engaging in speculative resales of the proceeds.[37]

Inter-market transactions were legally allowed and monitored at two levels: (1) swaps between cities in the same province or autonomous region; and (2) swaps between provinces and autonomous regions. The administrative requirements for the latter were more complicated and restrictive. As mentioned above, the total transaction volume in the swap markets amounted to US$20.4 billion in 1991. Out of that amount, about US$6 billion, or slightly less than 30%, turned out to be inter-regional swaps. Informational and administrative barriers resulted in

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[36]China Intric Ltd., *DHJMZN*, p.266-267.

[37]*Ming Pao*, Hong Kong, p.A11, August 21, 1993.

substantial differences in the swap rates. For example, on June 11, 1993, when the swap rate broke the Rmb 11 level in Hainan, the currency was traded at 10.36 against the US$ in Xiamen, and 10.73 at the SEAC Head Office in Beijing (Reuter Service).

8. GATT Issues

Officially, China has been keen to re-enter GATT.[38] The reasons often cited including the further opening of the Chinese economy, and the beneficial effects that may accrue from subjecting the domestic enterprises, particularly state enterprises, to foreign competitive pressure.[39] Jiang Zemin, in his report to the Party Congress in October 1992, listed "attracting foreign capital" as the second of the ten tasks confronting the CCP and the country. GATT membership certainly helps in increasing China's attractiveness.

There is of course another school of thought on the net gain that China could obtain from re-entering GATT by giving too much concession. To a number of observers and economists, inside and outside China, the export expansion effect of China's GATT membership is unlikely to be very large because the scope for any significant reduction in trade barriers (TBs) and non-trade barriers (NTBs) against Chinese exports is rather limited. About 9 out of 10 GATT member countries have already granted nondiscriminatory tariff treatment to China. The reduction of NTBs is, on the other hand, largely regulated by bilateral agreements, so GATT membership does not help much. Because of these considerations, some argue that China may harm herself if she pays too high a cost to achieve re-entry by opening up too many of her domestic markets and too much.[40]

As for the foreign exchange system, it is quite clear that in principle GATT membership

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[38]See Long Yongtu et al. (eds.), *Zhongguo yu guanshui yu maoyi zongxieding* (China and GATT), Zhongguo Jihua Chubanshe (China Planning Publishing House), 1993. Mr. Long is the Secretary General of the Chinese delegation to GATT negotiations. On p.13 of the book, it is claimed that "The request to recover the status as a contracting party to GATT is an important component of our country's policy of reform and opening, and wide participation in the world economy".

[39]*ibid.*

[40] See Chai, J.C.H., "China's GATT Membership: Impact on her Foreign Trade and Consequences for her Trading Partners," in W. Klenner (ed.), *Trends of Economic Development in East Asia*, Springer Verlag, 1989; and Y.Y. Kueh, "Industrial Deregulation and Economic Restructuring in China: a GATT Perspective," paper presented at the 34th *International Congress of Asian and North African Studies*, Hong Kong, 22-28 August 1993.

does not require free convertibility of the currency or even unification of the multiple exchange rates. GATT leaves the matter largely to the IMF, and China has been in the IMF since 1980. Indeed, Article XV-9 of the Text of GATT stipulates:

"9. Nothing in this Agreement shall preclude:

(a) the use by a contracting party of exchange controls or exchange restrictions in accordance with the Articles of Agreement of the International Monetary Fund or with that contracting party's special exchange agreement with the CONTRACTING PARTIES, or

(b) the use by a contracting party of restrictions or controls on imports or exports, the sole effect of which, additional to the effects permitted under Articles XI, XII, XIII and XIV, is to make effective such exchange controls or exchange restrictions."

In general, therefore, GATT membership does allow exchange restrictions and controls. Indeed, more than 80 of the existing contracting parties of GATT are still practicing various forms of such restrictions and control. China has been an IMF member since 1980 and it is strange that the pressure of foreign exchange liberalization has come from GATT rather than the IMF. China is of course a special case: she is not a market economy, and interpretations of the text of GATT and multilateral trade negotiations have become increasingly politicized. Foreign exchange restrictions can also sometimes be interpreted as a sophisticated form of trade restrictions.

It is a contentious issue whether China's offer to unify the multiple exchange rates (presumably with a high degree of convertibility) within a short period is a legitimate price to pay for a quick re-entry to GATT, given her "imperfections" in many other economic aspects.[41]

[41] In response to my question in a seminar organized in Hong Kong on 28 October 1993, the Secretary General of the Chinese delegation to the GATT negotiations, Long Yongtu, admitted that exchange liberalization or full convertibility was not a pre-requisite to GATT membership. He said however that a multiple exchange rate system was susceptible to accusation that the government was subsidizing exports unfairly. While China was not doing that at all, the government decided to unify the official and market rates as soon as possible to settle any suspicion. See *Wen Wei Po*, Hong Kong, 29 October, 1993 for a record of the seminar. The irony is of course that the official rate of the Renminbi, being much higher than its swap market counterparts, could hardly be said to be a ploy to "subsidize" the exporters unfairly. Indeed, the unification of the official and the swap rates, presumably at a level much nearer to the latter than

Into 1994, nevertheless, China's attitude towards external trade relations seemed to have hardened, partly because of its self-perceived increasing economic might. It took a hawkish stance towards the US policy of linking "human rights improvements" with the renewal of the "most favoured nation" (MFN) status for the country, to the extent that Foreign Minister Qian Qichen told a U.S. newspaper openly after the visit by the U.S. Secretary of State Warren Christopher to Beijing in March 1994 that even without MFN China would survive.[42] A similar message was conveyed by Li Zhongzhou, deputy director-general for international relations of the Ministry of Foreign Trade and Economic Cooperation (MOFTEC), when he told *China Daily* that "(w)ith or without access to GATT, China will emerge as a powerful global competitor".[43]

9. Mainstream Reform Recommendations before 1994

In the course of 1993 high ranking Chinese officials made various pledges to establish in China a unified foreign exchange system with trade-account convertibility within a period of five years. The World Bank had on the other hand recommended measures to widen the scope of the FEACs, i.e. the swap markets as widely and as quickly as possible so that they would cover virtually all current account transactions in the economy and generate the equilibrium exchange rate.[44] To meet this objective, several progressive measures were quite obvious, and often recommended inside and outside China:

a. Exporters should be given 100% of retention of their foreign exchange earnings.

b. More current account (trade and non-trade) transactions should be channelled to the

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the former, would be a boost to the Chinese exporters and could worsen the Sino-US trade imbalance, *ceteris paribus*.

[42]*New York Times*, 21 March 1994.

[43]*China Daily*, 3 April 1994. Emphasizing that "(t)he bottom line is equal treatment", Mr. Li even went so far as to say: "A passive return to import substitution, in parallel with continued investment incentives, may actually encourage foreign investment because local production would be favoured over imports." He warned that the "world trade community has a choice between accepting China as an equal trading partner by granting it GATT membership, or competing for access to the Chinese market on a reciprocal basis". This hardening in attitude was also reflected in the "watering-down" of the relatively radical foreign exchange reform package of 1994. See below.

[44]The World Bank, *China, Foreign Trade Reform....*

swap markets, with the priority list on the use of foreign exchange bought from them progressively relaxed. Foreign exchange plan for investment projects should be eliminated and that for imports should be phased out.

c. Access to swap markets should be liberalized by eliminating restrictions on entry. Moreover, an integrated national swap market should be developed by enhancing information flow and abolishing local administrative restrictions.

d. The hoarding of retention quotas should be reduced by fixing expiry dates. Stabilization funds for intervention in the swap markets should be established.

e. Eventually, foreign exchange retention by all parties should be in the form of cash instead of quotas.

f. Forward and futures markets for Renminbi should be developed to provide an effective hedging mechanism.

After the medium-run objective of current account convertibility at a unified exchange rate has been achieved, China presumably can proceed to unify the exchange rates for the capital account and relax restrictions on capital movements, ultimately reaching a foreign exchange regime under which all transactions across border are freely settled at a market-determined exchange rate.[45]

Can China achieve these medium-run and long-run objectives contained in the mainstream recommendations? Some of the suggestions are obviously easier to heed. The establishment of an integrated swap market, or swap network, for the whole country, for example,

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[45]Views along these lines abounded within China. See, for example, Chen Quangeng, "Zhongguo waihui guanli zhidu di gaige" (The reform of China's foreign exchange management system), and Wu Nianlu, "Dui renminbi huilu gaige zhi wojian" (My personal view on the reform of the exchange rate of renminbi), both in Liu Hongru and Wang Peizhen (eds.), *Zhongguo Gaige Quanshu: Jinrong Tizhi Gaige Juan* (Encyclopedia of Chinese Reform: Reform of the Financial System), Dalian Chubanshe (Dalian Publishing House), September 1992, pp.420-423 and pp.424-426 respectively; Tao Shigui, "Lun renminbi ziyou duihuan di yiyi ji mubiao xuanze" (On the meaning of and the choice of goal for the free convertibility of renminbi), *Renmin Zazhi* (Humanities Journal), no.1, 1993, pp.47-53; and Ji Chongwei, "Gaige waihui guanli tizhi, wanshan waihui shichang" (Reform the foreign exchange management system, improve the foreign exchange market) *Caimao Jingji* (Financial and Trade Economics), No.8, 1993, pp.3-6;

involves no principles but probably considerable administrative costs. Some of the costs may be borne by the participants, e.g. reducing the number of swap centres and increasing the commissions charged by the SAEC. However, the vetting of significantly increased inter-center transactions must still be the SAEC's responsibility. Theoretically, price differentials in various centres could be reduced by efficient information flow, so that any potential buyer or seller knows all the best bids and offers in all the other swap centres. That would be costly. Or the SAEC can implement that open market system in all centres and let in the arbitrageurs. Perhaps the SAEC and its branches could set up funds and do the arbitrage themselves. There are apparently a number of options in this aspect of the reform.

A related consideration is that in the process of enhancing convertibility, an inter-bank market for foreign exchange may be developed, in place of an auction system constituted by swap centres.[46] This recommendation, however, did not feature prominently in the discussions in 1992-93. A key concern is whether a sufficient number of experienced banks and brokers exists to ensure market efficiency, under a viable framework of control that can keep convertibility within the government's liberalization plan.[47]

10. Major Constraints on Convertibility

As to the question of permitting current account convertibility, or even going further to achieve free convertibility of the Renminbi, there are basically two answers. The first one is the radical answer. Some would argue that China could do it almost overnight: just announce the floating of Renminbi and the removal of current account restrictions, or even capital account restrictions. This approach may not be as outlandish as it sounds. Bulgaria, Poland and Romania in Eastern Europe have tried versions of this type of "big bang" approach, with mixed success. So has Russia, with very serious results. One thing is common in these experiments: the cost to pay, in terms of output and employment loss and other side-effects of very stringent fiscal, monetary, and incomes policies that are designed to prop up the currency after it floats, is very high indeed. In fact, Bulgaria's relative success has been attributed to the determination of the government to persist with austerity and the "cooperation" of the relatively homogeneous population, while Romania's poor performance with regard to inflation and the continued

[46]For a relatively indirect suggestion, see Zhou Xiaochuan and Xie Ping, *Zouxiang renminbi ziyou duihuan* (Towards Convertibility of Renminbi), Jingji Guanli Chubanshe (Economic Management Publishing House), September 1993.

[47]*ibid*., pp.171-192. The reform package of 1994 however included this "surprising" element. See below.

depreciation of the Romanian currency was due to the government being too soft in engineering the recession and restraining pay demands.[48]

Of course, the cost to pay is related to the initial macroeconomic condition on which the "big bang" is launched. 1991 was obviously a much better time than 1993 or 1994, to try out a "shock therapy" in China. The key question is of course whether China is prepared, and can afford, to pay the costs for rapid convertibility. Although one could argue that such costs to be borne by China should be lower than those which have been incurred in Russia and Eastern Europe, they would still be rather high. One must also remember that the costs are not just economic, but also political. Moreover, China's situation is very different from that in Russia and Eastern Europe. The latter have to save their economies from ruin, so even desperate methods need to be used. China is planning to become the largest economy in the world in the early 21st century. Why take the risk? What serious harm have the multiple exchange rate regime and non-convertibility brought to China?

These considerations lead us to the second answer which is a more cautious one: that China should achieve unification and full convertibility gradually over, say, a five to ten-year period. That was apparently the official line before 1994. A key consideration on the pace of liberalization is the reduction of costs, i.e. the freed exchange rate can hold itself without stringent policies that incur austerity. Of course, the exchange rate can be stabilized by a less costly method, open-market intervention by the government in a liberalizing foreign exchange market. The key question is obviously whether China has "sufficient" foreign exchange reserves.

In this regard, Vice Premier Zhu Rongji was reported to have said in early 1993 that China could float the Renminbi if the country managed to build up its foreign exchange reserves to US$100 billion, defined as the sum of the state balance and the Bank of China balance.[49]

At the end of 1992, the announced foreign exchange reserves of China totalled US$48.3 billion, which, according to the premier issue of the *Citibank China Monitor*,[50] "ranked the second largest among major Asian developing countries". However, the report goes on to point

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[48]See Zeljko Bogetic and Louise Fox, "Incomes Policy during Stabilization: A Review and Lessons from Bulgaria and Romania", *Comparative Economic Studies*, vol XXXV, No.1, Spring 1993, pp.39-57.

[49]Wardley James Capel, *China Quarterly*, June 1993, p.9.

[50]Citibank, *Citibank China Monitor*, premier issue, July 1993.

out that China's total reserve is "over-estimated" because it consists of two components: (1) the state balance, and (2) the BoC (Bank of China) balance. The BoC is the foreign exchange bank of China, and its "balance", according to the *Citibank China Monitor*, comprises (a) self-owned funds of specialized banks; (b) foreign exchange deposited by foreign investors; and (c) short-term overseas inter-bank borrowing. The state balance is the amount of foreign exchange assets that is at the direct disposal of the central government, i.e. its foreign exchange holdings and deposits. It stood at US$19.4 billion at the end of 1992, and US$19.8 billion at the end of July 1993. The *Citibank China Monitor* reasons that "As the BoC balance is not directly deposited by the government, it should not be counted as part of China's foreign exchange reserves". "At US$19.4 billion, China's foreign exchange reserves cannot be regarded as `sufficient'. This amount is able to cover China's present rate of merchandise import for only 2.9 months, which is less than the internationally recognized safety threshold of three months."[51]

The characterization of the BoC balance is unfortunately not very accurate. The BoC balance is derived as follows: it is the total in foreign exchange of its equity, deposits (absorbed domestically and overseas) and borrowing in international financial markets, *minus* its lending and investment in foreign exchange to non-financial institutions. In accounting terms, the balance is the sum of the BoC's holdings of foreign currencies and its claims on foreign financial institutions, identical in definition to the state balance.[52]

So, in general, as China's foreign exchange bank, the BoC's "balance" represents the part of the cumulative capital account surpluses that the central government might use as reserves.[53]

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[51] *ibid.*

[52] This is quite in line with the common-sense definition of anyone's liquid assets (cash plus bank deposits) that can be used to handle normal payments---irrespective of one's liabilities. The fact that the BoC could increase its reserves by borrowing from the international financial market or absorbing more deposits in foreign currency is worrying to some commentators, because it does not represent "net" assets. Such worry, however, arises from a misunderstanding of the concept of international reserves, which is defined on a *gross* rather than net basis. An IMF document explicitly says, "As international reserves in the International Liquidity section in *IFS* are a measure of the availability of official means of payments, they are defined on a gross basis." See International Monetary Fund, *International Financial Statistics: Supplement on International Reserves*, Supplement Series No.6, 1983, p.vi.

[53] Of course, the BoC balance is matched by various forms of its financial liabilities, a feature which distinguishes it from the state balance arising largely from current account surpluses as exports exceed imports. Current account surpluses, in the form of foreign exchange assets, are not matched by financial liabilities. They simply imply that the total amount of domestically produced goods and services consumed by foreigners is larger than that of foreign goods and services which residents consume. The "liabilities" are owed to the domestic residents. This

The reasoning by the *Citibank China Monitor* that the BoC balance should not be counted as China's foreign exchange reserves because it "is not directly deposited by the government" warrants further analysis. Indeed, from July 1992 onwards, China herself adopted the practice of publishing only the state balance for its foreign exchange reserves statistics, i.e. excluding the BoC balance.[54] The overt reason was to follow the international convention of presenting the reserves of the "monetary authority" of a country.[55] From a strictly *legalistic* viewpoint, such a treatment is certainly justified.

However, the practical consideration may be quite different. In assessing the ability of a government to defend the currency it issues, a purely legalistic perspective might be legitimate only for a market economy and, in China's context, if the BoC, one of four so called "specialized banks", were a truly commercial bank. Although legally not part of China's "monetary authority", the BoC was, and is, 100% state-owned. So Beijing's inclusion of the BoC balance as part of its official foreign exchange reserves in the past did have some solid grounds. Would the BoC refuse to use its foreign exchange assets in an intervention in the swap market to prop up the Renminbi if Vice Premier Zhu Rongji or the SAEC requested it? In the future, should the BoC become a truly commercial bank, privatize part of its equity, or even get listed in the stock exchange, that will of course be another story. It was probably more than a Freudian slip that more than six months after China adopted a "new" definition for its foreign exchange reserves, Vice Premier Zhu Rongji still used in early 1993 a composite reserve target of US$100 billion (on the basis of the state balance *plus* the BoC balance) as a prerequisite for the country to consider floating the Renminbi.

Overall, I would say that China's foreign exchange reserves were practically above the international safety threshold of being able to cover three months of merchandise imports at the end of 1992.

Into the future, though, the *Citibank China Monitor* is rightly concerned about China's supply-demand balance in foreign exchange. China is entering a cyclical peak in servicing its

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picture may change in the future if the Chinese government modifies its control on capital movements, particularly through the central bank, the People's Bank of China, whose foreign exchange balance would increasingly reflect China's capital account.

[54]See *Zhongguo Jinrong Nianjian* (*Almanac of China's Banking and Finance*), 1993, p.49 and p.367.

[55]*ibid*., p.49.

US$70 billion foreign debt, with annual outlays amounting to US$7-12 billion in 1993-95. This would put strains on its reserve position. On the supply side, the current macroeconomic cycle has pushed China into a trade deficit since late 1992. The current account does not look very rosy in the near future.

Moreover, there is a big gap between trade balance and the balance in trade-related foreign exchange in China. An important issue in this regard is the problem of ensuring foreign exchange receipts from exports. Trade liberalization in China has also been accompanied by an increasing leakage in foreign exchange revenue. The receipt ratio of export-generated foreign exchange fell from 94.6% in 1986 to 74.9% in 1989.[56] In 1992, total export was US$84.998 billion while foreign exchange revenue from exports amounted only to US$43.386 billion.[57] Netting out the exports of foreign-funded enterprises, the receipt ratio reportedly stood at 62.5%.[58] The Customs recorded a trade surplus of US$4.388 billion for the country in 1992. As far as the balance in trade-related foreign exchange is concerned, there was however actually a deficit of US$7.061 billion. The turn-around was more than US$10 billion![59] In the first half of 1993, the ratio of trade-generated foreign exchange earnings to total exports fell further to 53%.[60]

There are various factors which have contributed towards such a trend, e.g. classification problems and barter elements in trade and investment. The rising importance of manufacturing processing work that China has been doing for outside investors also plays a role, as exports under China's name would only yield a small percentage of foreign exchange to the country in terms of processing fees.[61] In any case, another key issue has been the illegal or illegitimate practice of diverting export-related foreign exchange receipts to other uses. A commentator, Ma

[56]Wu and Sung, *ZGWHGL*, pp.218-219.

[57]*Jingji Cankao Bao* (Economic Information Daily), 1 June 1993.

[58]Ma Jianhua, "Zhongguo waihui liushi" (The Drain in China's Foreign Exchange Reserve), *Jingji Wanbao* (Economic Evening News), 2 October 1993.

[59]See *Jingji Cankao Bao* (Economic Information Daily), 1 June 1993; and Tsang Shu-ki, "Zhongguo dangqian de jinrong xingshi" (Recent Trends in China's Financial Sector), paper presented at a seminar organized by CERD Consultants Ltd., Hong Kong, 15 June 1993.

[60]Ma Jianhua, "Zhongguo waihui liushi" (The Drain in China's Foreign Exchange Reserve), *Jingji Wanbao* (Economic Evening News), 2 October 1993.

[61]Note that the receipt ratios are calculated by netting out the exports by foreign-funded enterprises in China. The are of course exports under the names of Chinese enterprises which perform only processing work.

Jianhua, cited various cases that were known and called the phenomena "frightening".[62] A semi-official publication[63] revealed the striking fact that most of the 2,500 enterprises or representative offices that China had established overseas by 1990 did not have proper funding. They obtained the foreign exchange for their initial investments largely from diverting foreign exchange earnings from exports and non-trade activities.

The supply of foreign exchange to China can of course also come from the capital account. Despite the record inflow of capital into China since the "Deng whirlwind" in early 1992, the foreign exchange coffer of the Chinese central government has not shown much signs of significant swelling. Indeed, something extraordinary has occurred. According to the balance of payments statistics compiled by the SAEC,[64] capital inflow into China in 1992 amounted to US$30.22 billion, while accountable capital outflow was US$30.48 billion. There was also a negative entry of "errors and omissions" of US$8.42 billion, which essentially represented capital outflow.[65]

As the *Citibank China Monitor* puts it: "although foreign capital is expected to flow into China, the bulk of the investment is likely to be *in kind*, that is in the form of equipment and machinery rather than *in cash*, and hence will not add to China's foreign exchange reserves". Moreover, there is the problem of "foreigner investors issuing white slips" (*wai shang da bai tiao*), which has aroused increasing concern. According to a dispatch by the China News Agency, the "realization rate" (*dao wei lü* investments (*xie yi yin jin wai zi e*) to the actual input from foreign investment (*wai shang shi ji tou ru jin e*) was 100:62.3 in 1987. It fell to 100:18.98 in 1992. Obviously, changes in the foreign investment pattern, e.g. towards longer-term

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[62]*ibid.*

[63]Wu and Sung, *ZGWHGL*, p.219.

[64]*Zhonghua Gongshang Shibao* (China Industrial and Commercial Times), August 11, 1993, p.2.

[65]See Guo Shuqing, "Renminbi keduihuan yu waihui guanli tizhi gaige" (The Convertibility of Renminbi and the Reform in the Foreign Exchange Management System), paper presented at the *China Business Conference*, organized by the Economic Research Centre of the Planning Commission of the PRC and the China Business Centre of the Hong Kong Polytechnic, Shenzhen, 23 September 1993. According to another source which cites the 1992 Yearbook of the People's Bank, there was also an accounted capital account deficit of US$0.25 billion in 1992. See Lin Zhiyuan, "Renminbi ziyou duihuan gaige di tiaojian ji duice (Conditions and Policies of Reform of Convertibility of Renminbi), *Jingji Yanjiu* (Economic Research), February 1994, pp.33-38.

commitments, would have led to the fall in *dao wei lu*, but the report put forth more alarming evidence. The ratio of actual input from foreign investment on the one hand to investment from the Chinese side plus internal borrowing within China on the other rose from 1:2.16 in 1988 to 1:3.33 in 1991.[66]

Further down the 1990s, the question remains open. We cannot rule out the possibility that foreign investors may bring cash in bags to China if the macroeconomic readjustment and the comprehensive reform programmes work out well and another upswing unfolds in, say, 1994-96. Multinational corporations from the West will presumably behave in a more rational and responsible manner than many of those from Hong Kong or Southeast Asia. Things could turn the other way, though, if the Japanese economy and the economies on the two sides of North Atlantic recover and rebound healthily.

11. Twists and Turns since the Second Half of 1993

The comprehensive reform package presented in the Third Plenum of the Fourteenth Central Committee of the Chinese Communist Party in November 1993 aimed at breaking the deadlock by initiating "coordinated breakthroughs". However, as I have commented elsewhere, it gave an impression of "big thunders, small rain drops" (*lei sheng da, yu dian xiao*).[67] The proposals on the reshuffling of the central-local fiscal arrangements as well as the reforms of the central and commercial banking systems supposedly to modernize the macroeconomic control mechanism in China, which had lagged behind the changes in most aspects of the economy,[68] faced the danger of being watered down in the process of hard bargaining between the central government and the parties of vested interests at the local levels.

On the basis of the events surrounding the Third Plenum in November 1993, one could observe that there was a growing number of commentators and decision makers who thought that instead of continuing the muddling-through China should try something drastic. A big bang after

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[66] *Wen Wei Po*, November 14, 1993, p.4. The report put the blame largely on unscrupulous foreign investors and their equally self-interested counterparts in China, particularly at the regional level.

[67] Tsang Shu-ki, "Financial Disorder and Macroeconomic Reforms in China", *Hong Kong Economic Papers*, Hong Kong Economic Association, 1994, forthcoming.

[68] See Tsang Shu-ki, "Towards a System of Modernized Macroeconomic Control in China?", *BRC Papers on China*, CP93001, School of Business, Hong Kong Baptist College, October 1993.

15 years of gradualist reforms seemed to them at least worthy of a try. Rapidly freeing the Renminbi would force everybody to adjust behaviourally to the new circumstances. It would essentially be a "coup" that enabled the central authority to rise above the increasingly dirty mess of local interests. The freeing of the swap rates in June 1993, which was reversed just a month later, might just be the tip of the iceberg.

In the second half of 1993, the idea that the official and the market exchange rates would be unified in 1994 was proposed.[69] That was a significant shift from the previously stated time frame of five years, but officials did not specify the scope of transactions to which the unified rate would apply. In other words, it was unclear what degree of convertibility would accompany the unification of the exchange rates. The document of the Third Plenum in November 1993 was also vague on this aspect of the reform. It said,

> "We should reform the foreign exchange control system, set up a market-based manageable floating exchange rate system, and set up an integrated and standardized foreign exchange market. The Renminbi should gradually become a convertible currency."[70]

The pronouncement was not very specific and presented no concrete time-table, although the stipulation that the Renminbi should become convertible "gradually" did speak a lot against "big bang" liberalization. As far as the unification of the official and the swap rates is concerned, it is no big deal in itself. After all, China had a "unified" rate (the black market rates notwithstanding) in 1985-86, although the degree of convertibility of the Renminbi was very low as the uses of foreign exchange for many trade and current account transactions were rationed. Before 1980, of course, China also had a unified system and rationing of foreign exchange was even more severe. Convertibility is now much higher, but far from being full. As long as convertibility of a currency is not full, black market rates are bound to exist, and it is quite meaningless to talk about the unification of the official rate, the swap rate(s) *and* the black market rates. In other words, unification cannot be complete either.

12. The Wide-ranging Foreign Exchange Reform of 1994

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[69]The plan was first publicly revealed by the Vice Finance Minister, Jin Renqing in Europe. See *Ta-kung pao*, September 16, 1993, p.4.

[70]The document was entitled *Decision of the CPC Central Committee on Issues concerning the Establishment of a Socialist Market Economic Structure*. See *China Daily*, November 17, 1993 for the full text in English.

As it turned out, the foreign exchange reform package unveiled in late 1993 following the Third Plenum was quite ambitious.[71] Other than minor measures such as the termination of the FECs and the attempt to ban the circulation of foreign currencies within the country, major features of the package included the following:

(1) The dual exchange rates were unified by the abolition the official rate on January 1, 1994.

(2) The retention quota system was to be abandoned, and all foreign exchange earnings of domestic enterprises and units arising from exports had to be sold to designated banks, while cash accounts were allowed for overseas borrowing and equity issues.

(3) The system of currency trading was to be transformed from one centred around swap markets into a bank-based one. Designated foreign exchange banks would carry out foreign exchange trading in place of the swap centres. A national inter-bank market was to be established on the basis of the national exchange in Shanghai. Initial participants would include the 4 specialized banks, the 9 major domestic banks and possibly a number of foreign banks.[72]

(4) To improve the system of "managed float" for the unified rate, the People's Bank would set a middle rate in the light of market supply and demand in the previous day, around which designated foreign exchange banks could quote buying and selling prices. Foreign banks could apply to become designated foreign exchange banks.

(5) In line with these changes, the convertibility of Renminbi was to be enhanced through the abolition of the approval procedure for acquiring and using foreign exchange for normal current account transactions, which was a form of rationing exercised by swap centres under the SAEC.

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[71]For the full text of the announcement on the foreign exchange reform in Chinese, see *Wen Wei Po*, 30 December 1993. The English version was published on *China Daily Business Week*, 16 January 1994.

[72]The policy of allowing foreign bank participation in the foreign exchange market emerged after the official announcement in late 1993. For an official statement, see the interview with Zhu Xiaohua, the newly appointed SAEC Director, by the Xinhua News Agency, *Wen Wei Po*, 6 March 1994. The actual extent of participation however has caused confusion and resentment among the foreign banking circle in China. See below.

(6) Designated foreign exchange banks could develop forward hedging services for customers.

Overall, importers of items still covered by trade restrictions (quotas, licenses, registration etc.) would face under the new system only one barrier (trade approval) instead of two (trade approval and foreign exchange authorization). They could go to any designated bank and buy foreign currency by producing the necessary trade approval documents. In official terms, the Renminbi became "conditionally convertible under the current account". No significant changes in capital account convertibility were announced.

13. The "Three-in-One" Reform: a Relatively Bold Move in Conception

The People's Bank was apparently trading greater freedom for enterprises to acquire foreign exchange for more immediate central control over their foreign exchange earnings. The abolition of the retention quotas and imposition of the forced sales system were more conservative than the mainstream recommendation of achieving 100% cash retention for domestic enterprises and units, as discussed in Section 9, and could be regarded as a centralization attempt. Other aspects however exceeded the expectations of many. Overall, although the announced liberalization programme was not a "big bang" or a "shock therapy", like that adopted in Poland, Russia, or Bulgaria, it turned out to be more radical than that proposed or anticipated by most because it combined three separate moves into a single package:

(1) Unification of the dual exchange rates.

(2) Enhancement of the degree of convertibility through the abolition of foreign exchange authorization procedure for domestic enterprises and units, as far as normal current account transactions were concerned.

(3) Transformation of currency trading into a bank-based market system: the swap centres were to be abolished and possibly thousands of designated foreign exchange bank branches would become mini-trading centres, authorized to offer quotes within the limits set by the People's Bank.

From the perspective of policy selection, (1), (2), and (3) were essentially independent choices. The dual rates could be unified without changing the degree of convertibility.[73] If the latter was to be enhanced, there was no need to abolish the swap centres and opt for bank-based

[73] As mentioned above, China practiced a unified exchange rate system in 1985-86, with relatively low degree of convertibility.

currency trading. Indeed, as we discussed above, the mainstream recommendations in the past few years focused around a combination of (1) and various versions of (2), i.e. most advocated the unification of the dual rates plus enhancing convertibility through the liberalization of monitoring procedures in the swap centres as well as the expansion of their scope and functions.

The transformation of the system of currency trading from one based on swap centres into a bank-based market was a particularly significant move. As pointed out above, such a move was not widely advocated at all in 1992-93. In the first quarter of 1994, officials gave the impression that trading in all swap centres would be terminated on April 1, 1994, although some sources suggested that the SAEC was reluctant to concur with such a quick step, as its role in the bank-based system remains unclear. In this context, the announcement on February 17, 1994 that Zhu Xiaohua, a Vice Governor of the People's Bank and a close aide to Vice Premier Zhu Rongji, had taken over the directorship of the SAEC from Yin Jieyan (who became Deputy Director and was, probably in compensation, simultaneously appointed as a Vice Governor of the central bank) was indeed noteworthy.[74]

14. The New System: Rationales and Loopholes

The new system was undoubtedly a required step towards the ultimate full convertibility of the Chinese currency. The unification of the dual exchange rates would eliminate the possible objection that China was using the rate differential for unfair trade practices and pave the way for GATT re-entry. A bank-based market, on the other hand, is theoretically superior to the swap centres as far as market efficiency is concerned. Customers will benefit as competitive quotations by banks, including foreign ones, offer more choices than auctions and matching in a small number of heavily manipulated swap centres. A nationally integrated inter-bank market will also provide a more effective focal point for the balancing of supplies and demands for foreign exchange and for the central bank to carry out open market operation to smooth out the exchange rate.

Nevertheless, there was the concern whether China was quite prepared for all these changes in one go. A key question was whether the large number of designated bank branches, which would handle currency trading in place of the swap centres, could properly check the

[74] See *Wen Wei Po*, 17 February 1994. For a discussion of the possible resistance of the SAEC to the reform package, see Tsang Shu-ki, "Zhongguo waihui tizhi gaige de da yuejin" (A Big Leap Forward in China's Foreign Exchange Institutional Reform), *Caixun* (Wealth Magazine), Taiwan, March 1994, pp.307-310.

necessary approvals and authorizations, so as to keep convertibility within the limits set by the government and prevent a possible flight of capital. As discussed above, a bank-based market requires a sufficient number of experienced banks and brokers as well as a viable framework of control. A worry in China was that even with the best intentions, designated foreign exchange bank branches might not be prepared for such a rapid transformation, in terms of expertise and resources.[75]

The People's Bank made it clear that the principle of self-balance would apply to the buying and selling of foreign exchange by a designated bank. A "proportional control" system would be implemented, under which the foreign exchange working funds of the bank should be proportional to the volume of foreign exchange earnings settled through it and its total foreign exchange assets. The ratios were to be determined by the People's Bank. Any surplus or shortfall had to be rectified through the inter-bank market or with the central bank. The system looked like a "retention system", albeit for banks instead of enterprises. However, as many loopholes existed for the management of the 100-odd swap centres in 1993, whether the management of the bank-based market would be effective naturally became a worry. While the above arrangements might be designed to safeguard the reserve position of the Central Bank, there was no guarantee that the upsurge of demands for foreign currencies would not put serious pressure on the Renminbi.

15. Impacts on Foreign Investment

On paper, the foreign exchange arrangements for foreign-funded enterprises remained unchanged under the reform of 1994.[76] In reality, there were various direct and indirect effects arising from the "three-in-one" reforms. First of all, the unification of the dual rates at the much cheaper "market" rate was good news to potential foreign investors, as the value of their capital investment would increase. Unification also meant that there would no longer be any foreign

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[75]See "Business Weekly", *China Daily*, 13-19 March 1994, for the report of a working conference on foreign exchange reform in Shanghai. Many officials of financial institutions in the conference "pointed out that banks are inexperienced in examining and approving the sale of foreign exchange". "Officials also expressed concern over the heightened risks banks will face when they must deal entirely on their own account and without government involvement." In response, the SAEC said that "it will lend local State-designated banks a hand in supervising and managing the sale of hard currencies".

[76]Indeed, Section 6 of the "announcement" of the reform package began with the sub-heading "The foreign exchange management system of foreign invested enterprises will continue with the present arrangements". See footnote 65.

exchange loss in fund flows as a result of the rate differential between fund injection and fund repatriation. Foreign investment should therefore be encouraged.

In so far as the unification was equivalent to a *de facto* devaluation, the net impact for foreign-funded enterprises which had already been operating in China depended on the currency composition of their revenues and payments, and could be positive or negative.[77] The abolition of the FECs also created some problems for foreign-funded enterprises which received FECs as revenue.[78]

The move towards a bank-based trading system, on the other hand, should benefit foreign-funded enterprises in so far as market efficiency was enhanced. There was however the worry that individual bank branches lacked the economies of scale that a swap centre had, and the inter-bank market would take time to function properly. So foreign-funded enterprises in need of large amounts of foreign exchange might actually be worse off initially, as informal "rationing" at the bank branch level could be even more parochial and arbitrary. The fact that foreign banks could also become designated foreign exchange banks might redress the problems, but only to a limited extent, because of their very small network. It was therefore not too surprising that the authority decided to keep the swap centres for the use of the foreign-funded enterprises even after 1 April 1994.[79]

16. A Preliminary Assessment of the 1994 Reforms

The new system was supposed to come into full operation on 1 April 1994. The results so far have been mixed. On the one hand, the exchange rate of the Renminbi has been surprisingly stable. On the other, although the degree of currency convertibility has been enhanced, the extent of liberalization is less than that expected by many commentators[80] and proclaimed by some

[77] For existing investments, the tax implications of unification for the depreciation of past capital stocks also remained to be clarified.

[78] A related problem was that some local authorities and units in China made use of the unification of rates to raise service charges on foreigners, allegedly to compensate for their depreciation losses. This aroused complaints from many FIEs. See "Central bank probing two-tier price system", *South China Morning Post*, Hong Kong, "Business 5", 18 March 1994; and "Row over mainland labour cost: illegal recruitment charges disputed", *Sunday Morning Post*, Hong Kong, 20 March 1994.

[79] See *China Daily*, 2 April 1994, and the discussions below.

[80] In the first quarter of 1994, many analysts outside China talked about a "shock therapy" in China's macroeconomic reforms. Even after the implementation of the full system in April, a major news service still opined that "China...on January 1 launched a `big bang' of financial

officials and their advisors.[81] Alongside the move towards a bank-based trading system, China has also established a national foreign exchange centre in Shanghai, which has linked up the bank-based markets in twelve major cities. The trading price in that centre is therefore the most indicative of the exchange rates of Renminbi in the new system. According to a report, the Renminbi was traded at ¥8.6967 in the centre on 4 April 1994. It later strengthened to ¥8.6736/US$ on May 4 and 8.6591 on 3 June 1994.[82] The free market rates quoted by banks and financial companies in Hong Kong were quite close to these prices.[83]

The post-reform stability of the Chinese currency has probably been due to several factors. The first to note is that the Chinese government started to implement another round of tight monetary policy in early 1994 and many enterprises faced shortage in Renminbi funds. To get them, some enterprises were forced to sell foreign currencies. Secondly, the average foreign exchange cost of exports (*huanhuai chengben*) for Chinese enterprises by the end of 1993 was still less than Rmb7.0/US$ (i.e. the average Renminbi cost of earning one US dollar by exporting goods was below 7.0 yuan).[84] One of the reasons for this apparently surprising phenomenon was the huge supply of rural migrant labour to the coastal export zones, which kept a lid on wages. In so far as Chinese exporters were still major players in the liberalized foreign exchange market, they might already be quite happy with the present level of the exchange rate.

Thirdly, the downside pressure on the Renminbi should be limited anyway. The average market rate was about Rmb5.8/US$ in the second half of 1991, so the price of 8.70 already implied a depreciation to the tune of 35%. According to a recent report, for the country as a whole, sales of foreign currency exceeded purchase by over US$8 billion in the first half of 1994.[85] Fourthly, and partly as a result of the above factors, the state balance of China's foreign

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reforms". See "Beijing to limit exchange rates", 3 April 1994, *South China Morning Post*.

[81] I have described the developments after 1 April 1994 as a case of *lei sheng da, yu dian xiao* (big thunder, small rain drops). See Tsang Shu-ki, "Big Thunder a Storm in the Currency Teapot", China Business Review, *South China Morning Post*, 5 May 1994. However, this is not necessarily a bad thing. Decisions on the liberalization of the Renminbi should in my view also consider stability, not just speed.

[82] *Wen Wei Po*, Hong Kong, 4 June 1994.

[83] For the development of the free market of the Renminbi in Hong Kong, see section 5.

[84] The author obtained this piece of information from a highly reliable source.

[85] *Wen Wei Po*, 13 July 1993, p.A2.

exchange reserve rose from about US$21 billion to US$28 billion in the first quarter of 1994. The forced sales system and the narrowing trade deficit have certainly also helped. In June 1994, China actually chalked up the first trade surplus in 16 months, and the state balance went up to as high as US$31.8 billion by the end of the month.[86] This has strengthened the hands of the SAEC in stabilizing the exchange rate of the Renminbi.

On the other hand, those who expected "free floating and convertibility" when the new system came into full operation on 1 April 1994 faced an anti-climax. In fact, the new system was "watered down" in several major aspects.[87] The range of "float" around the "middle rate" was fixed at only 0.25% on either side. The official Xinhua News Agency admitted that the range was quite narrow, but said

> "Although some banks complain that the floating range is too narrow to reflect the actual market demand and supply, most financial experts agree that the limitation is necessary in the initial stage of the new exchange system. Authorities will relax the control of the floating scope only when the new system takes root and both banks and enterprises can afford the cost brought by bigger foreign exchange fluctuation".[88]

The total number of designated foreign exchange bank branches was estimated to be less than 2,000,[89] smaller than expected. It has therefore not been too difficult for the State Administration of Exchange Control (SAEC) to closely monitor their foreign exchange transactions and impose bureaucratic arms-twisting. Contrary to the fear expressed by many, leakages have apparently been contained.

At the same time, while domestic units could no longer buy or sell foreign exchange in

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[86] This was reported in an interview with the SAEC director Zhu Xiaohua by the Xinhua News Agency. See *Wen Wei Po*, 25 July 1994, p.A3.

[87] For further discussions of the leaders' motivation in launching the reform and my earlier prediction of a possible back-tracking, see Tsang Shu-ki, "Zhongguo di waihui tizhi tupo neng bu neng chenggong?" (Would the Breakthrough in China's Foreign Exchange System Succeed?), *Ming Pao*, Hong Kong, 25 February 1994; and Tsang Shu-ki, "Zhongguo waihui tizhi gaige di da yuejin" (A Big Leap Forward in China's Foreign Exchange Institutional Reform), *Caixun* (Wealth Magazine), Taiwan, March 1994, pp.307-310.

[88] *China Daily*, 2 April 1994.

[89] The estimate was from the author's source.

the swap centres, these centres have been retained for the benefit of the foreign-invested enterprises. The reasoning is that, unlike domestic parties, foreign-funded enterprises are not required to sell their foreign currency earnings to designated banks, "therefore there is no point for the banks to meet their hard currency needs".[90] In any case, according to an official report, there have been little problems for the foreign-funded enterprises even though they are constrained to operate in the swap centres. In April 1994, there was a net sales of US$135 million and HK$64 million in 19 major centres.[91] An apparent reason might have been the record inflow of capital into China in the past two years. Despite the possibly large portion of in-kind investments, the monetary component that is forthcoming seems to be providing a useful cushion for the balance of recurrent foreign exchange revenue and expenditure of the foreign-funded enterprises.

The participation of the foreign banks in the national foreign exchange centre based in Shanghai also turned out to be much more limited than anticipated and triggered considerable controversy. Foreign banks could only sell, but not buy, foreign exchange in the national centre, and to serve their needs for working balance in Renminbi they were allowed to exchange it from the central bank. The latter amount was however limited to 5% of their equity.[92] Moreover, according to one report, before foreign banks could join the centre they were required to make various deposits to the People's Bank, apparently with no interest returns.[93] While such measures have limiting effects on the convertibility of the Chinese currency, they have probably contributed to its stability.

These developments, which were disappointing to commentators who had high hopes of China's foreign exchange reforms, were probably a result of the fact that the central authority had become increasingly worried about the state of the Chinese economy in its third year of overheating. Stability has emerged as a key issue of concern as Beijing wants to avoid a "hard landing" for the economy and walks the tightrope between inflation and unemployment. Administrative measures such as price controls and the dispatch of inspection teams have already

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[90]*China Daily*, 2 April 1994.

[91]*Wen Wei Po*, 5 May 1994.

[92]*ibid*.

[93]*South China Morning Post*, Business 1, 1 April 1994. The report said that "foreign bankers were angry and confused about the proposed changes" and that the controversy "threatens to escalate into a diplomatic issue" as some bankers have turned to their embassy to put pressure on the Chinese authorities to clarify on the changes.

been resorted to. More seem to be forthcoming.[94]

Of course, the stability of the Renminbi cannot be taken for granted. If the government fails to control macroeconomic overheating properly, expectations-driven selling of the currency may emerge, at least in the black market inside China and the free market in Hong Kong. Overall, though, I am of the opinion that, with a combination of "stop-go" macroeconomic control, selective credit injection and soft price caps, the Chinese government could successfully engineer a soft landing for the economy by the first half of 1995.[95] The downside risk for the Renminbi should therefore be limited in the coming one or two years.

17. Towards Full Convertibility: 1997 versus 2004?

Rumours spread in late 1993 and early 1994 that China had made a pledge to GATT or the US to turn the Renminbi into a fully convertible currency by 1997, so much so that a top monetary official in Hong Kong said openly that he expected that such would be the case.[96] If a pledge of this kind has really been made, the "three-in-one" reform package seems a natural choice, as full convertibility can only be implemented in a bank-based market system, which requires time to gear up.

This however comes into conflict with the objective stated in early 1993 by Vice Premier Zhu Rongji, who also took over the governorship of the People's Bank in mid-1993, that the Renminbi could become fully convertible only when China's foreign exchange reserves (the state balance plus the BoC balance) reach the US$100 billion level. The chance for this target to be realized by 1997 looks rather slim.[97]

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[94]See Tsang Shu-ki, "Zhuozhong wending ci qi shi yi" (It is Time to Emphasize Stability), *Wide Angle*, Hong Kong, April 1994; and Tsang Shu-ki, "Why a soft landing is possible?", 22 May 1994, *Sunday Morning Post*.

[95]See Tsang Shu-ki, "Why a soft landing is possible?", *Sunday Morning Post*, Hong Kong, 22 May 1994; and Tsang Shu-ki, "So far so good for Chinese economy", *Sunday Morning Post*, 7 August 1994.

[96]See "Colony's Banker Says Yuan Faces Deadline in '97", *Asian Wall Street Journal*, 28-29 January 1994. Mr. Joseph Yam, the chief executive of the Hong Kong Monetary Authority, reportedly said that the Chinese currency must become fully convertible in 1997, or market forces in Hong Kong will set its exchange rate.

[97]See the discussions in Section 10 above.

In an interview with the Xinhua News Agency which was published on 6 March 1994,[98] the Director of the SAEC, Zhu Xiaohua, apparently wanted to put paid to such rumours when he said that "China will strive to achieve the full convertibility of the Renminbi in the current account within six years". This was of course a far cry from the goal of reaching full convertibility for both the current and the capital accounts within 3 years. If the report carried weight, the decision makers in Beijing might be slipping back to the original schedule of floating the Renminbi within 10 years.

18. Concluding Remarks

Since 1981, China has gone a long way in liberalizing its foreign exchange system. In 1993-94, the country came to a crossroads with regard to further progress in such an endeavour. Conflicting signs about the direction and pace of reforms were flashed out from Beijing. To cast the dilemma in a historical context, this paper reviews the evolution of the system after 1979, analyzes the rationality behind recent reform attempts, and their major constraints. It also presents a preliminary assessment of the package of 1994, which was relatively radical, at least in conception.

The Chinese government is apparently under pressure from various quarters, both external and internal, concerning the future of the Renminbi. Nevertheless, it has yet to make up its mind on exactly what to do about the foreign exchange system in the coming years. I expect this kind of institutional uncertainty to persist for some time. As far as the 1994 reforms are concerned, some real progress has been achieved. The dual rates were unified, and an embryo interbank market has been formed. The degree of convertibility has been increased, albeit not very significantly, and some parties were disappointed. Under cyclical influence, the government has apparently back-tracked to a more cautious plan of the liberalization of the Renminbi. Once again, the pragmatism of the Chinese leadership is reflected. However, the framework for a potentially much freer foreign exchange system has been established. Should the macroeconomic atmosphere improve in the future, the possibility of another bold attempt cannot be ruled out.

[98]See *Wen Wei Po*, 6 March 1994.