Towards the Full Convertibility of the Renminbi?

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A new stage in convertibility or an anti-climax?

In 1996, there were two important pieces of foreign exchange regulations launched in China. On 1 April, the *Regulations on Foreign Exchange Management of the People's Republic of China* (PRC),[i] formulated by the State Council, came into effect. It replaced the *Provisional Regulations for Exchange Control of the PRC*, adopted since 18 December 1980,[ii] and provided a more coherent policy framework. Then the *Regulations on Forex Sale, Purchase and Payment* were promulgated by the People's Bank of China (PBOC)---China's central bank---on 20 June.[iii]

With these regulations in place, the PBOC announced in July 1996 the intention of achieving current account convertibility for the Renminbi, the Chinese currency, by the end of the year.[iv] On 27 November 1996, Dai Xianglong, the President of PBOC wrote to the International Monetary Fund (IMF), officially stating that the transitional arrangements under the second clause of Article XIV of the Articles of Agreement no longer applied to the country as a member of the IMF. China would from then on accept the obligations of Article VIII.[v] Such an acceptance means that Beijing would no longer impose any restrictions on the payments and transfers in current account transactions, in terms of discriminatory monetary policies or in the form of multiple exchange rates. It was reportedly hailed as a "milestone" by the IMF.[vi]

For the foreign funded enterprises (FFEs) investing in China, a bonus was that they were admitted into the bank-based foreign exchange market instituted in the 1994 reforms, instead of being confined to the swap centres. The permission took effect on 1 July 1996. One notable point is that the swap centres were retained for their use. In other words, as far as foreign exchange purchases and sales are concerned, the FFEs now have two channels compared with one for domestic enterprises.[vii]

These moves were the interim conclusion of a series of measures taken by the government since late 1993. I have written several pieces on them.[viii] The foreign exchange reform was the most progressive, in both conception and practice, among the various macroeconomic reforms of 1994 (which included also fiscal, banking and trade reforms). It has also been the most successful so far, helped by a huge capital inflow and other institutional

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factors that have kept the exchange rate of the Renminbi surprisingly firm, despite very high domestic inflation rates in 1994-95.

The formal achievement of current account convertibility for the Renminbi came earlier than expected.[ix] In a way, though, it also turned out to be a kind of anti-climax, as the relations between trade restrictions and foreign exchange restrictions in the current account became clear. At the same time, in the course of 1996, the Chinese authorities took measures to rationalize capital account controls. Although nominally the degree of restrictions remains the same, it actually means that market participants now find it more difficult to exploit loopholes, even if they want to do so. Hence not everyone regards the progress on the front of foreign exchange in 1996 as really so exciting. Such an interpretation is not meant to belittle the achievements of the Chinese reforms in foreign exchange, which have indeed been huge, but to offer a more sober view of the progress so far, three years after the mis-named "big bang".[x]

Many economists of the gradualist persuasion, including myself, would even welcome such a cautious development. China should not rush towards full convertibility for its currency, without laying the necessary domestic foundations, which remains a formidable task.

The meaning of current account convertibility

I have commented that before the 1994 reform there existed two hurdles for an importer in China: trade approval and foreign exchange rationing. The 1994 reform theoretically removed the latter restriction and left only one hurdle for most trade transactions.[xi] But in reality the foreign exchange control regime is closely related to the trade control system. It means little for a country to "achieve" current account convertibility if significant trade restrictions in the form of licensing, quotas, canalization, and registration requirements still persist, or very high tariffs are imposed on imports. Nsouli has aptly used the term "Article VIII convertibility" to label the situation where a country practices "current account convertibility" in foreign exchange but maintains trade restrictions, in contrast to the state of "total current account convertibility". "Article VIII" of course refers to the Articles of Agreement of the IMF binding its members on foreign exchange but not trade behaviour.[xii]

To be fair, China has been making important efforts to reduce both the non-tariff trade barriers and the tariff rates. As far as import tariffs are concerned, the average tariff rate in China was cut from 35.6% to 23% in 1996, as President Jiang Zemin promised in the Asia Pacific Economic Cooperation (APEC) Leaders' Conference in Osaka in November 1995. Again in the APEC Leaders' Conference in Manila in November 1996, Jiang announced that China would reduce the arithmetic average rate to the level of 15% by the year 2000. This compares with the 4-5% and 13-15% for the developed and developing countries respectively reached in the Uruguay Round of the General Agreement on Tariffs and Trade (GATT). Already the plan was reportedly regarded as "insufficient" by European diplomats.[xiii] As we know, one contentious issue in China's application to join the World Trade Organization (WTO) is whether she should be treated as a developed or a developing country.

In any case, with regard to current account transactions, there are still some items which require "verification of truthfulness" by the State Administration for Exchange Control

(SAEC).[xiv] They are specified in Articles 13 and 15 of the *Regulations on Forex Sale, Purchase and Payment.* These concern advance payments exceeding 15% of the total contractual value or US$100,000 in absolute amount (Articles 13(4) and Article 15(1)), forex payments for implicit commissions exceeding 2% and explicit commissions exceeding 5% of the total contractual value respectively or above US$10,000 in absolute amount (Article 13(6) and Article 15(2)), "external payments under entrepot trade characterized by an payment in advance of reimbursement" (Article 15(3)), interest payments for external debts (Article 15(4)), and cash withdrawal exceeding an equivalent amount of US$10,000 (Article 15(5)).[xv]

FFEs and control on the capital account

At the same time, while Chinese domestic enterprises have had to sell all their current account receipts since 1994, FFEs are also required under the new post-1996 system to open a settlement account with designated banks where they may only keep a stipulated ceiling of such receipts. According to Chen Yuan, deputy governor of the PBOC, the maximum is to be set administratively in the light of "the actual investment made by the FFEs and their need for circulation in the current accounts". This differs from the pre-1994 situation where FFEs could keep all their receipts. The justification is that "idle balances" beyond the genuine current account needs of FFEs can help the country to maintain macro control and stabilize the exchange rate. Chen however promised that "the ceilings will be set rather loosely to ensure the need of the FFEs in businesses under current accounts."[xvi]

In the course of 1996, as China moved towards "current account convertibility", measures were also implemented on capital account transactions to rationalize control. Chapter three of the *Regulations on Forex Sale, Purchase and Payment*, promulgated by the PBOC on 20 June, stipulates that "entities in China" (including both domestic and foreign-funded enterprises) must open accounts for "capital items" with designated banks.

Moreover, these "capital items" are divided into three separate categories: (1) foreign exchange related to direct investment; (2) foreign exchange involved in overseas borrowing and repayment; and (3) other capital account transactions. Foreign-funded enterprises have to open separate accounts on these different transactions so that the authorities can monitor them closely.[xvii]

The surprising stability of the Renminbi

In any case, defying pessimistic forecasts which focused on macro instability and high inflation, the Renminbi has shown remarkable strength in the post-1994 system. On 4 April 1994, the first trading day of the China Foreign Exchange Trade System (CEFTS) in Shanghai, the Chinese currency was sold at RMB8.6967/US$. The exchange rate later strengthened and ended 1994 at 8.4462 and 1995 at 8.3174. In the course of 1996, favourable supply and demand conditions continued to underpin the Renminbi (see Table 1). The currency was quoted at 8.2982 at the end of the year. The rates offered by financial and other institutions in

Hong Kong have been very close to these prices, indicating that they were accepted as reasonable by the offshore free market.

Table 1 Monthly movements of the Renminbi in 1996

Unit: RMB/100US$

Month	Quotation at the End of Month	Average Quotation in the Month
January	8.3147	8.3186
February	8.3207	8.3132
March	8.3339	8.3289
April	8.3306	8.3315
May	8.3263	8.3288
June	8.3221	8.3225
July	8.3109	8.3160
August	8.3063	8.3081
September	8.3017	8.3043
October	8.3007	8.2999
November	8.3007	8.2988
December	8.2982	8.2992

The stability of the Renminbi in the new system is a testimony to the success of the reform. However, it is also surprising, particularly given the very high inflation rates until only the second half of 1996. There are various explanations.[xviii] The most important one has been the very impressive rise in the foreign exchange reserves of China, which went up from US$21.199 billion at the end of 1993 to US$51.62 billion a year later. The rise continued in the subsequent two years, albeit at slower rates, to reach US$105.0 billion by the end of 1996 (see Table 2).

Table 2 China's Gold and Foreign Exchange Reserves

Year	(1) Gold reserves (10,000 ounce)	(2) Foreign exchange reserves (US$ billion)	Growth of (2) (%)
1986	1267	2.072	-21.6
1987	1267	2.923	41.1
1988	1267	3.372	15.4
1989	1267	5.550	64.6
1990	1267	11.093	99.9
1991	1267	21.712	95.7
1992	1267	19.443	-10.5
1993	1267	21.199	9.0
1994	1267	51.620	143.5
1995	1267	73.597	42.6
1996	1267	105.00	42.7

Sources: The People's Bank of China, *China Financial Outlook '96,* Table 3-13; *Wen Wei Po,* 21 January 1997.

The surge in reserves is the result of a combination of factors. The imposition of the foreign exchange settlement system (and the abolition of the foreign exchange retention scheme) in 1994 has helped to centralize resources in the hands of the PBOC. At the same time, the steady arrival of funds from the very high post-1992 level of foreign capital absorption has been a powerful boosting factor in producing net capital inflows.

In the three years of 1994-1996, actually utilized foreign direct investment (FDI) totalled US$113.853 billion, compared with the amount of US$ 32.263 billion for utilized foreign borrowing.[xix] At the end of 1996, the outstanding balance of China's foreign debt reached US$116.28 billion,[xx] which represented an increase of US$32.705 billion over the balance of US$83.575 at the end of 1993. From these figures, one may be tempted to conclude that FDI has been a more important factor than external borrowing in the post-1994 rise of China's international reserves. Nevertheless, there are two uncertainties. First, it is not clear how much of the US$113.853 billion of utilized FDI in 1994-1996 actually arrived in the form of money. There were reports that significant portions of many foreign investments came in the form of imports of material and machines, which would not show up as monetary reserves. Second, there is the question of how much foreign money was used to service the post-1994 FDIs in the form of profit repatriation, which however should have been small because of the short history of these investments.

Another important reason is of course that China had only aimed at current account convertibility. Capital account transactions were not further liberalized, indeed controls on them have been "tightened", as pointed out above. This may have helped in checking informal or illegal capital outflow, and in preserving reserves.

Surprise of an opposite nature may also arise: that the Renminbi could have stabilized against the US$ for so long despite the huge capital inflows. Given more understanding about

the operation of the bank-based foreign exchange market launched since April 1994, we can now make the observation that the strength of the Renminbi has also been underpinned by a number of institutional peculiarities. The existence of "bilateral monopolies" in the Chinese interbank market has been a key factor. According to one source,[xxi] the share of the Bank of China (BOC) in the total sale of foreign exchange in the market was about 70% to 80%, while the central bank, PBOC, also bought up 70% to 80% of the foreign exchange offered. In other words, the transactions between the BOC and the PBOC could easily dictate the movement of the exchange rate.

Behind such a market structure is the imposition of the foreign exchange settlement system in 1994, with the concurrent limit by the PBOC for designated banks to keep working balances in foreign exchange. This has resulted in a persistent situation of excess supply in the interbank market. There could have been two types of responses: (1) the mopping of the excess by the PBOC; or (2) further relaxation of foreign exchange control. It appears that the PBOC has opted for the first response. Hence its dominance in the interbank market.

Full convertibility sequencing: where does the Renminbi stand?

The liberalization of China's foreign exchange system has in general followed the sequence advised by a number of economists in the field of international monetary economics: achieving current account convertibility first before attempting capital account convertibility. This is by no means a non-controversial issue. In practice, different countries have attempted different sequences: South Korea opened the capital account without much trade liberalization in the mid-1960s, with rather serious inflationary consequences that lingered.[xxii] In the so called "Southern Cone experiment" of Latin America in the late 1970s, Argentina and Uruguay opened the capital account first, while Chile opened the current account first, but both sides faced a common fate in the early 1980s: deep economic recession and some reversal of liberalization.[xxiii]

Theoretically, the debate has still not been settled. In the words of Sebastian Edwards,

> "Some authors have argued that, to the extent that the opening of the capital account will generate destabilizing capital flows, the exchange rate will be highly volatile....; for this reason the capital account should be opened only after the trade reform has been completed, and the new structure of production is `consolidated'. Other authors, however, have argued that the best way to avoid undesired real exchange rate movements is by having a freely floating exchange rate with full convertibility. This exchange rate system....should be implemented before the trade reform. Consequently, the capital account should be liberalized first."[xxiv]

Edwards himself, in any case, is in favour of opening the current account first. Using a three-sector-two-good model, he reasons that the opening of both accounts will generate *opposite* effects on production and income distribution. Resource movements in and out of particular sectors will involve real costs. There is therefore a need to *synchronize* current and capital account liberalization to minimize those costs. If as Frenkel[xxv] and Kahn and Zahler[xxvi] suggest, the speed of adjustment of the capital account is faster than that of the current account,

the current account should be opened first.

Note that Edwards' findings do not imply that a country with total inconvertibility of its currency should "achieve" current account convertibility first, without doing anything on the capital account. Such a discrete opening sequence is not a "synchronized" move as it will still lead to resource movements in opposite directions. The issue at hand is how one should synchronize the reform of a slow-moving sector with that of a fast-moving sector. There is no doubt that the former should start first and the latter should come in later, but at what point? and how? Edwards has not offered any clear answer.

Ronald McKinnon, on the other hand, argues more strongly that financial liberalization which allows the free flows of foreign capital should come "only at the tail-end of an otherwise successful programme of liberalization".[xxvii] His worry concerns the possibility of over-enthusiastic foreign capital that may disrupt a liberalization attempt that looks "successful". Citing the examples of South Korea, the Southern cone, and Pakistan and India, McKinnon reasons that the sudden rise in profitability may entice myopic movements of funds which throw out the wrong signals. In particular, the real exchange rate would turn "against exporters and firms competing with imports and make(s) it unduly hard for them to adjust to the removal of protection."

From this perspective, the Chinese monetary authority has been doing a relatively successful job of keeping the right degree of "convertibility" and avoiding the undue effects of capital flows on its largely trade-oriented liberalization programme. An opening of the capital account in the aftermath of the "Deng whirlwind" of 1992 could have produced results similar to South Korea's in the mid-1960s, and aggravated China's inflationary problems.[xxviii] With hindsight, it is quite amazing that the real appreciation of the RMB in 1994-96 has not produced a trade deficit in China.[xxix]

In another analysis,[xxx] McKinnon concludes that financial liberalization to the external world should come at the end of the liberalization programme. In his view, historical evidence points to the fact that countries which succeeded in stabilizing their price levels and real exchange rates, while maintaining positive yields on bank deposits in an open capital market, showed a higher productivity of physical capital than those whose financial systems remained repressed. But to reach this "noninflationary financial equilibrium", fiscal, monetary and foreign exchange policies need to be sequenced in an "optimal" manner.

McKinnon's recommendations for the liberalizing developing country or economy in transition are quite "classical": eliminate fiscal deficits and bring down inflation first. Then the domestic capital and money markets can be liberalized to ensure a positive return to depositors, but at the same time, the budget of the borrowing enterprises must be hardened (with help from the positive real interest rates). After the successful liberalization of domestic trade and finance, foreign exchange liberalization can proceed; but transacting on the current account is best liberalized much faster than capital movements.

> "Before allowing enterprises (or households) to borrow from, or deposit in, international capital markets, the national capital market should be fully liberalized, which in turn depends on the stabilization of the domestic price level and the elimination of substantial reserve taxes on domestic banks.... As

> long as domestic banks remain restricted and heavily taxed, it is pointless--indeed destructive--to allow foreign banks.....to operate freely in domestic financial markets. Even more destabilizing is to allow `hard' foreign currencies to circulate in parallel with the still `soft' domestic one."

Only when domestic borrowing and lending take place freely at equilibrium (unrestricted) rates of interest and the domestic rate of inflation is curbed so that the ongoing depreciation in the exchange rate is unnecessary, are the arbitrage conditions right for capital account convertibility. Otherwise, there may be unwarranted capital flight or an unwarranted buildup of foreign indebtedness or both. "Free foreign exchange convertibility on capital account is usually the *last* stage in the optimal order of economic liberalization".

From these perspectives, one may say that China has hardly reached the benign stage where she could open the capital account while maintaining a "noninflationary financial equilibrium". Indeed, the fiscal deficit in China has not been eliminated, and the budget of most financial institutions and enterprises (in particular state enterprises) has not been really hardened. Positive yields on deposits and positive real lending rates have emerged, thanks to the rapidly falling inflation rates since 1996. But nobody is sure how long they would last as they have not stemmed from successful institutional reforms. The "financial mess" within the lending institutions and between banks and enterprises still needs to be cleaned up.

Of course, one can criticize McKinnon's "optimal sequencing" as being too theoretical to be of much practical and policy relevance. After all, China has *not* followed the first half of his sequencing: Chinese enterprises have borrowed heavily before the fiscal deficit is eliminated, or before the national capital market is "fully liberalized", against his advice. His scheme looks like a "first best" abstract reasoning, rather than a "second best" analysis that caters for the impossibility of completing any one step without starting another, as well as the existence of formidable constraints on the policy maker's choices.

Nevertheless, his expressed worry about the possible dire consequences of opening the capital account without putting the domestic economy and financial system in proper order is still worthy of serious attention.

One Country, Two Currencies?

Irrespective of the actual speed of realization, as the Renminbi (RMB) moves further towards the state of full convertibility, given progress in China's domestic economic reforms, a question would arise concerning the fate of the currency of Hong Kong---the Hong Kong dollar (HK$). Hong Kong becomes a special administrative region (SAR) under Chinese sovereignty in 1997; but from the early 1980s onwards, its economic linkages with Mainland China have been rapidly strengthening through apparently phenomenal trade and capital flows. Are two separate currencies (the RMB and the HK$) really necessary when the RMB becomes fully convertible, some time in the future? Moreover, some cynics have already openly predicted that, because of political as well as economic considerations, the HK$ would be "swallowed" by the RMB in the post-1997 era, even before the RMB turns fully convertible. One reason sometimes cited is that China is after Hong Kong's huge foreign exchange reserves, as if China's

own ballooning reserves were not enough.

The official position on this issue is clear. As stipulated in the Basic Law, the Hong Kong SAR will continue to issue its own currency and decide its own monetary policies. Monetary relations between the Mainland and the SAR have been characterized by Joseph Yam, Chief Executive of the Hong Kong Monetary Authority (the territory's central bank), as "one country, two currencies, two monetary systems and two monetary authorities which are mutually independent."[xxxi] Chen Yuan, a Deputy Governor of PBOC, has openly endorsed such a view. Chen emphasizes that "(t)he Hong Kong dollar and the Renminbi will circulate as legal tender in Hong Kong and the mainland respectively. The HK$ will be treated as a foreign currency in the mainland. Likewise, the Renminbi will be treated as a foreign currency in Hong Kong."[xxxii]

Is this official line credible? In another paper,[xxxiii] we have analyzed the economic rationale for the coexistence of the HK$ and the RMB after 1997. As the other side of the same coin, such an analysis amounts to addressing critically the rationale of monetary unification, the alternative to the coexistence of the two currencies.

The benefits of a unification of currencies are basically related to (a) the transaction costs of the currencies and (b) the risk posed by exchange rate variations. In the case of China and Hong Kong, unification would reduce the transaction costs and the risk of exchange rate variations only between the HK$ and the RMB *but not* between the RMB (or for argument's sake a new unifying currency) and other currencies.

The economic linkages between the Mainland and Hong Kong have no doubt been strengthening rapidly, but their true scale and significance should not be exaggerated.[xxxiv] As I have analyzed elsewhere, the huge trade flows between Hong Kong and China have been dominated by trade in intermediate goods arising from Hong Kong's utilization of the Mainland as an outward processing zone. Netting out such activities, Hong Kong's dependence on the United States as a market for *final goods* has not fallen much since the 1980s.[xxxv] While Hong Kong accounts for over 60% of foreign direct investments in China, China's cumulative stock of direct investments in Hong Kong by 1994 made up only 18% of total foreign direct investments and ranked third, after the UK and Japan. In the year of 1994, China's direct investments in Hong Kong were estimated to constitute a meagre 4.5% of Hong Kong's capital formation.[xxxvi]

In other words, the "integration" between Hong Kong and Mainland China has not been that advanced. It has certainly not come to a stage that the two economies constitute an "optimum currency area".[xxxvii] Nor should such a stage be targeted in the post-1997 era. Among the criteria for monetary union, fiscal integration and a high degree of factor mobility are often regarded as the most important.[xxxviii] According to the framework of "one country, two systems", however, fiscal integration between Hong Kong and Mainland China is not supposed to take place as there will be no fiscal transfers to smooth out asymmetrical shocks to the two economies. Moreover, labour mobility across the border is to be strictly controlled. Hong Kong cannot export its unemployment to the Mainland, nor vice versa.[xxxix]

From the perspective of optimality, the unification of two currencies of different qualities will produce a net social benefit only if the "inferior currency" is eliminated. This is why, in a multi-currency environment such as the European Union, the "best currency" (the German mark)

is always seen as the model for the unified currency (Euro). In the case of China and Hong Kong, it is extremely unlikely that the RMB would be regarded as an "inferior" currency to be eliminated. Because of the political reality, a system of one currency could only mean the demise of the HK$. This will hardly be beneficial to Hong Kong,[xl] and its benefit to China is also in serious doubt.

Moreover, the net benefit is unlikely to become significant over time, particularly if the RMB, in its further progress towards full convertibility, is increasingly seen as a stable currency by international traders and investors. As is well known, the benefit of unifying two stable currencies is very low. All in all, the arrangement of "one country, two currencies" is perfectly consistent with the framework of "one country, two systems". There is no good economic argument for unifying the HK$ and the RMB after 1997.

Notes

i. See *Economic Reporter*, 12 February 1996, pp.49-51.

ii. For the text of the 1980 regulations, see Li Fen et. al, *China's Exchange Control and Banking Practice*, China Financial Publishing House, 1991, pp.161-172.

iii. See *China Economic News*, 2 September 1996, pp.6-10; and 9 September 1996, pp.7-8.

iv. "China Announces Convertibility of RMB under Current Account within 1996", *China Economic News*, 15 July 1996, pp.3-4.

v. See "A Decisive Step Toward RMB's Convertibility", *China Economic News*, 16 December 1996, pp.1-2.

vi. *Economic Reporter*, Hong Kong, 2 December 1996, p.19.

vii. "Bank Forex Settlement for FFEs"; "Banker on Significance of Eased Forex Control", *China Economic News*, 15 July 1996, pp.1-2 and pp.6-7.

viii. See Tsang Shu-ki, "Towards Full Convertibility? China's Foreign Exchange Reforms," *China Information*, Vol. IX, No.1 (Summer 1994), pp.1-41; "Financial Restructuring" in Lo Chi Kin, Suzanne Pepper and Tsui Kai Yuen (eds.), *China Review 1995*, The Chinese University Press, 1995, chapter 21; and "The Economy", in Maurice Brosseau, Suzanne Pepper and Tsang Shu-ki (eds.), *China Review 1996*, The Chinese University Press, 1996, chapter 8.

ix. In 1993, officials and economists were talking about ten years as the time frame for current account convertibility. The span was shortened to six years in early March 1994, then down to four or three years as the largely unexpected progress became obvious. See the first two papers in Note 8.

x. In any case, the 1994 reform was never intended to be a "big bang" despite popular misconceptions. See Tsang Shu-ki, "Financial Restructuring" (Note 8).

xi. See the papers cited in Note 8.

xii. Saleh M. Nsouli, "Current Account Convertibility: Anachronism or Transition?", in Manuel Guitán and Saleh M. Nsouli (eds.), *Currency Convertibility in the Middle East and North Africa*, International Monetary Fund, 1996.

xiii. *Ming Pao*, Hong Kong, 26 November 1996.

xiv. The SAEC was renamed the State Administration for Foreign Exchange (SAFE) towards the end of 1996.

xv. See Note 3 and Chan Pak-cheong, "*Dalu zuijin jinrong biangui ji taishang yinying ji dao*", (Recent Financial Reforms on the Mainland and Appropriate Reactions by Taiwan Merchants), *Liangan Jingmao* (Cross-Strait Economics and Trade), 10 August 1996, pp.3-6. Chan's summary of the relevant regulations, whilst useful, is not 100% accurate.

xvi. "Banker on Significance of Eased Forex Control", *China Economic News*, 15 July 1996, p.6.

xvii. See Chan Pak-cheong (Note 15) and Wang Tai-yun, "Dalu waihui guanli de zuixin guiding", (The Latest Regulations on Foreign Exchange Management on the Mainland), *Liangan Jingmao* (Cross-Strait Economics and Trade), 10 January 1997, pp.4-7.

xviii. Tsang Shu-ki, "Financial Restructuring" (Note 8).

xix. *China Statistical Yearbook 1996*, table 16-13; *China's Latest Economic Statistics*, February 1997, p.15.

xx. "China: Foreign Debt Increases by 9% in 1996", *Business Briefing*, BBC Monitoring Service, 5 February 1997.

xxi. Lin Guijun, "Dui woguo yinhangjian waihui shichang yunxing de fenxi" (An Analysis of the Operation of the Interbank Foreign Exchange Market of Our Country), *Guoji Maoyi Wenti* (Problems of International Trade), No.3, 1996, pp.43-50.

xxii. See, for example, Ronald McKinnon, "Comment 2" on Sebastian Edwards's paper in Armeane M. Choksi and Demetris Papageorgiou (eds.), *Economic Liberalization in Developing Countries*, Basil Blackwell, 1986.

xxiii. Sebastian Edwards, "The Order of Liberalization of the Current and Capital Accounts of the Balance of Payments", in Armeane M. Choksi and Demetris Papageorgiou (eds.), *Economic Liberalization in Developing Countries*, Basil Blackwell, 1986.

xxiv. *ibid.*

xxv. Jacob Frenkel, "The Order of Economic Liberalization: Discussion" in K. Brunner and A.H. Meltzer (eds.), *Economic Policy in a World of Change*, Amsterdam: North-Holland, 1982.

xxvi. Moshin Kahn and Roberto Zahler, "The Macroeconomic Effects of Changes in Barriers to

Trade and Capital Flows: A Simulation Analysis", *IMF Staff Papers*, 1983.

xxvii. See his comment on Sebastian Edwards (Note 20).

xxviii. Note that the inflow of foreign capital to China since 1992 has already been phenomenal, without much liberalization in the capital account.

xxix. The trade surplus was US$5.35 billion, US$16.69 billion and US$12.24 billion in 1994, 1995, and 1996 respectively. One complication is that of processing trade, i.e. trade in intermediate goods, reached 50% of total trade in 1996. Processing could drive a wedge between China's trade balance and foreign exchange balance. A classic example is that of Guangdong in 1993. A trade surplus of US$7.13 billion contrasted with a deficit of US$3.4 billion in the province's foreign exchange balance. For every US$100 of export in 1993, Guangdong received only US$26 in hard currency. See Cheng Yuk-shing and Tsang Shu-ki, "The Economic Link-up of Guangdong and Hong Kong: Structural and Developmental Problems", paper presented at the *International Conference on China and the Asia Pacific Economy*, organized by the Department of Economics, University of Queensland, Brisbane, Australia, 14-16 July 1996.

xxx. *The Order of Economic Liberalization*, John Hopkins University Press, 1991.

xxxi. Joseph Yam, "Hong Kong's Monetary Scene: Myths and Realities", speech at Bank of England Seminar on *Hong Kong Monetary Arrangements through 1997*, London, 10 September 1996.

xxxii. Chen Yuan, "Monetary Relations between China and Hong Kong", speech at Bank of England Seminar on *Hong Kong Monetary Arrangements through 1997*, London, 10 September 1996.

xxxiii. Edgardo Barandiaran and Tsang Shu-ki, "One Country, Two Currencies: Monetary Relations between Hong Kong and China", in Warren I. Cohen and Li Zhao (eds.), *Hong Kong under Chinese Rule: The Economic and Political Implication of Reversion*, Cambridge University Press, 1997, forthcoming.

xxxiv. This point is borne out by two quantitative studies. See Shu-ki Tsang and Yue Ma, "Simulating the Effects of Foreign Capital in an Open Macroeconometric Model of China", *Economic Modelling*, 1997, forthcoming; and Yue Ma, Shu-ki Tsang and Shu-hung Tang, "The Impact of the China Factor on the pre-1997 Hong Kong Economy: A Macroeconometric Analysis", paper presented at the *Conference on Economic Developments in China*, organized by the British Economic Association of Chinese Scholars, London School of Economics, London, 17-18 December 1996.

xxxv. Tsang Shu-ki, "The Political Economy of Greater China", *Asia Pacific Business Review*, Vol.2, No.3, pp.23-43.

xxxvi. See Industry Department, Hong Kong Government, *1994 Survey of External Investments in Hong Kong*; and Census and Statistics Department, Hong Kong Government, *External*

Investments in Hong Kong's Non-manufacturing Sectors. For an analysis of the significance of China's investments in Hong Kong, see Yue Ma, Shu-ki Tsang and Shu-hung Tang, "The Impact of the China Factor on the pre-1997 Hong Kong Economy..." (Note 32).

xxxvii. The theory of optimum currency areas was pioneered by Mundell and extended by McKinnon and others. The classic article is R.A. Mundell, "Theory of Optimum Currency Areas", *American Economic Review*, Vol. 51, 1961, pp.657-65. The push towards monetary union in Europe has prompted a new generation of models and analysis. For an update, see George S. Tavlas, "The `New' Theory of Optimum Currency Areas", *The World Economy*, Vol.16, No.6, 1993, pp.663-685.

xxxviii. See George S. Tavlas, "The `New' Theory of Optimum Currency Areas" (Note 35).

xxxix. I have emphasized these aspects of the economic relations between Hong Kong and China and argued that the Hong Kong economy should maintain a degree of "coherence" in the post-1997 era. Because of the constraints of the "one country, two systems" framework, Hong Kong should not be "Manhattanized" or "totally de-industrialized", to become just another, albeit very important, city economy in China. See Tsang Shu-ki, "The Economy", in Donald McMillan and Man Si-wai (eds.), *The Other Hong Kong Report 1994*, Hong Kong: The Chinese University Press, 1994, pp.125-148; and Tsang Shu-ki, "Economy", in *Hong Kong in Focus 1997*, Hong Kong: The Commercial Press, chapter 4 (in Chinese).

xl. The linked exchange rate system for the Hong Kong dollar has been relatively robust since its inception in October 1983. Problems persist, but can be solved with various moves that fall short of any fundamental overhaul. There is little reason to seek protection through unification with the Renminbi in the foreseeable future. See Tsang Shu-ki, *A Study of the Linked Exchange Rate System and Policy Options for Hong Kong*, a report commissioned by the Hong Kong Policy Research Institute, October 1996. An abridged version of the report appears as "Linked Rate System: through 1997 and into the 21st Century", in Nyaw Mee-kau and Li Si-ming (eds.), *The Other Hong Kong Report 1996*, The Chinese University Press, 1996, chapter 11.