The Foreign Exchange System in China: Review and Outlook

Tsang Shu-ki
Department of Economics
Hong Kong Baptist College

1. Introductory Remarks

Like most developing countries, China has been adopting a multiple exchange rate regime in its attempt to maintain control and order while liberalizing transactions in the spheres of trade, non-trade and cross-border fund flows. From a very rigid, highly centralized regime in 1979, China has by now progressed to a relatively flexible system under which the official rate, the swap rate, and the "free" market rate coexist. The tight control on international transfer of funds has also been progressively relaxed, as different parties (including individuals) gain increasing freedom to acquire foreign exchange.

The pledge to unify the offical and the market rates within *five* years has been made recently by high ranking government officials, in a bid to accelerate China's re-entry to GATT. Although 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, it is nevertheless conceivable that most of the current account transactions and an increased scope of capital account transactions might be brought into a Chinese system where the unified rate is to be determined by demand and supply. Compared with the "big bang" in foreign exchange liberalization such as that implemented in Poland, Bulgaria or Russia, China's pace is perhaps very slow. Nevertheless, by the standard of developing countries, such progress, if it is indeed achieved, is anything but mediocre. There are however concerns whether China has sufficient foreign exchange reserves and effective macroeconomic instruments to stabilize the unified and liberalized Renminbi. On the other hand, though, the possibility of China attempting a "big bang" in foreign exchange liberalization, out of confidence or frustration, cannot be ruled out.

2. A Brief Review of China's Foreign Exchange Regime in the Reform Period

From 1981 to 1984, China practiced a dual exchange rate system: the official rate depreciated gradually while 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 0.3 yuan to the average cost of export in the early 1980s, as an incentive to exporting units. The two rates were unified at 2.80 in January 1985, after the official rate slipped near that level.

In 1985-86, foreign exchange adjustment centres (FEACs), or "swap" centres as commonly called, were experimented with in several cities. In late 1986, the FEACs were given the official blessing and dual exchange rates effectively reappeared. The 1988 trade reform saw further 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 in 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.

From 1985 to 1991, the official rate of Renminbi was devalued several times. Since April 9, 1991, the government has adopted a "managed float" system under which the official rate is to be adjusted "continuously" and "in small steps". This mechanism is regarded as superior to the discrete large adjustments taken in the previous "fixed" rate system.

The system held pretty well in 1991, the official rate ending the year at 5.43 against the greenback. In the ten major swap centres, the weighted average price of retained US$ quota hovered around Rmb 0.50 for the whole year, implying a market discount of the official rate of less than 10%. With hindsight, that provided a *golden* opportunity for the country to unify its multiple exchange rates, which was unfortunately 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 it later.

In any case, the good time did not last long. The exchange rate system came under pressure in 1992 when the economy began showing signs of overheating. The twists and turns in 1993 are well known and I do not intend to go over them here. I have indeed commented on them in some detail elsewhere. I just want to say that in my view a reasonable exchange rate for Renminbi is about Rmb 8.00/US$, from an integrated consideration of factors including purchasing power parity (PPP), portfolio adjustment, *Chukou Huanhui Chengben* (i.e. the average cost, in Renminbi, of exporting one US dollar's worth of goods), and China's balance of payments position etc. Obviously, cyclical forces as a result of overheating or austerity measures could push the market rates far below or above it. All eyes are now on the success or failure of the macro-control programme launched in late June.

3. The Exchange Control System on Trade

China's exchange control system can be classified into the trade and non-trade subsystems. Within the trade subsystem, export and import receive differential treatments. The trade subsystem is important, because more than 80% of China's foreign exchange revenue has come from external trade.

While exports have no longer been under mandatory planning since the 1991 trade reform, the government has continued to exercise influence through methods such as canalization and licensing on about 10%-15% of total exports. Moreover, exporting units have to turn over their foreign exchange earnings to the government after receiving them. A foreign exchange retention system has since 1980 been practiced whereby these units retain the rights to buy back certain proportions of their foreign exchange earnings from the central government at the official rate. The retention rates for such "quotas" have been progressively raised over the years. For general commodities, the nominal rate of retention now is 80%. However as the government reserves the right, which it has apparently fully exercised, to purchase a further 30% at the swap rate, the effective quota retention rate is 50%. Cash retention has on the other hand been experimented with at a very limited scale.

The uses of foreign exchange are subject to various controls. Take the imports of goods as an example, it is estimated by the World Bank (1993) that in 1992 more than 50% of China's imports were still under various forms of non-tariff administrative controls through mandatory planning, canalization, import licensing, and foreign exchange allocation, often in an overlapping fashion.

Importers of items included in the import plan are 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 has been controlling uses of foreign exchange is 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 is supervised.

4. 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.

Again the government has 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, etc. In principle, retained non-trade foreign exchange is to be used mainly for the expansion or upgrading of projects that earn foreign exchange.

Like the control system for trade, quota and cash accounts have to be opened for non-trade foreign exchange. A further complication here is the separation of public and private accounts. Individuals with retained foreign exchange are allowed to open quota accounts, while anyone with proper foreign exchange receipts can open "cash accounts", i.e. deposit the foreign currencies into authorized banks or financial institutions.

Over time, the control on individual foreign exchange receipts has been 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 allows for the normal freedom in withdrawal and remittance. 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 can remit it abroad or sell it for Renminbi to the swap market through a bank. The swap rate is also used for selling foreign exchange to residents without it 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 has usually been more expensive than the actual swap rate.

Moreover, from March 1993 onwards, each individual is also allowed to bring 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 swap markets inside the country. Since the lifting of the cap on the swap rate in early June, the market rate in Hong Kong has been very close to its Mainland counterpart in the key swap centres.

5. 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*. Over the years, effort has been made to give more flexibility to the foreign-funded enterprises, in a bid to attract more overseas investors. For example, they can retain foreign exchange in cash and need not sell their foreign exchange earnings from exports and providing services to the government. Business expenditure, after-tax profit, and other lawful earnings can be drawn from their cash account and transferred abroad. They can borrow loans from abroad without approval if it is necessary for their business operation. Their products may be sold in foreign currency in the domestic markets etc.

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 accounts or to open one abroad. All foreign exchange receipts are to be deposited into the account.

As far as expenditure in foreign exchange is concerned, recurrent payments such as those for the import of raw materials, equipment, and spare parts needed for production are relatively free, only to be monitored by the depository bank. The outward remittance of profit requires the approval of the SAEC on the evidence of audited report, Board decision, and tax payment, while the transfer of capital abroad needs the approval of both the SAEC and the authorities in charge of the enterprise. Liquidation is yet more complicated, requiring the nod from the SAEC, the authorities in charge, as well as the financial and taxation departments before funds can be transferred abroad.

In principle, China still manifestly keeps to the requirement of self-balance in foreign exchange for foreign-funded enterprises. A World Bank discussion paper in 1991 (Zafar Shah Khan, *Patterns of Direct Foreign Investment in China*, 1991) so 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 Mr. Khan makes to appear. Vietnam, for example, has imposed the same requirement.

On January 15, 1986, the Chinese government promulgated the *State Council Regulations on Joint Ventures' Balance between Foreign Exchange Revenue and Expenditure,* which laid down the foundation for related policies. Over the years, key measures to help foreign-funded 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;

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. Foreign-funded enterprises are allowed to sell their foreign exchange revenue from and 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.

With the proliferation of swap centres and their increased activities, and the privileged access to them by foreign-funded enterprises, 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.

6. Liberalization of Foreign Exchange Transactions and the Swap Centres

The swap of foreign exchange retention quotas through the Bank of China (BoC) was allowed from 1980 onwards. In 1986, the SAEC formally took over the swap business, and the BoC concentrated only on accounting and settlement. Transactions were apparently stimulated and the swap volume was reported to be US$ 4.2 billion in 1987. The 1988 and 1991 reforms gave further impetus to the expansion of the number of swap centres as well as total volume of transactions. The number of swap centres now exceeds 100. Trading volume was reported to be US$6.3 billion in 1988, $8.6 billion in 1989, 13.1 billion in 1990, US$20.5 billion in 1991, and US$25.1 billion in 1992.

Participation in the swap markets has remained asymmetrical. Selling of foreign exchange at the swap rate has become virtually unrestricted since December 1991 when all domestic residents were allow to unload their foreign exchange holdings through designated banks into the swap market.

The major portions of sales have been 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.

In contrast, buying of foreign exchange from the swap market has been much more restricted. As mentioned above, individuals with foreign exchange can 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 is however small, and a discount of about 5% is in many cases charged. Foreign-funded enterprises can purchase foreign exchange for approved purposes including operating needs, debt repayments and remittances. Domestic enterprises and units which are given permission to import can 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. In some centres, domestic enterprises can also buy foreign exchange in cash. Authorization by SAEC of the use of swapped foreign exchange is in general subject to a *priority* list. In 1992, it was as follows:

1. Priority imports for which swapped foreign exchange can be used include:

a. argo-oriented commodities such as chemical fertilizers, pesticide and plastic film;
b. foodstuffs such as grains and sugar;
c. materials for projects that turn out export goods;
d. raw materials needed for light, textile and chemical industries;
e. imports for the technological upgrading of small and medium-sized enterprises.
f. reasonable expenditure by foreign-funded enterprises.

2. Priority items for which swapped foreign exchange can be used if conditions permit include:

a. equipment sets, apparatus, reagent, books etc. needed by scientific research, educational, medical and health departments;
b. key spare parts and components needed by priority electrical product manufacturers;
c. expenditure relating to key local construction projects;
d. raw and semi-finished materials needed by other industries;
e. repayments of the principal plus interest of foreign loans registered at SAEC or its branches;
f. repayment of overdue foreign loans and payment of lease fees when the export of the debtor's products are not allowed.

3. Uses for which swapped foreign exchange are not allowed:

a. import of general consumer goods such as cigarettes, wines, drinks, fuits, foodstuffs, clothing, clocks, pop-tops, color-films, cosmetics, and inhouse fitting materials;
b. import of high-grade consumer goods such as motor vehicles, household electrical appliances, and gold and silver products for sales at home;
c. import of machinery, equipment, electronic products, instruments and apparatus and raw materials the supply of which is available at home;
d. investment in domestic project;
e. payments for goods at stores limited to customers with inward overseas remittances;
f. purchase of goods to be sold on a commission basis;

g. unapproved expenses for visits abroad;

f. start-up capital needed by specialized banks for foreign exchange business (modified from China Intric Ltd., *China Business Guide Book*, 1993)

As one can see, there are many grey areas in what is and what is not a legitimate item for which foreign exchange can be swapped. When there is more demand for than supply of foreign exchange in the swap centre, how to prioritize the bids is also a touchy question. In practice, the local branch of the SAEC has the say and many have attributed the unruly movements in the swap rates since 1992 to the lack of discipline on the part of SAEC branches and the activities of unscrupulous speculators admitted to the swap markets. As a recent 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 (*Ming Pao*, Hong Kong, August 21, 1993, p.A11).

At a more technical level, the open bidding system of swapping was established in Shanghai with the launching of the Shanghai Foreign Exchange Swap Market in September 1989. A brokerage system was formed, and bids and offers were fed through them to the exchange to find the equilibrium rate for transactions. Independent dealers, who essentially were non-financial enterprises with large turnover in foreign exchange, were also admitted and they could buy and sell for themselves. Subsequently, the open-bidding system has been adopted in Shenzhen, Xiamen and other cities.

Inter-market transactions are legally allowed and they are 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 are more complicated and restrictive. As mentioned above, the total transaction volume in the swap markets amounted to US$20.4 billion in 1991. Of that amount, about US$6 billion, or 30%, turned out to be inter-regional swaps. Informational and administrative barriers have apparently continued to result in substantial differences in the swap rates. For example, on June 11, 1993, when the swap rate broke the Rmb 11 level in Hainan, the currency was traded at 10.36 against the US$ in Xiamen, and 10.73 at the SEAC Head Office in Beijing.

7. Forward and Futures "Markets"

In 1968, China began to use Renminbi as the accounting unit for its external economic and trade transactions. The move was intended to shore up the demand for Renminbi, to obtain more foreign currencies for the government and to stabilize the exchange rate. To facilitate the move, from 1971 onwards, foreign investors and foreign banks were allowed to purchase or sell Renminbi forward against 15 major currencies through the Bank of China. As the interest rates in China were rigid and did not reflect supply and demand for funds, the premium of the forward rate over the spot rate was apparently determined in an arbitrary fashion.

Into the reform period, the Renminbi is no longer used as the accounting unit for external transactions, but the forward market has never been formally closed. The Bank of China, and financial institutions approved by the SAEC, could buy or sell forward foreign exchange from or to parties engaged in proper current account and capital account transactions. All the requirements and restraints relating to spot transactions, as analyzed above, of course also apply to forward transactions. The "real demand principle" still holds. One complicating factor is the treatment of surplus or deficit in the case of forward contracts for import/export trade. A detailed set of rules to divide the costs and benefits, arising from the actual spot rate on the contract date deviating from the forward rate, has been devised.

In practice, however, it appears that not many investors have been able to hedge their exchange risk through the BoC and other financial institutions, particularly as the Renminbi came under pressure with the overheating of the economy from mid-1992 onwards.

Since June 1, 1992, futures contracts for Renminbi against the US$ and other foreign currencies with a maturity of one to six months have been experimented with in the Shanghai swap centre with the approval of the SAEC. Again the open bidding system is used, and a number of brokers and member traders, including foreign banks and foreign-funded enterprises, have been appointed. It has been reported that between June 1992 and April 1993, a total of 23,600 contracts, worth about US$430 million, was sealed, of which 90% were in US$ (Hongkong Bank China Services Ltd., *China Briefing*, September 1993). That was of course a very small transaction volume. Another futures market is now in preparation in Shenzhen.

8. Reform Pledges and Well-intended Recommendations

Overall, China has made remarkable progress in liberalizing its foreign exchange system in the past decade although considerable restrictions still exist. To evaluate economic feasibility of any restrictive system, one has of course to balance costs with benefits, and assess short-run barriers against long-term prospects. The fact that foreign capital has been flooding China since the 'Deng whirlwind" despite the fact that China remains one of the few countries in the world "that welcome direct foreign investments but require them to maintain foreign exchange balance" is a clear reminder that fund flows are motivated by net-profit calculations rather than superficial systemic comparison tainted with theoretical or ideological biases.

In any case, high ranking Chinese officials have pledged to establish in China a unified foreign exchange rate within a period of five years. The World Bank has on the other hand recommended measures to widen the scope of the FEACs so that they would cover virtually all current account transactions in the economy and generate the equilibrium exchange rate. To meet these objectives, several progressive measures are quite obvious, and often recommended inside and outside China:

a. Exporters should be given 100% of retention of their foreign exchange earnings. The government's noncurrent transactions should be priced at the swap rate instead of the official rate.

b. More current account (trade and non-trade) transactions should be channelled to the swap markets, with the priority list on the use of foreign exchange bought from them progressively relaxed.

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 achieving current account convertibility at a unified exchange rate has been achieved, China can proceed to ease controls on the capital account and relax restrictions on international fund movements, ultimately reaching a foreign exchange regime under which all transactions across border are freely settled at market-determined exchange rate. That is the long term goal of the Chinese authority and the expectation of the international community.

9. GATT Issues

China is apparently very keen to re-enter GATT. The reasons often cited include 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. Jiang Zemin, in his report to the Party Congress in October 1992, listed "attracting and absorbing foreign investment" as the second of the ten tasks confronting the CCP and the country. GATT membership certainly helps in increasing attractiveness. On top of these considerations, I suspect that there is a very important political dimension: China wants to re-enter GATT before Taiwan enters it, especially when the Taiwanese government is now nurturing the hope of getting admitted to the United Nations within three years. In this regard, I only want to add that the apparent enthusiasm may change quite significantly if global geopolitics turns against China beyond a certain threshold.

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 contracting parties 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 and too much of her domestic markets. On top of these considerations, the United States has already made it quite clear that GATT membership for China does not imply automatic renewal of MFN status.

As for the foreign exchange system, it is quite clear that GATT membership does not require free convertibility of currency or even unification of multiple exchange rates. GATT leaves the matter largely to the IMF. Indeed, Article XV-9 of the Text of GATT explicitly says:

"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 controls. 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. I do not know 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.

10. Constraints on Reform: Muddling Through versus Big Bang

Can China achieve these medium-run and long-run goals? Some of the recommendations are obviously easier to heed. The establishment of an integrated swap market, or swap network, for the whole country, for example, involves no principles but probably considerable administrative costs. There are indeed recent reports that a unified centre based in Beijing or Shanghai will be established next year. Some of the costs may be borne by the participants, e.g. reducing the number of swap centres and increasing the commissions charged. 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 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. Pure arbitrage activities are of course not allowed now. 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. Recent reports suggest that the Chinese authorities may choose to install a nation-wide computer network. It remains to be seen how they would finance its installation and operations.

The development of the forward and futures market should also pose no intrinsic hurdles, as the Shanghai experiment shows. Practical difficulties are two-fold: (1) the spot (swap) rate is subject to administrative influence; (2) interest rates in China are highly differentiated (there are about 50 rates now) and administratively manipulated. So one cannot calculate the forward premium or discount as "rationally" as in any western market. The maturity of the forward market in China is obviously tied to the liberalization of the spot rate and the interest rates.

As to the question of unifying the multiple exchange rates (using the swap rate) and 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. The result there, as we all know, is bordering on disaster. 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 depreciation of the Romanian currency was due to the government being too soft in engineering the recession and restraining pay demands.

Of course, the cost to pay is related to the initial macroeconomic condition on which the "big bang" is launched. Yeltsin has kept on defending his economic record by pointing to the mess he inherited from Gorbachev. 1991 was obviously a much better time than 1993, or even 1994, to try out the "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 the costs to be borne by China should be lower than those that have been incurred in Russia and Eastern Europe, they would still be very considerable. 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 ruins, so even desperate methods need to be attempted. China is planning how 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 much more cautious one: that China should achieve unification and convertibility gradually over, say, a five to ten-year period. That is apparently the official line, and the approach suggested by the World Bank. 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 punishing austerity. Of course, the exchange rate can be stabilized by a less costly method, open-market intervention by the government in the liberalizing foreign exchange market. The key question is obviously whether China has "sufficient" foreign exchange reserves.

In this regard, Executive Vice Premier Zhu Rongji was reported to have said earlier this year that China could float Renminbi if the country managed to build up its foreign exchange reserve to US$100 billion.

At the end of 1992, the announced foreign exchange reserve of China totalled US$48.3 billion, which ranked the second largest among major Asian developing countries. However, many commentators regard that China's reserve is "over-estimated" because it consists of two components: (1) the state balance, and (2) the BoC balance. 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$18.88 billion at the end of June 1993. Many have reasoned 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. The state balance alone would however be insufficient because it could cover less than 3 months of the country's imports, the internationally recognized safety threshold.

Others also commented that the BoC gets its foreign exchange by borrowing and therefore the BoC balance is not really foreign exchange reserve. The logic behind such an argument is not clear to me. The BoC balance is a net balance: it is the total of BoC's equity, deposits (absorbed domestically and overseas) and borrowing in international financial markets in foreign exchange minus its lending and investment in foreign exchange to non-financial institutions. In essence, it is the BoC's holdings of foreign currencies plus claims on foreign financial institutions.

Generally speaking, the BoC balance represents the part of the cumulative capital account surpluses that the central government can use as reserves.

The reasoning that the BoC balance should not be counted as China's foreign exchange reserves because it "is not directly deposited by the government" seems strange to me. It may be perfectly legitimate in a market economy and if the BoC, one of four so called "specialized banks", were a truly commercial bank. The BoC, however, was and is 100% state-owned. So Beijing's insistence that the BoC balance be counted as part of its official foreign exchange reserves does have solid grounds despite the liberalization in the Chinese financial system. Would 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 requests it? Of course, if later the BoC becomes a truly commercial bank, privatizes part of its equity, or even gets listed in the stock exchange, the story will be different.

On the other hand, though, the state balance does include the retention quotas of the earners of foreign exchange in trade and non-trade, which can be rightfully utilized in various manners. In a liberalizing environment, they would probably be used in large scale and rather rapidly. No official statistics are available, but estimates put the amount at US$8 billion to US$10 billion in mid-1993.

All in all, I would say that China's official foreign exchange reserve is still above the international safety threshold of covering three months of merchandise imports, at least for now.

Into the future, nevertheless, there is the justifiable concern about China's supply-demand balance in foreign exchange. China is entering a cyclical peak in servicing its US$70 billion foreign debt, with annual outlays amounting to US$7-12 billion in 1993-95. This would put some strain 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 despite the clampdown launched in late June this year, particularly when one considers the worsening leakages from export-generated foreign exchange revenue.

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. As the *Citibank China Monitor* (premier issue, July 1993) recently put 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". Further down the 1990s, this is of course an open question. We cannot rule out the possibility that foreign investors may bring cash in bags to China if the present austerity programme works out well and another upswing unfolds in, say, late 1994 or early 1995. Things could turn the other way, though, if the Japanese economy and the economies on the two sides of North Atlantic recover and rebound heathily.

Another question is whether China would be able to install effective macroeconomic control mechanisms to stabilize the Renminbi when it is unified and liberalized. The overheating of the economy in 1992-93 and the present austerity programme with its large doses of administrative measures have again exposed the serious weaknesses in China's ability to constrain macroeconomic fluctuations.

Both the financial and fiscal systems are basically pre-modern, some aspects of them (e.g. the *baogan* system in taxation) even outright feudalistic. The central government is caught in serious fiscal difficulties, and the taxation "system" has become the bone of contention in an endless process of bargaining and compromise among various interested parties. Fiscal policy has therefore been rendered largely ineffective as an macroeconomic tool.

The monetary system is not in much better shape. Under the painful burden of policy loans, specialized banks have not and cannot become autonomous. Non-bank financial institutions (NBFIs) have burgeoned and many have also gone out of control. Hence, credit expansion and diversion could easily turn out to be a wild game. The interest rates are bureaucratically manipulated and differentiated. Floating them would not be easy at all as many enterprises would simply go bankrupt. Ultimately, an effective central banking system faces the problems of de-commercializing the People's Bank, restructuring fund control in a vast country, and shaking off local interference.

I am fully aware of all the proposals of changes and the actual initiatives already taken. The blue-prints for fiscal, monetary and central banking reforms for China have been burgeoning, kind-heartedly put forward by the World Bank and many economists inside and outside China. On paper, they are strikingly similar and non-controversial. The problem is action. Any major restructuring of the fiscal and the financial systems in China touches on so many interests, vested or newly formed (thanks to more than a decade of decentralization without proper reform of the macroeconomic control mechanism), that it could only go through after a fight. The give-and-take process is likely to be a drawn-out one. Could so much be achieved within a few years' time, so that a unified and liberalized exchange rate for Renminbi would stabilize under effective macroeconomic control?

11. Future Scenarios

There is however a growing number of commentators who think that instead of continuing the muddling-through China should try something drastic. A big bang after 15 years of gradualist reforms seems worthy of at least a try. Rapidly freeing the Renminbi would force everybody to adjust behaviourally to the new circumstances. It is essentially a coup intended to enable the central authority to rise above the increasingly dirty mess of local interests. The freeing of the swap rates in June 1993, which has apparently been reversed, may just be the tip of the iceberg. More decision-makers could lose their patience, or their nerve, in the near future. The possibility that China might take a gamble, not just in foreign exchange liberalization, cannot be ruled out.

You must have read the report on *Ta Kung Pao* last Thursday that China's Vice Minister of Finance, Mr. Jin Renqing, allegedly revealed that the official and the market exchange rates will be unified *next* year (*Ta Kung Pao,* September 16, 1993, p.4). This is a dramatic shift from the previously stated time frame of five years, and an official from the SAEC said that he was "not aware of a change of policy" (*SCMP*, September 17, 1993, Business 2). Unfortunately, Mr. Jin did not specify to what scope of transactions the unified rate would apply. In other words, he did not define the degree of convertibility that would accompany the unification of the exchange rates.

Unification of exchange rates is no big deal in itself. After all, China had a unified rate in 1985-86, although the convertibility of 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 the rationing was even more severe. Convertibility is now much higher but far from 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.

Hence I find all these pledges of unification without defining the degree of convertibility quite mystifying. Moreover, even the concept of unification is usually not clarified: it may refer to unification at the market rate, through the abolition of the administered official rate, and letting the market rate be really determined by demand and supply. This is how one would normally understand the term. To avoid misunderstanding, let me call this "progressive unification". On the other hand, it could mean a return to the unified system before 1980 or that in 1985-86. That is obviously a joke if China intends to use it to please the outside world or the GATT negotiators. Alternatively, the Chinese government could abolish the official rate, adopt the swap rate, but intervene into the swap market heavily through both administrative measures and open market operations, and keep the degree of convertibility more or less the same (or raise or lower it slightly). I am not sure whether this was what the Vice Finance Minister had in mind when he talked about unification of the official and the market exchange rates in 1994. Mr. Jin could of course have meant something much more radical. After all, he also said that China already has a timetable for full convertibility, and that the goal will be achieved in the not-too-distant future, although he did not go into specifics.

Given all the above considerations, let me conclude by way of assigning probabilities to several possible scenarios of foreign exchange liberalization in China.

(1) China implements a "big bang" in liberalization (progressive unification of the official rate the swap market rates and the free market rates plus full convertibility within 18 months) and succeeds: 10% chance.

(2) China implements a "big bang" in liberalization (progressive unification of the official rate, the swap rates and the free market rates plus full convertibility within 18 months) and fails: 20% chance.

(3) China implements a "gradual" programme in liberalization (progressive unification of the official and the swap rates plus near-current-account convertibility within five years) and succeeds: 35% chance.

(4) China implements a "gradual" programme in liberalization (progressive unification of the official and the swap rates plus near-current-account convertibility within five years) and fails, or China slows the programme beyond the five-year time frame, by design or by default: 35% chance.

In other words, I think that the likelihood of China attempting a "big bang" type of foreign exchange liberalization (floating the Yuan and granting full convertibility within 18 months) is 30%. There remains a 70% chance that China would keep to a gradual course of liberalization.

If China opts for the "big bang", I would give it only a one-third chance of success. Should China choose the gradualist line, I reckon that the probability of success would be 50%, i.e. there is still a 50% chance that China may have to prolong its target period beyond 5 years. The key considerations are of course sufficient foreign exchange reserves and effective macroeconomic control.

This was the presentation material that I used in a forum organized by Streeter Communications, "FOREIGN EXCHANGE STRATEGIES FOR PRC OPERATIONS", 23 September 1993, Hong Kong