The temptation of China's capital account

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Despite fluctuations, China's overall economic growth has been stable over the last three decades, owing not only to the economy's strong fundamentals, but also to the government's successful management of cross-border capital flows.

Capital controls enabled China to emerge from the Asian financial crisis of 1997-1998 largely unscathed, even though its financial system was at least as fragile as those of the affected countries. The Asian financial crisis persuaded China's leaders to shelve plans, launched in 1994, to liberalize the capital account.

In 2002, China reinitiated liberalization efforts, lifting restrictions on Chinese enterprises' ability to open foreign-currency bank accounts, and allowing residents both to open foreign-currency accounts and to convert the renminbi equivalent of $50,000 annually into foreign currencies. The authorities also introduced the "qualified domestic institutional investors" (QDII) program to enable residents to invest in foreign assets – one of many initiatives aimed at easing upward pressure on the renminbi's exchange rate by encouraging capital outflows. At the same time, the "qualified foreign institutional investors" (QFII) scheme allowed licensed foreign entities to invest in domestic capital markets.

In early 2012, the People's Bank of China (PBOC) released a report calling for policymakers to take advantage of a "strategic opportunity" to accelerate capital-account liberalization. Shortly after the release, QFII quotas were relaxed significantly.

In fact, such an acceleration has been underway since the government initiated renminbi internationalization in 2009. Although currency internationalization is not tantamount to capital-account liberalization, progress on the former presupposes progress on the latter. By allowing enterprises to choose currencies for trade settlement, and creating renminbi "recycling mechanisms," the government effectively eased the restrictions on short-term cross-border capital flows.

Most economists in China seem to support the PBOC's stance, citing the potential benefits of capital-account liberalization. But Chinese policymakers should also recognize the significant risks inherent in relaxing capital controls.

First, China needs capital controls to retain monetary-policy independence until it is ready to adopt a floating exchange-rate regime. As Barry Eichengreen has pointed out in the context of the post-WWII Bretton Woods system, capital controls weaken "the link between domestic and foreign economic policies, providing governments room to pursue other objectives." Because capital controls capped "the resources that the markets could bring to bear against an exchange-rate peg," they "limited the steps that governments had to take in its defense." With current- and capital-account surpluses, the renminbi's exchange rate is still under upward pressure. Without adequate controls on short-term cross-border capital inflows, the PBOC will find it difficult to maintain monetary-policy independence and exchange-rate stability at the same time.

Second, China's financial system is fragile, and its economic structure rigid. Hence, the Chinese economy is highly vulnerable to capital flight. In recent years, China's financial vulnerability has been rising, with enterprise debt estimated to exceed 120% of GDP, and broad money supply (M2) amounting to more than 180% of GDP. At the beginning of 2012, China's concerns centered on local-government debt, underground credit networks, and real-estate bubbles. Now, growth in shadow-banking activities has been added to the list. Without capital controls, an unforeseen shock could trigger large-scale capital flight, leading to significant currency devaluation, skyrocketing interest rates, bursting asset bubbles, bankruptcy and default for financial and non-financial enterprises, and, ultimately, the collapse of China's financial system.

A third reason to go slow on easing capital controls is that China's economic reforms remain incomplete, with property rights not yet clearly defined. Amid ambiguity over ownership and pervasive corruption, the free flow of capital across borders would encourage money laundering and asset-stripping, which would incite social tension.

Finally, with more than $3.3 trillion in foreign-exchange reserves, China is a particularly attractive target for international speculators. Owing to its underdeveloped financial system and inefficient capital markets, China would be unable to withstand an attack akin to those that triggered the Asian financial crisis without the protection of capital controls. Already, even without a major speculative attack, the exchange-rate and interest-rate arbitrage facilitated by renminbi internationalization have imposed significant losses on China.

To be sure, a cautious approach should not be allowed to impede incremental progress toward capital-account liberalization. But a broad framework for determining the timing of each policy step, based on rigorous cost-benefit analysis, is essential. While some measures that the PBOC has taken under the banner of capital-account liberalization have turned out to be both necessary and appropriately moderate, others may need to be reassessed and rescinded.

Today, as all major developed economies resort to expansionary monetary policy, the global economy is being flooded with excess liquidity, and a "currency war" is looming large. As a result, short-term capital inflows, whether seeking a safe haven or conducting carry trades, are bound to become larger and more volatile.

In these circumstances, with China's financial system too fragile to withstand external shocks, and the global economy mired in turmoil, the PBOC would be unwise to gamble on the ability of rapid capital-account liberalization to generate a healthier and more robust financial system. On the contrary, policymakers should tread carefully in their pursuit of financial liberalization. Given China's extensive reform agenda, further opening of the capital account can wait; and, in view of liberalization's ambiguous benefits and significant risks, it should.

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