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China's Foreign Exchange Policies Since 1979: A Review of Developments and An Assessment

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Abstract

The paper takes a closer look at the process of China's foreign exchange reform since 1979. It describes major policy changes, assess their effects and identify challenges in furthering the process of capital account liberalization. The paper concludes that the core of China' foreign exchange reform since 1979 has been a gradual transformation of exchange allocation mechanism from one that was governed by central planning to one in which market forces play a significant role. The entire reform process is characterized by substantial trade liberalization, initial official exchange rate adjustments, exchange market development, easing restrictions for current international transactions and establishment of capital account control framework. China has moved to the last frontier of its exchange reform. Previous reforms have generally focused on gradual liberalization of the current account and inward direct investment, aimed at strengthening the real sector and export capacity of the economy. The next-phase capital account liberalization is more complex and tends to be closely related to the development of domestic financial sector. While China is faced with the tasks of removing barriers to international capital transactions, the current weaknesses of the domestic financial sector may pose the risk of financial instability if the capital account is to be liberalized. Therefore, China's future exchange reform should fully address the domestic financial sector's weaknesses in advance of, or in concurrence with the capital account liberalization.

Introduction

After eighteen years of persistent efforts, China achieved the current account convertibility for its currency in December 1996. As the authorities started to plan the next-phase exchange reform, the Asian financial crisis occurred. The financial disaster has alerted the authorities about the high risk of opening up the capital account without a sound financial system in place. A cautious approach to the capital account liberalization has gained greater respectability. In the aftermath of the Asian financial turmoil, the Chinese authorities intensified their efforts to reform and strengthen the financial sector. In November 2001, China concluded its accession to the WTO. As the result of the negotiations, China has agreed to open domestic financial markets substantially to foreign investment. While detailed analysis is still needed to assess the implications of those commitments for the current capital control regime, pressure on the capital account liberalization will certainly increase.

China has moved to the last frontier of its foreign exchange reform. Previous reforms have generally focused on gradual liberalization of current account and inward direct investment, aimed at strengthening the real sector and export capacity of the economy; whereas, the next-phase of capital account liberalization tends to be closely related to the development of domestic financial sector. China is faced with a formidable task of shaping its financial sector that would sustain capital account liberalization. But delaying reforms could be costly as the economy is already incurring high administrative costs associated with maintaining and enforcing the existing exchange controls. The issue is whether China can effectively coordinate the capital account liberalization along with domestic financial reform, and development of financial markets and instruments. An orderly transformation of the foreign exchange system is important to ensure a smooth integration of the Chinese economy into global markets.

China's foreign exchange reform started with providing greater incentives for the expansion of the export sector. For this purpose, China introduced two major changes. In 1979, it introduced a system that allowed exporters to retain a portion of their foreign exchange earnings. From 1981 to 1985, the government adopted a devalued Internal Settlement Rate (ISR) for trade transactions. The adoption of the ISR in early stages of reform was a good reflection of the government's intention to regulate import and export activities through manipulating an administratively determined exchange rate. However, in practice, the process of setting an administrative exchange rate was always subject to the influence of different interest groups. Despite frequent adjustments of the official exchange rate throughout the 1980s, it was never maintained at a level that would result in the supply of foreign exchange equaling demand in the absence of exchange controls and various compensating schemes.

The period after the mid 1980s witnessed a rapid development of a market-determined exchange rate. In 1985, the first foreign exchange swap center was established in Shenzhen Special Economic Zone (SEZ) to facilitate trading in foreign exchange retention quotas. To encourage inflows of foreign direct investment, the authorities allowed trading of actual foreign exchange by foreign-funded enterprises (FFEs) in 1986.

As the retention ratios steadily increased and market restrictions reduced, the importance of the swap market increased markedly. After 1991, the swap market rate was applied to over 80 percent of China's foreign exchange transactions.

In 1994, China embarked on a major market-oriented exchange reform. The official and swap market rates were unified. Foreign exchange retention system and foreign exchange swap business for domestic enterprises were abolished. Instead, domestic enterprises were required to buy and sell foreign exchange through designated foreign exchange banks. In April 1994, a new interbank foreign exchange market became operational. In December 1996, China accepted the obligations of Article VIII. However, since then, the pace of foreign exchange reform has slowed sown. The authorities have mainly focused on consolidating the current account convertibility while the capital account liberalization has remained basically stagnant.

The purpose of this paper is two-fold: First, it will describe the process of China's foreign exchange reform that have been introduced since 1979; second, the paper will examine major policy changes and assess their impacts on the economy. The paper is organized as follows: Section I briefly describes the pre-reform foreign trade and exchange regimes to serve as a starting point for the paper; Section II discusses the 1979 external reform and the adoption of the ISR from 1981 to 1984; Section III focuses on the rapid development of the foreign exchange swap market after the mid 1980s until 1993; Section IV describes the market-oriented exchange reform in 1994 and additional measures taken to achieve the *Renminbi* (RMB) current account convertibility in late 1996; Section V describes the policy changes before and after the Asian financial crisis and points out the constraints of the financial sector for China's capital account liberalization; and Section VI provides a summary and some concluding remarks.

I. The Pre-Reform Era

China's pre-reform foreign exchange system was mainly built upon its foreign trade regime. For over twenty years of central planning, the foreign trade system had exhibited three predominant features: monopoly, central planning and centralized accounting. In fact, these three institutional features were responsible for major inefficiencies existing in the pre-reform foreign trade system and thus, should be the main targets of the market-oriented reforms in the foreign trade sector.

Prior to the reform, China' s foreign trade was mostly controlled by about a handful of state-owned foreign trade corporations. [1] This monopolistic system was deliberately set up on the ground that it could help fence off foreign economic fluctuations and ensure that the central government could utilize the country's foreign exchange resources for its industrialization programs.

[1] The number of the state-owned foreign trade corporations varied at different time periods. On the eve of the reform in 1978, there were 10 foreign trade corporations that controlled most of China's foreign trade activities. See Table 1 for the names of these corporations.

With central planning, all the country's import and export activities were controlled by the state. The state planners would work out foreign trade plans in accordance with the requirements of the national economic plan and availability of the country's export resources. The rule of thumb was: exports were supposed to generate enough foreign exchange to support imports, while imports were expected to fill in the gaps in the country's total productive capacity and boost the total supplies as specified in the national economic plan.

The last feature, which had provided the financial foundation to China's pre-reform foreign trade system, is the centralized accounting. Under this system, all foreign exchange earnings of domestic exporters must be surrendered to the government and demand for foreign exchange would be allocated through state planning.[2] If the foreign trade sector suffered a domestic currency loss in its operations, the government would automatically cover the loss through the central budget. On the other hand, domestic importers and exporters had to surrender all their domestic currency profits to the central budget. As a result of this automatic tax-subsidy mechanism, exchange rates could be fixed at an arbitrary level, irrespective of changes in prices and other economic variables.

Ironically enough, these three institutional features, when initially designed, were regarded as advantages of a planned economy. Later on, however, it turned out that they were the sources of fundamental inefficiencies that existed in the pre-reform foreign trade system. For example, the monopolistic nature of the system had suppressed competition among trading firms and this had caused serious inefficiencies, while central planning had deprived firms of management autonomy. With the centralized accounting, cost consciousness was absent for foreign trade firms as all their profits would be taken away and losses would be automatically subsidized by the state.[3]

The pre-reform foreign exchange regime was closely related to the centralized accounting scheme. As the government attempted to neutralize the profits and losses of foreign trade corporations, the exchange rate had become meaningless in the sense that it had lost its traditional role of regulating the market demand and supply, and could be fixed at an arbitrary level irrespective of changes in prices. The major role played by the exchange rate was to serve as a conversion factor in determining the profitability and thus the amount of subsidies needed in the foreign trade sector.[4] Over the years, an important

[2] Before the reform, the power to control foreign exchange was shared by several ministries under the State Council. The Ministry of Foreign Trade was in charge of managing trade-related foreign exchange activities. The Ministry of Finance was responsible for controlling non-trade foreign exchange income and expenditure of various ministries under the State Council, while foreign exchange transactions related to local governments and private individuals were under the control of the People's Bank of China.

[3] As the official exchange rate was overvalued relative to the prices of imports and exports, the government could generally use the surplus from imports to finance the loss in exports. As a result, the overall budget for the foreign trade sector had remained in surplus for most of the time before the reform in 1979. For example, during the 28 years between 1953 and 1980, the foreign trade sector had a surplus for 19 years and there were only 9 deficit years. See Lin (1997, p. 4).

[4] Van Brabant (1985) used the term "passive accounting role" to describe this nature of exchange rates in centrally planned economies.

characteristic of the official RMB exchange rate had been that it remained fixed in an environment of highly distorted domestic price system for extended periods of time.[5]

II. The Reform in 1979 and Adoption of the Internal Settlement Rate

The first round of external reform started in 1979.[6] The above description implies that the foreign trade reform should involve three interrelated aspects: breaking up the monopoly to encourage competition among trading firms; abandoning central planning to allow market forces to play a major role in allocating resources; and making foreign trade firms financially independent. Accordingly, the fundamental task of the exchange reform is to transform the foreign exchange allocation mechanism from one that was dictated by government planning to one that is based on market principles, and establish a set of market-oriented regulatory framework.

At the initial stage of reform, the Chinese policymakers had no clear reform model in mind. The reform measures taken in 1979 had mainly focused on decentralizing some of the foreign trade management power and allowed more foreign trade corporations to be established. Specifically, Guangdong and Fujian provinces were granted greater autonomy to operate their own foreign trade businesses. Beijing, Tianjin, Shanghai and major industrial ministries were allowed to set up their own general foreign trade corporations. In addition to these foreign trade decentralization polices, one other important change had been the decision to create special economic zones in Shenzhen, Zhuhai, Shantou and Xiamen. [7]

With the process of decentralization, the monopolistic nature of foreign trade had started to break-up. At the end of 1981, about 400 new foreign trade corporations were established. By mid-1990s, the number exceeded 10,000. In 1981, the 10 traditional foreign trade corporations accounted for 76.6 percent of exports and 81.3 percent of imports. By 1992, theirs shares declined to 10 percent and 16.9 percent, respectively (see Table 1).

[5] The official RMB exchange rate was first quoted in Tianjin on January 18, 1949. Between 1949 and March 1950, the RMB exchange rates were frequently devalued with the increases in domestic prices. For example, from January 1949 to February 1952, there were 52 devaluations. However, after March 1951, partly because of the start of the country's transition to a centrally planned economy and partly because of the Korean War, the RMB exchange rate tended fixed. After 1953, as China completed its transition to the centrally planned economy, there were virtually no adjustments to the exchange rate according to the structural changes of the domestic economy. On the eve of the reform in 1978, the official exchange rate was around 1.60 Yuan per dollar. See Mah (1972, p. 42-49), and Shang (2000, p. 487-487).

[6] The external reform measures adopted in 1979 were mainly included in *Decision on Several Questions Concerning Greater Promotion of Foreign Trade and Increasing Foreign Exchange Income*, the State Council, August 13, 1979.

[7] Initially the Chongming Island close to Shanghai was also on the proposed list of special economic zones. However, for some reason, this proposal was not implemented. See *Decision on Several Questions Concerning Greater Promotion of Foreign Trade and Increasing Foreign Exchange Income*, the State Council, August 13, 1979. It should be noted that initially the special economic zones were intended mainly to attract investments by overseas Chinese.

Table 1 China's 10 Foreign Trade Corporations' Share of Annual Imports and Exports 1981-1992 (%)

Year	Exports	Imports
1981	81.3	76.6
1982	78.5	71.5
1983	77.9	60.6
1984	74.0	51.0
1985	76.7	42.3
1986	65.7	37.6
1987	64.3	30.3
1988	21.8	19.1
1989	20.2	17.8
1990	19.3	14.7
1991	21.6	9.8
1992	16.9	10.0

Note: The 10 foreign trade corporations that controlled most of China's foreign trade in 1978 are: China Machinery Import and Export Corp., China Minerals and Metals Import and Export Corp., China Chemical Import and Export Corp., China Technical Import and Export Corp., China Cereals and Edible Oils Import and Export Corp., China Textiles Import and Export Corp., China Native Produce and Animal By-Products Import and Export Corp., China Light Industrial Products Import and Export Corp., China Arts and Handcrafts Import and Export Corp. and China Instruments Import and Export Corp..

Source: Ministry of Foreign Trade and Economic Cooperation

In accordance with the foreign trade reform, the authorities began to take measures to reform the foreign exchange system. In March 1979, the State Administration of Foreign Exchange (SAFE) was established to assume the function of foreign exchange control.[8] In the same year, the authorities introduced a foreign exchange retention system to provide incentives to exporters.[9] Under this retention system, domestic exporters were allowed to retain a certain portion of their foreign exchange earnings. The retained foreign exchange earnings could be used to import goods over and above the state import plans.

With the decentralization and establishment of more foreign trade firms, unprofitable exports became an immediate problem to be resolved. Before the reform, the overvalued official exchange rate had made the country's import sector generally profitable and export sector unprofitable. However, with the centralized accounting scheme, the government was able to use the surplus from imports to subsidize unprofitable exports.

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[8] Initially, the function of foreign exchange control was performed by the Bank of China as the SAFE was created within the system of the Bank of China. In 1982, the SAFE was transferred under the leadership of the People's Bank of China.

[9] *Decision on Several questions Concerning Greater Promotion of Foreign Trade and Increasing Foreign Exchange Income*, the State Council, August 13, 1979

After the reform, however, the import and export of many commodities were transferred to foreign trade enterprises under local governments and industrial ministries. Given the overvalued official exchange rates and central government's reluctance to provide increasingd subsidies, many foreign trade firms found it difficult to engage in exporting. For example, in 1979, the national average cost of earning one unit of foreign exchange was ¥2.40 per dollar while the official exchange rate remained at around ¥1.50 per dollar. That means that the costs of many exportable goods could not be covered at the official exchange rate.[10]

In view of with this development, in August 1979 the State Council decided to introduce the RMB internal Settlement Rate (ISR) effective from January 1, 1981.[11] The ISR was fixed at ¥2.80 per dollar based on the national average cost of earning one unit of foreign exchange calculated for 1978 at ¥2.53 per dollar, plus a 10 percent profit margin for the export sector. The ISR would cover trade-related foreign exchange transactions. At the same time, the authorities also retained the more appreciated official exchange rate to cover mainly non-trade foreign exchange transactions such as overseas Chinese remittance, tourism, expenditure by foreign diplomatic and business representative offices in China and Chinese diplomatic and business offices abroad, foreign investments, and foreign trade transportation and insurance charges. The adjustments to the official exchange rate were determined by the changes in the value of a basket of currencies.

The adoption of this dual exchange rate system was, to a great extent, a compromise of a debate over the appropriate level of the RMB exchange rate among the Chinese policymakers and economists in the late 1970s. Typical to this debate, one group suggested that the prevailing official exchange rate had underestimated the value of the RMB and demanded revaluation of the official RMB exchange rate. This was based on the premise that prices of essential consumer goods and services in China were substantially lower than those in the developed economies. For example, in December 1978, the foreign exchange authorities and the Bank of China (BOC) compared the relative prices of basic consumer goods and services of Beijing with New York, London, Tokyo and Hong Kong. The calculated results showed that the RMB exchange rate should fall in the range between ¥ 0.35 per dollar and ¥0.76 per dollar (see Table 2).

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[10] The national average cost of earning one unit of foreign exchange had been an important indicator for the trade authorities in China as well as in other former socialist countries. It was calculated from the following formula:

$$e_x = \sum\left[\frac{P_{xi}}{P_{xi}^{*}}\frac{\omega i}{\sum\omega_i}\right]$$

where e_x=national average cost of earning one unit of foreign exchange, P_{xi}=domestic wholesale price for commodity i, Pxi=foreign currency F.O.B price for commodity i, ω_i=total export value of commodity i. The national average cost of earning one unit of foreign exchange measures the domestic currency cost of earning one unit of foreign exchange. The authorities usually compared this indicator with the existing exchange rate to determine the profitability of exports and thus consequent adjustments to the official exchange rate.

[11] *Decision on Several Questions Concerning Greater Promotion of Foreign Trade and Increasing Foreign Exchange Income*, the State Council, August 13, 1979

Comparing the results in Table 2 with the official exchange rate of ¥1.684 per dollar at the time of calculation, it is quite obvious that the official exchange rate had substantially underestimated the purchasing power of the RMB. In practice, those who held this "undervalued" view were mainly concerned about the difference between the official exchange rate and the purchasing power parity for a narrow basket of goods and services that mostly favored foreign tourists, and domestic recipients of overseas remittances. Therefore, they want to reduce the gap between the two through revaluation of the official exchange rate.

Table 2 Relative Prices of Beijing and Major World Cities (1978)

	Number of goods and services compared	Relative price	Relative price (¥ per US dollar)
Beijing-New York	64	¥0.76/US dollar	¥0.76/dollar
Beijing-London	71	¥1.1965/pound	¥0.62/dollar
Beijing-Tokyo	74	¥170/100,000Yen	¥0.35/dollar
Beijing-Hong Kong	61	¥0.1142/HK dollar	¥0.5493/dollar

Source: Qin in Wu and Chen (1989, p. 52-53).

In contrast to the "undervalued" view, another group of people believed that the official exchange rate was overvalued. The argument was mainly based on the fact at the existing official exchange rate many exporters were not able to cover their export costs. For example, in 1978 unprofitable exports accounted for 66 percent of China's total exports (Wu and Chen 1989, p. 47). In essence, people who held this view were mainly concerned about the situation in the export sector and growing export subsidies. To promote the expansion of exports, they insisted that the official RMB exchange rate be devalued.

Faced with the two conflicting views, the authorities decided to choose the middle of the road by adopting a dual exchange rate system, with the official exchange rate taking care of non-trade foreign exchange transactions and the more depreciated ISR taking care of the trade-related foreign exchange transactions. It should be noted that when the dual exchange rates were introduced, the authorities maintained the official exchange rate at the constant level instead of following the "undervalued" view to revalue it; partly because it was expected that foreign tourists and domestic remittees would oppose such an adjustment. More importantly, it was generally believed that as domestic economic reform went on, prices of domestic consumer goods and services would rise (Wu and Chen, 1989, p. 33-35 and p. 61-62).

While a formal discussion of the above debate is beyond the scope of this paper, it is interesting to note that among the many reasons advanced by the Chinese policymakers and economists to explain why the official RMB exchange rate was undervalued for basic consumer goods and services, they had ignored one general phenomenon that the relative prices of non-tradables in the low-income countries are generally lower than those that prevail in the high-income countries, even under conditions of free trade. Consequently, for low-income countries, the PPP exchange rate calculated by a composite of goods and services including tradables and non-tradables will surely be more appreciated than the market exchange rate. [12] If references had been made to this academic achievement in the decision-making process, a lot of the wasteful debates about the appropriate level of the RMB exchange rate before the eve of the foreign exchange rate reform could have been avoided and in such an event the policy directions would have taken a different turn.

The introduction of the ISR is an important event in the development of China's exchange rate policies. For over twenty years of central planning, the RMB exchange rate had been fixed despite of changes in economic variables. Though there were rather frequent adjustments to the official exchange rates in the early 1970s, these adjustments were mainly based on the changes in the value of a basket of currencies that the RMB exchange rate had been pegged and unrelated to the changes of domestic economic variables. The introduction of the ISR was the first attempt to adjust the RMB exchange rate according to the structure of domestic prices since 1953. However, with serious price distortions that resulted from a long-term planning control, one could not expect that the ISR should have been set at an equilibrium level. But in practice, it had indeed alleviated the extent of the RMB overvaluation and, in contrast to the more appreciated official exchange rate, it represented the direction of the future RMB exchange rate adjustments.

However, the positive impact of the ISR should not be overestimated. The 1979 decentralization of foreign trade management was administrative in nature as it was mainly directed at delegating the foreign trade management power to local governments and industrial ministries. Though the reform intended to increase the number of foreign trade enterprises the decision-making power and finance were still controlled by the state.[13] Furthermore, during the period when the ISR was adopted, the foreign exchange market was non-existent in China. Consequently, the ISR, once introduced, would soon lose its meaning because it was not able to adjust according to the forces of supply and demand in the market. In sum, the ISR played only a very limited role in regulating the country's import and export activities (Lin 1997, p. 20-21).

The co-existence of the official exchange rate and the ISR had caused a number of problems as generally observed in any dual exchange rate system. For example, enterprises and government institutions had tried to use various excuses so that the ISR should be applied when they sold foreign exchange to the bank and used the official rate when they bought foreign exchange from the bank (Wu and Chen 1989, p. 71). The system had greatly discriminated against the overseas Chinese remittances and inflows of foreign investment as the more appreciated official exchange rate was applied to them. For the period when the ISR was in effect between 1981 and 1984, the oversea Chinese

[12] The most well-known argument for the question was proposed by Balassa (1961, 1964) and further proved by the studies carried out by the United Nations International Comparison Program. See Falvey and Gemmell (1991), and Summers and Heston (1991).

[13] In the 1979 reform, only Guangdong, Fujian, the Import and Export Corporation of the First Ministry of Machinery Building and the Shanghai Toys Manufacturing Corporation were allowed to have some degree of financial independence subject to fulfilling the requirements in the export contract signed with the central government. For other regions and foreign trade corporations, only the responsibility to export was decentralized while the finance was still controlled by the central government. See Zheng (1983).

remittances through official channels dropped drastically from a normal level of $600 to $700 million annually in the late 1970s to $171 million in 1985 (Lardy 1992a, p. 68). Instead, the overseas Chinese tried to escape the price discrimination by bringing consumer durables through the customs while visiting China or converting their hard currency in a flourishing black market.

Apart from adversely impacting on foreign investors, there was also a problem of management confusions at the banks. For example, according to the official definition, foreign investments fell under the non-trade category and thus the official exchange rate should be applied. But if foreign investors were to enter into China with physical equipment, apparently, this should fall under the trade category and the ISR should be applied. Once foreign investors started their operations in China, they might purchase local raw materials and pay salaries to their employees. According to the definition, the first should be a trade-related activity while the latter should be a non-trade-related activity. In practice, it had proved extremely difficult for banks to distinguish all these different types of transactions and apply differential rates to them (Wu and Chen 1989, p.43-46). As a result, the dual exchange rate system adopted in 1981 had contradicted the policy that emphasized increased inflows of foreign investment.[14]

The ISR was practiced from 1981 to 1984. During this period, domestic prices had increased steadily. In 1983, the national average cost of earning one unit of foreign exchange rose above the ISR. Consequently, government subsidies became an essential factor to support the export growth. In 1984, the Chinese economy became overheated. All these changes had contributed to the devaluation of the official exchange rate close to the ISR. In addition, after the ISR was adopted China had been under the international pressure to abandon the practice. For example, the U.S. government had accused China of using the ISR to subsidize its exports. The IMF had several times persuaded the Chinese authorities to give up the ISR. In December 1984, the People's Bank of China (PBC) together with other 7 government ministries announced the decision to abolish the ISR by January 1, 1985 and official exchange rate was devalued to the level of ¥2.80 per dollar.

III. Developments of Foreign Exchange Swap Market

China launched the second round of external reform in 1984.[15] To encourage inflows of foreign investment, the government decided to open up major coastal areas to foreign investment in April.[16] As far as foreign trade is concerned, the State Council approved the

[14] To offset the adverse effects of the dual exchange rates on foreign investments, the Chinese authorities had to introduce a series of other distortionary policies including preferential tax rates, permission to retain 100 percent foreign exchange earnings and the right to hold foreign exchange accounts with banks. As a result, these favorable polices turned against domestic firms.

[15] See *Decision on the Economic Reforms*, the Third Plenum of the Twelfth Congress of the Communist Party of China, October 20 1984.

[16] In April 1984, the Chinese government announced its decision to open fourteen major cities along the east coast and Hainan Island to foreign investments. At the end of the year, it decided to extend the opening-up areas to Yangtze River Delta, Pearl River Delta and Liaodong and Shangdong Peninsulas.

reform proposals submitted by the Ministry of Foreign Trade and Economic Cooperation (MOFTEC) in September. The proposals included: separating government function from enterprise management; granting foreign trade enterprises with management autonomy and allowing them to be financially independent; promoting foreign trade agency system; encouraging the integration of foreign trade firms with manufacturing and hi-tech firms; and combining the mandatory foreign trade planning with guidance planning.

A fundamental difference between the 1979 reform and 1984 reform was that the 1979 reform was mainly intended to decentralize foreign trade management by empowering local governments and industrial ministries power, whereas the 1984 reform sought to make foreign trade enterprises independent of government controls.[17] If the proposed reform package was fully implemented, fundamental changes in China's foreign trade sector could have taken place (Sung 1994). However, in practice, it was not the case.

In the last quarter of 1984, the Chinese economy became overheated. At the end of the year, the trade balance turned into a deficit of $1.27 billion and in 1985 the deficit reached a record level of $14.9 billion. Foreign exchange reserves dwindled from $8.9 billion in 1983 to $2.6 billion in 1985. With the rising domestic inflation and widening trade deficit, the authorities adopted a number of administrative measures to control the domestic demand and imports. In the process of imposing these controls, the authorities also re-centralized a lot of delegated powers from local governments and enterprises (Lardy 1992b).

Faced with the domestic inflation, widening trade deficit and dwindling foreign exchange reserves, the foreign exchange authorities started to gradually devalue the official RMB exchange rate in the later half of 1985. On August 21, the exchange rate was devalued from ¥2.80 per dollar to ¥2.90 per dollar. On October 3, another devaluation brought the RMB exchange rate to ¥3.00 per dollar. On October 21, the RMB exchange rate was devalued again to ¥3.10 per dollar and on October 30, to ¥3.2 per dollar. The ¥3.2 exchange rate remained stable until July 5 1986 when the authorities announced another major devaluation to bring the official exchange rate to ¥3.71 per

[17] In Chinese history, the relationship between the center and the local had been an important issue for the political stability of the country. After the establishment of the People's Republic 1949, the Chinese leaders soon realized that the highly centralized Soviet model had suppressed the initiatives of local authorities. In 1956, Mao Zedong wrote *Ten Major Relationships* in which he emphasized the importance of giving more autonomy to local governments. During the "Great Leap Forward" in 1958, the center decentralized substantially to the local with a view to enhance their initiatives. However, this attempt had caused chaos to the economy. Later on, the center re-centralized the economic power and the official emphasis shifted to the central control over the economy and discipline of the state planning. In fact, the economic reforms launched by Deng Xiaoping in 1979 represented another attempt of decentralization. The problem with China's recent experience of decentralizing to the local government is that while the central control over the economy had declined, the local control had increased. In a market economy the economic power should be decentralized to the firm level, and there is no fundamental difference between the central control over the economy and the local control. In addition, decentralizing the economic power to the local governments had encouraged localism, which has intensified China's historical problem of the center and the local. See Sung (1994).

dollar[18]. After this major devaluation, the RMB official exchange rate remained unchanged for over three years until December 1989.

The frequent devaluations that were initiated between August 1985 and July 1986 did not resolve the issue of the overvaluation of the official exchange rate. In fact, the period throughout the 1980s and early 1990s had witnessed constant struggle by the policymakers in dealing with the overvalued official exchange rate. On the one hand, the process that was intended to fix the administrative exchange rate was generally a political compromise between different interest groups. As a result, overvaluation was inevitable. On the other hand, to offset the adverse effects of distorted official exchange rates and to promote export growth, the government introduced various compensating measures: such as direct export subsidies and other indirect measures including foreign exchange retention scheme and swap markets, export tax rebates and low-interest export loans-a case which illustrates that once a distortion is introduced into the economy, more distortionary measures may be required to offset the adverse effects of this first distortion. The introduction of these compensating measures had greatly complicated China's foreign trade system and furthermore, in future rounds of reform, considerable efforts would have to be made to eliminate the distortions.

After the exchange rate unification in January 1985, the policymakers had emphasized export subsidies to promote exports. However, as the volume of exports expanded, growing subsidies became a heavy burden to the government budget. Consequently, to sustain the momentum of rapid export growth, a new mechanism had to be devised to supersede the role of export subsidies. This was an important reason why the foreign exchange swap market had become an increasingly important factor in China's foreign exchange system after the mid 1980s to early 1990s.

The foreign exchange swap market really developed out of the foreign exchange retention system. In the 1979 trade reform, the authorities decided to allow domestic enterprises to retain a portion of their foreign exchange earned from trade and non-trade activities. The foreign exchange earnings were generally retained in the form of quotas, which represented holder's entitlements to foreign exchange. The holders of the retention quotas could purchase back from the government the foreign exchange equivalent to the amount represented by the quota at the official exchange rate. The retained foreign exchange earnings could be used to import goods and services approved by the state policy.[19]

The foreign exchange retention system adopted in 1979 was highly complicated and corresponded to a multiple exchange rate arrangement. Based on the sources of foreign exchange income, types of commodities exported and geographical locations, the government would assign differential retention ratios to local governments and foreign trade enterprises. The formula for calculating the retention of foreign exchange earnings

[18] After 1987, China's foreign exchange rate was classified as a more flexible arrangement (other managed float) by the International Monetary Fund.

[19] See Mehra and others (1996, p. 57) and Lardy (1992a, p. 51-57) for a more detailed description of the foreign exchange retention system.

from export activities was based on the amount of exportable goods procured in the domestic market in the previous year. However, if foreign exchange earnings were in excess of the previous year's procurement and if export commodities were under central management, the retention ratio was 20 percent, this would be divided equally among the central ministry responsible for the production and export of the product, the local government and foreign trade enterprises. For those products under local management, the retention ratio was 40 percent; for exports relying on imported material inputs, the retention ratio was 15 percent of net foreign exchange earnings; and for fees received from processing and assembly of foreign components, the retention ratio was 30 percent.[20]

The adoption of the foreign exchange retention scheme was an important step to break through the foreign exchange control. Under the old planning system, exporters were required to surrender all their foreign exchange earnings to the government; and the demand for foreign exchange to import goods and services was met by the allocation through the state planning process. In contrast, the foreign exchange retention scheme partly exempted exporters from the obligation to surrender their foreign exchange earnings to the government. More importantly, this policy change had opened up another channel to allocate foreign exchange resources outside the central control system. As the retention ratios steadily increased, China's emphasis on import controls gradually moved away from direct foreign exchange planning to trade restrictions such as tariffs, quotas and import licenses.

In October 1980, the BOC established a trading system for foreign exchange retention quotas in several major cities including Guangzhou, Beijing, Shanghai and Tianjin. Holders of retention quotas were permitted to transfer their quotas to other domestic enterprises authorized to buy them. The price for the transfer was fixed at the ISR of ¥2.80 per dollar with a band of ±10 percent. The BOC acted as a broker for the transactions and levied commissions of 0.1-0.3 percent on both sides of the transactions. However, as the transfer price was close to the ISR, it was generally more profitable for the foreign exchange holders to import directly the goods that were in short supply in the domestic market. Consequently, the volume of transactions was very small and it was only around $1 billion between 1980 and 1985.[21]

In 1985, a new policy was adopted to base the foreign exchange retention ratios on actual foreign exchange earnings instead of on the amount of export procurement in the previous year. For general export commodities, the retention ratio was 25 percent. A higher ratio of 50 percent was granted to electronic and machinery exports, while exports of military related products enjoyed 100 percent retention. In addition, preferential

[20] *Decision on Several Questions Concerning Greater Promotion of Foreign Trade and Increasing Foreign Exchange Income*, the State Council, August 13, 1979. Lardy (1992a) contains a more detailed description of the 1979 retention scheme.

[21] During the first three years of the foreign exchange swap business from 1980 to 1984, the official exchange rate was between 1.5-2.0 *Yuan* per dollar as compared with ISR of ¥2.80 per dollar. Consequently, the foreign exchange readjustment business was especially attractive to firms with retained foreign exchange earnings from non-trade sources.

retention ratios were applied to special regions. For example, the minority regions could receive a rate of 50 percent of foreign exchange retention.[22]

The late 1985 to 1986 saw major changes in the official policy toward the foreign exchange swap business. With the overheating of the economy after 1984, the black market rate considerably exceeded the swap rate. As a result, the foreign exchange swap business came to a virtual halt. In December 1985, the authorities decided to terminate the foreign exchange swap business at the BOC. A new foreign exchange swap center was created in Shenzhen SEZ with a more flexible approach to prices.[23] Later on, other special economic zones were allowed to establish similar foreign exchange swap centers. In 1986, the State Council increased the price of retention quotas to ¥1 per dollar and allowed the SEZs and Hainan Island to remove the price control.[24] In the same year, the State Council transferred the function of monitoring the foreign exchange swap market from the BOC to the SAFE.

In addition to foreign trade reform, liberalization of FDI inflows emerged as another driving force for the exchange reforms after the mid 1980s. For a long time, foreign exchange balancing requirements had been one of the most serious problems for FFEs operating in China.[25] To encourage more capital inflows, the State Council allowed FFEs to swap actual foreign exchange among themselves in 1986, whereas in the SEZs, FFEs were even allowed to swap with domestic institutions.[26] The swap price was determined by buyers and sellers through negotiations. With the rapid development of foreign exchange swap market in 1986, a dual exchange rate system of the official exchange rate and swap market rate reemerged in China. The swap market became an increasingly important tool to offset the distortionary effects of the overvalued official exchange rate and ensured the dynamism of the export sector.

The compulsory foreign exchange surrendering to the government and foreign exchange retention scheme were the basis of this dual exchange rate system. The operations of the official market relied mainly on the amount of foreign exchange surrendered by export enterprises at the overvalued official exchange rate, while the swap market functioned on the basis of the foreign exchange retained by domestic exporters and FFEs. The whole system had important welfare effects. As domestic enterprises had to surrender a portion of their foreign exchange earnings at the overvalued official exchange rate, it constituted a direct tax on exports. The system also imposed an indirect

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[22] See *Notice on Foreign Exchange Retention Arrangements for Export Commodities*, issued by the Ministry of Foreign Economic Relations and Trade, the State Planning Commission and the State Administration of Foreign Exchange, and approved by the State Council, March 29, 1985.

[23] While a more flexible approach to prices were adopted in Shenzhen, the authorities still kept tight controls on the sources and demand for foreign exchange in the swap market. Later on, this approach to prices was extended to other swap centers.

[24] The price of retention quotas was equal to the premium of the swap market price above the official exchange rate.

[25] For a description of foreign exchange balancing requirements and the effects on the FFEs, see Tseng, Wanda and others (1994), Frisbie and Brecher (1993), Davis and Yi (1992), and Frisbie (1988).

[26] *Regulations Regarding the Foreign Exchange Balancing of Joint-Venture Enterprises in China*, the State Council, January 15 1986, and *Provisions for the Encouragement of Foreign Investments,* the State Council, October, 11 1986.

tax on imports through the more depreciated swap market exchange rate. As the government generally allocated the surrendered foreign exchange to favored domestic importers at the official exchange rate, those importers would derive net gains of this dual exchange rate arrangement. Through foreign exchange retention, domestic exporters, local governments and FFEs would also receive part of the benefits generated by the system as the more depreciated swap market rate was applied to the transfer of their retained foreign exchange earnings. The net losers in this dual exchange rate arrangement were those importers who had no access to the cheap foreign exchange allocations from the government and were forced to acquire the foreign exchange needed for their imports at the swap market rate.[27]

Despite of the rapid developments of the foreign exchange swap market after 1986, price controls, restrictions on access to swap markets and the relatively low retention ratios continued to pose as obstacles to the growth of this market. In addition, as local governments attempted to restrict the inter-regional flows of foreign exchange funds, the foreign exchange swap market remained fragmented with wide differentials in rates across regions. Further development of the swap market, to a large extent, would depend on the removal of these constraints.

In 1988, China launched another round of foreign trade reform.[28] Key elements of this reform included adopting foreign trade contract responsibility system and experimenting management autonomy for firms in three foreign trade sectors: light industrial products, textiles and garments.[29] At the same time, policies were adopted to complement the foreign trade reform. As the government's total export subsidies were frozen at 1987 level, a system of export tax rebate was fully introduced as a compensating policy. In addition, the foreign exchange retention ratios were increased. For foreign exchange earnings within the contracted targets, the 25 percent retention ratio remained unchanged. But for earnings in excess of the contracted targets, 20 percent would be surrendered to the center, while the remaining 80 percent would be kept by local governments and foreign trade enterprises. A 70 percent retention ratio was applied to firms in the sectors of light industrial products, textiles and garments that were carrying out reform experiments. To encourage the exports of electronic and machinery products, a more favorable retention ratio was granted. For the exports of those products that exceeded the contracted targets, retention of 100 percent of foreign exchange earnings was allowed.

[27] For detailed analysis of the welfare effects of this dual exchange rate system, see Martin (1991), World Bank (1993) and Lin (1997, p. 60-64).

[28] See *Notice on Approval of the Reform Proposal Submitted by the Ministry of Foreign Economic Relations and Trade*, the State Council, September 26, 1987, and *Decision on Several Questions of Accelerating and Deepening the Foreign Trade Reform*, the State Council, February 1988.

[29] With the contract responsibility system, local governments and major foreign trade corporations would sign a three-year contract with the central government for three targets: foreign exchange earnings from exports, amount of foreign exchange surrendered to the center and export loss control. The central government would provide export subsidies only for those firms that had fulfilled the three targets. But the total amount of export subsidies for the country as a whole was frozen at 1987 level (12 billion *Yuan*).

After March 1988, all provinces were allowed to establish foreign exchange swap centers.[30] At the same time, a decision was made to establish a national swap center in Beijing to handle foreign exchange transactions among industrial ministries and various locals. They authorities also allowed FFEs to swap with domestic firms. Also in 1988, the SAFE began to issue periodically a "priority list" for the use of foreign exchange purchased from the swap market to guide decisions on the approval of firms' access to the swap market. In July 1989, trading of foreign exchange remittances by overseas Chinese and Hong Kong and Macao compatriots was permitted in the foreign exchange swap market.[31]

The increase in the price of retention quotas to ¥1 per dollar in 1986 had only temporarily stimulated the swap market. Later on, as domestic inflation rose, the swap market soon became dull again. In contrast to the price control for domestic firms, there were basically no restrictions on prices in the market for FFEs in SEZs. The differential treatments to the determination of the swap market price had led domestic firms to demand the removal of price control. Consequently, the authorities liberalized the swap market price in March 1988, but at the same time a price ceiling of $5.70 per dollar was imposed.

The higher retention ratios, the removal of price control and the expanded supply of foreign exchange had greatly stimulated the development of the foreign exchange swap market. By the end of 1988, about 90 foreign exchange swap centers were established across the country and the volume of their transactions increased from $4.7 billion in 1987 to $63 billion in 1988, and to $86 billion in 1989. Unfortunately, however, when the measures to improve the functioning of the swap market were implemented, China's macroeconomic environment worsened and the swap market experienced its first turbulence.

In the beginning of 1988, the price reform had fueled the domestic inflation. By the end of April 1988, the rate of inflation rose to 27 percent.[32] In the second half of the year, the trade balance became deteriorated. In 1988, the total trade deficit reached $7.75 billion, an increase of 106 percent over the previous year. With accelerated inflation, the national average cost earning one unit of foreign exchange rose to ¥4.60 per dollar, while the official exchange rate still remained at the 1986 level of ¥3.72 per dollar. The swap market rate had been sensitive to the worsening macroeconomic environment. In January 1988, the average swap market rate rose beyond the ceiling price of ¥5.70 per dollar to ¥5.73 per dollar. In July, it continued to rise to ¥6.80 per dollar, with a premium of 83 percent over the official exchange rate of ¥3.72 per dollar.

[30] *Notice on Regulations for the Foreign exchange Adjustment Business*, the PBC, February 9, 1988.
[31] *Interim Rules for the Trading of Foreign Exchange Remittances by Overseas Chinese and Hong Kong and Macao Compatriots*, SAFE, July 11, 1989.
[32] Faced with the serious inflation, the Chinese reformers openly insisted on continuing the price reform. Consequently, the public reacted with inflationary expectations. In August and September 1988, consumers rushed to the banks to withdraw their deposits and buy whatever goods they could think of as store of value.

At the third Plenum of the Thirteenth Party Congress held in September 1988, the authorities decided to control the run-away economy. However, with the decentralization of the economic power to local governments and enterprises, the center's control over the economy had weakened substantially. Consequently, the austerity measures taken by the central policymakers had no significant impact on the overheated economy and the macroeconomic situation continued to deteriorate. While the swap market rate showed a temporary drop to ¥6.40 per dollar in October 1988, it started to rise again at the beginning of 1989 to the highest level of ¥7.2 per dollar.

After the "June 4" 1989, the authorities adopted the most severe austerity measures to control the economy. Administrative controls on imports were tightened. Domestic credits were cut down drastically and interest rates were raised. Mandatory orders were used to scale down domestic fixed capital investments. This time, the policy was very effective. The rate of inflation fell back quickly and trade deficit shrank from $7.8 billion in 1988 to $6.6 billion in 1989. In 1990, China's trade balance turned into a surplus. In the meantime, dramatic changes had occurred to the exchange rates. In the fourth quarter of 1989, the swap market rate dropped below ¥6 per dollar. In the second half of 1990, the swap market generated an excess supply of foreign exchange and the Chinese rarely experienced such a situation as they were so used to foreign exchange shortage for very long time. Before the end of March 1992, the swap market rate had remained below the level of ¥6 per dollar.

As part of the austerity program, the authorities adopted two major devaluations to the official RMB exchange rate. On December 16,1989, the RMB was devalued by 21.2 percent with the official exchange rate increasing from ¥3.70 per dollar to ¥4.72 per dollar. The second major devaluation was adopted on November 17, 1990 to bring the official exchange rate to ¥5.22 per dollar. Following the appreciation of the swap market rate and devaluation of the official exchange rate, the spread between the two rates gradually narrowed. There was a time at the end of 1990 that the swap market rate appreciated to ¥5.4 per dollar while the official rate was ¥5.2 per dollar. The difference was only 0.2 *Yuan* (Lardy 1992b).

During this period, the black market exchange rate also dropped markedly from around ¥8 per dollar in 1988 to close to the swap market rate. It was mostly due to that fact the authorities exercised control over official overseas trips and reduced the quantity of duty-free consumer durables allowed to bring into the country by the Chinese citizens who had been on short trips to foreign countries. In addition, in China's border trade with Russia and other less developed neighbors during this period, the RMB was beginning to exhibit many of the characteristics of a convertible currency.

Because of these developments, people began to see the hope of making the RMB a convertible currency and the confidence of the Chinese authorities to achieve this goal in the near future was also greatly strengthened. After 1991, the Chinese monetary authorities, on different occasions, repeatedly announced that a major goal of the China's financial reform was to make the RMB a convertible currency. In 1993, while negotiating China's entry into the GATT, the Chinese government made a formal commitment to the international community that by the year 200 it would achieve the RMB current account convertibility.

The dramatic changes that took place in the swap market exchange rate during the period from late 1980s to early 1990s had profound policy implications. For the first time after the inception of reform, existence of a close link between changes in money supply and changes in exchange rate clearly revealed. As domestic credits were tightened in the second half of 1989, an excess demand for money was observed in the domestic money market and this was reflected in the shortage of liquidity in the RMB. Consequently, the market forces brought strong pressure on the swap market exchange rate leading to appreciation of the RMB. In general, the swap market rate had emerged as an important market signal reflecting the changes in macroeconomic environments.

In 1991, China started the third round of foreign trade reform.[33] The core of this reform was to abolish export subsidies.[34] The authorities also took measures to streamline the foreign exchange retention scheme. A uniform retention scheme based on major categories of commodities was adopted in March 1991.[35] In the case of petroleum which was under the central government's direct administration, local governments and foreign trade enterprises were allowed to retain 4 percent of the foreign exchange earned and surrender the remaining 96 percent to the center. For export of machinery, electronic and technology-intensive products, a ratio of 5 percent and 65 percent was applied respectively to local governments and foreign trade enterprises, while the central government would receive the other 30 percent at the swap market rate. For exporters of general commodities, the retention ratio was 40 percent, while remaining 60 percent would be distributed between the central government and the relevant local government or the responsible industrial ministry. According to the formula, the exporting firm should surrender 20 percent to the center and 10 percent to the local government or the responsible ministry, and the state would have the right to purchase from the exporting firm the remaining 30 percent at the swap market rate. Finally, exports based on the imported inputs such as raw materials were entitled a ratio of 90 percent and, Tibet and exporters of military-related products would enjoy 100 percent retention.

At the end of 1991, domestic individuals were officially allowed to participate in the swap market transactions and restrictions on the sale of foreign exchange by domestic individuals in the swap market were removed. Thus, after December 1991 there were virtually no restrictions on the sale of foreign exchange in the swap market. After 1991, measures were also taken, mainly on experimental basis, to improve the functioning of the swap market. For many years, the "quota retention" practice had been a controversial issue. As the retained foreign exchange was actually kept in an account held by the

[33] See *Decision on Several Questions Concerning Further Reforming and Improving the Foreign Trade System*, the State Council, December 9, 1990.
[34] The fading away of export subsidies had gone through a gradual process. When foreign trade contract responsibility was adopted in the 1988 reform, export subsidies were frozen at the 1987 level. The reform experiments carried out by the three foreign trade sectors of light industrial products, arts and handcrafts and garments had shown that foreign trade enterprises could survive without export subsidies.
[35] *Interim Regulations for Surrendering Foreign Exchange Earnings to the Center and Procedures for Approving Retained Foreign Exchange Quotas*, the SAFE, March 13, 1991.

central government with the BOC, from time to time the central authorities exercised its power to use that portion of the foreign exchange belonging to the holders of retention quotas for other purposes. Consequently, when firms and local governments presented their foreign exchange quotas to the bank for the actual foreign exchange, their requests were often delayed or not met.[36] This practice by the central government, to some extent, had undermined the credibility of the quota retention system. In 1991, the foreign exchange authorities started to experiment with a system of allowing cash retention in Fujian. Zhejiang and Shanghai. In addition, measures such as joint quotations, increasing the number of open markets and encouraging the flow of foreign exchange funds across regions were taken to reduce the regional price differentials.

In general, after 1991, the volume of foreign exchange transactions in the swap market grew markedly and the number of foreign exchange swap centers proliferated. In 1991, the total volume of transactions was $18.1 billion, an increase of 51 percent over the previous year. In 1992, it reached $25 billion (see Table 3). By 1993, there were 108 foreign exchange swap centers across the country. After the abolition of export subsidies, the swap market exchange rate together with the export tax rebate and mandatory and non-mandatory export targets had become the main policy instruments to sustain the rapid growth of exports. The continuous adjustments to the retention ratios had significantly increased the role of the swap market rate in settling the foreign exchange transactions. Before 1991 the swap market rate was applied to about 50 percent of China's foreign exchange transactions. But after 1991, the share rose to 80 percent (Lardy 1992a). Thus, the foundation for the future exchange rate unification was already established.

Starting from April 1991, the authorities adopted a gradualist approach to adjust the official RMB exchange rate by small increments at frequent intervals with the objective of eventually unifying the official rate with the swap rate. However, as domestic inflation started to climb up at the same time, the actual result appeared to be the official exchange rate chasing after the swap market rate. Until March 1992, the difference between the two rates was still around ¥0.26 per dollar to ¥ 0.50 per dollar.

At the third Plenum of the Fourteenth Party Congress held in early 1992, China modified its reform model as establishing a socialist market economy. In June, the State Council decided to open up 24 inland and 14 border cities to foreign investments. In an effort to bid for the GATT membership, China undertook a series of measures to liberalize its import regime. On January 1, China announced a major tariff reduction on 225 items. On December 31, China committed to a second tariff reduction, covering 3,371 items. In April, China abolished the import surcharge that was imposed to control the trade deficit in 1986. In October, the import substitution list for 1,700 import items was eliminated.

[36] The problem had been termed as "One girl married to two men" in Chinese publications.

Table 3 Volume of Transactions in the Exchange Swap Market

Year	Transaction Volume (Billion US$)	Share in Total Imports and Exports (%)	
		Export	Import
1981-1985	1.0	-	-
1986	2.4	-	-
1987	4.2	10.6	9.7
1988	6.3	13.2	11.3
1989	8.6	16.3	14.5
1990	13.6	19.3	22.5
1991	20.5	25.2	28.4
1992	25.1	29.6	31.1
1993	22.8	24.8	21.8

Source: The SAFE.

The investment and trade liberalization initiatives coupled with the acceleration of domestic economic growth had stimulated the demand for foreign exchange.[37] Beginning in late March 1992, the swap market rate started to depreciate. In April, the quota price rose to ¥0.55 per dollar as compared with the average price of ¥0.50 per dollar for 1991 and the actual swap market rate climbed to ¥6.05 per dollar. To stabilize the market, the authorities started to restrict access to the swap market in late April.[38] However, this policy did not have any significant effect on the market. In June, the swap market rate continued to rise to ¥6.36 per dollar. In early July, the SAFE modified the "priority" list for the use of foreign exchange purchased in the swap market, which was just issued in April and substantially reduced the number of items on the list.[39] Furthermore, in an effort to stabilize the market psychology, the foreign exchange officials repeatedly proclaimed through the media that the exchange rate depreciations did not reflect the economic fundamentals. Again these efforts had failed to prevent the depreciation of the swap market rate.

Beginning in 1993, as China's macroeconomic environment worsened, the depreciation accelerated. In February, the swap market rate reached ¥8.34 per dollar. In response to this sharp depreciation, the foreign exchange authorities imposed a cap on the swap market rate at about ¥8.2 per dollar (Mehra and others 1996). As a result, transactions in the swap market dropped sharply and most deals were struck outside in the black market (Khor 1993). In June, the authorities had to lift the cap to revive the market. As a result, the transaction volume quickly picked up and the demand released by the removal of the price cap had pushed the swap rate beyond ¥11 per dollar. Until June 1993, the swap rate stayed around ¥10 per dollar while the official exchange rate

[37] See Khor (1993) for a discussion about the causes of the fluctuations of the swap market exchange rate between 1992 and 1993.
[38] See *Notice on Strictly Enforcing the Procedures to Approve Purchase of Foreign Exchange in the Swap Market,* the SAFE, April 30, 1992.
[39] *Urgent Notice on Modifying the Directory Lists for the Use of the Swap Market Foreign Exchange,* the SAFE, July 6, 1992.

remained between ¥5.7 per dollar and ¥5.8 per dollar. The premium exceeded nearly 80 percent.

In July, the authorities took drastic measures to cool down the economy and restore the financial order. At the same time, the central bank began to intervene in the Shanghai swap center. Campaigns were also launched throughout the country to crack down on black markets activities. As a result, the swap market rate fell back below ¥9 per dollar in the middle of July and subsequently stabilized at ¥8.8 per dollar.

Despite the fact that the swap rate rose by about 90 percent from April 1992 to June 1993, the 1993 had been a difficult year for China's exports, especially in the first half of the year when exports were growing at a negative rate.[40] Consequently, pressure on the foreign retention arrangement mounted. Domestic firms pointed to the discriminatory nature of the scheme that had put them in a disadvantageous position relative to FFEs, because they had to surrender 30 percent of their foreign exchange income to the government, which was equivalent to a kind of tax on them, while the retention ratio for foreign investors was 100 percent. They called for the removal of the 30 percent surrendering requirement.

IV. Exchange Rate Unification and Achieving the Current Account Convertibility

In November 1993, the Third Plenum of the Fourteenth Party Congress formalized the reform model of establishing a socialist market economy. At the beginning of 1994, China adopted a most comprehensive reform package covering major aspects of the economy including taxation, banking, foreign exchange, foreign trade, investment and state-owned enterprises.[41] In fact, these measures, to a great extent, paved the way for China's eventual accession to the WTO in November 2001.

On the foreign exchange side, the most comprehensive reform of the official exchange rate was adopted after the inception of economic reform in 1979. The RMB official and swap market rates were unified at the swap market rate of ¥8.7 per dollar that prevailed at the end of 1993. The foreign exchange retention scheme was abolished and the foreign exchange swap business for domestic enterprises terminated accordingly.[42] Under the new system, domestic enterprises were required to sell all their foreign exchange receipts

[40] While the growth rate of exports was 8 percent in 1993, it was a low figure relative to most of the years after the reform. In addition, the growth of exports in 1993 was mostly contributed by the foreign-invested enterprises and the barter trade. See Shi Guangsheng, "Adapting to New Situation and Studying New Problems', in *Chinese Foreign Trade Development and Reform*, (China International Trade Association, 1994).

[41] *Decision of the Party Central Committee on Issues Concerning the Establishment of Socialist Market Economy*, the Third Plenum of the Fourteenth Party Congress, November 14, 1993. The guiding principle for the exchange reform stated in the *Decision* was to adopt a market-based managed floating exchange system, establish a uniform foreign exchange market and gradually achieve the convertibility of the RMB.

[42] The outstanding retention quotas could be converted at the official exchange rate prevailing on December 31 until the end of 1994. According to an unofficial estimate by the SAFE, the outstanding retention quotas amounted to 8 to 9 billion dollars. Also see Chen (1998), and Tseng and others (1994).

to designated foreign exchange banks.[43] In accordance with this change, the foreign exchange control on imports was abolished. Domestic importers could purchase foreign exchange needed for imports through designated foreign exchange banks upon presentation of import contracts and valid commercial documents.[44] Purchases and sales of foreign exchange through designated foreign exchange banks would take place at the reference exchange rate published daily by the PBC within a maximum spread of ±0.25 percent. After July 1, 1996, the maximum spread for the U.S. dollar was reduced to ±0.15 percent while the spread for the Hong Kong dollar and the Japanese Yen was widened to ±1 percent.[45]

In an effort to establish a single, unified national foreign exchange market, the model of interbank foreign exchange market was adopted to replace the swap market. On April 4, 1994, the interbank market-China Foreign Exchange Trading System (CFETS) based in Shanghai became operational. The previous foreign exchange swap centers were transformed into the local branches of the CFETS and were linked to the Shanghai center through a nationally integrated electronic network. Dealers in the market do not trade directly with each other. Instead, all trading is carried out through computer terminals connected to the CFETS with bids and offers automatically matched by the computer system.[46] Initially, the U.S. dollar and the Hong Kong dollar were the only two currencies traded in the interbank market. In March 1995, trading in the Japanese Yen was allowed. In April 2002, Euro became another currency traded in the market. So far, trading in U.S. dollars has accounted for over 90 percent of total transactions. At the start of trading each day, the PBC announces a reference rate against the U.S. dollar, the Hong Kong dollar, the Japanese Yen and Euro on the basis of a transaction-weighted average of the selling and buying rates at the close of the previous day's trading in the interbank market.[47] Movements of the RMB against the U.S. dollar is limited to ±0.3 percent of the reference rate while the floating band for the Hong Kong dollar, the Japanese Yen and Euro is ±1.0 percent of the reference rate.

Unlike the exchange swap market where transactions were dominated by non-financial institutions, participants of the interbank transactions include foreign exchange banks, non-bank financial institutions approved by the SAFE and foreign-funded banks. In addition, the central bank is also an active participant of the interbank market trading. A membership system was adopted for the interbank market trading and the CFETS is

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[43] However, foreign currency accounts may be maintained for foreign exchange receipts involving FEEs; Chinese residents and foreign nationals; foreign direct investment; temporary receipts and pending payments for international transactions; income collected or payment to be effected on behalf a third party; donations for use abroad as provided in donation agreement; foreign embassies and consulates, representative offices of international organizations and affiliates of foreign judicial persons, resident persons and foreign expatriates; and approved capital account transactions.

[44] For a description of the rules regarding the foreign exchange purchase for the import of goods and services subject to trade restrictions and trade-related activities. See Tseng and others (1994).

[45] See *Several Questions Concerning the Foreign Exchange Market After Allowing FEEs to Buy and Sell Foreign Exchange through Designated Banks*, the SAFE, June 28, 1996.

[46] For more information about the technical aspects of the trading system and its drawbacks, see Mehra and others (1996).

[47] The RMB exchange rates against other major currencies are calculated on the basis of exchange rates on international currency markets.

authorized to approve applications for membership. Members can choose from spot trading in the trading halls of the CFETS's various centers and remote trading at locations outside the centers through the system's computer network.[48] The total membership varies from year to year and the record level was registered in 1998 with a total of 442 members. At the end of February 2002, there were 309 members in the interbank trading system, including 170 foreign-funded financial institutions, 57 domestic-funded financial institutions and 82 traders on behalf of their customers.

Designated foreign exchange banks should rely on their own local currency resources for transactions with their customers. The central bank would, based on the total capital assets of banks and turnover of transactions, approve each individual bank's foreign exchange working balance. However, an upper limit was imposed for the whole market. In the 1994 reform, the total working capital for the market was limited to $900 million. By 1996, the limit was raised $5 billion. If a bank's foreign exchange holdings exceed the approved working balance, the excess amount should be sold to other banks or the central bank.

In the 1994 exchange reform, FFEs were still required to comply with the foreign exchange balancing requirements. In contrast to domestic enterprises that were allowed to purchase and sell foreign exchange through banks, FFEs had to continue to use the swap market to balance their foreign exchange needs and dealing through banks was prohibited. Transactions in the swap market would take place at the interbank market exchange rate and FFEs had to obtain approval from the SAFE for each transaction. While FFEs were still allowed to retain 100 percent of their foreign exchange receipts and hold foreign exchange accounts in local banks, new rules issued on April 1, 1994 required that FFEs should obtain a "Foreign Exchange Registration Certificate" from the SAFE before opening a foreign exchange account. As different rules were applied to domestic and foreign firms in the foreign exchange arrangement, there had been two market segments after the exchange reform in 1994. However, as foreign exchange trading for FFEs was integrated with trading in the interbank market, and as there had been an excess supply of foreign exchange in the swap market due to large inflows of foreign capital, the market segmentation did not cause any serious problems to the operations of the foreign exchange market.

The interbank market is expected to provide a price forming mechanism for the RMB exchange rate. However, this role has been constrained by several limitations of the market. Concerned with possible market instabilities, the foreign exchange authorities have imposed a floating band of ±0.3 percent of the reference rate published by the PBC for interbank transactions and a maximum spread of ±0.15 percent limit for retail transactions. These narrow bands for exchange rate fluctuations, however, have adversely affected the development of an active foreign exchange market.

[48] There are two kinds of members in the interbank bank: traders buying and selling on their own account and traders buying and selling foreign exchange on behalf of their customers. The former is also allowed to buy and sell foreign exchange on behalf of their customers.

It appears that a high proportion of foreign exchange transactions had concentrated at the retail level. For example, from April 4, 1994 when the interbank market started its operation to April 4, 1995, the total turnover in the interbank market was 56.8 billion U.S. dollars, representing only 48 percent of all imports for the same period. In 2001, the total turnover was $75.33 billion, accounting for approximately 37 percent of total imports (see Table 4).

Table 4 Annual Turnover of the Interbank Foreign Exchange Market (Billion USD)

Year	Amount	Imports	% of total Imports
1994	40.77*	115.61	35.27
1995	72.00	132.08	54.51
1996	62.80	138.83	45.24
1997	69.70	142.37	48.96
1998	52.00	140.24	37.08
1999	31.46	165.70	18.99
2000	42.18	225.10	18.74
2001	75.33	203.70	36.98

*The 1994 figure is from April to the end of December.
Source: China Foreign Exchange Trading Center

As for the market structure, there has been a high degree of monopoly. The BOC has controlled bulk of the retail foreign exchange transactions. In the interbank bank, around 70 percent of foreign exchange have been sold by the BOC. On the contrary, partly due to the intention to increase foreign exchange reserves and partly due to the pressure to absorb the excess foreign exchange supply and prevent the exchange rate appreciation, the PBC has become the largest buyer of foreign exchange, accounting for about 60-70 percent of the total buying.[49] As a result, the interbank market has exhibited a strong characteristic of "bilateral monopoly". Table 5 below provides some major characteristics of China's interbank market.

In 1993, China had a trade deficit of $12.2 billion. After the exchange rate unification in 1994, the trade balance turned into a surplus of $5.4billion. At the same time, the net inflow of foreign capital amounted to $32.6 billion. The surplus both on the trade and capital accounts resulted in an overall balance of payments surplus of $30.5 billion.

[49] See Wu (2001, p.79). It should be mentioned that after the 1994 reform, an excess supply of foreign exchange developed in the foreign exchange market. However, the working balance requirement imposed by the central bank had forced the foreign exchange banks to sell the balance to the central bank. In theory, the government had three choices to eliminate the excess supply in the foreign exchange market, namely, increasing the ratio of the working balance, relaxing the controls on foreign exchange demand or intervening in the foreign exchange market to buy up the excess supply. Relaxation of restrictions on foreign exchange demand would alleviate the pressure of the RMB appreciation and promote the development of the foreign exchange market while the central bank intervention could increase the official foreign exchange reserves, but would hinder the development of the interbank foreign exchanged market and stimulate domestic inflation. The Chinese authorities in practice opted for the last one.

Reflected in the foreign exchange market was an excess supply of foreign currency. Consequently, while the domestic inflation rate was rather high, the RMB exchange rate started to appreciate steadily after late April 1994. By the end of the year, the RMB exchange rate fell from ¥8.7 per dollar to ¥8.44 per dollar. To prevent a sharp appreciation of the exchange rate, the PBC actively intervened in the foreign exchange market, leading to a rapid build-up of the country's foreign exchange reserves. From January 1994 to January 1996, the official foreign exchange reserves nearly tripled, rising from $26.4 billion to $77.9 billion.[50] In May 1995, the RMB exchange rate began to stabilize around ¥8.3 per dollar until the end of 1996 when it started to move slowly toward ¥8.28 per dollar.

Table 5 Operational Characteristics of China's Interbank Market

Dealers	In early 2002, there were 309 including 170 foreign-funded financial institutions, 57 domestic-funded financial institutions and 82 traders on behalf of their customers
Broker	No.
Market monopoly	There is a high degree of monopoly by the PBC and the BOC. Typically, the market exhibits a characteristic of "bilateral monopoly" with the BOC accounting for about 70 percent of total sales while the PBC taking up about 70 percent of total buying
Surrendering Requirements	There are no surrendering requirements for FFEs. All their current account proceeds are allowed to keep in an account held with foreign exchange banks, but the maximum amount of foreign exchange in the account is subject to SAFE's limit control; For DFEs, 25 percent of export proceeds or total amount of foreign exchange spending in the previous year as approved by the SAFE may be held in a foreign exchange account while the remaining part of thet proceeds must be surrendered to commercial banks.
Exchange Rate Determination	Market-determined with strong government intervention.
Central Bank Intervention	Absorbing excess supply of foreign exchange to increase reserves and stabilize the exchange rate within a narrow moving band.
Working Balance	The total working balance for the market is limited to $5 billion. The PBC approves each bank's working balance.
Trading Time	9:00AM-11:00AM, Monday-Friday.
Trading Currencies	USD, Hong Kong dollar, Japanese Yen and Euro.

The foreign exchange reform gained a new momentum in 1996. In March, the SAFE started to experiment a system of allowing FFEs to purchase and sell foreign exchange through designated foreign exchange banks in Jiangsu, Shanghai, Shenzhen and Dalian.

[50] From 1994 to 1995, the central bank intervention in the foreign exchange market had also increased the inflationary pressure. However, with underdeveloped domestic financial markets, open market operations were not adopted to sterilize the increased money supply which resulted from the foreign exchange market intervention. Instead, direct measures were taken to sterilize the foreign exchange market interventions including withdrawing re-lending credits by the central bank and cutting down special-project loans.

The experiment included three aspects. First, FFEs were allowed to purchase and sell foreign exchange for current account transactions with designated foreign exchange banks.[51] Second, foreign-funded banks in the four trial areas were granted the status of designated foreign exchange banks and could engage in buying and selling of foreign exchange with FFEs. Third, in the trial areas, FFEs were required to open two foreign exchange accounts with banks, a settlement account for current account transactions and a special account for capital account transactions. To prevent excessive holdings of foreign exchange by FFEs, the SAFE placed a ceiling on the amount of foreign exchange held in the settlement account based on total paid-in capital and the amount of foreign exchange needed for the purpose of current account transactions and the monetary policy stance of the central bank. According to the rule, any foreign exchange holdings held in excess of the approved ceiling must be surrendered to designated foreign exchange banks.

On January 29, 1996, the State Council promulgated new regulations for foreign exchange administration and replaced the interim regulations issued in 1980. The new regulations were drafted in line with the official policy to strengthen the control on capital account transactions while pursuing the RMB current account convertibility. The main purpose was to officially endorse the achievements of earlier exchange reforms.

After a review of the experiments in Jiangsu, Shanghai, Shenzhen and Dalian in June 1996, the PBC modified the regulations that dealt with surrendering, sale and payment of foreign exchange as per the reform of 1994 and the new system was extended nationwide on July 1, 1996. Also in 1996, the foreign exchange authorities began to take selective measures to relax the control on foreign exchange transactions by private individuals. Beginning on July 1, individuals traveling abroad were allowed to exchange \$500 to \$1000 of foreign exchange with designated foreign exchange banks. On September 10, this limit was raised to \$2000.[52] Chinese citizens who migrate abroad could convert all their income including asset income into foreign exchange. In addition, domestic and foreign residents were allowed to carry up to ¥6000 out of the country.[53] In addition, measures were taken to reduce trade barriers in 1996. In April 1996, import tariffs on 4994 items were reduced, accounting for over 83 percent of China's total tariff items. As a result, China's average tariff level was brought down from 35.9 percent to 23 percent. In the meantime, 170 import licenses and quotas were abolished.

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[51] The authorities offered two tracks for foreign investors to choose at their discretion. They could either transact with the foreign exchange banks or continue to trade in the swap market.

[52] Before 1996, purchases of foreign exchange by domestic individuals were tightly controlled. A main exchange policy adopted for domestic individuals was to allow them to keep their foreign exchange in a bank account. According the interim foreign exchange regulations issued 1980, except permitted by the State, domestic individuals must surrender their foreign exchange income to the BOC. In practice, this compulsory surrendering requirement had forced most of the foreign exchange held by individuals into the black market. After 1985, the authorities allowed domestic individuals to open foreign exchange accounts with banks and imposed few restriction on the withdrawal. As a result, foreign exchange savings by domestic individuals increased markedly.

[53] See Shang (2000, p. 511) for details of the policy change.

On November 27, 1996, in a letter to the IMF, the PBC governor, Mr. Dai Xianglong announced that China would accept the obligations under Article VIII of the Fund's Articles of Agreement beginning on December 1, 1996 and thus, three years ahead of the officially announced timetable, China attained the goal of the current account convertibility. In that year, China had accumulated over $100 billion of foreign exchange reserves and had $42 billion surplus on the balance of payments.

V. The Asian Financial Crisis and the Road to Full Convertibility

After the liberalization of current international transactions in December 1996, China continued to maintain tight controls on the capital account. As differential treatments of the current and capital accounts were likely to encourage activities of using current account transactions to evade restrictions on capital account-related payments, the authorities were quick to respond to this situation. In July 1997, the SAFE promulgated a regulation aimed at closing off the venues of evasion.[54]

In fact, illegal capital flights have long been a major concern by the foreign exchange authorities. According to Gunter (1996), the amount of China's capital flights between 1984 and 1994 ranged from $50 billion to $75 billion. In another estimate by Song (1999), the figure exceeded $20 billion each year after 1993, and in 1997 it was over $40 billion. While these estimates may not accurately reflect the real situation, few have doubts about the large size of capital flight in China. Over the years, the authorities have been battling hard to control the flights of capital. After the exchange rate unification in 1994, a system for verification of export receipts first adopted in 1991 was greatly strengthened. Under this system, each exporter is required to provide ex post the relevant documents including verification form issued by the SAFE, customs clearance form and proof of export proceeds received by its bank. The SAFE required the documentation to prove that the amount of foreign exchange actually received is consistent with the value of the export contracts. Also in 1994, a system for verification of import payments was adopted. It was first operated by designated foreign exchange banks. In March 1997, the responsibility of verification was transferred to the SAFE.

The compulsory surrendering system is another major attempt to force firms to repatriate their foreign exchange earnings. However, even at the very beginning of its adoption in 1994, the arrangement was controversial. Particularly, domestic firms complained that they were not equally treated with FFEs as the latter could retain 100 percent of their foreign exchange income. In October 1997, the PBC began to relax the surrendering requirements for domestic firms. Specifically, they were allowed to establish foreign exchange accounts with designated foreign exchange banks for current international transactions. However, the policy was more restrictive to domestic firms than to foreign ventures. To open a foreign exchange account, domestic trading firms should maintain a total registered capital in excess of ¥10 million and annual export/import volume in excess of $30 million. For producing enterprises with foreign trade rights, the minimum requirement for the registered capital is ¥30 million and annual

[54] See *Provisions for Sales of Current Account Foreign Exchange Proceeds*, the SAFE, July 25, 1997.

export/import volume must exceed $10 million. The maximum amount of foreign exchange held in the account must not exceed 15 percent the firm's annual imports and exports. According to the regulation, foreign exchange held in the account must be generated from current account income and could only be used for payments on the current account or officially approved capital account transactions. In April 2000, the ratio was raised to 30 percent.

In early 1998, the Asian Financial crisis began to have a significant impact on the Chinese economy. Exports turned sluggish and the growth rate was only 0.6 percent for the whole year. In addition to the depressed foreign demand, the economy was also under the pressure of internal deflation. After October 1997, domestic consumer prices had grown at a negative rate. Despite substantial currency devaluations by the crisis-stricken neighbors, the Chinese authorities made the commitment to maintain the stability of the RMB exchange rate.

In the second half of 1998, the Chinese authorities began to adopt a policy mix of fiscal expansion and monetary easing, aimed at boosting the domestic demand. The core of this policy mix was the fiscal expansion. In 1998, the government issued ¥270 billion special treasury bonds embarked on raising the capital/asset ratios of state-owned commercial banks to above 8 percent minimum recommended by the Basle Committee. In September, additional ¥100 billion treasury bonds were issued to support the infrastructure development. In total, a record level of ¥650 billion treasury bonds was issued in 1998. In August 1999, another ¥60 billion additional treasury bonds were issued. The PBC announced three interest rate cuts in 1998. Also measures were taken to promote exports. For instance, from August 1998 to July 1999, the government offered three increases in export tax rebate rates, while commercial banks were urged by the PBC to provide incentive loans to support domestic exporters.[55]

Uncertainties about the value of the RMB and the poor prospect of the Chinese economy in the midst of the Asian financial crisis had stimulated unauthorized capital outflows. In the first half of 1998, despite of continuous FDI inflows and trade surplus, the country's $14.4 billion foreign exchange reserves barely increased. For the whole year, foreign exchange reserves had only increased by $5.5 billion as compared with $32 billion in 1997, with the "errors and omissions" in the balance of payments amounting to $16.6 billion. Noticeably from the second half of 1998, the authorities began to tighten the supervision of foreign exchange transactions and raised the requirements for conversion and remittance of foreign exchange. Numerous notices and regulations on foreign exchange supervision were issued and unprecedented nation-wide campaigns were launched to enhance the enforcement of existing foreign exchange regulations and crack down on illegal foreign exchange activities of fraud, unauthorized capital outflows and black market dealings. Early redemptions of hard currency loans were banned. The SAFE and its local branch offices stopped approving outward direct investment. Banks were not allowed to buy and transfer foreign currencies in cities other than their own locations. As it was suspected that firms might use the foreign exchange swap centers for

[55] *Advice on Providing Greater Support for the Development of International Economic Relations and Trade*, the PBC, July 19, 1998.

capital flight purpose, the PBC decided to close down the foreign exchange swap centers for FFEs on December 1, 1998. Table 7 in the Appendix lists the major notices and regulations issued from June 1998 to March 1999 when the Asian financial crisis had a substantial impact on the Chinese economy.

The slow growth of foreign exchange reserves in 1998 had alerted the foreign exchange authorities. Beginning in March 1999, they introduced a system for evaluating exporters' performance in meeting foreign exchange surrendering requirements. Those with low surrendering rates may face differential treatments in bank loans and even risk losing their export licenses. In June 1999, the SAFE ordered the BOC to halt RMB remittances from accounts held by foreign banks at the BOC. Furthermore, the BOC was asked to close all offshore RMB accounts. As a result, offshore RMB could no longer be converted into foreign currencies or remitted to China.

These measures, while necessary for defending the pegged exchange rate, had also caused significant negative effects. Foreign investors complained openly about the disruptions and delays that these foreign exchange control measures had caused to normal foreign exchange transactions. For example, in a survey conducted by US-China Business Council, 80 percent of the member companied surveyed reported that the new foreign exchange control measures had adversely affected them in a significant manner. [56]

During the Asian financial crisis, the RMB exchange rate remained highly stable. It slightly appreciated from ¥8.28 per dollar in August 1997 to ¥8.27 per dollar at the end of the year and then remained at this level until the date of this writing. In April 1999, the International Monetary Fund began to classify China's exchange rate regime as the conventional pegged arrangement.

As the effects of the Asian financial crisis diminished, the authorities began to take steps to ease foreign exchange restrictions. In August 1999, FFEs were allowed to use foreign exchange settlement accounts as time deposits. In addition, they were also allowed to obtain the RMB loans backed by foreign exchange collateral. In September 2001, the SAFE lifted some of the restrictions on capital account transactions imposed during the Asian financial crisis. [57] Specifically, the ban on the purchase of foreign exchange for repayment of past overdue debts was removed. The restrictions on purchasing foreign exchange for advance repayment of domestic foreign currency debts, foreign currency debts that are re-lent domestically and external debts were relaxed. The SAFE and its local branch offices resumed the procedure to approve outward direct investment.

In December 2001, several steps were taken to improve the existing foreign exchange system. First, a more generous foreign exchange policy was adopted toward individuals

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[56] See "Impact of Recent Foreign Exchange Circulars on US Companies", The US-China Business Council, December 1998.

[57] *Notice on Amendments to Some Provisions for the Purchase of Foreign Exchange under the Capital Account*, the PBC and the SAFE, September 18, 2001.

paying for their own study abroad.[58] According to the previous regulation, individuals paying for their own study abroad could only convert their first year tuition and living expenses into foreign exchange, whereas the new rule permits them to convert all tuition and living expenses needed throughout the period of their study. In addition, designated foreign exchange banks were given the authority to sell up to US$20,000 directly to eligible customers.[59]

Second, the foreign exchange authorities decided to lower the standards for domestic firms to establish foreign exchange accounts.[60] The previous minimum registered capital requirement was abandoned. The new rule requires that domestic enterprises applying for a foreign exchange account must have foreign trade rights and demonstrate their annual foreign exchange earnings in excess of $2 million and annual foreign exchange spending in excess of $200,000. The approved balance in the account is equivalent to 25% of export proceeds in the previous year or the total amount of foreign exchange spending in the previous year. The lower value of the two would be used by the authorities to assign the maximum balance in the account. Small- and medium-sized firms seem to have responded positively to this policy change. According to the SAFE, as many as 568 new firms in the country opened foreign exchange accounts with designated banks during December 1, 2001 to January 10, 2002.

Third, in an effort to discourage black market trading in the US dollars, the SAFE adjusted banks' buying and selling rates for the dollar. The maximum spread between the dollar spot buying and selling rates was widened from 0.15 percent of the reference rate announced by the PBC to 0.16 percent, and the difference between the buying rate for cash transactions and the median of the spot buying and selling rates was narrowed from 2.5 percent to 1.0 percent. [61]

In addition to the relaxation of exchange controls, the authorities took further steps to liberalize the foreign trade regime during the same period. In January 2001, as part of its efforts to join the WTO, China reduced its average tariffs by 6.6 percent to bring the average level of its import tariffs to 15.3 percent. In the meantime, MOFTEC announced a decision to remove quotas, licenses and other special administrative barriers for 21 types electronic and machinery products. In January 2002, China committed to another round of tariff reduction from form 15.3 percent to 12 percent before the end of the year.

Despite all these efforts, China's capital account still remained tightly controlled. So far no timetable has been announced for the liberalization of the capital account. The existing controls on the capital account may reflect the concerns by the authorities regarding possible capital flight, underdeveloped domestic financial infrastructure, macroeconomic instability arising from the volatility of short-term capital movements,

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[58] See *Notice on Foreign Exchange Policies toward Individuals paying their own Study Abroad,* the SAFE, November 5, 2001.

[59] For amounts over US$20,000, application to and approval by the local SAFE office are required.

[60] *Notice on Adjustments to the System for Verification of Export Proceeds and Management of Foreign Exchange Account*, November 12, 2001, the SAFE.

[61] *Notice on Questions Concerning Foreign Exchange Cash Management*, November 21, 2001, the PBC.

protecting domestic financial institutions from foreign competition and/or potential external debt crisis. Table 8 in the Appendix illustrates the current status of China's restrictions on international capital transactions and foreign exchange accounts.

In general, China's capital account liberalization focused initially on encouraging inflows of foreign direct investment with the removal of most of restrictions. This strategy has enabled the economy to gain access to modern technological and managerial resources, and strengthen the competitiveness of the real sector. However, China maintains tight controls on other components of the capital account including outward direct investment, capital and money market transactions and external borrowing. The restrictions vary mainly from prior approval and authorization to quantitative limits and in many cases, outright prohibition. Domestic capital and money market are most tightly controlled as inflows and outflows of foreign investment into and out of these two markets are prohibited. At this time, foreign capital could enter the domestic capital market only through purchase of domestically issued B shares or securities issued by Chinese institutions in overseas markets. External borrowing is controlled by the state plan that provides for directions to the utilization of foreign capital and only authorized financial institutions are allowed to channel the inflow. In generally, capital outflows tend to be regulated more strictly than inflows. By the end of 2001, the accumulated value of China's capital inflows including FDI, external borrowing and security investments amounted to $600 billion, while the total outflow was only $350 billion.

On November 10, 2001 after nearly fifteen years of negotiations, the WTO's Ministerial Conference approved China's accession to the WTO. In order to meet the requirements of the accession, China has made a series of commitments to substantially liberalize its trade and investment regimes, especially in the areas of agriculture, telecommunications and financial services.[62] Table 9 in the Appendix contains the major commitments undertaken by China to open its financial sector. Noticeably, controls on local currency business have been relaxed considerably and foreign financial institutions are allowed participate in the local security markets. By the end of 2006, the national treatment will be granted to all foreign financial institutions. Though capital account liberalization is not included in China's commitments to the WTO accession, the accelerated trade and investment liberalizations will pose unprecedented challenges to the existing foreign exchange regime.

China has moved to the last frontier of its foreign exchange reform. While the authorities have so far proceeded with determination in further liberalizing the foreign exchange regime, the Asian financial turmoil has alerted them about the high risk of opening up the capital account without sufficient preparations. Consequently, a high degree of consensus has been built among Chinese economists and policymakers that a gradualist approach should be adopted to capital account liberalization. In domestic literature, considerable attention has been given to the preconditions of the RMB capital account convertibility mainly in the fashions of Greene and Isard (1991), and Mathieson and Rojas-Suarenz (1993), which emphasize the importance of prudent fiscal and

[62] See *The Report of the Working Party on the Accession of China*, Doha, 9-13 November 2001, Fourth Session, Ministerial Conference, World Trade Organization.

monetary policy, a market-clearing exchange rate, an adequate level of foreign exchange reserves, a sound financial system and a market-oriented incentive system.[63]

The liberalization of capital account is more complex than that of the current account, as it generally requires a close coordination with domestic financial sector reform and development of financial markets and instruments. Lack of coordination between domestic financial sector and the capital account reforms can create distortions and regulatory incentives for capital movements that are unrelated to the underlying economic conditions, thus risking greater instability in capital movements (Johnston (1997). While China has achieved remarkable progress in the development of its financial institutions, instruments and markets, domestic financial reform is lagging behind the external sector liberalization.[64] In recent years China's financial reforms have shown signs of acceleration. In late 1997, the authorities announced a new initiative of financial reform. The timetable for the reform includes the construction of a modern financial system consisting of institutions, markets and supervisory and regulatory framework that are compatible with the socialist market economies by 2000.

One of the essential issues in the domestic financial reform is the liberalization of interest rates. For a long time, the slow progress of interest rate reform could be partly attributed to the poor performance of the state-owned enterprises. Policymakers have been concerned that liberalization of interest rates would lead to collapse of inefficient SOEs, which in turn would intensify the strain on the banking system. Recently, the authorities have taken encouraging steps to liberalize interest rates. At this time, interest rates on foreign currency deposits, inter-bank loans and treasury bonds have been liberalized. In July 2000, the PBC authorities indicated to remove controls on other interest rates mainly related rural and urban deposits and lending within three years.

Another issue is the weakness of the big four state-owned banks. Currently, the non-performing loans held by the big four banks make up over 20 percent of their outstanding loans. The big four state-owned banks have been playing a dominant role in China's financial sector, accounting for over 90 percent of total bank assets, two-thirds of financial assets and nearly 70 percent of all deposits held by financial institutions (Shang (2000). Despite the last two decades of financial reforms, the big four state-owned banks are still characterized by low competitiveness, inefficiency, decentralized bank structures and government policy interventions. The current poor performance of the state-owned banks may pose a potential threat to the financial stability as China further opens its financial markets to foreign competition and liberalize capital account transactions.

China is facing a formidable task to shape its financial sector for a sustainable capital account liberalization. While the recent financial turmoil in some developing countries has highlighted the importance a fundamentally sound financial system, delaying capital account reforms could also be costly (McKibbin 1998). For an orderly liberalization of the capital account, it is now imperative for policymakers treat capital account

[63] See, e.g., Wu and others (2001), Shang (2000), Jing (1996), and Jiang and others (1999).

[64] For the developments of China's financial reforms see Mehara and others (1996) from 1978 to 1995, and Shang (2000) for the reforms until 1999.

liberalization as an integral part of their overall financial reform program. In addition, China's WTO commitments to allow foreign financial firms to operate directly in the country shall provide a good opportunity to accelerate China's financial reform and the pace of capital account liberalization The increased level of competition and the opportunity to acquire the best practices of international financial institutions will enable Chinese state-owned banks to develop a more sophisticated and more efficient financial system.

VI. Summary and Concluding Remarks

The core of China's foreign exchange reform since 1979 may be viewed as a gradual transformation of exchange allocation mechanism from one that was governed by rigid central planning to one in which market forces play a significant role. The whole reform process is characterized by trade liberalization, initial exchange rate adjustments, exchange market development, easing of restrictions for current international transactions and establishment of capital account control framework. So far, capital account measures have been highly selective and focused mainly on liberalizing inward direct investment. These strategies largely reflect the government's policy emphasis on strengthening the real sector and export capability of the economy.

The exchange reform process has gone through three distinct periods that can be characterized by the adoption of the ISR, introduction of a secondary market mechanism and establishment of a market-orient framework to ensure the current account convertibility. The reform was initially driven by the trade reform that started in 1979. In the absence of foreign exchange market, the authorities first attempted to regulate import and export activities through manipulating an administratively determined official exchange rate. However, in practice, the process of setting an administrative exchange rate was generally a political compromise of conflicting interests. Consequently, overvaluation became inevitable.

The overvalued official exchange rate had induced a good number of compensating arrangements including the ISR, export subsidies, foreign exchange retention, exchange swap market, export tax rebates and low interest loans to exporters. These arrangements had only exerted strong distortionary effects on resource allocations but also inflicted high costs on the economy as resources had to be expended to maintain their functioning and in future reforms, considerable efforts would have to be made to eliminate them.

The initial introduction of market mechanism was unintended by the authorities. With the overvalued official exchange rate in the mid 1980s, the authorities found that the swap market could provide a useful way to help raise the profitability of the export sector, reduce the burden of export subsidies and increase the inflow of foreign investment. As the retention ratios steadily increased and market restrictions reduced, the role of the swap market in allocating foreign exchange resources increased markedly. After 1991, the swap market rate was applied to over 80 percent of China's foreign exchange transactions. While the exchange swap market remained as a highly distorted arrangement, it has been a unique experience and was a major factor in contributing substantially to the increased convertibility of the RMB. The application for the GATT membership had lent considerable impetus to the exchange reform. In 1994, China embarked on a major market-oriented exchange reform in conformity with international norms. Exchange rates were unified and a nationwide unified foreign exchange market was established. In late 1996, China accepted the obligations of Article VIII.

Despite the remarkable progress, China still depends substantially on government controls to ensure the functioning of its exchange system. This may be partly evidenced by the complicated approval procedures for transactions under the capital account, transaction-based verification for import payments and export receipts, annual inspection of foreign exchange accounts, evaluation of exporters' performance in meeting foreign exchange surrendering requirements, active intervention by the central bank in the foreign exchange market, heavy use of circulars for policy clarification and changes, and continuous crackdowns on illegal foreign exchange transactions. China's capital control framework was established after the reform in 1979 (Chen 1998). Throughout the reform period, the authorities have maintained tight controls on the capital account. The asymmetric treatment to current and capital accounts may raise the question of whether controls on capital flows are effective. In recent years, especially during the Asian financial crisis, the authorities have expended considerable amounts of resources to control the capital flight. However, the result has not been encouraging. While a case may be made, at least for China today, that the government may play a useful role to prevent the economy from a major collapse, the day-to-day foreign exchange management has proved highly inefficient.

In November 2001, China concluded its accession to the WTO. As China is committed to opening its domestic financial markets substantially to foreign investment, the WTO accession may become another driving force for the liberalization of its capital control regime. While benefits of opening capital account transactions have been well documented, the process is more complex than that of the current account liberalization as it generally involves coordination with the domestic financial sector reform. At this point, the reform in the domestic financial sector has lagged behind the liberalization of the external sector. The weaknesses of the financial sector and inefficiencies of the major state-owned banks may raise the risk of financial instability if the capital account is to be liberalized. Therefore, it is critical to address the weaknesses of the financial sector in advance of, or in concurrence with capital account liberalization and this may be an important issue for China's future exchange reforms.

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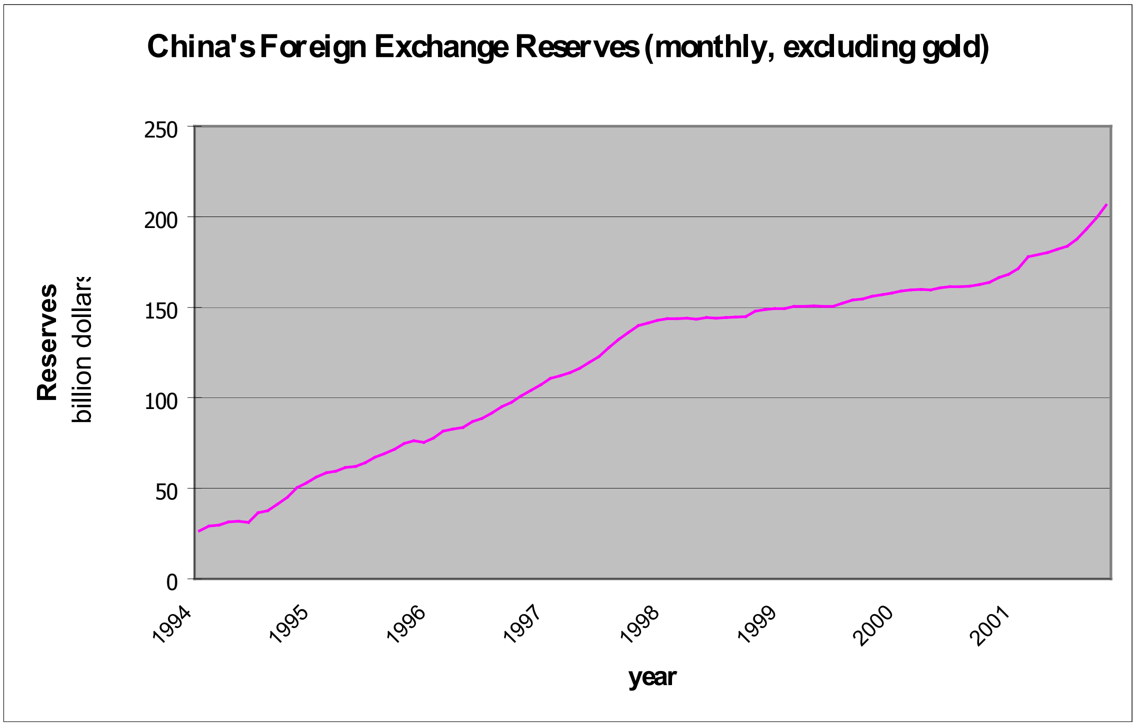
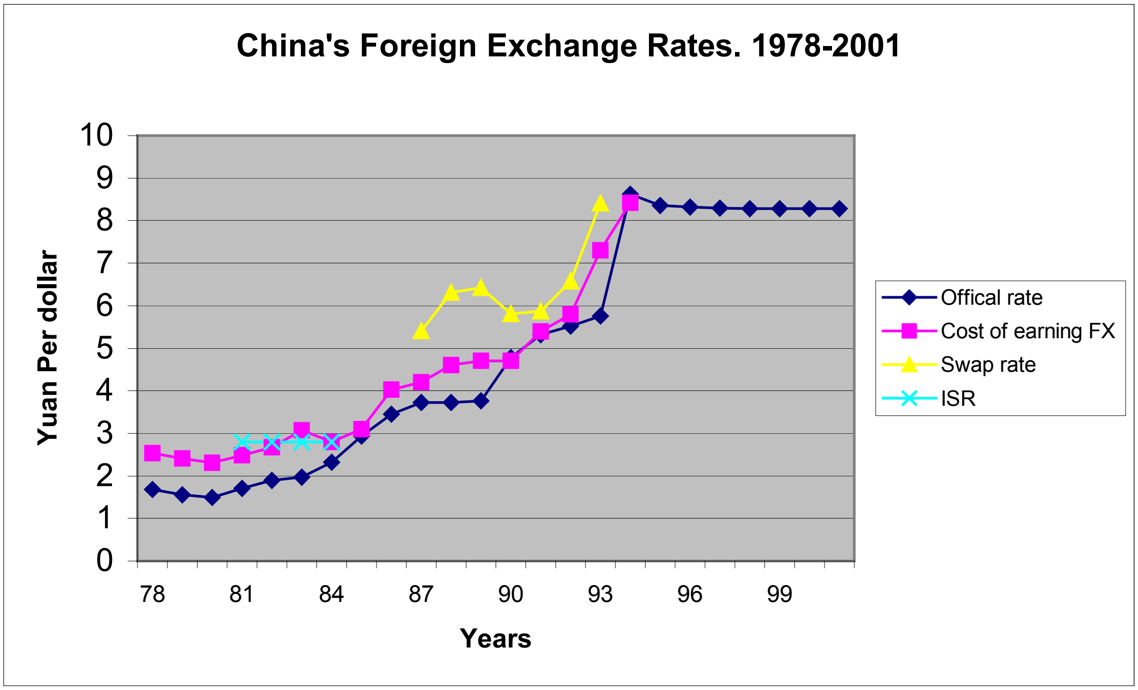
APPENDIX

Figure 1



The figures in the graph show the level of official reserves at the end of the month.
Source: *International Financial Statistics (Monthly)*, various issues, International Monetary Fund.

Figure 2

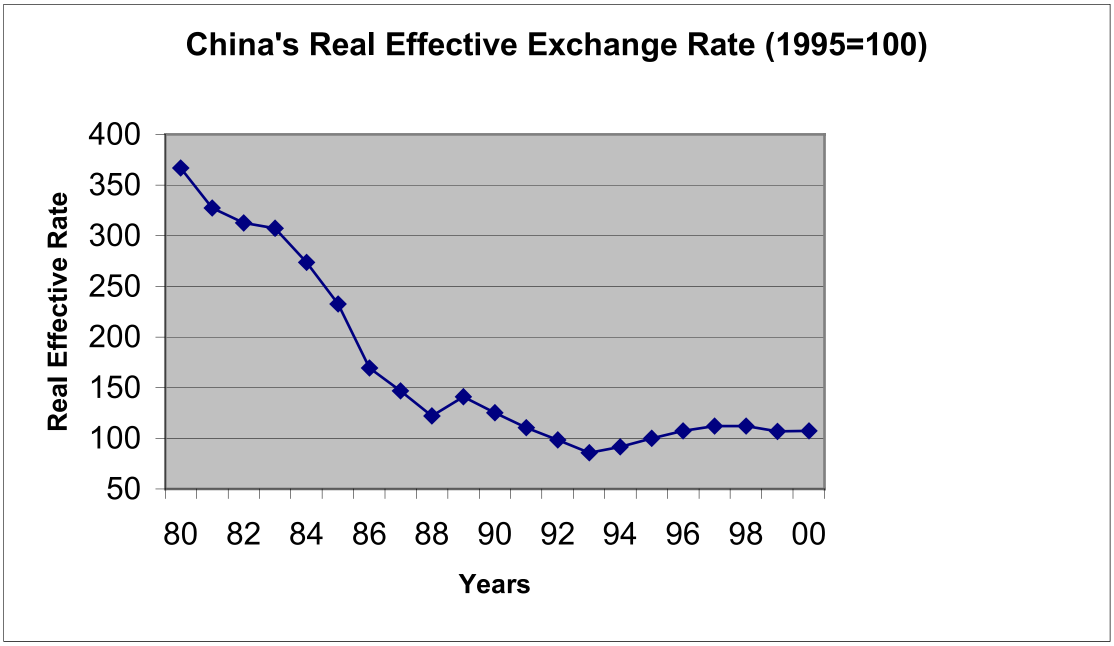


Source: *International Financial Statistics*, International Monetary Fund, and SAFE

Figure 3

Source: *International Financial Statistics*, International Monetary Fund.

Figure 4



Source: *International Financial Statistics*, International Monetary Fund.

Table 7 Notices and Regulations to Strengthen Exchange Controls Issued in the Midst the Asian Financial Crisis (June 1998 to March 1999)

Notices and Regulations Issued	Issuing Date	Issuing Organization(s)
Implementing Rules for Verification of Export Receipts	June 22, 1998	SAFE
Provisions for Verifying the Authenticity of Import Transactions in the System for the Verification of Import Payments	June 22, 1998	SAFE
Notice on Strengthening the Supervision on Import-Related Sale and Payment of Foreign Exchange	June 30, 1998	SAFE
Notice on Several Questions Concerning Cracking Down on Illegal Arbitrage and Falsification of Documents for the Purpose of Obtaining Foreign Exchange	July 1, 1998	PBC, SAFE and MOFTEC
Notice on Requiring Domestic Designated Foreign Exchange Banks to Strengthen Controls over their Overseas Branches	July 16, 1998	SAFE
Notice on Strengthening the Scrutiny and Approval Procedures for the Use of Foreign Exchange by Domestic Individuals	August 10, 1998	SAFE
Notice on Improving the Supervision over Purchase and Sale of Foreign Exchange by Designated Foreign Exchange Banks	August 14, 1998	SAFE
Notice on Forbidding the Purchase of Foreign Exchange for Advance Repayment of Debts.	August 20, 1998	PBC and SAFE
Notice on Several Questions Concerning the Acquisition of Foreign Exchange by Domestic Individuals	August 21, 1998	SAFE
Supplementary Notice on Improving the Supervision over the Purchase and Sale of Foreign Exchange by Designated Foreign Exchange Banks	September 16, 1998	PBC and SAFE
Urgent Notice on Strictly Forbidding the Purchase of Foreign Exchange for Advance Repayment of Debts.	August 31, 1998	SAFE
Notice on Foreign Exchange Management in Bonded Zones	September 1, 1998	SAFE
Provisional Regulations on Foreign Exchange Transactions by Domestic Individuals	September 15, 1998	SAFE
Notice on Several Questions about Strengthening the Management of the Capital Account Transactions.	September 15, 1998	SAFE

Notices and Regulations to Strengthen Exchange Controls Issued During the Asian Financial Crisis (*continued*)

Notices and Regulations Issued	Issuing Date	Issuing Organization(s)
Notice on Further Strengthening the System for Verification of Export Receipts.	September 21, 1998	SAFE
Notice on Several Questions Regarding Outward Transfer of Profits and Dividends by Designated Foreign Exchange Banks	September 22, 1998	SAFE
Notice on Strengthening the Controls over Domestic Financial Institutions' RMB Loans backed up by Foreign Exchange Collateral	September 26, 1998	PBC and SAFE
Notice on Several Questions Regarding the Crack-down on Illegal Arbitrage and Falsification of Documents for the Purpose of Obtaining Foreign Exchange.	October 1, 1998	PBC MOFTEC SAFE
Provisions for Rationalizing the Foreign Trade Agency System.	October 6, 1998	MOFTEC and Customs General Administration
Notice on Rationalizing the Procedures of Double Verification of Customs Clearance Form for Imports.	October 16, 1998	SAFE, Customs General Administration
Notice on Terminating the Foreign Exchange Swap Business.	October 25, 1998	PBC
Provisions for Shipment of Foreign Currency Notes into and out of the Border by Banks.	November 19, 1998	SAFE and Customs General Administration
Notice on Several Questions Concerning Foreign Exchange Management in the Bonded Warehouses	November 30, 1998	SAFE
Decision on Punishing Illegal Acquisition of Foreign Exchange through Fraud, Illegal Evasions and Dealings.	December 29, 1998	National People's Congress
Notice on Several Questions Concerning the Improvement of the Capital Account Management	January 7, 1999	SAFE
Procedures for Evaluating the Performance of Firms in Meeting Foreign Exchange Surrendering Requirements.	March 3, 1999	SAFE
Provisions for the Punishment of Financial Crimes.	February 23, 1999	The State Council

Table 8 Status of Controls on Capital Transactions and Foreign Exchange Accounts

Category	Restrictions
Foreign Direct Investment	
Outward	Approval and registration are required.
Inward	Only registration is required.
Repatriation	No restrictions.
Liquidation	Prior approval is required.
Real Estate Transactions	The same regulations apply as for direct investment.
Sale locally by nonresidents	Prohibited if purchased originally with the RMB.
Capital Market Securities	
Shares	
Purchase locally by nonresidents	Prohibited except for B shares.
Sale or issue locally by nonresidents	Prohibited.
Purchase abroad by residents	Special approval is required.
Sale or issue abroad by residents	Prior approval is required.
Bonds and other debt securities	
Purchase locally by nonresidents	Prohibited.
Sale or issue locally by nonresidents	Prohibited.
Purchase abroad by residents	Authorized institutions are permitted but must use their own funds.
Sale or issue abroad by residents	Approval is required.
Money Market Instruments	
Purchase locally by nonresidents	Prohibited.
Sale or issue locally by nonresidents	Prohibited.
Purchase abroad by residents	Authorized institutions are permitted but must use their own funds.
Sale or Issue abroad by residents	Approval is required.
Collective Investment Securities	
Purchase locally by nonresidents	Prohibited.
Sale or issue locally by nonresidents	Prohibited.
Purchase abroad by residents	Authorized institutions are permitted but must use their own funds.

Sale or issue abroad by residents	Approval is required.
Derivatives and other Instruments	
Purchase locally by nonresidents	Prohibited.
Sale or issue locally by nonresidents	Prohibited.
Purchase abroad by residents	Only authorized financial institutions are permitted.
Sale or issue abroad by residents	Only authorized financial institutions are permitted.
Credit Operations	
Commercial credit	
By residents to nonresidents	Only authorized financial institutions are permitted.
To residents from nonresidents	Only financial institutions are permitted and subject to strong government supervision.

Controls on Capital Transactions and Foreign Exchange Accounts (*continued*)

Category	Restrictions
To FEEs from nonresidents	No restrictions.
Financial credit	The same regulations apply as for commercial credits.
Guarantees, sureties, and financial backup facilities	
By residents to nonresidents	Prior approval and registration are required.
To residents from nonresidents	Permitted if borrowing from overseas.
Deposit Account of	
Nonresidents in foreign exchange	No restrictions.
Nonresidents in local currency	No restrictions.
Residents abroad	Approval is required.
Residents in foreign currency	Permitted, but subject limitations.
Personal Capital Movements	
Loans	
By residents to nonresidents	Prohibited.
To residents from nonresidents	Prohibited.
Gifts, endowments, inheritances and legacies	
By residents to nonresidents	Permitted, but subject different quantitative constraints.
To residents from nonresidents	Control measures are mainly for the purpose of preventing illegal capital inflows.
Transfer of assets	
Transfer abroad by emigrants	Funds under capital items are not permitted.

Table 9 China's WTO Commitments on Financial Service Sector

Banking	Commitments
Foreign Currency Business	Upon accession, foreign financial institutions will be permitted to provide all foreign currency services in China without restrictions as to clients and geographic regions.
Local currency Business	Upon accession, foreign financial institutions will be permitted to provide banking services in Shanghai, Shenzhen and Dalian. The geographic restrictions on local currency business will be gradually phased out within five years after accession. Foreign financial institutions will be permitted to provide services to Chinese enterprises within two years after accession and to all Chinese clients within five years. Foreign financial institutions licensed for local currency business in one region of China may service clients in any other region that has been opened for such business. Business licenses will be issued solely on prudential basis.
Motor Vehicle Financing	Upon accession, foreign non-bank financial institutions will be permitted to provide motor vehicle financing services with all restrictions on market access and national treatment removed. Foreign financial institutions licensed for local currency business will also be permitted to provide motor vehicle financing services.
Financial leasing	Foreign financial leasing corporations will be permitted to provide financial leasing services at the same time as domestic corporations.

Securities	Upon accession, representative offices in China of foreign securities institutions may become special member of all Chinese stock exchanges. Foreign securities institutions may engage directly (without Chinese intermediary) in B share business. Upon accession joint-venture based investment fund companies with foreign investment up to 33% will be allowed and in three years foreign investment shall be increased to 49%. Within three years after accession foreign securities institutions will be permitted to establish joint ventures in underwriting A shares and in underwriting and trading of B and H shares as well as government and corporate debts, and launching of funds.
Insurance	Form of establishment: Foreign non-life insurers will be permitted to establish as a branch or as a joint venture with 51% foreign ownership. Within two years after accession, the restrictions on the form of establishment will be removed. For foreign life insures, 50% foreign ownership in a joint venture will be permitted upon accession. For brokerage for insurance of large commercial risks, brokerage for reinsurance and brokerage for international marine, aviation, and transport insurance, joint venture with foreign equity no more than 50% will be permitted upon accession. Within two years, foreign equity share will be increased to 51%. Within five years after China's accession, wholly foreign owned subsidiary will be permitted. Geographic coverage: Upon accession, foreign life and non-life insures and insurance brokers will be permitted to provide services in Shanghai, Guangzhou, Dalian, Shenzhen and Foshan. The geographic restrictions will be phased out gradually within three years after China's accession. Business Scope: Upon accession, foreign non-life insures will be permitted to provide "master policy" insurance/reinsurance of large commercial risks with no geographic restrictions. Foreign non-life insures will also be permitted to provide insurance of enterprises abroad as well as property insurance, related liability insurance and credit insurance of foreign invested enterprises in China upon accession. Within two years after accession, foreign non-life insures will be permitted to provide the full range of non-life insurance services to both foreign and domestic clients. Foreign insurers are permitted to provide individual insurance to foreigners and Chinese citizens. Within three year, health insurance, group insurance and pension/annuities insurance foreigners and Chinese will be opened up.

Table 10 Chronology of Foreign Exchange Reforms

Year	Reform measures undertaken
1979	• In March, the State Administration of Foreign Exchange (SAFE) was established as part of the Bank of China (BOC) to assume the function of foreign exchange control. • In August, Foreign exchange retention scheme was introduced to allow exporters to retain a portion of their foreign exchange earnings based on the amount of exportable goods procured in the previous year
1980	• In March, the BOC was authorized to issue the "foreign exchange certificate". • In April, China assumed its seat on the Executive Board of the International Monetary Fund. • In October, the BOC established a trading system in major cities to allow domestic enterprises to transfer their retained foreign exchange earnings. The BOC acted as broker. • In December, the State Council promulgated the Interim Regulations for Foreign Exchange Control. This was the first time for China to disclose its foreign exchange regulations after 1949.
1981	• In January, The RMB Internal Settlement Rate (ISR) was adopted. The rate was fixed at ¥2.8 per dollar.
1982	• In August, The SAFE was separated from the BOC and began to function under the leadership of the People's Bank of China (PBC).
1984	• In October, Shenzhen branch of China Industrial and Commercial Bank was allowed to engage in foreign currency business.

1985	• In January, the ISR was discontinued. • In February, the PBC announced that it was authorized to approve and supervise the issue of bonds abroad. • In March, a new formula was adopted to base the foreign exchange retention ratios on actual foreign exchange earnings instead of on the amount of export procurement in the previous year. Domestic individuals were allowed to hold foreign exchange accounts with the BOC. In response to widening trade deficits and dwindling foreign exchange reserves, the State Council imposed strict controls on the use of retained foreign exchange. • In July, the PBC announced that all external borrowing should be subject to its approval and under its supervision. • In December, the foreign exchange swap business at the BOC was terminated and the first foreign exchange swap center was created in Shenzhen Special Economic Zone.
1986	• In February, the State Council decided to transfer the function of monitoring the foreign exchange market from the BOC to the SAFE. To stimulate the development of the swap market, the State Council approved an increase in the price of retention quotas to ¥ 1 per dollar. • At the beginning of the years, the foreign exchange regime was changed from one of pegging to a basket to a system of managed floating. • In October, FFEs in special economic zones and major costal cities were allowed to trade foreign exchange among themselves in the exchange swap markets at rates agreed between buyers and sellers. • With the rapid development of the foreign exchange swap market, a dual exchange rate began to reemerge. • The state-owned specialized banks and 10 other newly established commercial banks were allowed to engage in foreign currency business.
1987	• China's foreign exchange rate system was classified as more flexible other than managed floating arrangement by the IMF. • In September, individuals were allowed to carry ¥200 out of the country.

Chronology of Foreign Exchange Reforms (*continued*)

Year	Reform measures undertaken
1988	• In February, foreign exchange retention ratios were increased to accommodate the foreign trade reform. In this round of reform, foreign trade contract responsibility system was adopted and export subsidies were frozen at 1987 level. The price control on the swap market rate was removed • In March, all provinces were allowed to establish foreign exchange swap centers • At the beginning of the year, the exchange swap market rate began to rise. • FFEs were allowed to trade with domestic firms in the foreign exchange swap market. • In September, the first electronic open bidding system was established in Shanghai foreign exchange swap center.
1989	• The swap market disturbance continued throughout 1988 and the market price reached ¥7.2 per dollar at the beginning of the year. • In July, Trading of foreign exchange remittances by overseas Chinese and, Hong Kong and Macao compatriots were permitted in the foreign exchange swap market. • The government took drastic measures to cool down the economy after the "June 4". As a result, the swap market rate dropped below ¥6 per dollar in the last quarter of the year. In November, the official exchange rate was devalued to ¥5.22 per dollar.
1991	• Early in the year, the government announced the abolishment of export subsidies. A verification system for export receipts was introduced to force firms to repatriate their export

	proceeds.
	• In March, a uniform foreign exchange retention scheme based on major categories of export commodities was adopted. The policy was intended to increase the amount of foreign exchange retained by exporters and streamline the retention system. • Starting from April, a gradualist approach was adopted by the foreign exchange authorities to adjust the official exchange rate by small increments at frequent intervals with an aim to unify the official exchange rate with the swap market rate. However, as domestic price level started to climb up, the actual result appeared to be the official exchange rate chasing after the swap market rate. • In December, individuals were allowed to sell foreign exchange in the swap market. Thus, all restrictions on the sale of foreign exchange in the swap market were removed.
1992	• In late March, as investment and trade liberalization initiatives coupled with the acceleration of domestic demand pushed up the swap market rate to ¥6.5 per dollar, the foreign exchange authorities started to take measures to control the swap market rate. • In July, the SAFE substantially cut down the number of items in the priority list for the use of foreign exchange obtained from the swap market.
1993	• In late February, the SAFE imposed a cap on the swap market rate to control the continuous increase. As a result, transactions in the swap market dropped sharply and most deals were struck outside in the black market. • In May, in the negotiations for the GATT membership, China made a commitment to unifying the exchange rates and establishing a market-based floating exchange rate system within five years. • In June, the SAFE lifted the cap to revive the market and the swap market rate rose beyond ¥11 per dollar. • In July, the swap market rate fell below ¥9 per dollar as a result of government efforts to cool down the economy and restore the financial order.

Chronology of Foreign Exchange Reforms (*continued*)

Year	Reform measures undertaken
1993	• At the third Plenum of the fourteenth Party Congress held in November, the government announced that the goal of foreign exchange reform was establish a market-based, managed exchange rate system with an integrated and standardized foreign exchange market, and with RMB becoming gradually a convertible currency.
1994	• In January, the government launched a major market-oriented foreign exchange reform. Measures include unification of exchange rates, abolishing foreign exchange retention system and government allocation of foreign exchange for imports, termination of swap market for domestic enterprises, and creation of a retail foreign exchange market between banks and customers and an interbank market among banks and authorized financial institutions. • In April, China's interbank foreign exchange market-China Foreign Exchange Center became operational in Shanghai. • In August, a verification system for import payment was introduced.
1995	• On January 1, the "Foreign Exchange Certificate" withdrew from circulation. • In March, Trading in Japanese Yen was allowed together with US dollar and Hong Kong dollar in the interbank market.
1996	• In January, the State Council promulgated new regulations for foreign exchange administration to replace the interim regulations issued in 1980. • In March, the SAFE started to experiment a system of: 1) allowing FFEs to trade current

	account foreign exchange through designated foreign exchange banks; 2) granting foreign-funded banks in trial areas the status of designated foreign exchange banks; and 3) allowing FFEs in trial areas to hold a settlement account for current account transactions and a special account capital account transactions. • In July, foreign exchange reform for FFEs experimented from March was extended nationwide; and individuals traveling abroad were allowed to exchange up to \$500 to \$1000 with designated foreign exchange banks. • In September, the maximum amount of foreign exchange that individuals traveling abroad were allowed to exchange with designated foreign banks was raised to \$2000. • Domestic and foreign residents were allowed to carry up to ¥6000 out of the country. • In October, China's foreign exchange reserves exceeded \$100 billion dollars. • In late November, China accepted the obligations of Article VIII. • In December, an experiment was carried out in Pudong, Shanghai to allow foreign-funded banks to engage in local currency business.
1997	• In January, the State Council modified the regulations for foreign exchange administration issued in January 1996. Forward foreign exchange transactions were allowed. However, as the RMB exchange rate remained more or less fixed, trading was inactive. • In March, SAFE took over the responsibility of verifying the authenticity of import payment from designated foreign exchange banks. • In July, the maximum spread between buying and selling rates quoted by foreign banks for the HK dollar and the Japanese Yen was widened from ±025% of the reference rate to ±1%. Financial institutions were required to obtain license for engaging in local currency and foreign exchange business. • In October, domestic firms were allowed to open foreign exchange accounts for current international transactions. The maximum amount of foreign exchange balance allowed in the account was 15% of firm's annual imports and exports.

Chronology of Foreign Exchange Reforms (*continued*)

Year	Reform measures undertaken
1998	• As the pressure of Asian financial crisis increased, the authorities began to take measures to protect the stability of the RMB exchange rate in the second half of the year. Numerous notices and regulations were issued. Unprecedented campaigns were launched to enhance the enforcement of existing and crack down on unauthorized foreign exchange transactions. • In December, foreign exchange swap centers for FFEs were closed.
1999	• To prevent capital flights, a system for evaluation of exporters' performance in meeting foreign exchange surrendering requirements was introduced in March. Those with low surrendering rates may risk losing their export licenses. • In April, the International Monetary Fund classified China's exchange rate regime as conventional pegged arrangement. • FFEs were allowed to use foreign exchange settlement accounts as time deposits.
2000	• In February, the maximum amount of foreign exchange allowed foreign exchange accounts for domestic firms was raised to 30% of their annual imports and exports.
2001	• In February, domestic individuals were allowed to participate in the trading of B shares. • In October, China's foreign exchange reserves exceeded \$200 billion. • In September, the SAFE lifted some of restrictions on capital account transactions imposed during the Asian financial crisis. The ban on the purchase of foreign exchange for repayment of past overdue debts was removed. Advance repayment of domestic foreign currency debt,

	re-lending of foreign currency debts and external borrowing were allowed. The SAFE and its local branch offices resumed the procedure to approve outward direct investment. • In November, China was accepted as a member of the WTO. In financial service sector, China made a series of commitments to open local banking business, security markets and insurance to foreign financial institutions. • In December, individuals paying for their own study abroad were allowed to convert tuition and living expenses throughout the period of their study. Standards were lowered for domestic firms to open foreign exchange account and the approved balance in the account was changed to 25% of export proceeds or total amount of foreign exchange spending in the previous year, with lower value relevant for the determination. In an effort to discourage black market trading in the US dollars, maximum spread between the dollar spot buying and selling rates was widened from 015% of the reference rate to 016% and the difference between the buying rate for cash transactions and the median of the spot buying and selling rates was narrowed from 2.5% to 1%.
2002	• In April, trading in Euro was allowed in the interbank market.

Table 11 Abstract of China's Capital Control Regime

Category	Restrictions
Foreign Direct Investment	
Outward	Foreign exchange is provided for the investment after (1) examination of sources of foreign exchange and assessment of foreign exchange risk involved by the SATE, (2) approval by the Ministry of Foreign Trade and Economic Cooperation (MOFTEC), and approval and registration of outward foreign exchange remittance with the SAFE. The SAFE closely monitors the repatriation of the investment profits.
In ward	Nonresidents are free to invest in China as long as they meet requirements under Sino-foreign joint-venture laws and other relevant regulations, and approval by the MOFTEC. There is no restriction on the inward remittance of funds. Direct investments are allowed in all industries except those specified for environmental and security reasons.
Liquidation & repatriation	Repatriation of profits and transfers relating to the income of foreign employees in China may be arranged with designated foreign exchange banks. However, prior approval from the original review and approval agency is required for liquidation. SAFE verification is required to purchase foreign exchange to remit funds belonging to foreign investor after liquidation.

Real Estate Transactions	The same regulations apply as for direct investment.
Sale locally by nonresidents	With SAFE approval, foreign exchange may be purchased for remittance abroad using Renminbi obtained by nonresidents from the sale of commercial real estate purchased originally with foreign exchange. Foreign exchange may not be purchased using Reminbi obtained from the sale of commercial real estate purchased originally using Renminbi.
Capital Market Securities	
Shares	
Purchase locally by nonresidents	Nonresidents are only allowed to purchase B shares. The face value of B shares is denominated in U.S. dollars or Hong Kong dollars. Prior to February 22, 2001 the B shares could only be bought by foreign investors. After this date, domestic residents were allowed to participate in the transactions of the B shares.
Sale or issue locally by nonresidents	These transactions are not permitted.
Purchase abroad by residents	No institutions may purchase securities except those with special approval from the Stat Council.
Sale or issue abroad by residents	Prior approval by China Securities Regulatory Committee (CSRC) is required.

Abstract of China's Capital Control Regime (*continued*)

Category	Restrictions
Bonds or other debt securities	
Purchase locally by nonresidents	These transactions are prohibited
Sale or Issue locally by nonresidents	These transactions are prohibited
Purchase abroad by residents	Institutions authorized by the PBC may purchase foreign bonds but must use their own foreign exchange funds and are not permitted to purchase foreign exchange for this purpose.
Sale or issue abroad by residents	These transactions are subject to the state plan for utilizing foreign capital. The potential issuer must submit an application for approval to SAFE. Upon approval the potential issuer shall obtain an international rating report. The final approval is granted by the PBC. The use and repayment of the debt are under the supervision of SAFE. Prepayment of external debt is prohibited when there is no early repayment clause in borrowing contracts. If there is such a clause, borrowers may repay such debt in advance using their own foreign exchange, with the SAFE verification. The purchase of foreign exchange for the purpose of advance repayment is prohibited.

Money Market Instruments	
Purchase locally by nonresidents	These transactions are prohibited.
Sale or issue locally by nonresidents	These transactions are prohibited.
Purchase abroad by residents	The same regulations apply as for bonds or other debt securities.
Sale or issue abroad by residents	The sale or issue abroad of securities, other than stocks, requires the PBC approval.
Collective Investment Securities	
Purchase locally by nonresidents	These transactions are prohibited.
Sale or issue locally by nonresidents	These transactions are not allowed.
Purchase abroad by residents	The same regulations apply as for the purchase of money market instruments.
Sale or issue abroad by residents	The same regulations apply as for the sale or issue of money market instruments.
Derivatives and Other Instruments	
Purchase locally by nonresidents	These transactions are prohibited.
Sale or issue locally by nonresidents	These transactions are prohibited.

Abstract of China's Capital Control Regime (*continued*)

Category	Restrictions
Purchase abroad by residents	Only financial institutions that are approved by the PBC and have "foreign exchange trading for own account or on behalf of customer" operations may purchase and sell derivative instruments without SAFE prior approval. The purpose of such purchases or sales may be for hedging risk only. Speculative trading is not permitted. Nonfinancial institutions may engage such activities through financial institutions as part of approved operations without prior approval. Prior SAFE approval must be obtained if these transactions are required to be made with foreign institutions. Trading may be done directly with foreign institutions for derivatives transactions under the provisions of the debt of FFEs without approval; however, debt provision modification procedures must be completed after the fact.
Sale or issue abroad by residents	The same regulations apply as for purchases.
Credit Operations	
Commercial Credits	

By residents to nonresidents	Authorized financial institutions may lend directly to overseas institutions or purchase overseas credits; however, these activities must be reported to the SAFE.
To residents from nonresidents	Only domestically funded financial institutions are permitted by the SAFE to engage in external borrowing, and authorized industrial and commercial enterprises or groups may engage in external borrowing of commercial credit. For credit over a one-year maturity, the loan must be part of the state plan for utilizing foreign capital and must be approved by the SAFE. Financial institutions permitted to engage in foreign borrowing are free to conduct short-term foreign borrowing, with a maturity of one year or less, within the balance approved by the SAFE. Specific, transaction-based approval is not required, but the borrowing mush be registered with the SAFE. Forward LCs with a maturity exceeding 90 days, but of less than 365 days, are included in the category of short-term credits, while those exceeding one year are included in the medium- and long-term international commercial loans. If there are no provisions on the advance repayment in the lending contract, no advance repayment of debt is permitted. If there are provisions on advance repayment, enterprises may redeem debt with their own foreign exchange, provided that approval has been granted by the SAFE, but may not purchase foreign exchange for this purpose. *Renminbi* credits extended by banks to domestic institutions should only be used for productive purposes and may not be used to purchase foreign exchange for debt service. At the same time, domestic banks are prohibited from accepting foreign bank guarantees for *Renbimbi* loans to DFEs. However, domestic banks may accept guarantees from foreign banks to extend *Renminbi* loans to FEEs.
To FEEs from nonresidents	No restrictions
Financial credits	The same regulations apply as for commercial credits.

Abstract of China’s Capital Control Regime (*continued*)

Category	Restrictions
Guarantees, sureties, and financial backup facilities	
By residents to nonresidents	Prior SAFE approval is required for financing guarantees provided by banks and all guarantees provided by other institutions (with the exception of FEEs). Prior approval is not required for nonfinancing guarantees. Registration must be completed for all foreign guarantees. Specific, transaction-based approval by the SAFE is required when the guarantee is exercised.
To residents from nonresidents	Residents may accept guarantees from nonresidents only if borrowing from overseas. When residents borrow Renminbi from Chinese-owned banks, acceptance of guarantees from overseas banks is restricted to FEEs.
Deposit Account of	
Nonresidents in foreign exchange	No restrictions.
Nonresidents in local currency	No restrictions.

Residents abroad	These accounts are permitted, but approval is required.
Residents in foreign exchange	Domestically funded enterprises (DFEs) may maintain foreign exchange settlement accounts for current account purposes. The approved balances shall be equivalent to 25% of the lower value of previous year's export earnings and foreign exchange spending. Domestic establishment involved with receipts and payments as an agent, temporary receipts and payments, and temporary receipts and pending payments in external contract projects, large machinery and electronic product exports, donations, and aid may maintain foreign exchange accounts with approval of the SAFE and settle receipts and payments within the scope stipulated by the SAFE. FFEs may open (1) foreign exchange settlement accounts for receipts and payments under the current account and for verified payments under capital account stipulated by the SAFE for each enterprise; and (2) foreign exchange special accounts for receipts under the capital account, payments under the current account, and approved payments under the capital account. Natural persons may open foreign exchange accounts with authorized banks.
Personal Capital Movements	
Loans	
By residents to nonresidents	These transactions are not allowed.
To residents from nonresidents	These transactions are not allowed.
Gifts, endowments, inheritances, and legacies	
By residents to nonresidents	In the case that a resident's directly related family member abroad encounters illness, death, or unexpected disaster, the resident is allowed to purchase and remit abroad up to US$1,000 or its equivalent, once the resident has valid, notarized proof or proof from the Chinese embassy or consulate; application from

Abstract of China's Capital Control Regime (*continued*)

Category	Restrictions
	the patient's local agency (work unit) or prescription from the hospital; the relevant documents from the resident's work unit (if without a work unit, from the local sub-district office or the people's government department above the town level); and proof of the documents related to foreign exchange payments. As for other foreign exchange purchases, amounts of up to US$500 may be provided by the bank. For a onetime purchase of foreign exchange for private purposes with an amount exceeding the stipulated standard and up to US$50,000 or its equivalent, application to the local SAFE offices against specific documented proof is required, and, after verification by the local SAFE office, the foreign exchange needed may be purchased from the bank and remitted or taken abroad. When a onetime purchase exceeds the stipulated standard or US$50,000 or its equivalent, the transaction must be reported to the SAFE by the local SAFE office for verification before the bank provided the foreign exchange. Remittances from a resident's domestic currency account for payment for gifts, donations, inheritances or legacies, for a onetime amount of less than US$10,000 or its equivalent, may be made directly through a bank. For amounts of more than US$10,000 but less than 50,000 or their equivalents, application to the local SAFE office is required with stipulated documented proof, and, after verification by the

	local SAFE office, remittances may be made through a bank. For amounts of more than US$50,000 or its equivalent, the transaction must be reported to the SAFE by the local SAFE office for verification before the bank makes the foreign exchange remittances. Transfers of a resident's domestic foreign currency cash or deposits from a resident's foreign currency cash account for payments of gifts, donations, inheritances or legacies, for a onetime amount of less than US$2,000 or its equivalent, may be made directly by a bank. For amounts of more US$2,000 but less than US$10,000 or their equivalents, application to the local SAFE office is required with specific documented proof and corresponding customs declaration documents to remit foreign currency before remittances may be made by a bank. For amounts above US$10,000 or its equivalent, the transaction must be reported to the SAFE by the local SAFE office for verification before the bank makes the foreign exchange remittances.
To residents from nonresidents	If the foreign currency income from donations and legacies needs to be paid in foreign currency cash or converted into Reminbi and if the onetime amount is less than US$10,000 or its equivalent, payments may be made directly by banks. When the amount is above US$10,000 but less than US$40,000 or their equivalents, relevant documented proof must be provided to the banks or the SAFE. For inherited foreign currency, the required documentation included proof of identification of authenticity, a notarized statement, and proof of tax clearance abroad. For household use of foreign currency, proof of identification of authenticity and documentation of kinship are required. For foreign currency donations, proof of identification of authenticity and donation agreement are needed. Banks may make payments after verifying the documented proof, and recording the transaction. When the amount is above US$50,000 but less than US$200,000 or their equivalents, application to the local SAFE office is required, with documented proof, and after the verification of authenticity by the local SAFE, payments may be made through banks. For amounts above US$200,000 or its equivalent, application to the local SAFE office is required with documented proof

Abstract of China's Capital Control Regime (*continued*)

Category	Restrictions
	and the transaction must be reported to the SAFE by the local SAFE office for verification before the bank makes the foreign exchange remittances.
Settlements of debts abroad by immigrants	n.a.
<u>Transfer of assets</u>	
Transfer abroad by emigrants	Routine foreign exchange revenues including retirement and pension funds may be remitted abroad. Funds falling under capital items, such as proceeds from selling residential property may not be converted into foreign exchange for remittance abroad; rent income, however, may be converted for remittance abroad.
Provisions Specific to Commercial Banks and Other Credit Institutions	

Borrowing abroad	The same regulations apply as for commercial credits.
Maintenance of accounts abroad	Registration with SAFE is required for domestic banks to open foreign exchange accounts abroad. As for domestic nonbank financial institutions and non-financial enterprises, prior approval by the SAFE is required.
Lending to nonresidents (financial or commercial credits)	The same regulations apply as for commercial credits.
Lending locally in foreign exchange	Lending is mainly subject to review of qualifications by the PBC and to asset-liability ratio requirements. Borrowers need to register ex post the transaction with the SAFE and should get a permit from the SAFE to repay the principle.
Purchase of locally issued securities denominated in foreign exchange	China does not issue securities denominated in foreign currency.

Source: International Monetary Fund, *Annual Report on Foreign Exchange Arrangements and Exchange Restrictions*, 2001, and documents issued by the SAFE and PBC.