Net Positive Non-FDI Capital Inflows in China

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Abstract

1. **Since 2002, both the net non-FDI capital inflows and the "error and omission" have turned positive. Reversing the pattern of the last decade, the positive "error and omission", which usually can explain the most part of the capital inflow volume out of the state supervision, does not give a satisfactory explanation to what happened since 2002. The "double positives" should be partly contributed to the hidden inflow of speculative capital driven by the expectation of RMB appreciation.**

2. **With the rapid growth of non-FDI capital inflow, the government's failure to stop the tide of speculative capital inflow has accelerated the accumulation of foreign reserves in China. If this trend continues, China will not be able to sustain the existing peg regime.**

3. **Though the Chinese leadership has expressed the view that the exchange rate formation of RMB would be "gradually perfected", its slow pace to bridge the huge gap between the real market rate and official rate of RMB has strengthened people's expectation of a stable and well-controlled forex floating mechanism with a band of 5% or less. Unfortunately, this situation would make the capital inflow—both FDI and non-FDI—to China a long-drawn development, which will further make the foreign reserve accumulation a sustained phenomenon.**

4. **No evidence indicates that the speculative capital or the so-called "hot-money" has been driven mainly by foreign players. Most likely, the repatriation of Chinese offshore capital plays a role; or at least it is the result of money maneuvering by the Chinese entities.**

5. **Despite the fact that China imposes a strict control over the capital movement, many effective conduits still exist for cross-border capital movement. This is restricted by that the speculative capital inflow caused the unexpected quick accumulation of FX reserves.**

6. **Facing this problem, the Chinese government has adopted the following as its strategy: to maintain the stability of basic exchange rate long enough in order to make it impossible for speculative capitals with long position to sustain.**

7. **The increasing multiplicity of conduit for the non-FDI capital movement has increased the difficulty of Chinese authorities to regulate financial activities and to control capital flows. Therefore, it has become a central issue under the consideration of Chinese leadership to seek international cooperation and coordination as well as to introduce new measures for monitoring capital flow. For example, these measures may include accrediting the qualified domestic and foreign institutions for supervision.**

8. **In the past, facing the pressure of RMB depreciation, the Chinese government adopted a policy of "loose on entry but strict on exit" for capital flows. Now facing the serious threat of speculative capital inflow flood and the ensuing appreciation pressure relaxed, close scrutiny over inflow capital will be introduced.**

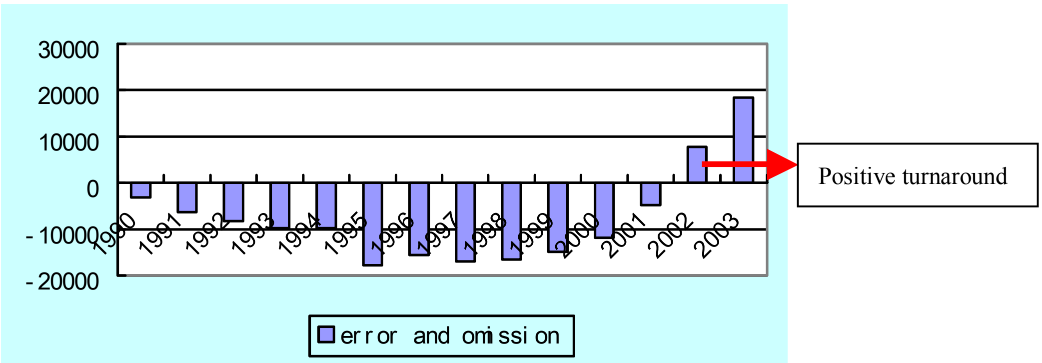
9. **The approach to managing capital account has gradually shifted from rigid control to a more open regulatory system. This shift will proceed under the following guiding principle: the opening-up process will firstly shift with easier items, long-term account, real transactions, and the authorized financial institutions, then it will apply to the more complex items, short-term account and those non-financial institutions.**

1. The Turning Net Positive Non-FDI Capital Flows and "Error and Omission"

Since the last quarter of 2001, according to the monthly data, the negative "error and omission" of China's balance of payment (BOP), which existed at least for over ten year, has converted into the positive (Chart 1). It is widely believed that some foreign capital has not been accounted into regular non-FDI capital inflow in state statistics, or out of the supervision of Chinese authorities. The problem is that so far the positive error and omission has not only continued but also increased quickly even after 2004.

What have happened in China's BOP and particularly at capital flow? One of explanations by professionals is that such capital movement has been motivated by the RMB's appreciation expectation as China is under the much heavier pressures than before from the main advanced economies. As we have heard for several years, the main complain is based on the fact that China's FX regime of RMB's managed peg to US dollar for many years, particularly narrowed band since Asian financial crises.

Chart 1 the "Error and Omission" in China's BOP (1990-2003)



Source: Own graphing based on BOP data from SAFE website, China, June 25, 2004

Compared with RMB convertible transaction under the current account of China's BOP, the control of non-FDI capital inflow has long been strictly regulated. The inconvertibility of RMB under the "capital and finance account" should not have huge unaccountable inflow of capital, but is estimated over 30 billion US$ for about one year from July, 2002 year[1]. Where does foreign capital come from? How can they inflow? what kinds of channels or ways have the capital taken for the money movement?

As Chinese monetary policy has been burdened with the huge foreign reserves recent years (Chart 2a and 2b), PBC (People's Bank of China) does hope the gradual reducing over reserves of FX. Hereby some important measures have been taken during recent months. Among them, the steps aimed at deterring speculative capital inflows will be of course the first exercisable choice.

[1] http://finance.sina.com.cn, August 27, 2003, and http:// www.people.com.cn, August 15, 2004. The investigation for hot money inflow by SAFE is started from September 2003 while the public media reported the volume was estimated about US$30 bn and then said over US$ 50 bn during the last quarter of 2003.

Chart 2a Foreign Reserve (100 Million US$)

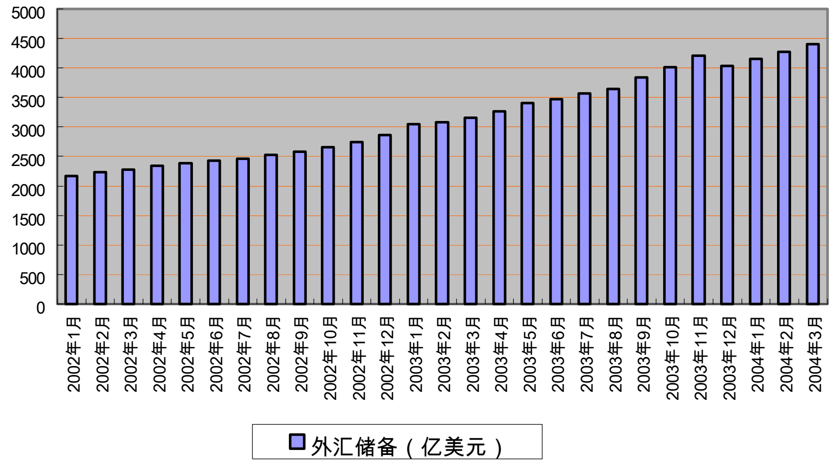
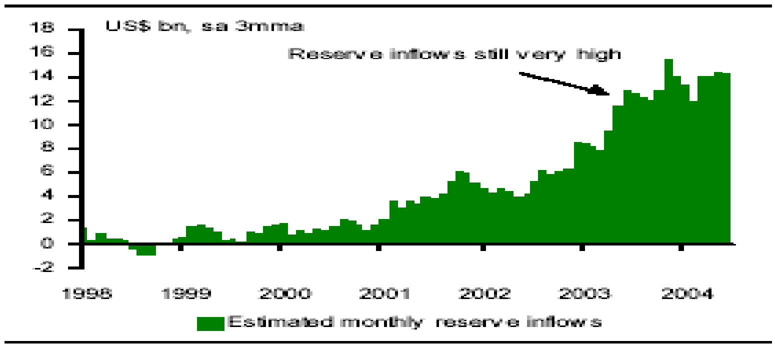


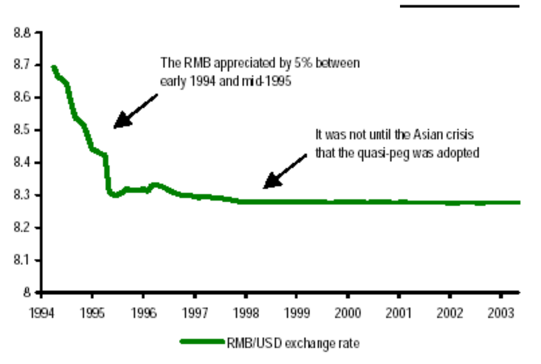
Chart 2b FX reserve monthly since 1998[2]



Source: CEIC, UBS estimated[3].

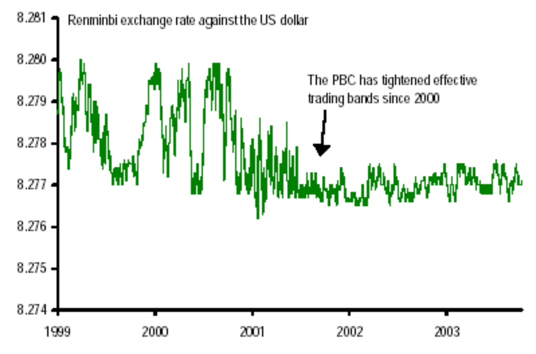
Chart 3a and 3b the "peg" and narrowed band of floating

Chart 3a China under the "peg"



Source: CEIC

Chart 3b The PBC has been tightening Exchange Policy



Source: CEIC

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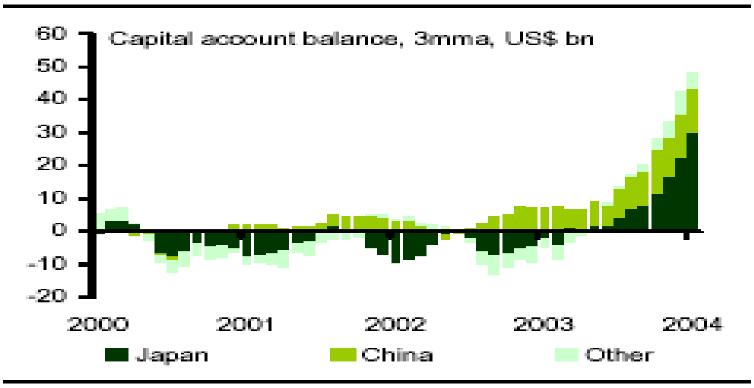
[2] The monthly updated data during second quarter of this year are 449 in April, 458.6 in May and 470.6 in June by SAFE, increase continued.

[3] Jonathan Anderson, "China: Capital Inflows Stabilizing", UBS Asian Economic Comment, July 16, 2004). The charts below in PDF are mostly come from reports of UBS Investment Research.

2. The foreign capital inflow and FX reserves in China

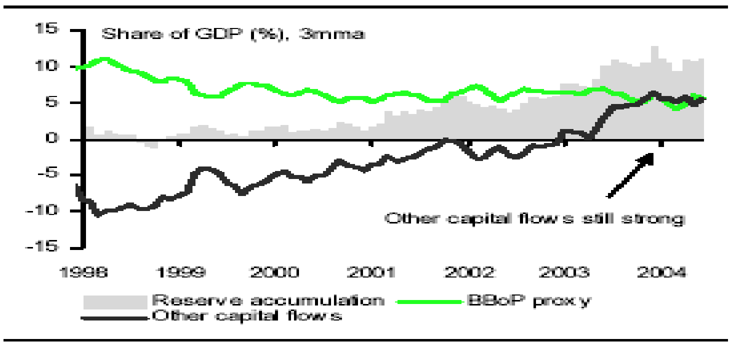
Except for Japan, only China has the huge, impressive and increasing FX reserves (Chart 4) in Asia and also in the world. Even during the second half of 2003, China was still the second largest FX reserves-holding country. On average, Japan had accounted for 50% of regional FX reserves accumulation, with China taking another 25% (Chart 4). But it is worthy note that a little difference from recent 12 or more months, the increased FX reserves in China before had mainly come from the surplus of current account and FDI inflows.

Chart 4 Japan and China have 90% of Asian Foreign Reserves



Source: CEIC, UBS estimates

Chart 5 "Hot" Capital inflows in China



Source: CEIC, UBS estimated.

It is well known that China has long had the negative non-FDI capital flows, which was resulted from the massive circulation of China's national currency in China's neighboring economies. However, significantly from the fourth quarter of 2002, China has started the positive net non-FDI capital inflow and more interesting positive "Error and Omission" (Chart 1). It indicates that the capital flows, under the widely expectations on RMB appreciation, have taken over from trade surpluses as the main driver of China FX reserve growth for the first time since the Asian crisis[4].

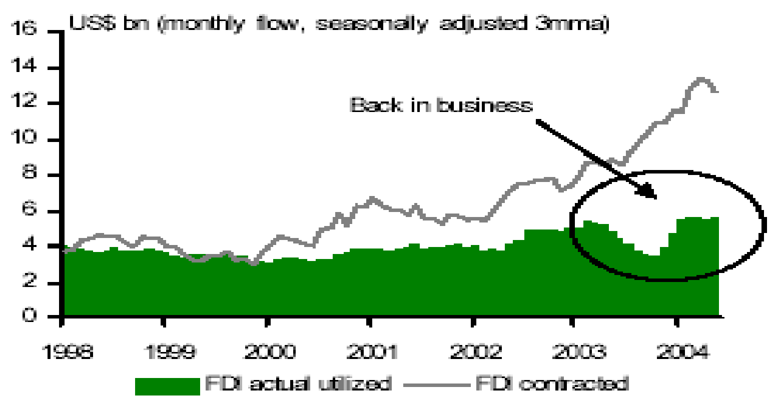
[4] In January 2004, net capital inflows outspaces the Asian current account surplus by a significant margin. Once again, Japan and China were the most important destination countries for capital inflows, together accounting for nearly 90% of the total.

We think that there are at least five factors behind the positive turnaround error and omission or the opposite regular direction of "hot money". They are as follows:

(1) The first, as the external force, is the strong expectation on RMB's appreciation within one year. The foreign investors in the financial market seem to have believed that this time Chinese government could persist on the existed FX regime under growing external pressure from advanced economies;

(2) The second, as the internal force, is the narrow band floating regime reform expectations[5] based on China's government on promise of "perfecting RMB exchange rate formation", which have led to continued growing capital inflow, not only offshore hot money, but FDI. Last year, just after SARS, the real FDI has been back soon to its business and the contracted FDI has grown surprisingly (chart 6);

Chart 6 Updated FDI inflows in China



Source: CEIC.

(3) The expectations of a weak US dollar. In recent years, the deposit rate differences between RMB and four main foreign currencies have been positive in all commercial banks in China[6]. (Table 1). Under the appreciation expectation on RMB and the positive of domestic deposit rate difference, the individuals and institutions have recently preferred to hold RMB assets rather than foreign currencies, which is the main reason why the FX deposits in the domestic commercial banks have been down obviously while the official holding FX has increased. In China, it is well known that the rate return of assets in foreign currencies, except some special cases, always follows the benchmarks of FEB, ECR, Bank of England etc, which are all heading downward during the recent years. (Chart 7)

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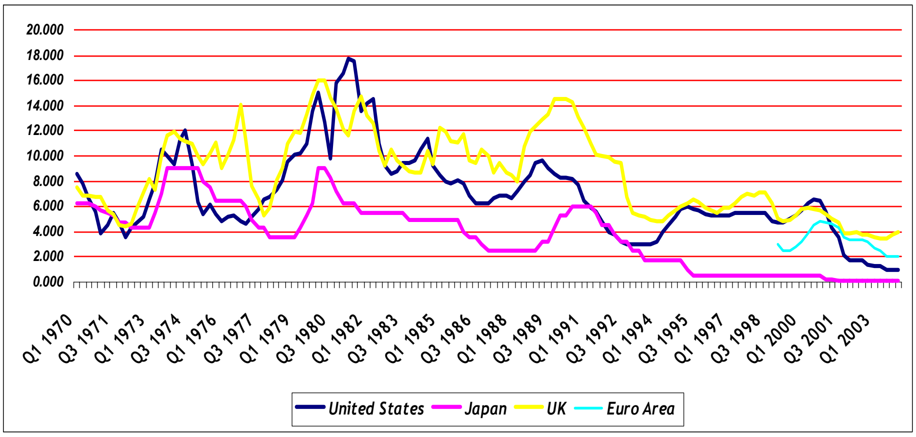
[5] The public have been looking forward the 3% or 5% floating band.

[6] The big amount of deposit in foreign currency could be negotiated with the banks but usually still lower than the deposit rate issued by PBC. The updated rate is being 1.44% (http://www. bank-of-china.com/rate). All the RMB deposit rates have been available since Feb. 21, 2002 and FX rates have been announced since Jan.19, 2004.

Chart 7. The trends of benchmarks in the main advanced economies



Sources: FEB, ECR, Bank of England and Bank of Japan. June 2004

Table 1 before tax annual rates (%) of deposits in RMB and foreign currencies

Interests of deposits	**RMB**	**US$**	**Euro**	**JP**	**HK$**
Current Account deposits	0.072	0.0750	0.1000	0.0001	0.0001
Seven days call deposits	1.62	0.1250	0.3750	0.0005	0.0010
One month	-[7]	0.2500	0.7500	0.0100	0.0025
Three month	1.71	0.4375	1.0000	0.0100	0.0050
Six month	1.89	0.5000	1.1250	0.0100	0.0200
One year	1.98	0.5625	1.2500	0.0100	0.1000
Tow year	2.25	0.6875	1.3125	0.0100	0.1625

Source: BOC website July 22, 2004

(4) The longstanding higher economic growth and other good economic performances in China have created much more opportunities of business and investment, which are considered as the better timing of capital inflow with expected higher returns in the future. The chart 8 shows net portfolio or more accurate capital flows (considered as main source of positive "errors and omissions" at least in China) for individual countries as a share of each country's GDP[8].

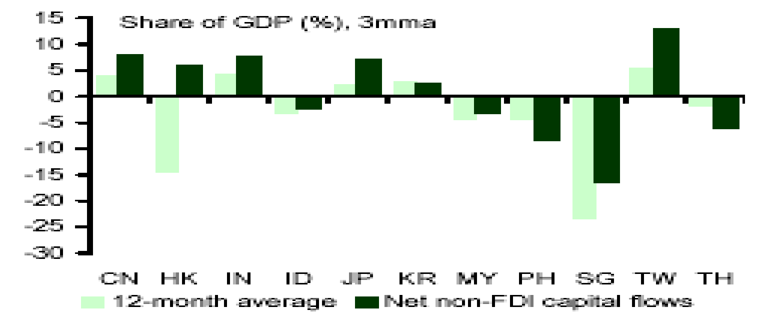
(5) An increasingly active domestic debate on the existed foreign exchange regime has

[7] Chinese commercial banks have no long one month deposit product so far.

[8] As before, Japan, PRC, India and Taiwan are the largest inflow recipients on a relative basis, with Hong Kong recording a very sharp positive turnaround over the last few months.

been seen in both academic circle and public society. More and more people have believed now their national currency is truly undervalued. Some of scholars even think former premier Zhu Rongji lost the best opportunity for changing China's FX regime after 1997.

Chart 8: Net portfolio capital inflows/GDP



Source: CEIC, UBS estimates

In PRC, even during the peak period of capital outflows, it is always a difficult question either for outside observers or Chinese authorities. There is a typical year we can see such conundrum. 1999 just after Asian crisis, China had the combined value of the external trade surplus and FDI inflows reaching USD70bn. However, headline FX reserves rose by only US$9bn during the entire year. It was very interesting that compared 2002 of 83.11 bn US$, total earnings from the trade and FDI surplus in 2003 were almost at 79.04 bn US$, but FX reserves this time leapt so much from 286.407 bn in 2002 to 403.251 bn in 2003, almost 116.844 bn[9].

3. The main explanations to the net positive capital inflows in China's BOP

Under the very strict capital control regime, we can't image massive non-FDI capital cross-board movement, whether positive or negative. That is the reason why non-FDI capital movement, in particular portfolio capitals in developing host economies, including China, is usually mixed or got along with legal FDI for cross-board moving. We have been accustomed to the massive capital outflows in foreign currencies in China but the recent reverse flow. Thus a question here is, under the similar regulation framework, why non-FDI capital flows becoming easier than before. And furthermore, why has non-FDI outflow been instead of inflow with huge amount and particularly so quickly?

Based on our information and knowledge, some tentative explanations are given below.

(1) **The gradual internationalization and regionalization of RMB**. The course of RMB partial convertibility has impacted the efficiency of current control regime on foreign. The gradual flexible regulation of cross-boarder capital movement makes RMB exchanges direct and indirect transaction costs lower.

(2) **The much more channels existed after over twenty years of economic reform**. Along

[9] SAFE, China, June 2004.

with the more opening to outsides, more available business channels and other exchange ways such as QFII, overseas investment, the hidden "tubes" serviced to various capital movement have been "innovated" so actively that China's supervision institutions with limited budget can't sustain the effective detection.

(3) **Encouraging rational FX usage by the public with offering some effective outflow channels**. Aiming at more effective operation of monetary policy, and less net purchasing of over supply of foreign currencies[10] in Chinese FX market[11], and less accumulation of FX reserve, Chinese authorities have encouraged institutions and the public to increase their FX holdings for their international activities. Thus during recent years, more conveniences or channels have been given to the society to lessen the pressures of FX. However, it is a pity that these channels not merely subterranean tubes, now have been used for non-FDI capital inflows[12]. This is really something beyond the imagination of the supervisors.

(4) **China lacks a modern FX markets network of fair information, high efficiency, transparence and openness.** A lot of FX transactions are carried out directly by dealers and end-users in OTC market. So the database from trading platform, which is the main source of state statistics, is often confused. At the same time, China still lacks functional national financial center, which could be connected well with some global financial centers. We herewith thought the real vision behind of "errors and omissions" in Chinese BOP would be much worse than the disclosed by data.

4. Main players who turned non-FDI capital inflow to the positive?

Similar to the situation during the period of net negative capital outflows, we don't think that the foreign players are responsible for making both net positive capital inflows and "error and omission". We think the foreign institutions in China have been increasing RMB exposure, including a limited channel of existed QFII[13]. The case during Asian crisis indicates that usually the foreign big players carry speculative attacking operation with great risk exposure only when the worse imbalance of host economy accumulated to such extent that "big bang" is inevitable. China is believed not to have reached such degree and its currency, after all, has not been fully convertible.

As all of us know that there has been an active RMB NDF market to all players, the foreign capital would exactly only need the market for their speculative operation. Therefore we would suppose that quite a volume of actual non-FDI inflows into the mainland are most probably a Chinese game, driven primarily by reallocation of assets holdings in favor of domestic currency

[10] So far there are four foreign currencies, US$, Euro, HK$ and Japanese Yuan for transaction in China's FX market. Euro is relative new one starting trade from June 2002.
[11] Referring to Zhang Jikang and Liang Yuanyuan's working paper in English titled with "Structural Analysis on Chinese Foreign Exchange Market", The Financial Studies Institute, Fudan University. Forthcoming of next month, 2004.
[12] The volume was estimated over 50 billion US$ for last 12 months.
[13] Possibly just for this exposure, Nomura Securities, as one of first QFII in China, has been criticized for no action for Chinese A share purchasing as their application originally.

(including the repatriation of Chinese offshore capital). Existing capital controls make it much more difficult to borrow abroad at will, and much more difficult for foreign institutional money to move in and out of the mainland.

As the UBS researcher said[14], "we think the 'revaluation trad' from China has fueled a very pronounced correction in the external balance, with net outflows turning to large net inflows. The main contributors have been the repatriation of offshore holdings, further conversion of domestically-held assets, and more recently a move to leveraged positions; to the extent possible, banks and firms borrowed abroad and held RMB long".

Thus, for the point, a considerable share or maybe the lion's share of flows would come from Chinese sources and even most probably from offshore Chinese institutional sources. We think the regulations on capital account is not quite effective or even ostensible, but at least in keeping out the potential attacking from "big guns", the existed supervision and control of capital movement is strong enough as we saw in Hong Kong during Asian crisis. However, faced with domestic source rather than foreigners, the Chinese authorities are still embarrassed that locally-rooted firms and institutions with the different international business background as they have a much easier time distinguishing capital flows and keeping themselves under the strictly supervision.

5. What channels or tubes could be used for ongoing speculative flows in China?

Basing on our previous research experience, the main channels of non-FDI capital inflows could be briefly summarized below.

(1) Cash smuggle. The individuals or families as the tourists, business tour and even private visit could now carry cash in foreign currency or RMB to go abroad or enter China;

(2) Cross-border deposit exchange. For example, in order to encourage sightseeing tours to Hong Kong, the Chinese tourists have been permitted to use RMB international credit cards for consumption and then the financial institutions in Hong Kong have also been authorized to offer the cross-border currency exchange services;

(3) The cross-board portfolio investments, such as local B share investment or offshore H share investment have been more easily done with the help of unauthorized local or overseas intermediate institutions. In 2003, only US$1 bn permitted investment volume to local securities issued by PBC to QFII, but the real portfolio capital inflow is absolutely exceeded the quota. Currency swap, parallel loan as well as private remittance on half of overseas Chinese are believed to be the main tubes.

(4) The non-FDI capital movement hidden under FDI project. As more and more FDI capital recently in China have focused on market seeking projects and expectation on RMB appreciation, more and more FDI capital inflows each year are requested to be changed

[14] Mainly from the UBS investment research reports recently on China's economy by economist Jonathan Anderson.

into local currency. Before July 2002, the real and registered capital input under FDI project for Changing RMB has to be approved by SAFE. But after that, as the convenience offering to foreign invested firms, the local commercial banks can deal the transaction directly on behalf of SAFE. So "Leads & Lags", in particular the input capital and superadded registered capital asking for earlier exchange with RMB under capital account, instead of traditional under current account, have recently become the important methods for capital inflow.

(5) From this new century, except for the sectors not yet opened to foreign share majority, more projects approved in China are wholly foreign owned, which means the more freedom and less watching from locals. It is truly not difficult now for foreign investors borrow money directly from international market and take some capitals to make other investments, such as A-share, bond, portfolio fund, insurance fund and even real estate assets. Under the current FDI policy, the financial operation inside the foreign invested project is hardly supervised. In other words, RMB under FDI related could be almost supposed as fully convertible. So far the usage and movement of foreign project capital, no matter of outflow from or inflow to the project, are only booked into the special account at authorized commercial banks. The movement and transaction are monitored loosely by the local and foreign commercial banks accredited by SAFE.

(6) The transactions under the current account of BOP are still considered as main and effective source of cross-board capital flows. Before this RMB appreciation expectation, by using either illusive invoices or black market, it was so popular for Chinese institutes' to escape overseas or domestic incomes from the mainland. Now the direction has been changed but the method is still more effective.

(7) There are more and more local and foreign financial service institutions, authorized or unauthorized locally, give various services to their customers legally or illegally. Even some state-owned or shared financial institutions with the authorized overseas branches, as disclosed by authorities or public media, did the same capital movement services to their big customers, typical ways including traditional swap, currency swap, parallel loans.

The growing multiplicity of channels or tubes for the movement of non-FDI capital potentially increases the difficulty of Chinese authorities financial regulation and control of capital flows. Along with the more opening to integrated global economy, the government has to cost more and more to detect the bulk of covered-up business activities unless it has to give up some targets. Looking for international cooperation and coordination, accrediting the qualified institutions and so on for stakeout, as the new ways of capital flow regulation in China, has therefore had a source of great concern by Chinese authorities.

6. The measures have been taken by Chinese authorities

Aimed at keeping control of non-FDI capital inflow, keeping it in the existing peg regime with a period, lowering the growing speed of official foreign exchange reserves and reducing RMB appreciation pressure, Chinese government has adopted some series measures recently along with the structured tightening policies for so-called soft landing of international imbalanced economy and up growing CPI trend. The main measures taken are listed in summary as follow.

(1) Opening some capital account items firstly for encouraging outflow of capital supervised

Chinese government recently announced that more items under capital account are being opened recent months, which would encourage outflows of capital, increase demand of FX for reducing pressures of exchange rate, and support PBC's sterilizing operation as well. For instance, a number of steps to loosen capital restrictions in an attempt to promote capital outflows have been carried out: (1) Exporters are no longer required to convert the bulk of their export earnings into RMB; (2) Some institutional investors, such as the social security fund and insurance companies, are to be allowed to invest in overseas markets though the detailed rules have not yet been worked out; (3) Some special portfolio foundations are to be granted greater access to overseas bonds, as well as new domestic dollar-denominated issues by the policy banks; (4) More and more Chinese companies, even the private-owned ones, are pushed to internationalize their activities. These companies can hope to expedite their approvals for overseas direct investment (which averaged around US$5 bn per year from 2001-2003) as well as full retention of overseas income earned.

And just last month, the senior official in SAFE has also announced other measures: (1) the local private assets owned by immigrants to abroad and non-residents, if validated, are allowed to transfer to abroad. But before this measure, only the returns on the assets can be moved out of mainland; (2) the QDII system would be established and exercised very soon. This can surely reduce the FX reserves; (3) OPI (Overseas Portfolio Investment) to global capital market by the funds from Society Guarantee and Insurance Foundation has been approved by the State Council. As the SAFE said, it would be in practice soon.

It is obvious that China seems to open further some items of its capital and finance account. However the progress is to be carried carefully as it is related to the sensitive FX rate issue. Suppose if China does go for a significant gradual capital opening as said, it would have to firstly move to a flexible exchange regime. Otherwise, China could go the same path as the Asian crisis economies, facing "one way bets" with large inflow pressures under a perceived guaranteed return, which can then turn to debilitating capital outflows when the markets begin to worry about the strength of the peg. Indeed, nearly every emerging market financial crisis in recent memory was associated with a fixed or quasi-fixed exchange rate, which is recently described as the main exchange regime in emerging Asian economies, before the final blowup occurred.

(2) Increasing marketable demand for foreign currency

Chinese authorities are increasing the marketable demand for fostering the capital outflow. One of the typical measures is to deal with the competitive applications by domestic financial institutes for strengthening and fasting QDII. The measure is also aimed at guiding domestic capital outflows for higher capital returns while under the effective control of FX transaction by authorities. The idea, actually very similar to rules of QFII, is trying to concentrate non-FDI inflows to the limited number of authorized qualified foreign investment Institutions. Hence the authorities could focus their supervision on limited QFII. Thus the authorized QFII have had the obligation for indirect monitoring while offering legal business services to their customers domestic and abroad.

Another recent measure attracting public attention is that Chinese government is encouraging local enterprises to invest abroad. Different from strictly approving procedure before and mostly limited to qualified state enterprises, the local shared and private firms are now prompted to go abroad with flexible foreign currency exchange quotas. Such stimulated demands for foreign currency are not requested on traditional self-balance and are accordingly expected to increase the FX demand in Chinese foreign exchange market.

Unfortunately June data on FX reserve growth is highly sticky. It means we should have to wait for longer the real growing demands for foreign currencies. Anyway, the increasing money has not flooded into the banking system since the PBC is continuing to sterilize domestic liquidity.

(3) Keep the interest rates, in particular the deposit rate lower level than America for deterring non-FDI inflow.

Chinese money market is again rife with concerns and rumors about Chinese interest rate hikes, in particular just after FEB arising rate last month. Under the pressure of RMB appreciation expectation, and possible interest rate arbitrage speculation on rate gap, such benchmark up moving, even with only 25bp, is absolutely beneficiary to deterring hedge capital further inflow. At least we think that PBC has now more time given by FEB to postpone rate hike, in other word, Chinese central bank would herewith stress “broadly stable” interest rates and instead keep using other monetary policy instruments such as liquidity management, reducing the overall pace of credit growth, stopping lending to targeted real estate sector and raw material manufacturing sector.

However, even if the rates are changed as expected during the fourth quarter of this year, we still believe that Mr. Zhou Xiaochuan will hike deposit rates within this year mainly for compensating household depositors for CPI inflation[15]. Referring to the level up, deposit rates should be at most raised 100bp and regarding to lending rate, should be less than 100bp or preferring further liberalized. These imply that the central bank will have to care seriously about the very high level of capital inflows motivated by wide rate gap. Remember that the PBC is already buying up FX reserves of US$10 bn to US$15 bn a month, as Chinese companies and banks take advantage of the positive interest spread between RMB and USD assets, as well as continued expectations of a RMB appreciation.

No matter whether the measures are effective, a massive further acceleration in non-FDI

[15] June data on the cost-push CPI has reached to 5% though the GDP growth rate is a little down.

inflow volumes could happen if the appreciation expectation is strongly preserved. However, on the other side, China still maintains a higher closed capital account, and portfolio activity is mostly limited to domestic firms and banks which are relatively adept in working within the current framework of regulatory restrictions. Meanwhile the PBC has been successfully tightening monetary policy to date, but a rising tide of speculative inflows eventually overwhelm the authorities' ability to sterilize the domestic liquidity impact, effectively forcing China off the peg.

(4) Raising exit barriers to the speculative hot money outflow

As we have seen in several cases, the "hot" money usually can't sustain longer than one year for their speculative movement as increasing financing costs, opportunity costs and other related costs. What China has successfully done during the Asian crisis is just keeping FX rate stable enough or even fixed while making strict control of capital outflows. China's experience was surely based on its large economy but uncertainty for other small host economies with pegged or quasi- pegged regime. Regarding the strategies to the speculative capital inflows, Chinese authorities would increase the hot money exit barriers like closely monitoring financial transactions, increasing supervision to business of domestic and foreign commercial banks and other financial institutions while (1) keeping the FX rate unchanged so that no near future return expected; (2) Strengthening the supervision to the targeted institutions on illegal money transferring and business transaction irregularity. (3) Inspecting the transferred investment such as portfolio and real estate investment.

The recent hot economy came from the real estate sector and related others like its upstream sectors. Chinese government's soft landing policies have recently targeted at the investment on luxury apartments located in large municipal cities like Shanghai, Beijing and Guangzhou. The governments have considered that these kinds of assets would mostly absorb transferred hot money. As the part of reason, the current structural measures calming down the economy, as we have seen, would be placed to the targeted sectors. Actually also as we have noticed, the hard landing bank loans have resulted in a series of expected bankruptcies and losses.

(5) Making FX reserve at adequate level

The second half of last year, faced with net positive both non-FDI capital inflow and "error and omission", PBOC and SAFE did the investigation on about US$50 bn other capital inflows in coastline areas and particularly at Guangdong province. The state council has appraised the actions as (1) the flooding capital inflows have been deterred successfully; (2) the appreciation pressures to RMB have also been released obviously as well as (3) the growing of FX reserves has been slowed effectively.

Except for the measures aimed at control of foreign capital inflows, the authorities have gradually loosened the foreign currency regulation. For example, one of the practices is to let enterprises keep more foreign currencies no matter whether they have already had international business, giving firms with overseas business more FX quotas no matter what kinds of ownership, permitting enterprises more freedom on FX purchasing if they have the real demand for import.

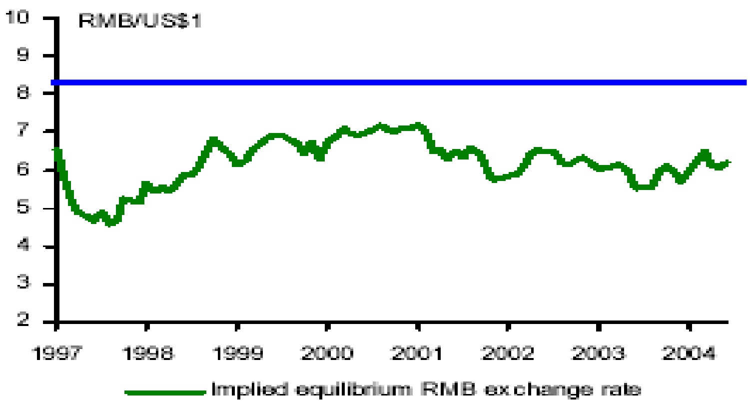
All of above measures are actually not only proposed for controlling FX reserves growth, but also strategically for creating effective volume of marketable FX demands, which is planned to perfect the exchange rate formation mechanism as soon as possible[16].

(6) Stabilizing FX rate.

The Chinese government has taken the similar relative long term strategy as during Asian crisis, that is to maintain "basic exchange rate stability" long enough while speculative capitals with longer position can't be sustained. The measure, usually could be understood and accepted by advanced economies, is to maintain "basic exchange rate stability" while "perfecting the exchange rate mechanism". As we can image, this standard formulation suggests that the authorities are not interested in a large RMB exchange rate adjustment at all but continue to leave the door open for the gradual introduction of limited flexibility. Such action was done against the RMB depreciation expectation made the global speculative capitals in China and Hong Kong with huge losses during Asian crisis.

The government is well advised that a flexible change regime is much more suitable in the medium term, as it would allow the economy to avoid long-term speculative pressures and adjust dynamically to future structural changes in trade and capital flows. From the experiences in so many economies, at least in medium term the estimated impacts of exchange rate movements on exports, economic growth and FDI are quite small. Actually both from a theoretical standpoint and historical record, while a more flexible rate might encourage speculative flows in the near term, a fixed exchange rate regime would be also the target for speculative attacking when the economy, as we observed in Thailand in 1997, has the fundamental imbalance of international payment.

Chart 10 RMB Valuation Estimate



Source: CEIC, UBS estimates

Except for all the above, other measures directly or indirectly related to the objectives under the both current account and capital account have been or to be adopted by the supervision authorities under the commitments to WTO, such as

[16] Zhang Jikang, "Establishing marketable demands and supplies of foreign currencies to foster function of Chinese FX market", ***Journal of Chinese Money Market***, Feb. 2004.

(1) Encouraging increasing imports of commodities;
(2) Pushing state-owned enterprises for ODI (overseas direct investment);
(3) Prompting the local firms with good business performances for international financing instead of traditional international debt;
(4) Lifting restrictions on foreign financial institutions by CBRC (China Banking Regulatory Commission) for RMB business to foreign invested firms and forex business to local invested enterprises;
(5) Increasing the percentage of share in the joint-ventured financial institutions, allowing foreign investors to join local financial institutions and so on.

Anyway, it should note that since China opened its current account in 1996, so far the authorities said that they have lifted control over about half of 43 capital account items.

Conclusions

As conclusions, we would stress two points for the measures above and more broadly on related policies.

The first is that the effects of all above measures are beyond of our sights. The updated data of "hot" capital inflows during June is still strong though momentum has basically peaked since the last quarter of 2003 (Chart 5). Maybe we need the longer time to observe the tendency;

The second, as a speech delivered by Mr.Wei Benhua, vice-director of SAFE in a business conference in New York, is that in opening the capital account, the financial authorities would use a phased approach and follow the principle of doing the easy parts before the hard ones. For every move financial authorities take to open the capital account, Chinese government would make sure that "the risks are controllable and there is room for manoeuvre." Specifically, controls over transactions concerning capital inflow would be relaxed before outflow, long-termflow before short-term flow, transactions with real background before ones with no real background. Control of financial institutions would be loosened before that of non-financial institutions and private individuals.