China’s Foreign Exchange Management

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I. The history of China’s foreign exchange management system

For a long time China has been implementing relatively strict foreign exchange administration system due to shortage of foreign exchange resources, insufficiency of macro control capability, imperfection of market system. Since China took on the innovative opening-up policy in 1978, China forms a foreign exchange administration profile--“RMB (Chinese Yuan) is convertible for current account items, while partially convertible for capital account ” step by step.

China’s foreign exchange reform can be divided into three periods:

Exchange regime during the planed economy (1949-1978). A highly centered, planning system was implemented in the planed economy environment. Bank of China was the only specialized bank involving in foreign exchange business. All foreign exchange receipts were obliged to surrender to the state, any purchase of foreign exchange should be included in the state plan. The nation never incurred foreign borrowings or allowed foreign direct investment.

Exchange regime during the transitional period (1979-1993). (1) The State Administration of Foreign Exchange, which is authorized for charging foreign exchange control matters under the leadership of the People’s Bank of China, was established. (2) The enterprises were permitted to retain a portion of their foreign exchange earnings. (3) Foreign exchange swap center was set up and developed. (4) The RMB exchange rate regime was reformed. (5) Various financial institutions were allowed to involve in foreign exchange business. (6) Restrictions on domestic individuals’ foreign exchange receipts were relaxed. (7) The foreign exchange certificate was introduced in order to encourage foreign exchange inflows and sales for RMB from oversea Chinese residents.

Exchange regime after 1994. (1) In 1994, China realized RMB conditionally convertible under current account transactions. (2) The dual exchange rate regime of the RMB was unified into a single managed floating exchange rate on the basis of market demand and supply. (3) A system of purchasing and surrendering foreign exchange through designated foreign exchange banks was formed. (4) A nationwide, unified and standard inter - bank foreign exchange market, i.e. China Foreign Exchange Trade System(CFETS) was established. (5) Domestic enterprises that meeting some conditions was allowed to open settlement foreign exchange account to keep export receipts within the upper limit set by SAFE.

On December 1st, 1996, China officially accepted the obligations of Article VIII of the IMF Articles of Agreement and made the RMB fully convertible for current account transactions.

II Present foreign exchange administration in China

When people talk about convertibility, they normally think that China is one of the few countries still with strict capital control. But if we go into this issue in more detail, we will find that at present China's capital account is partially convertible. Corresponding to the 43 items of the seven categories under capital account transactions set up by the IMF, some of the items have always be treated as fully or basically convertible ; some of them are still strictly or totally prohibited. When evaluating the extension of China's capital account opening-up, some international organizations, including the BIS, conclude that the RMB has become convertible to a substantial extent for capital account transactions. In conclusion, China is already on its way to capital account convertibility.

First of all, FDI flows are encouraged. The only measure applied is authenticity test. The priority area for FDI has enlarged from manufacturing sector to high technology and infrastructures. At present, China fulfills its commitment to access to WTO, foreign investments are also allowed in financial services, insurance, securities and other specialist service areas. In the future, China support the foreign investors to take part in the restructuring and reform of state-owned enterprises and commercial banks by way of merger and acquisition.

Secondly, portfolio investment liberalization has been conducted in a cautious manner in order to stay away from associated shocks. Foreign investors are allowed to invest in B-shares and foreign currency-denominated bonds issued domestically and H-shares and N-shares issued on overseas markets except for RMB-denominated equities and bonds on the domestic markets. According to the WTO commitments, there is possibility to set up Chinese and foreign joint venture securities companies. However, their trading activities are limited to primary market underwriting and fiduciary trading on the secondary market. In addition, priority trading is not allowed.

Thirdly, external debts are strictly controlled and China are working towards centralized administration on foreign debts. Short-term foreign debts are monitored by their outstanding amounts whereas medium and long-tem foreign debts are controlled by the pre-determined quota. The borrowers are also subject to qualification examination. In principal, international borrowings of domestic enterprises are subject to permission from the administrative agencies and have to be carried out through qualified financial institutions. The exceptions are that foreign-invested enterprises have the discretion to borrow internationally to make up the difference between their registered capital and paid-in capital. The international borrowings of foreign banks and short-term trade finance within three months have been included in the foreign debt statistics.

III Improve China's foreign exchange regime.

(1) Improve Balance of International Payment statistics.
(2) Enhance the supervision over the financial institutions' foreign exchange operation.
(3) Gradually formulate a foreign exchange regulatory system in compatible with the market economy.

IV Prudentially pushes forward RMB convertibility for capital account transactions.

China does not possess the conditions for full convertibility in the near future. On the way to capital account convertibility, China needs to make necessary preparation. These preparation mainly include: developing domestic foreign exchange market, perfecting China's exchange rate regime, strengthening laws and regulations in place of administration fiat and setting up a capital flow monitoring system. There are other important issues which need to be handled, such as state-owned enterprises reform, financial institutions reform, government budget strengthening, ect.

China has been targeting capital account convertibility as a long-term goal, and set up a prudent policy that is implemented on a graduated basis. China will follow the principles of prudence, controllability, and gradualism in the progress towards the convertibility under capital account.