CONTROLLING FOR RISK: AN ANALYSIS OF CHINA'S SYSTEM OF FOREIGN EXCHANGE AND EXCHANGE RATE MANAGEMENT

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I. INTRODUCTION

After more than twenty years of rapid development of China's economy and foreign trade sector, both China itself and the rest of the world are for the first time coming to grips with the reality that China's economic policy choices now have global repercussions. As the international consciousness of China's influence grows, China's economic policies have naturally come under increasing criticism from countries that feel they are being affected negatively by those policies. This phenomenon can be seen in the recent controversy surrounding China's foreign exchange regime and pegged exchange rate system.

Calls on China to revalue or float its currency – coming primarily from Japan and the United States – have been intensifying since late 2002.[1] The accumulating international political pressure for China to adjust its exchange rate policy has sparked intense debate among economic and political analysts concerning the appropriate foreign exchange and exchange rate system for China. While this debate has focused principally on China's choice of exchange rate mechanism, i.e. the pros and cons of letting the RMB float according to market demand and supply versus pegging the currency to one degree or another, the debate has also encompassed China's overall policy of maintaining restrictions on the free flow of foreign currency and the convertibility of the RMB.

This paper is intended to contribute to the current debate on China's foreign exchange regime by providing a systematic analysis of China's current regulatory and administrative regime governing foreign

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[1] On December 2, 2002, two senior officials in Japan's Ministry of Finance published an article in the Financial Times accusing China of "exporting deflation" through its policy of pegging the renminbi (RMB) exchange rate to the U.S. dollar. Haruhiko Kuroda and Masahiro Kawai, *Time for a Switch to Global Reflation*, FIN. TIMES, December 2, 2002, at 23. As pressure from Japan to revalue the RMB continued throughout 2003, by the summer of 2003, the United States had decisively joined in the offensive, arguing that China's currency peg was unfairly harming U.S. producers and costing American jobs. *See, e.g.*, Michael Morgan and David Pilling, *Snow Urges Beijing to Drop Fixed Currency*, FIN. TIMES, September 2, 2003, at 12.

exchange transactions and the RMB exchange rate. Because the public debate on China's foreign exchange policies has been waged primarily by economists and politicians, it is not surprising that relatively little attention has been paid to the underlying regulatory regime and how it serves to promote the overall policy choices adopted by the Chinese leadership. By providing a comprehensive overview of China's foreign exchange regime, it is hoped that this paper will aid in better understanding and analyzing China's foreign exchange system and exchange rate mechanism.[2]

In addition, by analyzing the historical development as well as current manifestation of China's forex regime, this paper aspires to contribute to the substantial existing literature on China's economic and legal reform and development. The ongoing reform of China's foreign exchange regime should provide an illuminating example of China's characteristic development path. Moreover, the relative success of China's gradualist approach to foreign exchange and exchange rate liberalization allows it to serve as a model for other transitional or developing economies.

In addition, it is hoped that an analysis of China's current foreign exchange regime will promote a more thorough understanding of the overall state of China's regulatory mechanisms today. As a critical part of China's economic policy and law, comprehensive knowledge of China's forex regime should be useful to lawyers, academics, and all those interested in China's legal system and economic policy choices.

The body of this paper is divided into five sections. Section II covers the historical development of China's foreign exchange policy and law since the Nationalist era. Section III provides an analysis of the institutional and legal framework underlying China's current foreign exchange regime. Section IV deals with the regulation of supply and demand of foreign currency through regulation of current account and capital account transactions. Section V describes China's current exchange rate policy and its relationship to regulatory controls on capital movements and forex trading. The final section will

[2] As the focus of this paper is on the historical development, current guise, and future prospects of China's foreign exchange system, this paper will not go extensively into the economic issues surrounding the questions of what foreign exchange rate regime or which exchange rate mechanism would be optimal for China today and in the future. However, it is the author's hope that this paper may contribute to that discussion, which is best left to the pages of economics journals, by enhancing the understanding of the legal regime which surrounds and undergirds those political and economic decisions.

examine the likely path of further reform of China's forex regime in the years ahead.

II. MODERN HISTORY OF CHINA'S FOREIGN EXCHANGE SYSTEM

A. *Pre-1949: Instability and Foreign Domination*

In the years leading up to the Communist victory in the Chinese Civil War, China's foreign exchange system was plagued by instability and repeated crises. During this period, foreign interests dominated China's foreign trade and foreign exchange systems, with foreign currencies -- either brought in from abroad or issued by foreign banks operating in China -- commonly used in the coastal regions.[3] The Nationalist government, which governed mainland China until 1949, continuously struggled to maintain sufficient foreign exchange reserves to support the country's economy. Up until 1935, China's currency had been fully convertible to silver, but the combination of rapid specie outflow and the devaluation of silver on global markets forced the government off the silver standard in that year.[4] From then until the fall of the Nationalist regime, the government attempted, with varying degrees of success, to peg the value of China's currency, known as the fabi (*fabi*), to the British pound. However, a general shortage of foreign exchange and frequent bouts of capital flight forced the Nationalist government to borrow money from Britain and America in order to maintain sufficient liquidity in the forex markets to meet the needs of China's foreign trade sector.[5] While these emergency loans provided a modicum of order and predictability to the foreign trade sector, they also tended to serve the interests of the foreign capitalists, thus further delegitimizing the Nationalist regime and paving the way for its eventual downfall.

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[3] ZHONGGUO WAIHUI SHICHANG [CHINA'S FOREIGN EXCHANGE MARKET] 4 (He Zerong ed., Xinan Caijing Daxue Chubanshe, 1997). In particular, the U.S. dollar and, in southern China, the Hong Kong dollar were widely circulated.

[4] All silver was nationalized at that time. *See* D. K. LIEU, CHINA'S ECONOMIC STABILIZATION AND RECONSTRUCTION 82 (1948).

[5] In order to stabilize the exchange rate and ensure enough reserves for the conduct of foreign trade, the Nationalist government established the Exchange Stabilization Fund (*zhongying pingzhun jijin*) in 1939, to which Chinese and British banks contributed five million pounds each. Two years later, American loans, combined with further British and Chinese contributions, created a new fund, which was administered by nationals of the three states and effectively took control of foreign exchange regulation from the central bank. *Id.* 83-85.

B. *1949-1979: Centralization and Autarky*

As the Chinese Civil War drew to a close, the Chinese Communist Party (CCP) acted rapidly to stabilize and nationalize the foreign exchange system. The circulation of foreign currency was strictly forbidden and all foreign currency was required to be either exchanged for renminbi (RMB), the new national currency, or deposited in the Bank of China. Initially, the new government adopted a flexible exchange rate policy[6] and permitted private companies and interests to play a major role in the foreign exchange market in an attempt to stimulate foreign trade and encourage the repatriation of the substantial wealth owned by overseas Chinese.

By 1953, however, the Communist government's economic policies had turned sharply against free markets and cultivation of the private sector in favor of autarky and central planning. For more than two-and-a-half decades thereafter, all international transactions were handled by government ministries according to a centralized national economic plan. Foreign trade, which accounted for the bulk of China's international balance of payments, was conducted solely by designated state enterprises. Under this system, the Bank of China controlled a monopoly on foreign exchange business. Central planning ensured that the overall trade balance was not allowed to diverge far from equilibrium, but, because the central government did not promote or incentivize exports,[7] total foreign trade remained stagnant and China's foreign exchange reserves remained small. Lacking export revenues,

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[6] During the early years of the Communist government, the exchange rate was allowed to fluctuate dramatically roughly according to its purchasing power parity value. Due to high inflation in China and the desire to stimulate exports, the "old renminbi" depreciated from 80 per U.S. dollar in January 1949 to 42,000 to the dollar in March 1950. As China's inflation rate stabilized and the country shifted towards an autarkic economic model, the old RMB appreciated back to 26,140 per dollar by the end of 1952. In 1955 old RMB notes were replaced by new RMB notes at a rate of 1 new RMB = 10,000 old RMB. The exchange rate remained essentially unchanged, at approximately 2.5 RMB to the dollar, from then until the collapse of the Bretton Woods fixed exchange rate regime in the early 1970's. *See* CHINA'S FOREIGN EXCHANGE MARKET, *supra* note 3, 121-125.

[7] Like many other developing countries in the early post-war years, China adopted "import substitution" economic policies, which de-emphasized the role of international trade in economic development. Under this development model, exports were used primarily to finance needed imports, and were not considered to be drivers of economic growth. Designated enterprises were given export quotas, but had no incentive to increase their exports, as they would not share in any profits earned. *See* NICHOLAS LARDY, FOREIGN TRADE AND ECONOMIC REFORM IN CHINA, 1978-1990, 17-19 (1992).

China could not afford the imports necessary to raise standards of living.

During this period, the RMB exchange rate was set by government fiat. After initially allowing the RMB to depreciate substantially, the Communist government fixed the exchange rate at approximately 2.5 RMB per dollar by the mid-'50s. Although the nominal rate was fixed, the RMB steadily appreciated in real terms over the next several decades, becoming significantly overvalued by the early 1960s.[8] The overvaluation, however, meant little to China's external trade balance since, under the planned economy, no matter what the exchange rate was, a trade balance in terms of international prices was guaranteed. As the central government controlled all foreign currency and directed all foreign trade, it could ensure that all imports were sufficiently financed by foreign currency earnings. The overvalued exchange rate allowed importers to earn excess profits, which served to offset the losses sustained by exporters. In this way the exchange rate served merely as a tool with which to adjust the relative balance of profits and losses between importers and exporters, without affecting the actual levels of imports and exports. Moreover, as neither the exchange rate nor domestic prices were allowed to adjust relative to their international competitiveness, the composition of China's foreign trade during this period had little relation to the economic principles of comparative advantage. The result was a distorted and dysfunctional foreign trade sector that contributed very little to China's modernization.

C. *1979-1993: Decentralization and Managed Market Forces*

Between 1979 and 1994 a series of major reforms to China's foreign exchange regime radically altered the control and distribution of foreign exchange within the Chinese economy and paved the way for future liberalization in the 1990s. The reforms were part and parcel of Deng Xiaoping's overall "reform and opening" (*gaige kaifang*) policy, which sought to spur rapid economic development through increased

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[8] *Id.* at 24-29. The overvaluation was the result of the gradual divergence between domestic prices, set by the government, and international prices, set by international markets. Since the nominal exchange rate was not adjusted sufficiently to offset the price differentials, as domestic prices increased faster than international prices, the real exchange rate of the RMB became increasingly overvalued.

exports and the gradual introduction of market forces and a private sector – including foreign-invested enterprises (FIEs) – into China's economy. In order to encourage exports, attract foreign investment, and nurture private enterprises, the government decentralized control of foreign exchange and experimented with market-determined exchange rates. However, as with other aspects of China's early economic reforms, Deng Xiaoping's government chose a gradualist, heavily *dirigiste* development path, whereby the inherited state-owned sector continued to exist side by side with the newly burgeoning private sector.[9] In the context of foreign exchange management, this parallel economy approach was manifested in a system of dual foreign exchange markets and multiple exchange rates.

The first major reform of the Deng Xiaoping era was the creation of the State Administration of Foreign Exchange (SAFE) (*Guojia Waihui Guanli Ju*) in 1979.[10] Through SAFE, the central government began developing a regulatory and administrative regime for foreign exchange management as actual control over foreign exchange became increasingly decentralized during the 1980s. Thus SAFE enabled the government to shift from direct management of foreign exchange through central planning to indirect management through regulatory supervision. One of SAFE's most significant powers was the authority to license banks and non-banking financial institutions to deal in foreign exchange, eliminating the Bank of China's monopoly on foreign exchange business. Allowing these "designated foreign exchange banks" (*waihui zhiding yinhang*) to handle foreign exchange transactions and trading laid the initial foundations for the current interbank foreign exchange market.

Even more important to the development of China's economy was the introduction of the "foreign exchange retention system" (*waihui liucheng zhidu*) in 1979, whereby enterprises earning foreign exchange

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9 For an overall analysis of China's parallel-economy approach to economic development, *see* Lan Cao, *The Cat That Catches Mice: China's Challenge to the Dominant Privatization Model*, 21 BROOK. J. INT'L LAW 97 (1995).

10 Initially, SAFE was known as the State General Administration of Exchange Control (SGAEC). When it was placed under the supervision of the People's Bank of China in 1982, the SGAEC lost the "General" in its appellation and was referred to as the State Administration of Exchange Control (SAEC). In 1998 its English name was changed to its present form. Since the bureau's basic functions and its Chinese name have remained essentially unchanged, for the sake of consistency and ease of understanding, the bureau will be referred to as SAFE throughout this paper. For more information on the role of SAFE generally, see Sec. III below.

could retain a right to a share of those earnings for their own use.[11] By allowing local governments and enterprises to retain forex earnings,[12] the central government provided incentives to export that were lacking in the earlier central planning system. However, the incentive effect of the retention system was initially limited by two restrictions imposed on the use of forex earnings: 1) the retained forex earnings could only be used by the entity that earned them, and 2) the holders of forex retention rights could only use them in accordance with national policy objectives, which required approval by relevant government agencies.[13] Since enterprises earning foreign currency oftentimes did not have the need or capability to purchase imports, these restrictions not only reduced the incentive to earn forex retention rights, but also meant that a substantial portion of China's foreign currency resources were unutilized or utilized inefficiently.

In response to these problems, the government created the Foreign Exchange Adjustment Market (*waihui tiaoji shichang*), wherein Chinese enterprises could exchange their forex retention rights at one of the Foreign Exchange Adjustment Centers (*waihui tiaoji zhongxin*) located at Bank of China branches throughout the country.[14] For the first several years of their existence, though, these centers remained relatively small, their attractiveness and effectiveness hampered by government-mandated restrictions on exchange rate fluctuations and the disallowance of participation by FIEs, which were among the largest importers and exporters.

A major step forward in the liberalization and rationalization of China's foreign exchange system occurred in 1985-6, when the government opened special Foreign Exchange Adjustment Centers for

11 Under this system, all foreign currency earnings had to be handed over to the central government in exchange for RMB at the official exchange rate, but the foreign currency earner was granted a right to repurchase a portion of that foreign currency if and when it needed to use it. Initially, the retention quotas were relatively low (about 20%), but they grew steadily during the 1980s, exceeding 50% for certain industries and regions by the end of the decade. *See* LARDY, *supra* note 7, at 52-7.

12 Many of China's state-owned enterprises during this time were controlled by local governments. Thus, in effect the forex retention rights accrued to these local governments.

13 LARDY, *supra* note 7, at 57. Due to tight restrictions on the outflow of capital, foreign currency earnings generally could only be used for purchasing imports. However, many exporters with forex retention rights lacked importing licenses.

14 The first forex adjustment center opened in the Guangzhou branch of the Bank of China in 1980, with a second center opening in Shanghai the next year. Gradually, more centers were opened in major cities over the next several years.

use by FIEs.[15] These centers, which became known in English as "swap centers," for the first time allowed FIEs to obtain domestic currency at rates dramatically more favorable than the official exchange rate. The swap centers were placed under the direct supervision of SAFE, with all transactions requiring pre-approval by SAFE.[16] However, the swap centers were not integrated nationally. Instead, each province had its own swap center market with its own exchange rate.

Between 1987 and 1993 the swap centers grew substantially in number, size, and scope. Although originally restricted to FIEs, eventually the centers were combined with the earlier domestic ones and, by the end of the decade, were also opened to money transfers from abroad as well as, on a limited basis, to individual Chinese citizens.[17] The total value of forex transactions conducted in the swap centers rose from US$4.2B in 1987 to over US$20B in 1991.[18] By 1993, the last year that domestic Chinese enterprises and individuals traded in the swap centers, roughly 80% of all legal forex transactions occurred in the swap centers.[19]

Notwithstanding the rapid growth of the swap centers, tight restrictions on who and for what purpose one could enter the swap center market ensured the existence of a robust foreign exchange black market throughout the swap center period. However, following the relaxation of restrictions on exchange rate fluctuations in the swap centers during the late 1980s, the gap between the swap rate and the

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15 The first FIE swap center opened in late 1985 in Shenzhen. Several others were opened the following year. By the end of the decade, every province had a swap market servicing local enterprises.

16 Regarding the swap markets, SAFE was specifically assigned the tasks of:

1. Establishing policy and regulations for the swap centers;
2. Ensuring that the swap centers were used in a way which conformed with and furthered national policy goals (such as promoting certain export industries and discouraging imports of luxury goods);
3. Intervening in the markets when exchange rate movements were deemed unhealthy;
4. Regulating the participants in and the source and end-use of funds entering the swap markets; and
5. Administering punishment to those who violated the swap center rules.

CHINA'S FOREIGN EXCHANGE MARKET, *supra* note 3, at 25-6.

17 Zhongguo Waihui Guanli Tizhi de Yange [The Evolution of China's Foreign Exchange Management System], http://www.safe.gov.cn/0430/js_tzyg.htm.

18 CHINA'S FOREIGN EXCHANGE MARKET, *supra* note 3, at 18.

19 Thomas Yunlong Man, Note, *National Legal Restructuring in Accordance with International Norms: GATT/WTO and China's Foreign Trade Reform*, 4 IND. J. GLOBAL LEGAL STUD. 471,490. The relative importance of the swap market versus exchanges conducted at the official exchange rate made the subsequent elimination of the official exchange rate much less disruptive economically.

black market rate narrowed substantially, suggesting that the swap center rate was not dramatically distorted.[20] This conclusion is made more tenuous, however, by the fact that each swap center acted independently, with significant divergence between exchange rates in different swap centers.[21]

Until 1993, China operated a dual exchange rate system, whereby the swap center exchange rates existed side by side with the official rate, which was used for most non-trade transactions.[22] The dual rate system allowed the government to gradually expand access to the free market, thus obviating the dangers associated with rapid liberalization without a fully developed regulatory regime in place. It also allowed China to effectively devalue its currency for trade transactions while retaining the purchasing power parity rate, traditionally favored by communist economists, as the official rate.

Both the official exchange rate and the swap center rates depreciated significantly throughout the 1980s and early nineties. The official rate for the yuan devalued from about 1.5 per U.S. dollar to 3.72 per dollar between 1980 and 1985 and depreciated further to about 5.3 to the dollar by the early nineties.[23] More importantly, the government allowed the RMB swap center rates, which had a greater impact on China's external trade sector, to drop substantially. The average swap center rate dropped from about six yuan per dollar to around nine yuan per dollar between 1988 and 1993.

By increasing the price competitiveness of Chinese exporters, the devaluation of the yuan almost certainly was a major factor in China's rapid export growth during this period. The devalued exchange rate also helped China attract more foreign investors looking for a cheap production base for goods sold globally. In addition, the

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20 LARDY, *supra* note 7, at 62-6.

21 For instance, in 1993 the weighted average exchange rate for the Inner Mongolia Autonomous Region swap market was 2.96 RMB per dollar, compared with 9.07 RMB per dollar in the Hebei Province market. While nationally swap center rates varied substantially, rates among the larger coastal province markets did not diverge significantly. CHINA'S FOREIGN EXCHANGE MARKET, *supra* note 3, at 20-1,27.

22 In fact, the swap centers did not represent China's first attempt at operating a dual exchange rate system. Between 1981 and 1984, China adopted a devalued Internal Settlement Rate (ISR) (*maoyi waihui neibu jiesuanjia*), used for foreign trade transactions. The system was eventually abandoned because of administrative difficulties and the lack of a mechanism for determining the appropriate ISR exchange rate. Lin Guijun, *China's Foreign Exchange Policies Since 1979: A Review of Developments and An Assessment*, at 6 (2002), *at* http://faculty.washington.edu/karyiu/confer/adb02/papers/lin.pdf.

23 LARDY, *supra* note 7, at 148-9.

fact that the swap center rates were largely market-determined may have made it harder for foreign countries to criticize China for engaging in unfair competitive currency devaluations. The legitimacy of the devaluations was further evidenced by the fact that, although China's total foreign trade volume jumped dramatically during the eighties and early nineties, China suffered from a trade deficit during much of this period.[24] However, perhaps more importantly, China's foreign exchange reserves grew more than 10-fold between 1986 and 1993,[25] substantially decreasing the danger of a balance of payments crisis.[26]

D. 1994-1996: Consolidation and Liberalization

The next set of major reforms to China's foreign exchange regime began at the end of 1993, by which time the weaknesses in the foreign exchange retention and dual exchange rate systems had become a clear threat to further economic reform and development. As the forex retention system grew in size and scope throughout the 1980s and early 1990s, effective control over China's foreign currency reserves shifted from the central government to local governments and enterprises, thereby weakening the central government's control over the supply, demand, and allocation of these funds.[27] This in turn decreased the ability of the government to ensure a balance of payments surplus and increased potential exchange rate volatility. Inefficient allocation of foreign currency also seriously hampered the effectiveness of the swap centers. As there was no guarantee a buyer of forex could find someone willing to sell, the swap markets were plagued by repeated shortages of foreign currency, putting severe pressure on the exchange rate and disrupting the smooth flow of international trade.[28]

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[24] China's imports exceeded its exports from 1984 to 1989 and again in 1993. During the period 1981-1993, China's cumulative imports exceeded its exports US$654 billion to US$619 billion. 1978 Nian Yilai Jinchukou'e [Imports and Exports Since 1978], http://www.mofcom.gov.cn/article/200303/20030300072323_1.xml.

[25] State Foreign Exchange Reserves, 1950-2002, http://www.safe.gov.cn/Statistics/Reserve.htm.

[26] A balnce of payments crisis occurs when a country does not have sufficient foreign currency to pay its immediate foreign currency liabilities. This often occurs due to a large or prolonged trade deficit, or when foreign currency-denominated loan burdens become too great. The result is usually a major and disruptive currency devaluation, sometimes accompanied by massive capital flight.

[27] LARDY, *supra* note 7, at 57. By 1993, almost all exporters enjoyed a 50% retention rate, while a further 30% of earnings could be sold to the central government at the swap market rate. Chris Brown, *China's GATT Bid: Why All the Fuss About Currency Controls?*, 3 PAC. RIM L. & POL'Y J. 57, 70-71.

[28] John Frisbie and Richard Brecher, *A Tough Balancing Act*, CHINA BUS. REV, Nov/Dec 1993.

Meanwhile, the dual exchange rate system was causing problems both domestically and in China's relations with its main trading partners. By the early 1990s the swap market rate dramatically exceeded the official rate (in spite of the devaluations of the official rate during the 1980s), thus providing an arbitrage opportunity for those with access to both markets.[29] This situation was exacerbated by the dramatic divergence between rates among the provincial swap markets, which created a chaotic and undesirable multiple exchange rate phenomenon.[30] Moreover, by the early 1990s, as China's share in world trade grew, exchange rate reforms had also become a major issue in China's foreign relations. The dual exchange rate was perceived as a non-tariff trade barrier by many of China's trading partners and had become a significant obstacle to China's WTO accession.[31]

In light of these issues, both the forex retention system and the dual exchange rate were eliminated as of January 1, 1994.[32] A single unified exchange rate was established at 8.7 RMB per U.S. dollar, the prevailing swap market rate at the time. At the same time, the old system of retention rights and forfeiture to the central government was replaced by the "bank foreign exchange settlement system" (*yinhang jieshouhui zhidu*), which remains the core of China's forex regime today. Under this system, control over forex transactions, previously divided among the swap centers, local governmental and business entities, and the central government, was concentrated in the designated forex banks. Rather than forfeit all forex earnings to the central government while retaining rights to repurchase a percentage of those earnings, as was the case under the forex retention system, the new laws required Chinese entities – as opposed to FIEs[33] – to convert all foreign currency earnings into RMB at the prevailing market rate at one of the

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[29] CHINA'S FOREIGN EXCHANGE MARKET, *supra* note 3, at 27-8.

[30] *Id.*

[31] Brown, supra note 27, at 69-70. Certain domestic industries could purchase imports using the overvalued official exchange rate, which, it was argued, amounted to a subsidy for these industries. *Id.*

[32] The 1994 reforms were part of a comprehensive package of economic reforms designed to ease China's path toward eventual WTO accession. Lin, *supra* note 22, at 20.

[33] While the 1994 reforms greatly simplified and rationalized forex transactions for domestic enterprises, they continued to reflect differential rules for domestic Chinese and foreign-invested enterprises. In fact, for the most part the 1994 reforms had little effect on foreign-invested enterprises. Unlike domestic enterprises, FIEs 1) did not have to exchange all their foreign earnings at one of the designated banks, 2) were not allowed to participate in the interbank market, and 3) were still forced to balance their foreign exchange accounts. Lucille Barale and Thomas E. Jones, *Getting Strict With Foreign Exchange*, CHINA BUS. REV, Sept/Oct 1994.

designated foreign exchange banks. At the same time, any domestic Chinese enterprise wishing to purchase foreign currency could do so directly from one of these banks, instead of through the swap centers.[34] For importers and others purchasing foreign currency for current account transactions, pre-approval by SAFE was no longer required, and the overall procedures for obtaining foreign currency were simplified and expedited dramatically. Although Chinese enterprises to some extent lost direct control over their forex earnings under the bank settlement system, overall access to foreign currency was increased substantially.[35]

Consolidating control of the nation's foreign currency in a limited number of banks served several goals of the central government. First of all, the government could more easily and efficiently monitor and control the flow of foreign exchange through regulation of bank accounts than through direct regulation of every transaction in the swap centers.[36] Secondly, the new system allowed foreign currency to flow more rapidly and efficiently through the economy than under the more cumbersome retention system, under which buying back retained forex required multiple bureaucratic approvals.[37] Thirdly, by allowing banks to trade foreign currency surpluses amongst themselves, the bank settlement system eliminated the liquidity problem that had plagued the swap market system.[38] Finally, establishing banks as the central players in forex trading enhanced the capabilities of the financial sector and moved it towards greater integration with and conformity to international banking standards.

Perhaps the most important aspect of the new bank-centered system was the establishment of the interbank foreign exchange trading market (*yinhangjian waihui jiaoyi shichang*). This market, described in more detail in Section V below, established a single national "market" exchange rate. On April 4, 1994, the China Foreign

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[34] Under the bank settlement system, foreign currency purchases are still subject to limitations, depending on whether the foreign exchange would be used for current account or capital account transactions. For all foreign currency purchases and outward remittances, proper documentation had to be submitted to the bank at the time of purchase. For details, *see* Section IV below.

[35] CHINA'S FOREIGN EXCHANGE MARKET, *supra* note 3, at 29-30.

[36] Larry Drumm, *Foreign Exchange Reform in the People's Republic of China*, 18 HASTINGS INT'L & COMP. L. REV. 359, 387-8. Under the bank settlement system, not only was there a unified paper trail for all forex purchases made by an enterprise, but enterprises were also no longer able to stockpile forex retention rights, as they had been able to do under the old regime. *Id.*

[37] CHINA'S FOREIGN EXCHANGE MARKET, *supra* note 3, at 30.

[38] *Id.*

Exchange Trading Center (CFETC) (*Zhongguo Waihui Jiaoyi Zhongxin*) opened in Shanghai, connecting by electronic network all domestic and foreign financial institutions licensed to trade forex. CFETC also incorporated the swap centers – which continued to serve foreign-invested enterprises until 1998 – thereby guaranteeing sufficient liquidity for FIEs.

Although access to foreign exchange was greatly liberalized by the 1994 reforms, the unification of the exchange rate through the creation of the interbank market did not mark a liberalization of exchange rate policy, but rather a consolidation and centralization of control over exchange rate movements. The single interbank market has allowed the central government to prevent unwanted exchange rate volatility through regulation of the market and intervention by the central bank. After appreciating to around 8.3 to the dollar in 1995, the exchange rate has not been permitted to move significantly since.

After a couple of years of settling into the new bank settlement system, 1996 saw a new round of forex reforms, culminating in China's official acceptance of Article VIII of the International Monetary Fund (IMF) Articles of Agreement[39] in December 1996. On April 1, 1996, a new set of forex regulations, the People's Republic of China Regulations on Management of Foreign Exchange (Forex Regulations),[40] came into effect. While these new rules were vague and largely instituted policy which had been in effect since 1994,[41] they reflected the Chinese government's commitment to eliminate the remaining limitations on foreign exchange derived from or used for current account transactions and have served as the basis for later reforms. In July 1996, the bank settlement system was opened to FIEs, thus obviating the need for the swap markets, which finally disappeared in December 1998. After eliminating the few remaining overt restrictions on foreign exchange used for current account transactions, on December 1, 1996 Beijing formally declared that current account

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39 IMF Art. VIII provides, *inter alia*, that "no member shall ... impose restrictions on the making of payments and transfers for current international transactions." In other words, it requires that members allow full convertibility of their currencies for current account transactions. The vagueness of this provision, however, allows for indirect restrictions (such as import/export licensing) and procedural roadblocks (such as onerous documentation requirements and delays in processing), thus limiting its actual significance.

40 Zhonghua Renmin Gongheguo Waihui Guanli Tiaoli, promulgated by the State Council on Jan. 29, 1996 and effective as of April 1, 1996.

41 Anne Stevenson-Yang, *Easing Up On Foreign Exchange*, CHINA BUS. REV, Mar/Apr 1996.

transactions were fully convertible and that China therefore was in conformity with IMF Article VIII.

The realization of current account convertibility marked a major milestone in the gradual opening of the Chinese economy to world trade. Current account convertibility was both a symbol of China's commitment to free trade and markets as well as a practical spur to further rationalization and increased efficiency of China's external trade sector. It was also the next logical step in China's economic reform and development path. Prior to declaring current account convertibility in late 1996, the government had maintained restrictions on current account transactions as part of an overall policy of gradual and guided liberalization of China's economy. In line with its *dirigiste* attitude towards economic development, the Chinese Communist Party adopted rules designed to ensure sufficient foreign exchange reserves, guide the content of imports and exports, and regulate the activities of foreign enterprises in China.[42] By the mid-nineties, however, domestic and foreign factors merged to impel the government towards full convertibility of the current account. First, and most importantly, China's balance of payments, after fluctuating dramatically during the 1980s and early 1990s, had settled into consistent surpluses, leading to rapid increases in China's foreign exchange reserves.[43] These increases in turn alleviated downward pressure on the RMB exchange rate, increased liquidity for the forex market, and reduced the chances of a balance of payments crisis. The government's willingness to relax controls on forex transactions was also spurred on by the growing global competitiveness of China's export industries, steadily rising foreign direct investment, and the cooling of import demand through domestic austerity policies. Furthermore, the establishment of the bank settlement system and interbank forex market provided the regulatory infrastructure to properly monitor current account transactions that had previously been lacking. In addition, foreign investors had lobbied vigorously for current account convertibility in order to improve the efficiency and predictability of their China operations as well as ensure the ability to repatriate their RMB

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42 For example, as China's trade balance turned sharply negative in the mid-80s, the central government had temporarily blocked the use of some retained forex earnings. LARDY, *supra* note 7, at 60.

43 From 1993 through 1996, China's foreign exchange reserves surged nearly five-fold, from US$21.2B to US$105B, a jump from 20.4% of yearly imports to over 75% of yearly imports. State Foreign Exchange Reserves, 1950-2002, *supra*, note 25.

earnings.[44] As a major step in the overall liberalization of China's foreign trade sector, current account convertibility also conformed with one of China's primary foreign policy goals during the 1990s: gaining entry into the WTO.

E. *1997 – Present: Stability in the Face of External Pressures*

Following the rapid large-scale reforms of the early to mid-1990s, Beijing more recently has moved cautiously with further reforms, emphasizing stability and focusing primarily on incremental and ad hoc improvements to the regulatory and administrative regime. During this period, China's domestic economy has enjoyed relatively stable and sustained growth with low inflation, thus reducing domestic pressure to institute large-scale and potentially destabilizing reforms. On the other hand, a series of external factors have forced both retrenchment and further liberalization. From late 1997 to early 1999, capital flight and devaluation pressure linked to the East Asian Financial Crisis required the government to tighten existing regulations and rethink the proper pace of capital account liberalization. More recently, China's entry into the WTO and consistently robust international payments position have served to stimulate greater liberalization of the foreign exchange regime. While these pressures have led to substantial modifications in China's forex laws and regulations, the overall forex regime remains essentially the same today as it was at the end of 1996.

Following China's declaration of current account convertibility in December 1996, many observers expected China to move rapidly towards capital account convertibility, achieving full convertibility perhaps as early as 2000.[45] Those sanguine predictions, however, were quickly dashed as the East Asian Financial Crisis deepened during 1998. Although China's tight restrictions on capital account transactions protected it against exposure to many of the more serious maladies suffered by other East Asian countries,[46] the deep regional

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44 *Currency Convertibility: End of the Balancing Act*, 3/1/97 CHINA ECON. REV. 13.

45 *Id.*

46 While many different hypotheses have been put forth explaining its root cause, today the East Asian Financial Crisis is widely perceived to have been precipitated by a combination of high levels foreign currency-denominated debt, large current account deficits, and a surge in short-term and portfolio capital inflows followed by rapid outflows. China did not share any of these characteristics due to its tight restrictions on both inward and outward investment flows.

recession and the competitive advantages China's neighbors gained through currency devaluation put serious strains on China's economy. As a result, there was widespread speculation that China would be forced to devalue the yuan to remain competitive. This speculation in turn prompted a significant flow of assets out of China.[47]

In order to stem the capital flight, SAFE instituted a series of measures in 1998 and 1999 clamping down on certain types of forex transactions and perceived abuses of the forex rules. Given the great fanfare surrounding China's declaration of current account convertibility less than two years earlier, the central government was understandably loath to reinstate direct controls on current account transactions. However, the government did take steps to seal off loopholes that had allowed capital to be siphoned out of the country under the guise of current account payments. In particular, the government was concerned about companies illegally storing foreign currency earnings abroad and using fraudulent import documentation to illegally remit foreign currency out of the country. In response to the former concern, the government instituted a grace period for companies to repatriate funds illegally held abroad, after which period severe punishments would be handed down to those caught violating the repatriation requirement.[48] Meanwhile, the problem of fraudulent documentation was handled by increasing SAFE's direct supervision of letter of credit payments and enhancing customs requirements for remitting funds abroad.[49]

The crackdown on undesirable outflows was not limited to these measures, though. Over a period of several months in late 1998 and early 1999, SAFE and the PBC issued a barrage of regulations and notices designed to shore up China's forex reserves and dissuade capital flight, including:

1. Tightening regulation of borrowing in foreign currency;
2. Prohibiting the early repayment of foreign currency loans;

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[47] The outflow of capital was evidenced by China's stagnant foreign exchange reserves in early 1998. Despite a large trade surplus and robust foreign investment inflows, China's foreign exchange reserves grew only marginally during the first half of 1998. *See* Foo Choy Peng, *PBOC Deadline Set On Return Of Forex Earnings*, S. CHINA MORNING POST, Sept. 29, 1998, at 1.

[48] *Id.*

[49] *See* Foo Choy Peng, *Forex Rules Hurt Legitimate Firms, Say Foreign Bankers*, S. CHINA MORNING POST, Feb. 1, 1999, at 3. This resulted in widespread discontent among businesses, particularly FIEs and foreign banks.

3. Requiring that banks conduct foreign exchange transactions only in the city in which they are located;
4. Prohibiting banks at or below the county level from conducting capital account foreign exchange business;
5. Temporarily halting approvals for outward foreign investment;
6. Closing the last of the swap centers;
7. Providing incentives for trading companies to repatriate foreign currency earnings through the institution of a grading system;
8. Tightening restrictions on carrying foreign currency out of the country; and
9. Discouraging certain undesirable imports through the adoption of an import product classification system.[50]

Notwithstanding the high number of circulars emanating from SAFE and the PBC during this period, for the most part the crackdown was carried out not through issuing new rules, but rather through tightening the enforcement of pre-existing regulations, many of which had routinely gone unenforced prior to the East Asian Financial Crisis.[51] The sudden strict enforcement of previously ignored regulations understandably caused significant consternation among many businesses and financial institutions, but the crackdown appears to have served its purpose without seriously damaging China's long-term goal of full currency convertibility. Although dangerously large-scale currency flight may have been unlikely even without many of these new regulations, their issuance demonstrated clearly the willingness of the Chinese government to risk short-term alienation of domestic and foreign economic interests in order to ensure that forex reserves remained high and growing. Although most of the measures adopted during the East Asian Financial Crisis were short-term in nature and were lifted or relaxed within a few years, the long-term effect of the crisis has been a more gradual and circumspect move towards capital account convertibility of the yuan.

As the effects of the East Asian Financial Crisis waned, pressures for further liberalization of the foreign exchange regulatory regime arose from China's successful WTO accession bid. Although

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50 For an extensive list of notices and regulations for strengthening exchange controls issued during the East Asian Financial Crisis, *see* Lin, *supra* note 22, Table 7.

51 Wang Xiangwei, *Regime Change Causes Delays*, S. CHINA MORNING POST, Jan. 14, 1999.

WTO rules and China's WTO Accession Agreement do not require capital account convertibility or exchange rate liberalization per se, WTO accession has had and continues to have a substantial effect on China's forex laws. The WTO principle of National Treatment requires China to eliminate any laws and policies which discriminate against foreign enterprises.[52] Even prior to officially joining the WTO, several controversial laws had already been taken off the books, including the requirement that FIEs balance their foreign exchange receipts.[53] More recently, China has eliminated rules stipulating differential treatment for FIEs and domestic enterprises regarding opening foreign exchange accounts and settling foreign exchange earnings.[54] Perhaps most notable, though, are the commitments China has made to open its financial services industry to foreign competition within five years of WTO accession.[55] By the end of 2006, foreign-owned banks should have equal treatment as domestic banks, including equal access to the foreign exchange services and trading markets.[56]

WTO accession in December 2001 has been followed by a period of extremely rapid growth in trade and inward FDI for China.[57] The resulting strong balance of payments position has made further liberalization of the capital account and exchange rate easier to digest. Moreover, it has opened China's foreign exchange system to increasing

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[52] The National Treatment requirement (found in Article III of the 1947 GATT) is one of the basic pillars of the GATT/WTO legal system. National Treatment, which also applies to investment laws affecting the trade in goods and services vis-a-vis the agreement on Trade-Related Investment Measures (TRIMs), requires that a country's domestic laws treat imported products no less favorably than products produced domestically.

[53] *See* William Kazer, *Outdated Forex Rules Face Axe*, S. CHINA MORNING POST, Oct. 25, 2000.

[54] See Section IV.C. below.

[55] As part of its Accession Agreement, China made liberalization commitments in the following sectors:

1. Local (renminbi) currency business
2. Foreign currency business
3. Motor vehicle financing
4. Financial leasing
5. Securities
6. Insurance

See Lin, *supra*, note 22, Table 9.

[56] *See* Lin, *supra* note 22, at 30.

[57] In 2002, the first full year following China's WTO accession, China's exports surged 22.3%, slightly outpacing the 21.2% rise in imports. In 2003, both export and import growth accelerated, rising 34.6% and 39.9%, respectively. Jinchukou Tongji [Import and Export Statistics], www.mofcom.gov.cn/jinchukou.shtml. At the same time, actual utilized foreign direct investment rose 12.5% to $52.7B in 2002, and gained a further 1.44% to $53.5B in 2003. Liyong Waizi Tongji [Utilized Foreign Investment Statistics], www.mofcom.gov.cn/waimaotongji.shtml.

criticism from abroad. In response, China has recently made substantial moves toward freeing capital account controls and has hinted at possible adjustments to its current exchange rate policy. The prospects of further liberalization of capital account transactions and relaxation of exchange rate controls are discussed in Section VI below.

III. INSTITUTIONAL AND LEGAL FRAMEWORK OF CHINA'S FOREIGN EXCHANGE SYSTEM

A. *The institutional framework*

Three government bodies – SAFE, the People's Bank of China (PBC),[58] and the State Council – play the most prominent roles in the design and implementation of China's foreign exchange regime. These roles can be divided into: 1) policymaking, 2) lawmaking (or regulatory role), and 3) implementation of laws (or administrative role). Although the precise division of responsibilities between the three government bodies is often blurred, a broad division of responsibilities and hierarchical relationship has developed since the inception of SAFE in 1979. Generally speaking, the PBC, in close consultation with SAFE, the State Council, and other government agencies, is in charge of formulating overall foreign exchange and exchange rate policy, while SAFE is the most important regulatory and administrative body.

The hierarchical relationship between SAFE, the PBC, and the State Council has shifted repeatedly since SAFE's inception.[59] Under the current organization structure, established in 1998, the State Council has delegated responsibility for the direct supervision of SAFE to the PBC, thus making SAFE a de facto division of the PBC.[60] As the PBC is itself a ministry directly under the State Council, there is a clear hierarchical relationship in descending order from the State Council to the PBC to SAFE.

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58 The People's Bank of China is often referred to in English as the PBOC or PBoC. However, this paper will use the acronym PBC, which the People's Bank uses to refer to itself on its website, www.pbc.gov.cn.

59 From 1982 to 1988 SAFE was designated a bureau under the PBC. In June 1988, SAFE was placed under the direct supervision of the State Council and raised to the ministerial level the next year. After being merged into the PBC in 1992, SAFE was again established as a separate state bureau during the governmental reorganization of 1998. In that same year, however, the State Council delegated responsibility over SAFE to the PBC. Thomas Jones, *Foreign Exchange Control*, *in* DOING BUSINESS IN CHINA 2.4 (Freshfields eds. 2003).

60 Symbolic of this relationship between SAFE and the PBC, the director general of SAFE has concurrently held the position of deputy governor of the PBC since May 2000.

By placing SAFE under the purview of the central bank, it appears the State Council has largely obviated the possibility of turf fighting between the two agencies, a phenomenon which appeared to be more prevalent before the 1998 reorganization.[61] As a result, though some confusion still remains concerning the relative responsibilities and decision-making authority of SAFE and the PBC,[62] SAFE is now the promulgating body for the great majority of newly issued foreign exchange regulations as well as being the most important administrative agency in China's foreign exchange system.

1. Policymaking

Overall foreign exchange and exchange rate policy is formulated primarily by the PBC. SAFE contributes to overall policymaking principally by conducting research and making suggestions on forex policy to the PBC. In addition, it appears that SAFE has significant leeway in interpreting and executing policies approved by the PBC. The role of the State Council in designing forex policy is less clear, however any substantial change in policy will likely require consultation with and approval by the State Council. In reality, due to the complexity and importance of foreign exchange policy and its interrelationship with other governmental policies, major policy decisions are generally the result of a dialogue between several government bodies. One example of this interdepartmental cooperation is the PBC's Monetary Policy Committee, which advises the PBC on a wide range of policy issues, including interest rate and foreign exchange policies. The Monetary Policy Committee is composed of members of multiple government departments, including the State Council, SAFE, the State Development and Reform Commission, and the Ministry of Finance, as well as experts from outside of the government.[63]

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61 Prior to 1998, it was more common to see regulations dealing purely with foreign exchange regulation issued by the PBC. During this period, several major regulations which under the current system would most likely be promulgated by SAFE were issued by the PBC, including the important Jiehui, Shouhui, Fuhui Guanli Guiding [Administrative Provisions on the Settlement, Sale, and Payment of Foreign Exchange] (Forex Settlement Provisions), promulgated by the PBC on June 20, 1996 and effective as of July 1, 1996.

62 For instance, certain responsibilities have been explicitly given to both bodies, e.g. management of China's foreign exchange reserves.

63 *See China Central Bank Names New Monetary Policy Committee Lineup*, DOW JONES INT'L NEWS, June 16, 2003.

Lawmaking

SAFE, the PBC, and the State Council all may, and do, issue laws regulating foreign exchange. As lawmaking bodies, however, their respective bailiwicks are fairly clear. For the most part, the State Council only issues regulations regarding extremely important or overarching issues. The PBC, in its role as formulator of monetary policy and chief regulator of the financial sector, has responsibility for the oversight of foreign exchange business conducted by financial institutions, including issuing and monitoring permits to conduct forex business, regulation of forex asset quality and risk management, establishing working balances for members of the foreign exchange interbank market, etc.[64] In addition, the PBC's responsibilities include intervening in the foreign exchange market (when necessary) and managing foreign currency reserves.[65] SAFE, meanwhile, is responsible for drafting and implementing most laws regulating the settlement, sale, trading, and use of foreign exchange, including regulation of foreign exchange bank accounts. While most forex regulations are promulgated by SAFE, the PBC, or the State Council alone, it is also common for multiple departments, including the Ministry of Commerce (formerly the Ministry of Foreign Trade and Economic Cooperation), the Ministry of Taxation, the Customs Bureau, etc., to jointly issue regulations. This type of interdepartmental cooperation may help to synthesize the work and tasks of multiple government agencies, improve overall regulatory and administrative coordination, and consolidate the promulgation of what would otherwise be repetitive or overlapping regulations.

Implementation of laws

The administrative responsibilities of SAFE and the PBC parallel their respective regulatory roles, with SAFE playing the predominant role and the PBC dealing with particular issues relating to monetary policy and the financial sector. SAFE's responsibilities include, *inter alia*, monitoring foreign exchange bank accounts,

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64 Jones, *supra* note 59, at 2.5.

65 Zhonghua Renmin Gongheguo Renmin Yinhang Fa [The People's Republic of China People's Bank Law] (PBC Law), passed by the National People's Congress on and effective as of March 18, 1995, Art. 4. See Section V below

approving certain individual forex transactions, keeping registration records, and compiling statistics. SAFE's administrative responsibilities are divided between the central branch of SAFE, located in Beijing, and the provincial- and local-level offices, located throughout the country.[66] The precise balance of administrative responsibilities undertaken by the central versus the provincial and local branches of SAFE has shifted with changes in the mood of the overall regulatory environment.[67] During the East Asian Financial Crisis, as the regulatory environment was tightened to limit illegal foreign currency outflows, the central bureau took on a more active administrative role. As the overall trend has shifted towards liberalization in recent years, though, the central bureau's role as administrator has diminished. As a result, most businesses and individuals wishing to conduct foreign exchange transactions today will find themselves working almost exclusively with provincial- or local-level SAFE offices.[68]

In addition to the above-mentioned responsibilities, SAFE has also adopted the role of clearinghouse for all forex regulations and policies. This role is reflected in the SAFE website, www.safe.gov.cn, the creation of which marked a substantial step forward in progress towards greater transparency and systematization in China's forex regime. Launched on May 28, 1999, the website provides full text releases of important regulations and circulars regarding foreign exchange laws, no matter which government body issued them. In addition, the website provides news, background information, FAQs, commentary, registration lists, and other information pertaining to China's foreign exchange regime.

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66 SAFE is divided into four administrative levels. As of late 2003, in addition to the central bureau, SAFE had 36 subordinate bureaus (*fenju*), mostly at the provincial and Special Economic Zone level, 294 "central branches" (*zhongxin zhiju*), at the city/municipality level, and 487 branches (*zhiju*), at the county and district level. Fenzhiju Jigou Shezhi [The System of Branch Offices], http://www.safe.gov.cn/0430/whfjjg.htm.

67 In theory, the local branches, whose head is named by the PBC, are closely linked to the central office and independent of the local government. However, in reality, there is some evidence that local SAFE offices are subject to parochial local interests. In addition to central SAFE's apparent distrust of local branches, as demonstrated by the centralization of administrative policies during the East Asian Financial Crisis, local SAFE bureaus have also been known to be eager to offer quick approvals for certain transactions, even in cases where central office approval should be required. Interview with Nicholas Howson, Of Counsel for the law firm of Paul, Weiss, Rifkind & Garrison (Sept. 29, 2003).

68 Jones, *supra* note 59, at 2.6.

B. The legal framework

The foundations of China's current foreign exchange regime are set forth in the 1996 Forex Regulations, issued by the State Council. The Forex Regulations provide a broad, generalized overview of the basic principles underlying China's foreign exchange regulatory system. As with other overarching laws issued by the National People's Congress (NPC) or the State Council, the Forex Regulations provide few detailed rules. Rather, the general principles and guidelines it sets out are clarified by further "tertiary regulations" issued by SAFE, the PBC, or other law-making agencies.[69] For instance, Article 10 of the Forex Regulations requires that all foreign currency earnings from current account transactions be repatriated and either converted into RMB or deposited in a foreign exchange bank account. However, the specifics as to who can open a forex account, how much can be deposited, restrictions on use of the account, disclosure requirements, etc., are only handled by additional regulations, such as the Administrative Provisions on Management of Domestic Foreign Exchange Accounts (Forex Account Provisions),[70] issued by the PBC, or the Detailed Implementation Rules for Management of Domestic Institution Current Account Foreign Exchange Accounts (Current Account Forex Account Rules),[71] issued by SAFE.

As China's legal system and foreign exchange regime have matured in recent years, foreign exchange regulations, especially tertiary regulations issued by SAFE, have proliferated, creating a veritable labyrinth of rules and regulations.[72] While the present system may be inconveniently complex and opaque for the average individual or business to easily comprehend,[73] the proliferation of discrete

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[69] Chinese national laws can be divided into three tiers: primary legislation, issued by the National People's Congress, secondary regulations, issued by the State Council, and tertiary regulations, issued by ministries and bureaus below the State Council. *See* Perry Keller, *Sources of Order in Chinese Law*, AM. J. OF COM. LAW 42, 711, 726 (1994).

[70] Jingnei Waihui Zhanghu Guanli Guiding, promulgated by the PBC on Oct. 7, 1997 and effective as of Oct. 15, 1997.

[71] Jingnei Jigou Jingchang Xiangmu Waihui Zhanghu Guanli Shishi Xize, promulgated by SAFE on Sept. 9, 2002 and effective as of Oct. 15, 2002.

[72] The SAFE website lists hundreds of regulations, most of which are issued by SAFE. As of November 1, 2003, the website lists 135 active regulations pertaining to the regulation of current account transactions alone, of which 78 have been issued since the beginning of 2000.

[73] Some recent regulations have attempted to ameliorate the complexity of the current regulatory regime by consolidating and systematizing administrative procedures. *See, e.g.*, Feimaoyi Shoufuhui ji Jingnei Jumin Geren Waihui Shouzhi Guanli Caozuo Guicheng (Shizing) [Administrative Procedures for Management of Buying and Selling Foreign Exchange for Non-trade

regulations has greatly added to the sophistication and presumably the predictability of the foreign exchange administrative regime. Moreover, this trend should be pleasing to those critical of the vagueness and indeterminacy that has traditionally permeated Chinese legislation. To some extent, the maze of regulations may be an unavoidable by-product of the transitional state of China's present foreign exchange system. As China gradually opens its capital account and deregulates current account transactions, the financial sector, and the foreign exchange market, piecemeal and ad hoc reforms, which tend to take the form of short-term, detailed regulatory notices, may be necessary to avoid complete confusion or undesirable discretion on the part of local bureaucrats.

In spite of the growing complexity of China's foreign exchange regulatory framework, there remains a basic internal rationale and structure to the foreign exchange system as set forth in the Forex Regulations and elaborated in subsequent rules. The contemporary legal regime is designed, as it has been since the beginning of the reform era in 1979, to serve China's overall economic development goals.[74] Under the present foreign exchange regime, these goals principally include 1) promoting international trade, foreign investment into China, and technology transfers to China, 2) ensuring the international competitiveness of China's exports and a balance of payments surplus, and 3) preventing large foreign currency debt burdens or unstable capital flows. China's foreign exchange system has been designed to accomplish these goals through two tiers of regulations:

1. Control of the supply and demand of foreign currency vis-à-vis regulation of current account and capital account transactions, and
2. Control of exchange rate movements vis-a-vis regulation of forex trading and central bank intervention in the interbank market.

Transactions and Foreign Exchange Payments by Individual Domestic Residents (Temporary)], promulgated by SAFE on Mar. 18, 2002 and effective as of May 1, 2002. Also, the launching of the SAFE website has greatly improved the transparency and availability of foreign exchange regulations.

74 Art. 1 of the Forex Regulations provides three basic purposes for the law:

1. Strengthening the management of foreign exchange,
2. Maintaining the international balance of payments, and
3. Spurring the development of a healthy economy for the Chinese people.

The controls on the supply and demand of foreign currency minimize the threats related to unstable capital flows while trying to avoid undue limitations on the growth of China's foreign trade. Exchange rate controls, meanwhile, are focused on maintaining a stable macroeconomic environment and a competitively valued RMB. As will be shown in the following two sections, these two levels of regulation are mutually reinforcing. Restrictions on the outflow of foreign currency both necessitate and facilitate exchange rate controls by creating a chronic oversupply of foreign currency in the interbank forex market, while tight regulation of exchange rate movements are sustainable in the long term only under a system of restricted capital flows.

IV. REGULATION OF THE SUPPLY AND DEMAND OF FOREIGN CURRENCY

A. *Current Account vs. Capital Account Transactions*

China's foreign exchange regulatory regime divides all international transactions into either current account transactions or capital account transactions. The degree of regulatory and administrative oversight any individual transaction will be subject to depends significantly on this designation, with current account transactions generally subject to indirect and ex post regulation, while capital account transactions frequently receive more direct and discretionary oversight.

The Forex Regulations define current account transactions (*jingchang xiangmu*) as "transactions that frequently occur in the international balance of payments, including such items as receipts and payments for trade in goods and services and unilateral transfers."[75] While this definition is extremely broad, presumably intentionally so, more precise definitions and clarifications are dealt with by tertiary regulations issued by the PBC, SAFE, or other ministerial and bureau-level regulators.[76] Broadly speaking, the rubric of current account transactions covers all international purchases and sales for consumption, along with certain recurrent international payments, such

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75 Forex Regulations, *supra* note 40, art. 52 (6).

76 An extensive list of current account items and their respective regulations are set forth in the Forex Settlement Provisions, *supra* note 61, arts. 6-25.

as the remittance of profits and dividends. The regulatory regime divides current account transactions into three major categories:

1. Import and export of goods (*jinchukou maoyi*);
2. "Non-trade transactions" (*feimaoyi xiangmu*), including a) trade in services (e.g. consulting, software, transportation, etc.); b) trade in rights and licenses (e.g. for IP, land-use, software, etc), and c) repatriation of profits and dividends, payment of salaries, etc.;
3. Payments by individual residents in China, including expenses from travel abroad and income in foreign currency (e.g. for services, interest on loans, remittances from family members abroad), and the physical carriage of foreign currency into and out of the country by residents or non-residents of China.[77]

Because each of these three categories of current account transactions requires a different type of administrative mechanism and carries a different degree of risk to the nation's supply of foreign currency and sustained economic development, the regulatory regime does not treat them all equally. For instance, given that in recent years the amount of foreign currency remitted into and out of China for international commercial transactions has dwarfed the amount attributable to transactions by individuals, payments and receipts for international commercial transactions understandably have received greater attention from the administrative regulations. However, this does not mean that commercial transactions necessarily face tighter restrictions than transactions affecting individual residents.[78]

In contrast to current account transactions, capital account transactions (*ziben xiangmu*) are defined by the Forex Regulations as international transactions that cause an "increase and decrease in assets and liabilities in the international balance of payments as the result of inflow and outflow of capital, including direct investment, various

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[77] The division used here is based on the division of SAFE's responsibilities concerning current account transactions as delineated on the SAFE website. Jingchang Xiangmu Waihui Guanli [Management of Foreign Exchange for Current Account Transactions], http://www.safe.gov.cn/0430/zcfg.jsp?cx1=2.

[78] In fact, restrictions on the use of foreign currency by individuals, e.g. for travel or study abroad, have been generally more stringent than restrictions on forex used for purchasing imports. This is probably due to the fact that it is less practicable to conduct ex post verification of individual expenses while abroad than it is of payments for imports of goods and services.

kinds of loans, portfolio investment, etc."[79] As used in China's foreign exchange regulations, the term capital account transactions refers to both the capital account and financial account (*jinrong xiangmu*) sections of China's balance of payments.[80] The sum of these two accounts comprises the entirety of China's non-current account balance of payments. That is to say, any international transaction that does not fall under the current account rubric is necessarily a capital account item, and vice versa.[81]

Although there are a great many types of transactions that may fall under the capital account rubric, the vast bulk of China's capital account transactions fall under one of three broad categories:

1. Foreign direct investment (*waishang zhijie touzi*);
2. Foreign currency borrowing (*waizhai*), including issuing bonds and securing loans in a foreign currency; and
3. Securities (or portfolio) investment (*zhengquan touzi*).

Under China's capital account regulatory regime, each of these three categories receives distinct treatment. Furthermore, while each of these categories can have both inward and outward capital flows, China's regulatory and administrative regime treats all outward investment as a separate category with specific – and especially stringent – rules.

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79 Forex Regulations, *supra* note 40, art. 52 (7).

80 The vast bulk (more than 99.9% in 2002) of what are considered "capital account transactions" for the purpose of China's forex regulations are in fact financial account transactions on the balance of payments. Since the foreign exchange regulations do not differentiate between the two accounts, the precise differences are not important for the purposes of this paper. For a systematic explanation of the items that comprise each account, *see* 2001 Nian Zhongguo Guoji Shouzhi Pinghengbiao [2001 Table of China's International Balance of Payments], http://www.safe.gov.cn/Statistics/BOP_2001.htm.

81 By definition, the balance of capital and financial account items – including reserve assets (*chubei zichan*) held by the central bank – in the balance of payments must equal the inverse of the balance of current account items. In other words, a current account surplus necessarily means a capital account deficit of equal size, and vice versa. However, since the actual statistical entries are not necessarily made at the same time and may miss some transactions, the national balance of payments includes a further section, errors and omissions (*wucha yu yilou*). This section equals the difference between the current account, on the one side, and the capital and financial accounts on the other. The errors and omissions section of the balance of payments is often used as an indicator of the amount and direction (inward or outward) of illegal or under-the-table capital flows.

B. *Regulation of Current Account Transactions*

In principle, all current account transactions have been fully convertibility since 1996. This principle of current account convertibility is codified in Article 5 of the Forex Regulations, which states that China "shall not restrict the payment in and transfer of foreign exchange for current international transactions." In other words, individuals and enterprises are, in principle, free to receive foreign currency as payment for international sales that fall under the current account as well as to procure and use foreign currency for similar international purchases. By adopting current account convertibility, the Chinese government has partly abdicated control of the supply and demand of foreign currency to market demands.

Though technically not restricted, buying and selling foreign currency for current account transactions remains heavily regulated.[82] In order to prevent current account convertibility from threatening China's supply of foreign currency, the regulatory regime for current account transactions is designed primarily to: 1) ensure that all current account earnings are repatriated, and 2) protect against the use of false records of current account transactions to illegally remit foreign currency out of the country. SAFE and the other administrative agencies carry out these goals primarily through the use of three administrative tools:

1. Monitoring and supervising foreign exchange bank accounts;
2. Establishing documentation requirements for the procurement of foreign currency for current account purchases; and
3. Conducting ex post verification of the authenticity of payments and receipts for international commercial transactions.

The most fundamental restriction on current account earnings is the repatriation requirement. Article 9 of the Forex Regulations requires the repatriation of all foreign exchange receipts of domestic

[82] In terms of sheer number of regulations, current account transactions are more regulated than capital account transactions.

institutions[83] and prohibits their deposit abroad without specified authorization. Without this provision, China could possibly face a currency crisis even while enjoying a substantial current account surplus. That is to say, if companies could purchase forex freely for current account transactions but did not have to repatriate their current account receipts, the supply of foreign currency in the forex market might be insufficient to support its demand, thus threatening to dramatically drive up the price of foreign currency in the interbank market.

Upon repatriation, current account receipts must either be converted into renminbi or deposited in a current account foreign exchange bank account, both to be done at one of the designated foreign exchange banks.[84] All outbound payments in foreign currency similarly must be conducted through a designated forex bank, either by purchasing foreign currency from the bank or by running down one's foreign exchange account.[85] No matter which of these two options the domestic institution chooses, in order to transfer the funds overseas, it must provide to the bank documentation proving the authenticity and legality of the underlying current account transaction.[86] The gist of

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83 Here, as is generally the case, "domestic institution" (*jingnei jigou*) includes FIEs. Forex Regulations, *supra* note 40, art. 52(1).

84 Forex Regulations, *supra* note 40, art. 10. Any domestic institution with a license to engage in international business, including FIEs but not including financial institutions, may open a current account forex bank account upon registration with and approval by its local SAFE branch. Current Account Forex Account Rules, *supra* note 71, arts. 2,3,5. Prior to the issuance of the Current Account Forex Account Rules, which came into effect in October 2002, the rules for opening a forex account and retaining hard currency were different for domestic enterprises and FIEs. The Current Account Forex Account Rules standardized procedures and regulations for both Chinese enterprises and FIEs in order to bring them into compliance with WTO requirements. Under these regulations, every account is given a ceiling on the amount of foreign currency, in terms of US dollars, which may be held in the account (in general, up to 20% of the previous year's equivalent earnings, or, if the company did not have foreign currency earnings the previous year, no more than US$100,000). *Id.* art. 17. All remaining current account earnings must be converted immediately at the market rate. *Id.* art. 14.

85 Forex Settlement Provisions, *supra* note 61, arts. 13-18

86 *Id.* Before an importer may directly remit foreign currency abroad through a designated forex bank, the importer must be registered as such with SAFE. Maoyi Jinkou Fuhui Hexiao Jianguan Zanxing Banfa [Provisional Measures for the Supervision of the Verification of Foreign Exchange Paid for Trade Imports] (Import Verification Measures), promulgated by SAFE on Jan. 17, 1997 and effective as of March 1, 1997, art 6. The documentation requirements depend on the mode of payment and the type of underlying transaction. Documentation requirements for so-called "non-trade transactions" can be particularly complicated and onerous. *See* Jones, *supra* note 59, at 2.72-2.76 (describing problems confronting foreign businesses regarding documentation requirements for payments for intellectual property and the remittance of profits). Oftentimes, the regulations require documentation issued by multiple governmental bureaus proving the authenticity and lawfulness of the underlying transaction (e.g. certification of tax payments, licenses from the State Bureau of Trademarks, etc.). For an extensive list of requirements for non-trade transactions,

these regulations is that access to foreign exchange has been centralized in the designated forex banks, where it can be monitored more easily by SAFE.[87]

In addition to the supervision and regulation of forex bank accounts and documentation requirements, SAFE conducts ex post Verification of Forex Receipts and Payments for Imports and Exports (*Jinchukou Shoufuhui Hexiao*) to ensure that all such receipts and payments are valid and accurate. Beginning in 1991, SAFE instituted a verification process for export transactions, with a similar system for import transactions established in 1994. Depending on the payment method used, importers must submit certain documentation to the local SAFE office before payment of foreign currency and after receipt of goods. SAFE then compares these documents with those submitted to the designated forex bank remitting the funds overseas and with customs records.[88] To verify export receipts, China has created an on-line "Export Forex Earnings System" (*Chukou Shouhui Xitong*), integrated with the customs and tax authorities to allow for rapid verification and quantification of export earnings.[89]

As with commercial transactions, current account transactions by individuals are in principle fully convertible. However, in reality, de facto limitations on forex purchases have been imposed through administrative approval requirements. Individuals purchasing forex for current account transactions, e.g. study or travel abroad, can purchase foreign currency up to an established limit directly from a designated forex bank by providing certain documentation.[90] Above

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see Feimaoyi Waihui Yewu Caozuo Zhinan [Operational Guide for Non-Trade Foreign Exchange Business], http://www.safe.gov.cn/0430/ywzn_25.htm.

[87] *See* Section I. D. above for a list of specific advantages this system offers. To expedite the monitoring of current account foreign exchange accounts, SAFE has recently instituted an electronic account system, whereby all current account transactions are reported daily to SAFE. Current Account Forex Account Rules, *supra* note 71, art. 23. Previously, financial institutions submitted a monthly report to SAFE, and SAFE conducted a yearly review of all current account forex accounts. *Id.* arts. 23-24. The old system still functions for those areas of the country not covered by the electronic system. *Id.*

[88] Import Verification Measures, *supra* note 86, arts. 10-15. Also, *see* Jones, *supra* note 59, at 2.41-2.44.

[89] This system is part of the broader Electronic Port system (*Dianzi Kou'an*), a nationwide computer network designed to monitor trade transactions. *See id.* at 2.46

[90] Forex Regulations, supra note 40, art. 14. A complete list of documentation requirements is provided in Article 17 of the Jingnei Jumin Geren Waihui Guanli Zanxing Banfa [Provisional Measures for Management of Foreign Exchange for Individual Domestic Residents] (Individual Resident Forex Measures), promulgated by SAFE on Sept. 1, 1998 and effective as of Sept. 15,1998. Article 15 of the Individual Resident Forex Measures sets out the standard limits, which vary depending on the type of current account transaction. These standard limits have been gradually

that limit, SAFE approval is required.[91] Similarly, all foreign currency carried into or out of the country above a certain amount must be reported to the customs bureau and may require authentication by a designated forex bank or SAFE.[92]

C. *Regulation of Capital Account Transactions*

At the same time Beijing proudly touts the convertibility of the yuan for current account transactions, the government makes few apologies for the overtly strict controls it maintains on foreign exchange used in capital account transactions. The more restrictive treatment of capital account transactions is generally justified on the grounds that, due to their relative volatility, free capital flows would pose a grave risk to China's balance of payments and overall economic stability.[93] Whereas a country's current account balance rarely fluctuates substantially in a short period of time, sudden massive shifts in international capital flows have been commonplace over the last several decades.[94] Smaller and less developed economies like China's, lacking

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raised over the last several years. Most recently, SAFE has lifted the limits for most personal expenses abroad to US$3000 for those holding a less than six-month visa and $5000 for those holding a six-month or longer visa. Guojia Waihui Guanli Ju Guanyu Tiaozheng Jingnei Jumin Geren Jingchang Xiangmuxia Gouhui Zhengce de Tongzhi [SAFE Notice on Adjustment of Policy Regarding the Purchase of Foreign Exchange for Current Account Transactions By Individual Domestic Residents], promulgated by SAFE on Sept. 1, 2003 and effective as of Oct. 1, 2003.

91 Forex Regulations, *supra* note 40, art. 14.

92 According to the new rules that came into effect Sept. 1, 2003, residents or non-residents carrying more than US$5000 into the country must declare that money with Customs. Xiedai Waibi Xianchao Churujing Guanli Zanxoing Banfa [Provisional Measures for Management of the Carriage of Foreign Currency Cash Into or Out of the Country], promulgated by SAFE and the Customs Bureau on Aug. 28, 2003 and effective as of Sept. 1, 2003, art. 3. Persons carrying more than US$5000 but not more than US$10,000 out of the country must get a bank-issued certificate. Those carrying more than US$10,000 in cash must get a certificate from the local SAFE branch. *Id.* art. 5.

93 Many have argued that the 1997-8 East Asian Financial Crisis was to a large extent caused by the overly rapid deregulation of capital flows. *See* Joseph Stiglitz, *Captial Market Liberalization and Exchange Rate Regimes: Risk Without Reward*, 579 ANNALS AM. ACAD. POL. & SOC. SCI. 219 (January 2002). Following rapid deregulation of capital account transactions in several East Asian countries in the early and mid-1990s, tremendous amounts of foreign capital inflows – often in the form of short-term foreign currency loans -- led to expanding current account deficits and asset bubbles. As these current account deficits reached dangerous levels, capital began fleeing these countries, putting pressure on their forex reserves and exchange rates. When these governments were finally forced to devalue their currencies, companies found it impossible to pay back their foreign currency loans at the new exchange rates, thus precipitating major economic contractions in these economies. In contrast, China's relatively stable growth over the last decade, especially in the face of international crises like the 1997-8 Asian Financial Crisis, has been linked to prudent regulation of capital account transactions.

94 *See, generally, id.*

in sophisticated financial and capital markets, are especially vulnerable to the caprices of unregulated international capital markets.

Moreover, both large-scale inflows as well as large-scale outflows can be extremely hazardous to a country's economic well-being. On the one hand, a sudden inbound surge of foreign capital can lead to currency appreciation pressure, rising inflation, and current account deficits. Perhaps more importantly, large capital inflows have been linked to asset price bubbles and the resulting crashes when those bubbles pop.[95] Rapid capital outflows, on the other hand, can lead to pressure to devalue the currency and raise interest rates, both of which can lead to widespread bankruptcies and economic recession. As a result, merely monitoring and authenticating individual capital account transactions, as is done with current account transactions, may be insufficient to prevent undesirable or overly volatile capital flows.

Compared with China's regulatory and administrative regime for current account forex transactions, the hallmark of China's capital account regime is the more active and discretionary role played by SAFE in monitoring and approving certain types of transactions. This role allows SAFE, through both regulatory and administrative means, to discourage or disallow individual or groups of transactions that are deemed unnecessary or undesirable for economic development and the maintenance of a healthy balance of payments. In particular, transactions which may impose significant foreign currency liabilities on Chinese institutions are subject to discriminatory administrative oversight. However, it must be remembered that forex regulation is only one facet of a broader regulatory and administrative regime in which several central ministries and bureaus play important roles in approving and monitoring different aspects of capital account transactions. Thus, any given inward or outward investment must pass a panoply of administrative approvals designed to ensure that that particular investment conforms to China's overall development policies and needs. Within this context, SAFE's principal responsibilities include:

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[95] As foreign currency enters an economy and is converted into domestic currency at a fixed exchange rate, unless it is "sterilized" through central bank open market operations, the domestic monetary supply will increase. This "new" money frequently is used to fuel speculative bubbles in asset markets, a phenomenon which occurred in several East Asian countries during the years leading up to the Financial Crisis. Recently, some commentators have expressed concern that a similar phenomenon is occurring in China, in particular with regard to the real estate markets in Beijing and Shanghai. *See, e.g.*, Tim Holland, *Don't Revalue*, FAR E. ECON. REV., June 26, 2003.

1. Regulating and monitoring capital account bank accounts, including the sources and uses of funds in those accounts;
2. Registering, regulating, and monitoring inbound foreign capital, including FDI, foreign currency debt, and portfolio flows; and
3. Evaluating and monitoring outward foreign investments.

The degree to which a particular type of transaction is subject to regulatory and administrative restrictions is a function of the importance of that type of transaction to China's economic development and the risk it poses to China's balance of payments. Transactions which are considered relatively benign or encouraged, such as inward FDI, face mostly just registration requirements and bank account monitoring. On the other side of the spectrum, capital account transactions considered especially volatile, such as securities investments, or capable of imposing heavy debt burdens on China, such as long-term foreign currency borrowing, are met with an extensive administrative approval process. Although an array of restrictions and limitations remain on most types of capital account transactions, the last several years have seen a steady stream of new regulations marking a gradual, tentative, but clear shift from a system based on direct administrative oversight by SAFE to one based primarily on indirect regulation through the designated foreign exchange banks.

As with the current account administrative regime, regulation of foreign exchange bank accounts plays a crucial role in the capital account regime. The primary difference between the two regimes lies in the strict subdivision of capital account forex bank accounts. Whereas all earnings from current account transactions may be accumulated in a single account and used for payment of any current account item, capital account forex bank accounts must be divided according to the type of underlying transaction from which the income was earned or for which it will be used. Specifically, the Forex Account Provisions divide capital account transactions into eight categories (the eighth being miscellaneous), each of which must have its own account.[96] Generally, the funds from these accounts may not be

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[96] Forex Account Provisions, *supra* note 70, art. 20. Upon approval by SAFE, each account is given a set of parameters regarding permissible payments and receipts, time limits for use of the account, and maximum deposits. *Id.* art. 30.

shared, with each individual account requiring approval by SAFE.[97] By separating the accounts and requiring SAFE approval, this system helps mitigate opportunities to improperly utilize foreign exchange and expedites account monitoring by SAFE, but it also can be a great burden on the forex earner, the bank handling the accounts, and the administrative bureaucracy supervising them. As a result of these perceived drawbacks, we have begun to see a gradual devolution of supervisory authority to the designated forex banks as part of the overall shift towards an indirect, registration-based administrative regime,[98] but as of yet there has been little relaxation of the strict separation of accounts.

Given the crucial role inward foreign direct investment has played in China's economic development over the last twenty-five years, it is hardly surprising that forex brought in by FDI faces fewer regulatory hurdles than other types of capital account income. Since slowing the rate of FDI inflow has generally not been a policy goal, and in order to avoid unnecessarily burdensome bureaucratic approvals, the FDI administrative regime relies primarily on ex post registration and indirect supervision of bank accounts. However, while FDI is certainly treated relatively more leniently than other forms of capital account forex income, forex brought in by FDI is still subject to an impressive array of regulations. Principally, these include 1) requiring that the foreign investor's capital be deposited into a specialized forex account,[99] 2) restricting the use of the foreign-invested capital,[100] 3)

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97 *Id.* art. 28 According to art. 28, SAFE pre-approval is not required to open an account for buying and selling B shares – shares on one of China's bourses traded in foreign currency. This exception may be due to the fact that these funds may not be converted into RMB. *Id.* art. 35.

98 An example of this is the recent Guojia Waihui Guanli Ju Guanyu Shishi Guonei Waihui Daikuan Waihui Guanli Fangshi Gaige de Tongzhi [SAFE Notice Concerning Implementation of Reform of Means for Managing Domestic Forex Loans], promulgated by SAFE on Dec. 6, 2002 and effective as of Jan. 1, 2003, which has shifted responsibility for approving forex accounts for foreign currency loans issued by a domestic financial institution onto the loan issuer, which must submit monthly reports on all such accounts to SAFE.

99 Forex Account Provisions, *supra* note 70, art. 24.

100 Remittances out of the account are generally limited to current account transactions and capital account transactions authorized by SAFE. *Id.* Beginning in June 2002, SAFE delegated permission to approve and monitor the conversion of foreign currency from an FIE's foreign investment capital foreign exchange account to the designated forex bank handling the transaction. Guojia Waihui Guanli Ju Guanyu Gaige Waishang Touzi Xiangxia Zibenjin Jiehui Guanli Fangshi de Tongzhi [SAFE Notice Concerning Reform of Methods for Managing Settlement of Foreign Investment Capital], promulgated by SAFE on June 17, 2002 and effective as of July 1, 2002, art. 1 (the amount convertible without SAFE approval is restricted by the limitations imposed by SAFE upon initial approval of the account, while all capital account forex income above this amount requires SAFE approval. *Id.* art. 2).

requiring registration of the foreign-invested enterprise at the local SAFE,[101] and 4) conducting an annual inspection of the FIE's forex bank accounts.[102] Significantly, these regulations are for the most part aimed more at the illegal utilization of forex funds brought in by FDI than imposing safeguards on potentially excessive inward FDI.

In comparison to FDI, foreign debt, as both a source of much-needed foreign currency and a potentially serious drain on the country's foreign currency reserves, has generally been viewed more circumspectly by China's leadership. As a result, foreign currency borrowing transactions – principally commercial loans, bond issuance, and securing foreign loans – remain heavily restricted. However, the degree to which foreign borrowing is restricted varies significantly depending on the period of repayment and the borrowing entity. All medium- and long-term foreign commercial loans (*zhongchangqi shangye daikuan*) – loans maturing in more than one year – by Chinese enterprises must be incorporated in the State Development and Reform Commission's (formerly the State Development and Planning Commission) plan for the utilization of foreign capital.[103] In contrast, Chinese enterprises may borrow short-term commercial loans (*duanqi shangye daikuan*) – loans of one year or less – freely up to a maximum loan balance, as designated by SAFE for that enterprise.[104] The foreign debt regulations are less restrictive of borrowing by FIEs, which are generally free to borrow and repay foreign loans at will.[105] However, certain limits remain on the total debt burden that an FIE may incur relative to its registered capital.[106] In addition, FIEs, like all domestic

101 Upon receiving a business license from the Ministry of Commerce (formerly MOFTEC), the enterprise must be registered with the local SAFE branch, after which the new enterprise may open a capital account foreign exchange account at a designated foreign exchange bank. Waishang Touzi Qiye Waihui Dengji Guanli Zanxing Banfa [Provisional Measures on Management of Foreign Exchange Registration for Foreign-Invested Enterprises], promulgated by SAFE on June 28, 1996 and effective as of July 1, 1996, arts. 4,6.

102 *See* Guojia Wahihui Guanli Ju Guanyu Wanshan Waishang Zhijie Touzi Waihui Guanli Gongzuo Youguan Wenti de Tongzhi [SAFE Notice Concerning Questions Regarding Improving the Management of Foreign Exchange from Foreign Direct Investment], promulgated by SAFE on Mar. 3, 2003 and effective as of Apr. 1, 2003.

103 Waizhai Guanli Zanxing Banfa [Provisional Measures on Management of Foreign Debt] (Foreign Debt Measures), promulgated by the State Development and Planning Commission, the Ministry of Finance, and SAFE on Jan. 8, 2003 and effective as of Mar. 1, 2003, art. 15.

104 *Id.* art. 16.

105 *See* The Evolution of China's Foreign Exchange Management System, *supra* note 17.

106 Previously, any FIE's medium- and long-term debt balance was not permitted to exceed the difference between total investment and registered capital. However, the 2003 Foreign Debt Measures have changed the rules so that the sum of an FIE's total medium- and long-term borrowing plus its short-term debt balance may not exceed the difference between total investment and

institutions, must register all foreign debt with SAFE.[107] The issuance of foreign currency bonds is subject to similar regulation as foreign commercial loans, with short-term bonds and those issued by FIEs confronting relatively less severe restraints.[108] Chinese foreign debt regulations also cover loan securities by domestic institutions to foreign lenders, requiring that all Chinese financial institutions, Chinese companies, and FIEs – excluding wholly foreign-owned enterprises – gain SAFE approval for and register all securities on foreign loans.[109]

Investment in Chinese securities has traditionally been one of the most restricted of all capital account items. In order to obviate the risks associated with speculative short-term investment flows, China until recently did not allow foreigners to invest in RMB-denominated Chinese equities (so-called A shares). Instead, China created a market for shares traded in foreign currency (so-called B shares) specifically for foreign investors. However, this bifurcated approach suffered from several drawbacks, including insufficient liquidity in the B share market[110] and the inability of the A share market to compete and integrate globally. Two recent efforts have initiated the gradual

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registered capital. Foreign Debt Measures, *supra* note 103, art. 18. Within this limit, FIEs do not need prior approval to borrow foreign currency or to pay it back, but all debt must be registered with SAFE. If an FIE will exceed the limit, it must have its total capital raised. *Id.*

107 *See* Waizhai Tongji Jiance Shishi Xize [Detailed Implementing Rules for Maintaining Foreign Debt Statistics], promulgated by SAFE on Sept. 24, 1997 and effective as of Jan. 1, 1998.

108 Like commercial loans, all foreign currency bonds are divided into medium- and long-term (maturing in more than one year) and short-term (maturing in one year or less) bonds. Jingnei Jigou Faxing Waibi Zhaiquan Guanli Banfa [Administrative Measures on Management of Domestic Institutions Issuing Foreign Currency Bonds] (Foreign Currency Bond Measures), promulgated by SAFE on Sept. 24, 1997 and effective as of Jan. 1, 1998, art. 5. In general, issuance of medium- and long-term bonds must be approved by the State Development and Reform Commission and the State Council, in addition to SAFE, while short-term bonds need only be approved by SAFE. Foreign Debt Measures, *supra* note 103, art. 13. In addition, short-term bonds issued by Chinese enterprises are limited by the short-term loan balance limits set forth by SAFE. Foreign Currency Bond Measures, *supra*, art. 6. With the exception of convertible bonds, FIEs do not need SAFE approval to issue foreign currency bonds. *Id.*

109 Jingnei Jigou Duiwai Danbao Guanli Banfa [Administrative Measures on Management of Domestic Institutions Securing Foreign Debt], promulgated by the PBC on Aug. 21, 1996 and effective as of Oct. 1, 1996, arts. 4, 10, 14. Only non-financial institutions with subrogation rights may guarantee foreign loans. *Id.* art. 4. Foreign loan guarantees by any financial institution are limited to twenty times its foreign exchange capital, while guarantees by any non-financial institution are limited to the lesser of 50% of its net assets or the previous year's forex income. *Id.* art. 5. WFOEs do not need SAFE approval to guarantee foreign loans. Jingnei Jigou Duiwai Danbao Guanli Banfa Shishi Xize [Detailed Implementation Rules for the Administrative Measures on Management of Domestic Institutions Securing Foreign Debt], promulgated by SAFE on Dec. 11, 1997 and effective as of Jan. 1, 1996, art. 8. SAFE approval and verification is also required to perform duties under a foreign loan guarantee contract. *Id.* art. 40)

110 *See* Matthew Miller, *Taking Stock of B-Team*, S. CHINA MORNING POST, February 21, 2001.

demise of the bifurcated system. First, in an attempt to ameliorate the B share liquidity problem, in February 2001 the government began allowing Chinese companies and individuals to use forex deposited in Chinese banks for the purchase of B-shares.[111] More far-reaching, however, is the recent selective opening of the A share market to Qualified Foreign Institutional Investors (QFII) (*Hege Jingwai Jigou Touzizhe*),[112] which must be approved by and registered with SAFE.[113] Inward and outward remittances of foreign currency by the QFII are subject to limitations,[114] and SAFE approval is required for repatriating income earned on the investments.[115]

Finally, outward investments of all kinds are treated particularly stringently by the foreign exchange regulatory regime. The strict regulatory and administrative regime surrounding outward capital flows is driven largely by the fear of capital flight out of China and the low priority of outward investments in China's economic policy. However, this policy stance has shown clear signs of changing in recent years. In particular, recent administrative regulations have significantly streamlined the foreign exchange regulatory regime for outbound investments. Previously, all outbound investments were required to be evaluated by SAFE regarding 1) the foreign exchange risk of the venture (*waihui fengxian*), i.e. its feasibility and expected return,[116] and 2) the source of the forex funds to be used (*waihui zijin laiyuan*).[117] In addition, Chinese investors were forced to deposit a "profit guarantee" (*lirun baozhengjin*) with SAFE, recovering the sum as profits were remitted from the foreign investment.[118] In 2002 and 2003, the Chinese government decided to eliminate the forex risk

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[111] Guanyu Jumin Geren Touzi Jingnei Shangshi Waizigu Ruogan Wenti de Tongzhi [Notice Concerning Several Questions Regarding Individual Residents Investing in Domestic Foreign Capital Stocks], promulgated by the China Securities Regulatory Commission on and effective as of Feb. 22, 2001, art. 1.

[112] *See* Chi Lo, *China's Liberalization Strategy*, FAR E. ECON. REV., Dec. 5, 2002.

[113] Hege Jingwai Jigou Touzizhe Jingnei Zhengquan Touzi Guanli Zanxing Banfa [Provisional Measures on Management of Domestic Securities Investment by Qualified Foreign Institutional Investors], promulgated by the China Securities Regulatory Commission and SAFE on Nov. 19, 2002 and effective as of Dec. 1, 2002. art. 10.

[114] *Id.* art. 24.

[115] *Id.* art. 29.

[116] Jingwai Touzi Waihui Guanli Banfa [Administrative Measures on Management of Foreign Exchange for Outward Investment] (Outward Investment Measures), promulgated by SAFE on and effective as of Mar. 6, 1989, art. 3.

[117] *Id.*

[118] *Id.* art. 5.

evaluation and profit guarantee requirements as well as simplify the forex funds source evaluation.[119] However, notwithstanding the recent relaxations of SAFE supervision over outbound investments, all such investments still must gain approval from a national administrative bureau (generally, the Ministry of Commerce or, in the case of setting up overseas financial institutions, the PBC). Following approval by the relevant government bureau, the Chinese investor must then return to SAFE to register the investment before remitting the funds abroad.[120] In addition, all outward foreign investments must submit an annual report to SAFE and the other relevant departments on the condition of the foreign investment.[121] Finally, all earnings from the foreign investment must be repatriated and converted into RMB within six months of the end of the company's fiscal year, absent SAFE permission otherwise.[122]

V. EXCHANGE RATE CONTROLS

A. *The Pegged Exchange Rate*

Since the abolition of the dual exchange rate system and creation of the interbank market in 1994, China has operated what it terms a "managed floating exchange rate" (*youguanli de fudong huilu*). Notwithstanding the rhetoric of a "managed float," however, China has in fact maintained a hard nominal exchange rate peg between the RMB and the U.S. dollar since 1995.[123] That is to say, the USD/RMB

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119 *See* Guojia Waihui Guanli Ju Guanyu Jianhua Jingwai Touzi Waihui Zijin Laiyuan Shencha Youguan Wenti de Tongzhi [SAFE Notice Concerning Questions Regarding Simplifying the Evaluation of the Use of Forex Funds Used for Outward Investment], promulgated by SAFE on March 19, 2003.

120 Outward Investment Measures, *supra* note 116, art. 4.

121 *Id.* art. 9. SAFE, in conjunction with the Ministry of Commerce, has recently instituted an electronic annual inspection process for Chinese investors who establish non-financial enterprises abroad. *See* Jingwai Touzi Lianhe Nianjian Zanxing Banfa [Provisional Measures on Unified Annual Inspections for Outward Investment], promulgated by MOFTEC and SAFE on Nov. 27, 2002 and effective as of Jan. 1, 2003.

122 Jingwai Touzi Waihui Guanli Banfa Xize [Detailed Rules for Administrative Measures on Management of Foreign Exchange for Outward Investment], promulgated by SAFE on and effective as of June 26, 1990, art. 15. According to Article 6(7) of the Forex Settlement Provisions, profits on outward foreign investments are current account earnings, and thus repatriation does not need pre-approval by SAFE.

123 Following the 1994 reforms, the RMB exchange rate was initially allowed to fluctuate fairly substantially, although subject to central bank intervention. In 1995, after allowing the RMB to appreciate to 8.3 to the dollar, the central bank began to intervene more heavily to prevent any further significant fluctuations.

exchange rate has not been allowed to move *much* around a single nominal rate determined to be appropriate by the government. Since 1997, this pegged rate has been set at the auspicious sounding number of 8.28.[124] As a nominal peg, the real (i.e. inflation-adjusted) exchange rate may still fluctuate substantially.[125] As a U.S. dollar peg, both the nominal and real exchange rates of the RMB to currencies other than the U.S. dollar are allowed to float relatively freely. In fact, the RMB's trade-weighted real exchange rate (the so-called Real Effective Exchange Rate) appreciated by more than 20% between 1995 and 2002.[126]

It is important to note that the RMB peg is not established by law. Rather, the peg is a policy decision, maintained through a combination of two government tools:

1. Regulation of foreign exchange trading, and
2. Central bank intervention in the foreign exchange market.

While the regulation of forex trading limits the potential volatility of exchange rate movements, the actual exchange rate is determined primarily by the degree to which the central bank intervenes in the interbank market. Since the degree of central bank intervention is not a legally determined phenomenon, but rather a political decision, the peg could be abandoned without any change to the current legal or regulatory regime.

Although maintaining a hard peg is a policy decision, China's restrictions on the supply and demand of foreign currency discussed in Section IV above essentially necessitate heavy regulation of and intervention in the foreign exchange market. Restrictions on capital flows, in particular capital outflows, have resulted in a severe distortion of the supply and demand of foreign currency and created a chronic oversupply of foreign currency in the interbank market. Absent central bank intervention, the oversupply of foreign currency would lead to a

124 *See* Renminbi Jizhun Huijia Huizongbiao [RMB Reference Rate Table], www.safe.gov.cn/0430/tjsj.jsp?c_t=3. The pronunciation of 8.28 in Chinese (ba-er-ba) has a similar pronunciation to the characters meaning "prosperity leads to prosperity." Given the relatively strong propensity for numerology in Chinese culture, it is unlikely that this number was chosen arbitrarily.

125 Theoretically, the real exchange rate is more indicative of movements in relative cost-competitiveness than the nominal rate, but most of the advantages of nominal exchange rate pegs posited later in this section would not apply to real exchange rate pegs.

126 International Monetary Fund, *International Financial Statistics* (2003).

structurally overvalued RMB exchange rate, which could have a severely negative impact on China's economic development. As a result, so long as heavy capital account restrictions are maintained, the government must determine itself the fair exchange rate for the RMB and absorb the excess foreign currency through central bank intervention in the forex market.

Conversely, once the decision to peg the RMB exchange rate has been made, capital controls aid in maintaining the integrity of the exchange rate peg. Absent such controls, there would remain the risk that excessive capital flight could cause a shortage of foreign currency in the forex market, thus adding devaluation pressure on the RMB and potentially leading to a balance of payments crisis. In this way, capital account controls and the exchange rate peg are mutually reinforcing policies, which in combination ensure both sufficient foreign currency reserves to avoid a balance of payments crisis as well as a competitively valued RMB exchange rate.

While capital account controls essentially necessitate heavy governmental intervention in the forex market, they do not require a hard peg. A system of heavy intervention could also accommodate a soft, or crawling, peg, whereby the exchange rate would be allowed to gradually shift in response to changes in the macroeconomic environment. However, the Chinese government has chosen to adopt a hard peg due to its perceived benefits to China's overall macroeconomic development. These benefits include: 1) providing a predictable business environment for importers/exporters and foreign investors;[127] 2) providing a competitive boost to China's exporters (so long as the RMB is kept at sufficiently weak levels); 3) serving to obviate the dangers associated with speculative trading (so long as the peg is "credible");[128] 4) encouraging the perception of the yuan as a reliable

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127 Some analysts have claimed that the nominal peg has played a major role in the recent marked shift of global production capacity to China. Andy Xie, *China: Revaluation Fallacies*, MORGAN STANLEY GLOBAL ECON. FORUM, June 11, 2003, *at* http://www.morganstanley.com/GEFdata/digests/20030611-wed.html. A credible pegged exchange rate has largely obviated the need for importers, exporters, or investors to hedge, which can be particularly important for small or relatively unsophisticated businesses. However, given that the U.S. dollar may fluctuate substantially against third currencies, Chinese companies have increasingly turned to forward contracts or other derivative tools to reduce foreign exchange risk. *See Chinese Enterprises Alert Against Exchange Rate Risks*, XINHUA NEWS AGENCY, June 9, 2003.

128 A consistent problem with floating exchange rate regimes has been that exchange rates have a tendency to overshoot or undershoot their equilibrium levels due to speculative trading. This is a particular problem for small economies, whose exchange rates can be more easily manipulated by large international speculators. Pegged exchange rates may also be the target of speculative trading if speculators believe that the government cannot or will not maintain the peg in the face of market

store of value; and 5) serving to stabilize the East Asian regional economy by reducing the risk of competitive currency devaluation.[129] On the other hand, several factors mitigate the potential benefits of a hard peg over the long term: 1) over time, the pegged rate tends to deviate further and further from the equilibrium market rate, and may eventually lead to a sharp, destabilizing, and potentially economically destructive correction;[130] 2) an artificially high or low currency valuation can distort domestic resource allocation, leading to long-term inefficiencies; and 3) because there is no need to hedge under a peg, the development of more sophisticated currency trading tools (such as forward, futures, and options trading) may be retarded, thereby weakening the international competitiveness of the financial system and making the eventual transition to a floating exchange rate regime more difficult. Because of these potential dangers, most economists today seem to agree that in the long term a freely floating exchange rate, which in theory would allow the economy to adjust more efficiently to changes in the macroeconomic environment, is desirable.

B. *Regulation of Foreign Exchange Trading*

The Chinese government is able to tightly regulate and control trading between the RMB and foreign currencies by disallowing settlement of RMB trades made outside of China.[131] Within China, the government regulates both 1) retail trading, i.e. trading between financial institutions and their customers or clients, and 2) interbank trading, i.e. trading between financial institutions and either other financial institutions or the central bank. While the bulk of everyday trading occurs in the former market, the latter market plays the more important role in China's forex regime. The interbank market, known as the China Foreign Exchange Trading Center (CFETC), serves two

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pressure. Recent currency crises in Asia and Latin America were to a substantial extent the result of self-fulfilling prophecies by currency speculators. *See, generally*, Harris Dellas, P.A. V.B. Swamy, and George S. Tavlas, *The Collapse of Exchange Rate Pegs*, 579 ANNALS AM. ACAD. POL. & SOC. SCI. 53 (January 2002).

[129] This role was especially important during the East Asian Financial Crisis, when a devaluation of the RMB was widely expected and likely would have resulted in a longer and deeper regional depression.

[130] Many believe the East Asian Financial Crisis was greatly exacerbated due to governments maintaining distorted exchange rates far too long. Because of this, fixed and pegged exchange rate regimes have recently become less popular amongst economists. *See, id.*

[131] In early 2004 China began allowing the interbank settlement of RMB trading in Hong Kong. *See* Section VI below.

primary purposes: 1) ensuring that foreign currency liquidity remains ample by shifting foreign currency from banks with a surplus to banks with a deficit; and 2) establishing the unified market exchange rate.

The CFETC is a unified national market headquartered in Shanghai and linked to major cities across China via an electronic network.[132] The current legal regime governing the interbank market was established in 1995 by the Trading Rules for the China Foreign Exchange Trading Center Market (CFETC Rules)[133] and the 1996 Provisional Regulations on Management of the Interbank Foreign Exchange Market,[134] which delegates to SAFE responsibility for administrative oversight of the interbank market. In order to trade in the interbank market, one must become a member of the CFETC and pay annual dues.[135] Membership is open to all domestic and foreign-funded financial institutions licensed to engage in forex business,[136] which may trade on their own accounts or as agents of others.[137] However, the bulk of trading on the interbank market is conducted by the Bank of China and the PBC, with the former accounting for more than half of all selling of foreign currency and the latter accounting for the majority of foreign currency buying.[138]

The government has maintained tight restrictions on the forex trading tools available on the interbank market. While all internationally accepted tools are permitted for trading between two foreign currencies, as of today RMB trading is limited to spot trading with the US dollar, Hong Kong dollar, Japanese yen, and euro. More sophisticated exchange tools, such as currency swaps, futures, and

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132 The interbank market has expanded rapidly since its inception, with total yearly trading volume reaching US$151.1 billion, or US$602 million per day, in 2003. That represented an increase of about 55% over the previous year. More than 95% of all trades involve the U.S. dollar. However, total interbank trading volume still only amounts to less than one-fifth of China's total foreign trade volume, which may suggest that a large amount of foreign exchange transactions occur outside of the legal forex market. 2003 Nian Zhongguo Hobi Zengce Zhixing Baogao [China 2003 Annual Report on Monetary Policy Execution] (2003 Annual Report), http://www.pbc.gov.cn/xinwen/?id=790.

133 Zhongguo Waihui Jiaoyi Zhongxin Shichang Jiaoyi Guize, promulgated by SAFE on and effective as of Jan. 14, 1995.

134 Yinhangjian Waihui Shichang Guanli Zanxing Guiding, promulgated by the PBC on and effective as of Nov. 29, 1996.

135 CFETC Rules, *supra* note 133, art. 7.

136 *Id.*

137 *Id.* art. 9.

138 *See* Lin, *supra* note 22, at 24.

options are not yet available on the interbank market, although certain banks have received permission to offer these services to their clients.[139]

The government has imposed tight restrictions on exchange rate movements in order to limit volatility in the interbank market. Every trading day morning the PBC posts a median price, known as the reference rate (*jizhun huijia*), based on the previous day's weighted average exchange rate for the four currencies traded with the RMB. Each currency's exchange rate is then allowed to fluctuate only within a certain range from the reference rate. Since June 1996, the U.S. dollar rate has been permitted to fluctuate by 0.3% in either direction, while the yen and HK dollar may appreciate or depreciate up to 1% a day.[140] The euro, which began trading on the interbank market on April 1, 2002, is allowed to fluctuate up to 10% per day.[141] Retail rates which banks charge their customers are restricted to similarly narrow bands in relation to the reference rate.[142] While there has been widespread speculation for several years that the daily trading band will be widened, the band has remained essentially unchanged since 1996.[143]

C. *Central Bank Intervention*

Although the daily trading bands restrict short-term volatility in the forex market, they do not in and of themselves prevent longer-term appreciation or depreciation of the RMB exchange rate. Rather, the central bank maintains the desired exchange rate level by entering the market to buy and sell foreign currency on its own account. Because of

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139 As of mid-2003, only four Chinese banks were permitted to offer RMB forward contracts to customers. *See Chinese Enterprises Alert Against Exchange Rate Risks*, *supra* note 127. According to the Zhongguo Renmin Yinhang Yuanqi Jieshouhui Yewu Zanxing Guanli Banfa [People's Bank of China Provisional Management Measures for the Settlement and Sale of Foreign Exchange Forwards Business], promulgated by the PBC on Jan. 18, 1997 and effective as of Jan. 1, 1997, designated forex banks can apply for a permit to engage in forward contracts, limited to 120 days, with clients.

140 *See* The Evolution of China's Foreign Exchange Management System, *supra* note 17.

141 *Id.*

142 Banks permitted to deal in foreign exchange can post retail buy and sell rates on a daily basis within 0.17% above or below the PBC reference rate for the US dollar, and within 1% for the other three currencies. Retail rates for all other currencies are determined by reference to the US dollar interbank rate and the exchange rate between the USD and the currency in question on international markets. Buy rates for cash are allowed a further small margin over the non-cash buy rate. *Id.*

143 The current permitted daily exchange rate movements for the U.S. dollar, HK dollar, and Japanese yen were established by the Guanyu Waishang Touzi Qiye Yinhang Jieshouhui Hou Waihui Shichang Youguan Wenti de Tongzhi [Notice on Questions Relating to Post-Bank Settlement Foreign Exchange Trading], promulgated by SAFE on and effective as of June 28, 1996.

the general condition of oversupply of foreign currency in the interbank market, the central bank has been a heavy net purchaser of foreign currency. The foreign currency purchased by the PBC is then added to its balance sheet in the form of official foreign exchange reserves, which are invested abroad, usually in the form of low-risk government bonds. While the total amount of foreign exchange reserves in dollar terms held by the PBC is published regularly, the precise distribution of the reserves among foreign currencies and the investments made with the reserves are considered state secrets.[144] If for some reason demand for foreign currency exceeds supply at the desired exchange rate level, as happened for a short time during the East Asian Financial Crisis, the central bank is prepared to run down its forex reserves as required to maintain the desired RMB exchange rate.

As the central bank uses RMB to purchase foreign currency on the interbank market, it in effect pumps money into the Chinese economy, thus increasing the amount of RMB in circulation. In this way, the rapid rise in forex reserves in recent years, due primarily to large trade surpluses and strong growth in inward FDI, has contributed to a dramatic increase in money supply in China.[145] In order to slow this increase, which it is feared could lead to excessive inflation or asset bubbles, the PBC has more recently engaged in "sterilization" measures, whereby the central bank sells bonds on the open market in order to sop up the extra liquidity created by purchasing forex on the interbank market.[146]

VI. THE FUTURE OF CHINA'S FOREIGN EXCHANGE REGIME

Empirically speaking, China's policy of gradual and limited liberalization of foreign exchange controls has been a resounding success. China has succeeded in stabilizing the value of the RMB at a

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144 *China to Continue Padding Forex Reserves with Euros: Minister*, PEOPLE'S DAILY, Jan. 7, 2002, *at* http://fpeng.peopledaily.com.cn/200201/07/eng20020107_88188.shtml. According to this article, U.S. dollar-denominated assets probably accounted for at least 50% of China's forex reserves as of the beginning of 2002.

145 Broad money supply, or M2, has been growing at a rate of close to 20% per annum for the last several years. *See* 2003 Annual Report, *supra* note 131.

146 Such "open-market transactions" began in earnest in the spring of 2003 as China's forex reserves were experiencing extremely rapid growth. Between April 22 and July 15, 2003, the PBC issued about RMB 230B in bonds. Still, this issuance accounted for less than half of the US$60.1B (or RMB 498B) increase in forex reserves during the first half of 2003. James Kynge, *China Claims Success on Currency Front*, FIN TIMES, July 24, 2003 at 9.

competitive rate, thus setting the stage for the sustained strong growth in exports and inward FDI that has underpinned China's rapid economic growth in recent years. At the same time, China has avoided any significant foreign exchange crises while amassing the world's second-largest supply of foreign currency reserves.[147] Because the current system of regulating the supply and demand of foreign currency and maintaining a pegged RMB exchange rate has been, on the surface at least, so successful, it is hardly surprising that China has in recent years balked at instituting substantial changes to the current regime.

In spite of the apparent success of the current forex regime, however, there appears to be a consensus among Chinese officials and academics that China must continue to push for complete convertibility of the RMB and eventually adopt a floating exchange rate policy. This consensus is based on a widely held view that the current restrictions on capital movements and exchange rate fluctuations pose a serious threat to the long-term health, efficiency, and competitiveness of China's economy.[148] In addition, full integration into the global capital and currency markets is seen as a prerequisite for China to gain international recognition and acceptance as one of the leading economies of the world, a dream shared by most Chinese.

Notwithstanding the consensus as to the ultimate end-goal, the path towards full convertibility of the RMB and a floating exchange rate will certainly be a gradual one. As this paper has shown, the present

[147] As of the end of 2003, China's foreign exchange reserves stood at US$403.25 billion, more than any other country in the world except Japan. Zhongguo Linian Waihui Chubei [China's Historical Foreign Exchange Reserves], http://www.safe.gov.cn/0430/tjsj.jsp?c_t=5.

[148] Recently, a large number of Chinese and foreign economists have put forth several arguments for liberalizing China's capital account. First of all, liberalizing capital account flows may allow for more external financing of China's economic development. Secondly, freeing capital outflows would allow Chinese institutions and individuals to minimize investment risk while maximizing returns on investment, thereby improving the overall economic well-being of Chinese. Another argument often posited in favor of capital account liberalization is that, in theory at least, free capital markets should more efficiently allocate China's capital resources than the politically-driven system which still dominates China's financial sector. Free capital flows, often seen as part of a larger deregulation of the financial markets, would allow financial institutions to seek higher yield investments and be less dependent on political exigencies, thus stimulating Chinese companies to improve their efficiency. Many also argue that allowing China's capital markets to compete with foreign markets would help spur improvements in their services, including the development of more advanced financial tools, such as derivatives. Finally, capital account liberalization would allow the private sector to enjoy more of the benefits from China's recent balance of payments surpluses, a large portion of which has been swallowed by the central bank in the form of foreign currency reserves. For these reasons, almost all economists now agree that capital account liberalization is in China's long-term interests. *See, generally,* Yao Huiyuan, *Quanmian Shixian Renminbi Ziyou Duihuan de Zhang'ai Yu Cuoshi* [*The Obstacles and Measures for Complete Realization of the Free Convertibility of the Renminbi*], SOUTH CHINA FINANCIAL RESEARCH, Vol 16, No. 5 (Oct. 2001).

system of restrictions on capital flows has created significant distortions in the supply and demand of foreign currency in the forex market, thus making complete exchange rate liberalization untenable. As a result, immediate reforms to China's forex regime will likely focus on loosening capital account controls.

However, capital account liberalization itself must proceed slowly due to the immaturity of China's financial system. Rapid capital account liberalization would create the risk of capital flight from China's weak state-owned banks. Also, the lack of market-determined interest rates means that China's capital markets cannot yet function properly in a world of free capital flows.[149] Thus, until China improves the solvency and international competitiveness of its state-owned banks and liberalizes interest rates, capital account convertibility will remain an impracticable goal.

Notwithstanding the problems posed by China's weak financial sector, the government has recently emphasized its resolve to push forward with capital account liberalization. SAFE has publicly announced a series of reforms planned for the near future, which include 1) further loosening restrictions on outbound FDI, 2) allowing foreign and domestic MNCs to reallocate capital abroad, 3) relaxing limits on asset transfers abroad by individuals, and 4) allowing Qualified Domestic Institutional Investors (QDII) to engage in overseas portfolio investments.[150] More surprisingly, the head of SAFE has recently announced that China should achieve "basic convertibility" of the capital account by 2010.[151] In addition to being aimed at improving the international competitiveness and global integration of China's capital markets, these reforms also reflect an attempt to alleviate appreciation pressure on the RMB by allowing more capital to flow out of China. By reducing appreciation pressure on the RMB, it is also hoped that foreign criticisms of China's exchange rate "manipulation" will dissipate.

Although China is in no position to fully liberalize the exchange rate prior to achieving capital account convertibility, modifications to

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149 *See* Chi Lo, *supra* note 112.

150 *See China to Further Relax Control on Capital Account in Near Term*, XINHUA FIN. NETWORK NEWS, Dec. 3, 2003. According to this article, "China currently has loosened or cancelled controls on nearly half of the 43 items under the capital account stipulated by the International Monetary Fund."

151 *See* Christine Chan, *Beijing Sets Timetable for Full Convertibility*, S. CHINA MORNING POST, Mar. 7, 2004.

the current hard dollar peg regime are likely over the next several years. Foreign criticism combined with domestic concern over possible negative effects of the rapid growth in forex reserves have been increasing pressure on the Chinese government to adjust the current exchange rate policy. Possible reforms focus on two distinct issues: 1) valuation, i.e. the actual exchange rate level, and 2) flexibility, i.e. the degree to which the central bank intervenes to limit exchange rate fluctuations. China could retain tight restrictions on exchange rate fluctuations while allowing for a one-off or gradual shift in the pegged rate. Or, conversely, the central bank could permit greater fluctuations in the interbank rate, but keep a fixed central target rate. In addition, China is considering switching the peg from the dollar to a basket of several currencies.[152] In recent months there has been widespread speculation that China will adopt a combination of these options, simultaneously or near simultaneously switching to a basket peg, widening the daily trading band, and allowing for a modest appreciation in the value of the RMB.[153]

Another major step on the road towards full convertibility of the RMB and exchange rate liberalization is the establishment of offshore trading in the RMB. The establishment of offshore trading is crucial for developing an efficient and flexible exchange rate mechanism as well as enhancing the international status of the RMB. With this in mind, China recently began permitting banks in Hong Kong to engage in certain RMB business, including foreign exchange transactions, thus laying the foundations for the probable establishment of Hong Kong as an offshore trading hub for the RMB.[154] By creating mechanisms for the international settlement of RMB transactions, this tentative move is also a first step towards the eventual full integration of the RMB into the world's currency markets.

Although the precise timing of the RMB's full integration into the global currency markets is still very uncertain, the ultimate role of

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[152] Some have suggested switching to a basket of the three major currencies (dollar, euro, and yen). *See* Morris Goldstein and Nicholas Lardy, *Two-stage Currency Reform for China*, ASIAN WALL ST. J., Sept. 12, 2003. There has also been speculation that the basket peg may consist of the currencies of China's ten largest trading partners. *See China Plans Yuan Link to Currency Basket*, AGENCE FR.-PRESSE, Dec. 22, 2003.

[153] *See, e.g.*, Anette Jonsson, *Merrill Sees 10pc Yuan Revaluation by Year's End*, S. CHINA MORNING POST, Mar. 4, 2004.

[154] *See* Denise Yam, *Hong Kong: Monetary Implications of Renminbi Banking*, MORGAN STANLEY GLOBAL ECON. FORUM, Nov. 24, 2003, *at* http://www.morganstanley.com/GEFdata/digests/20031124-mon.html.

the RMB as one of the world's premier currencies now appears almost certain. Despite the lack of full convertibility, the RMB has already gained the status of a "hard currency" in several countries bordering China.[155] This trend will likely continue and intensify as China's share of regional and global trade increases and China's financial markets integrate globally. However, the greatest threat to the eventual leading status of China's economy and currency lies in the ongoing and delicate process of reforming China's internal economy and markets. Given the precarious state of China's financial system today, the Chinese government would be well-advised to continue to err on the side of caution and hold at bay those foreign interests presently pushing for immediate and large-scale changes to China's foreign exchange regime.

[155] For a general discussion of the growing status of the RMB in parts of East Asia, in particular Southeast Asia, *see* Michael Vatikiotis and Bertil Lintner, *The Renminbi Zone*, FAR E. ECON. REV. May 29, 2003.