CAPITAL ACCOUNT LIBERALISATION IN CHINA: RECENT TRENDS AND DEVELOPMENTS

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Executive Summary

1. Capital account liberalisation can provide numerous benefits for an economy in terms of greater financial integration, more efficiency in the use of capital and diversification of its assets. However, there are also risks to the transition to a more open capital account.

2. In China, the authorities have carefully sequenced and heavily managed capital account liberalisation to make it a gradual process. Portfolio investment is the most restricted component of China's capital account.

3. Compared to the more volatile capital flows like banking-related and portfolio flows, foreign direct investment (FDI) is more stable and longer term. FDI has dominated capital inflows to China, partly because such flows have been subject to fewer restrictions than other forms of capital flow.

4. Outward direct investment has been considerably smaller than FDI in China, amounting on average to only 1% of gross domestic product (GDP) over the past decade or so. However, it has been increasing in recent years, largely reflecting expansion overseas by Chinese firms to acquire natural resources and seek new markets.

5. The volatility of the foreign exchange and equity markets in China had tempered the pace of capital account reforms significantly. Between 2014 and 2016 when RMB (renminbi) depreciation expectations were pronounced and capital outflows intensified, the pace of China's capital account liberalisation slowed.

6. The government, for instance, stopped issuing new quotas for schemes that allow Chinese residents to purchase overseas debt and equity. In contrast, schemes that allow foreigners to invest in China were relaxed and the quota for individual institutions to invest under the Qualified Foreign Institutional Investors programme was loosened in February 2016.

7. Liberalising the capital account will inevitably make the task of macroeconomic management more challenging. Full RMB internationalisation entails capital market opening which may exert pressure on the domestic financial system if financial markets are not well developed.

8. China has lately announced some financial opening measures. Although these may have been announced to diffuse the tension with the United States in the current China-US trade tussle, the measures came at a time when China faces less capital outflows and currency depreciation pressures than that in the 2014-2016 period.