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China unveils detailed roadmap for financial and capital account liberalization

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A recent PBoC report and press conference have clarified China's plans vis-à-vis financial and capital account liberalization. China appears ready to proceed with liberalization while exercising care to prevent risks through such means as establishing a deposit insurance program.

PBoC report on three-stage capital liberalization

China's plans for financial and capital account liberalization have been gradually becoming clearer. On February 27, the People's Bank of China's (PBoC) Financial Survey and Statistics Department issued a report to the effect that conditions are basically aligning for acceleration of capital account liberalization. The report presents a three-stage process and timeline for prospective capital account liberalization and has accordingly garnered considerable attention.

The crux of the report, which draws on examples of other countries that have already liberalized their capital accounts, is that now is a good time for capital account liberalization because its benefits outweigh its risks[1]. The report cites several factors to substantiate that the risks of capital account liberalization are currently manageable, including a relatively low level of short-term external debt, low foreign ownership ratios in the real estate and equity markets, and banks' low nonperforming loan ratios[2].

In terms of the sequence of capital liberalization, the report recommends liberalizing "capital inflows before capital outflows, long-term capital instruments before short-term capital instruments, direct investment before indirect investment, and institutional capital flows before retail capital flows" in accord with the PBoC's previously expressed views. The specific timeline is as follows.

Short-term target (years 1–3): Deregulate direct investment and promote overseas expansion by Chinese companies.

Medium-term target (years 3–5): Deregulate commercial finance based on the principle of economic demand and proceed with internationalization of the renminbi. Financial deregulation will contribute to promoting domestic banks' competitiveness, improving companies' (particularly SMEs') access to funding, and expanding repatriation channels for renminbi-denominated trade settlement and Hong Kong's offshore renminbi market.

Long-term target (years 5–10): Structurally strengthen financial markets and liberalize capital outflows once capital inflows have been liberalized. Cautiously liberalize real estate transactions, equity trading, and bond trading, in that order. Gradually transition from volume-based regulation to price-based controls.

The report thus advocates a general approach of reducing risk by first liberalizing the most mature markets and then sequentially proceeding to progressively less mature markets. Specifically, the report recommends liberalizing the real estate market, which is regarded as China's most mature capital market, followed by the equity market, and then the bond market. It also sets forth a general principle of liberalizing "primary markets before secondary markets" and "nonresidents' domestic transactions before residents' overseas transactions."

The report states that liberalization of China's capital account will be nearly complete upon conclusion of the third stage, suggesting that derivative markets, money markets, financial institutions' lending and borrowing not backed by economic demand, and individuals' capital transactions may end up not being liberalized. In particular, the report recommends not liberalizing highly speculative short-term external debt for a long time, if ever. In such an event, China could take a decade or longer to progress beyond Japan's stage of capital liberalization as of the mid-1980s.

Possible widening of exchange-rate band and hint of deposit insurance

The PBoC's report states that China will not wait until interest rates and exchange rates are completely liberalized and the renminbi is completely internationalized as prerequisites for capital account liberalization. Rather, it notes that these "prerequisites" and capital account liberalization are mutually conducive to each other. As capital account liberalization progresses through the aforementioned three stages, China will unavoidably have to widen the renminbi's trading band and also proceed with liberalization of interest rates in preparation for integration of domestic markets into global financial markets.

Shortly after the report's release, the PBoC held a noteworthy press conference[3] on monetary policy and financial reform while the National People's Congress was in session.

While the press conference covered a wide range of topics, the PBoC made clear that it will continue with interest rate liberalization in an orderly fashion, as it has done to date.

However, the PBoC apparently recognizes that because future interest rate liberalization will be accompanied by full-fledged liberalization of deposit and loan rates, it will have a direct impact on banks' earnings environment[4].

Specifically, the PBoC said that it will have to consider establishing a deposit insurance program due to the possibility of bank failures due to market competition after interest rates have been liberalized. In other words, establishment of a deposit insurance program would be intended to expedite interest rate liberalization, protect depositors, lower barriers to entry to financial markets, and stimulate market competition.

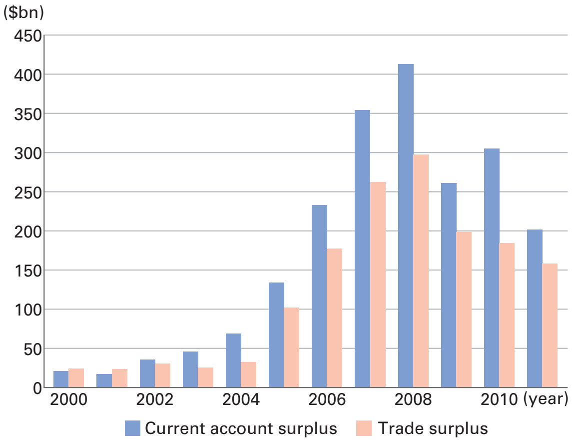
The PBoC indicated that it also recognizes that upgrading of financial institutions' corporate governance and attainment of target regulatory metrics (e.g., capital adequacy ratio) are essential to averting unhealthy competition.

Regarding near-term interest rate liberalization, the PBoC mentioned the possibility of liberalizing wholesale funding rates ahead of other interest rates and permitting greater interest rate flexibility through new financial products.

In terms of the renminbi exchange rate, the PBoC noted that China's trade surplus has recently been decreasing, bringing China's balance of payments into better balance (see exhibit), the renminbi has been fluctuating up and down in the market, and market expectations of the renminbi's future direction are split between appreciation and depreciation. On this basis, the PBoC said that, overall, the renminbi's exchange rate is approaching the equilibrium point and that market supply and demand will play an even bigger role in determining renminbi exchange rates. To increase market supply and demand's role, the PBoC stated that it will scale down its involvement and intervention in markets in an orderly manner.

These comments were echoed by Premier Wen Jiabao in his Report on the Work of the Government at the 2012 National People's Congress. Specifically, Premier Wen said, "We will improve the mechanism for setting the renminbi exchange rate, make the floating exchange rate regime more flexible, and keep the renminbi exchange rate basically stable at an appropriate and balanced level. We will vigorously develop the foreign exchange market, diversify foreign exchange products, and provide more

Exhibit. China's current account and trade balances



Source: NRI, based on official statistics tools for market participants to hedge foreign exchange risks.... We will tighten oversight on cross-border flows of capital." Taken together with the PBoC's comments above, Premier Wen's words suggest that Chinese authorities intend to widen the renminbi's trading band (against the US dollar).

China will likely widen the renminbi's trading band while simultaneously proceeding with capital account and interest rate liberalization. When it does, risk prevention measures by Chinese authorities, such as establishment of a deposit insurance program and strengthening of financial institutions' capacity to withstand interest rate and exchange rate volatility through adoption of a Chinese version of Basel III[5], will be key factors in terms of the speed of liberalization.

Note

1) Specific benefits cited by the report include acquisition of technologies, foreign market share, and resources by Chinese companies through foreign direct investment (M&A, etc.). The report also noted direct investment's cost advantage in light of projections that the renminbi will appreciate.

2) The report also noted that capital flows that circumvent capital controls are growing. Given that capital account liberalization is already happening outside of the authorities' supervision, the authorities apparently recognize that it is better for liberalization to take place under their direction and in an orderly manner.

3) The press conference was held on March 12. Participants included PBoC Governor Zhou Xiaochuan, and Deputy Governors Hu Xiaolian, Liu Shiyu, and Yi Gang, the last of which also serves as Director of the State Administration of Foreign Exchange.

4) Liberalization of interbank lending rates was completed in the 1990s. Since October 2004, deposit rates have been capped at the PBoC's base rate and loan rates are subject to a floor of nine-tenths of the base rate but are otherwise free-floating. Banks currently earn a positive spread between deposit and loan rates.

5) If capital flows increase, financial market infrastructure will need to be developed further from the standpoint of financial regulation by the central bank

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