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China's Currency Control: Features, Mechanisms, and Effects

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Five years have passed since China's foreign exchange regime entered the era of current account convertibility in 1994. During the turbulent Asian currency crisis, China's foreign exchange management has met tests and challenges. To fight capital flight and defend the stability of the renminbi, *the Chinese monetary authorities tightened foreign exchange controls in 1998. In this context, this paper reviews the evolution of China's foreign exchange management regime and reveals the features of the current regime's functional mechanisms. By critically assessing the successes and failures of the system, the paper examines the nature of foreign exchange policy changes in 1998. The paper concludes that, in the near future, Beijing is likely to consolidate the framework of the current foreign exchange regime by ensuring current account convertibility and keeping its grip over cross-border capital flows.*

KEYWORDS: China's foreign exchange policy; China's foreign exchange management; China's currency controls; capital account control

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Since East Asia sunk into the currency-financial turmoil in 1997, the Chinese currency, *renminbi*, has so far managed to avoid the Asian contagion. By mid-September 1998 when the turmoil was in its trough, most regional currencies had slumped by 15-78 percent against the U.S. dollar from their pre-crisis values in June 1997. Only China's *renminbi* remained steady and strong, even appreciated slightly against the U.S. dollar by an

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eighth of one percent.[1]

There are many factors contributing to China's immunity to currency contagion. Thanks to its robust export competitiveness, China has sustained comfortable current account surpluses through the 1990s.[2] China has also a major attraction for foreign direct investment (FDI), thanks to its cheap labor costs, abundant technological talents, and improved infrastructure. By the end of 1997, China's accumulated FDI stock was US$225 billion, more than half as much as the total value of foreign borrowing. In 1997, more than 70 percent of received foreign capital (US$64 billion) was FDI, making China the second largest recipient country next only to the United States for five consecutive years. China's foreign debt structure has also remained healthy by consisting of more than 80 percent of long-term borrowing.[3]

China does, however, share some vulnerabilities with other troubled Asian economies, including an enormous buildup of nonperforming loans in a financial system highly dominated by poorly regulated banks. Fortunately, China has kept these vulnerabilities from international speculators' attacks with a solid shield, i.e., the country's effective control over capital account transactions.

This paper examines the mechanisms of China's foreign exchange management, comments on its effectiveness and costs, and analyzes the context of the monetary authorities' tightening of foreign exchange controls in 1998. The paper will first review the evolution of China's foreign exchange management regime and reveal the features of the regime's functional mechanisms. It will then critically assess the successes and failures of the system. In this context, we will examine the nature of foreign exchange policy changes in 1998. Finally, the prospect of China's foreign exchange policy will be discussed.

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[1]Exchange rate statistics in this paper are from the International Monetary Fund's quarterly *International Financial Statistics*.

[2]Except for 1993.

[3]Figures are from *China Statistical Yearbook 1997* (Beijing: Statistical Publishing House, 1997); *Almanac of China's Foreign Economic Relations* (Beijing: Foreign Trade and Economic Cooperation Press), various issues in 1997 and 1998; and *China Economic News* (Hong Kong), various issues in 1997 and 1998.

Evolution of China's Foreign Exchange Regime

Before China embarked on economic reform in the late 1970s, the domestic economy was largely isolated from the world. The state grip over the minimal economic links to the external world was built on two pillars, namely the mandatory plan of foreign exchange revenue/expenditure and the state monopoly on foreign trade and tourism.[4]

Market-oriented reforms in the 1980s revamped the highly centralized mode of international transactions.[5] State monopoly in foreign trade and tourism gave way to markets with thousands of participants at the local level. To adapt to the changes, a dual exchange regime was phased in. "Foreign exchange certificates" (denominated by the *renminbi*) were initially issued at an official rate of US$1.00 = Rmb 1.80 for use by foreign tourists and visitors in China. For a time the designated domestic firms in foreign trade businesses were allowed to sell their export earnings to the state-run foreign exchange bank at an internal settlement rate that was less distorted but still overvalued the Chinese currency. When export firms were allowed to retain a proportion of their hard currencies, the internal settlement rate for trade became less relevant. Beginning in 1986, foreign exchange swap centers were set up in major cities for foreign-funded enterprises and domestic foreign trade companies to exchange currencies for trade use. Apart from that, all the other foreign exchange transactions must be settled by the state bank at the official rate that seriously overvalued the *renminbi*. Over time, the authorities gradually adjusted the official exchange rate toward the market rate at the foreign exchange swap centers.

In April 1994, China's foreign exchange regime entered the era of current account convertibility. A unified national interbank foreign exchange market, the China Foreign Exchange Transaction Center (CFETC), was set

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[4]For a more detailed description of China's pre-reform trade and exchange rate regime, see Feng-hwa Mah, *The Foreign Trade of Mainland China* (Chicago: Aldine, 1971); and U.S. Congress, Joint Economic Committee, *Chinese Economy Post-Mao* (Washington, D.C.: Government Printing Office, 1978).

[5]Outlines of China's reform in foreign trade and exchange rate management during the 1980s can be found in the World Bank, *China: External Trade and Capital* (Washington, D.C.: World Bank, 1988), and *China: Between Plan and Market* (Washington, D.C.: World Bank, 1990).

up in Shanghai.[6] Circulation of foreign exchange certificates ended as the official and market rates were unified at around US$1.00 = Rmb 8.70. The state mandatory plan of foreign exchange revenue/expenditure was finally abandoned.[7]

The interbank foreign exchange market consists of nearly two hundred members, including major domestic banks, financial institutions, and foreign-funded banks.[8] These members are designated by China's central bank, the People's Bank of China (PBOC), to undertake foreign exchange business. The PBOC sets foreign exchange reserve ratios for member banks/institutions according to their asset value. When the foreign exchange held by a bank exceeds its foreign exchange reserve ratio, the bank should sell the excess at the CFETC. When its foreign exchange holding is below the reserve ratio, the bank should buy enough foreign exchange to redress the deficit. The PBOC supervises the banks' foreign exchange reserves through the State Administration of Foreign Exchanges (SAFE) and its branch offices. The daily mid-price of foreign exchange trading is announced by PBOC based on the previous day's closing rate. Meanwhile, through open market operation, the PBOC intervenes to maintain the exchange rate fluctuation within its desired range (see chart 1).

The kernel of the regime is current account convertibility with strict controls over cross-border capital flows.[9] Current account convertibility is guaranteed by residents' right of holding and depositing foreign exchange; legal persons' right to purchase foreign exchange from banks for payment of trading expense and operational expense; foreigners' right to exchange

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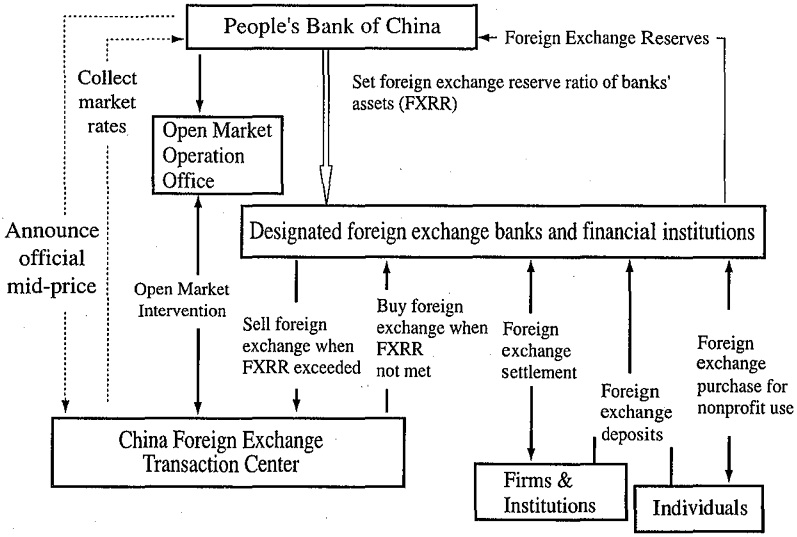
[6]Only foreign-funded enterprises continued to exchange currencies at swap centers between April 1994 and June 1996. They started to settle foreign exchange with the foreign exchange-designated banks in July 1996 while business of the swap centers diminished, being totally phased out in December 1998. See *Jinrong shibao* (Financial Times) (Beijing), October 30, 1998.

[7]*Almanac of China's Foreign Economic Relations 1995* (Beijing: Foreign Trade and Economic Cooperation Press, 1995).

[8]Sino-U.S. Information Inc., *Sino-U.S.-Europe Trading Almanac 1995* (Shanghai: Jiaotong University Press, 1995), 176-77.

[9]PBOC, "Provisional Regulations on the Management of Settlement, Sales, and Payments of Foreign Exchange" (PBOC Decree No. 3, March 26, 1994); State Council, "Foreign Exchange Regulations of the People's Republic of China" (State Council Decree No. 193, January 29, 1996).

Chart 1
China's Foreign Exchange Management Regime



Sources: Drawn according to information in PBOC, "Provisional Regulations on the Management of Settlement, Sales, and Payments of Foeign Exchange" (PBOC Decree No. 3, March 26, 1994); Ministry of Finance, "Provisional Regulations on Financial Management of Nontrade and Nonoperational Foreign Exchange" (MOF Decree No. 7, March 29, 1994); State Council, "Foreign Exchange Regulations of the People's Republic of China" (State Council Decree No. 193, January 29, 1996).

and remit salary, dividends, and other legal incomes abroad; and individuals' right to purchase foreign exchange for personal use abroad. All these transactions, however, must be handled through the designated foreign exchange banks. As for capital accounts, transactions and activities require official approval and authorization.

There are two mechanisms that prevent funds from being diverted from current account uses to capital account uses. One is the principle of immediate settlement, which requires that all current account incomes be either sold to or deposited in designated foreign exchange banks within a deadline after they are received. The second mechanism is the principle of transaction on needs, which requires all purchases/payments of foreign exchange for both trading and nontrading expenses to be supported by transaction documents verifiable by banks (see table 1).

Table 1
General Principles Governing Foreign Exchange Settlement, Sales, and Payments

Currency Sovereignty
No foreign exchange-denominated transaction is allowed within the territory.

Repatriation
All foreign exchange incomes from abroad must be repatriated to China.

Separation of Revenue and Expenditure
Foreign exchange receipts shall not be set off against expenditures without official approval.

Sequential Use of Foreign Exchange
When there is a foreign exchange account, external payments (within the scope of use as set for the account) must be first paid through the balance of the account. Foreign exchange can be bought for the payment only if it is used out of the scope set for the account or if the balance of the account cannot make up for the full payment.

Current Account

Immediate Settlement
All current account foreign exchange incomes must be either sold to or deposited in designated banks after they are received.

Convertibility
*Residents have the right to hold and deposit foreign exchange.
*Legal persons have the right to purchase foreign exchange from banks for payment of trading expenses and operational expenses.
*Foreigners have the right to exchange and remit salary, dividends, and other legal incomes abroad.
*Individuals have the right to purchase foreign exchange for personal use abroad.

Transaction on Needs
All purchases/payments of foreign exchange for trading and nontrading expense must be supported by transaction documents to be verified by banks.

Capital Account

Deposit
All capital account foreign exchange incomes must be deposited in designated banks.

Official Approval
The following transactions must be approved by SAFE:

*Selling foreign exchange incomes for the *renminbi*
*Remitting investment abroad
*Debt servicing on foreign loans

Official Authorization
The following activities need official authorization:

*Borrowing foreign loans
*Issuing foreign exchange bonds overseas
*Providing payment warranty

Foreign Debt Registration
All foreign borrowing must be registered by obtaining "registration certificate for foreign debts" within fifteen days of signing the contract.

Sources: Compiled from PBOC, "Provisional Regulations on the Management of Settlement, Sales, and Payments of Foreign Exchange" (PBOC Decree No. 3, March 26, 1994); Ministry of Finance, "Provisional Regulations on Financial Management of Nontrade and Nonoperational Foreign Exchange" (MOF Decree No. 7, March 29, 1994); State Council, "Foreign Exchange Regulations of the People's Republic of China" (State Council Decree No. 193, January 29, 1996).

Effectiveness and Costs

With such controls in place, Chinese savers concerned about the viability of China's financial institutions would not legally convert the *renminbi* deposits and purchase foreign exchange-denominated financial assets. Meanwhile, foreigners own only small amounts of *renminbi*-denominated financial assets (mainly bank deposits). China's capital market has experienced rapid development since its inception in 1990, reaching a level of market capitalization equivalent to 25 percent of gross domestic product (GDP) in 1997. In this market, foreigners can only own the foreign exchange-denominated "B" shares rather than the *renminbi*-denominated "A" shares. Since "B" shares account for less than 2 percent of the total capital market, foreign speculators therefore have little leverage to engage in profiteering in domestic capital market.[10] Access to the interbank futures market for foreign exchange is limited to those with a documented trade-related need, precluding speculators from selling the *renminbi* short.

Of course, there are considerable costs to these controls. For instance, the requirement that commercial documents to prove real needs are necessary for all foreign exchange purchases could cause many inconveniences for many businesses. Supervision costs incurred to regulatory authorities could also be significant. Official approval and authorization of capital account transaction may create lucrative rents for those privileged agents and may also invite rent seeking. Market participants constantly seek loopholes in current account management to make profits.

In practice, however, the controls over capital flows, until recently, had not been effective. As shown in chart 2, the ratio between China's registered direct investment outflow and direct investment inflow dropped to 5-6 percent after 1993 and remained at that level after then. Meanwhile, the "errors and omissions" (E&O) entry in China's balance of payments account shot up by 90 percent in 1995 and has remained above US$15 billion per annum in the past few years (see chart 3). The change raised the ratio

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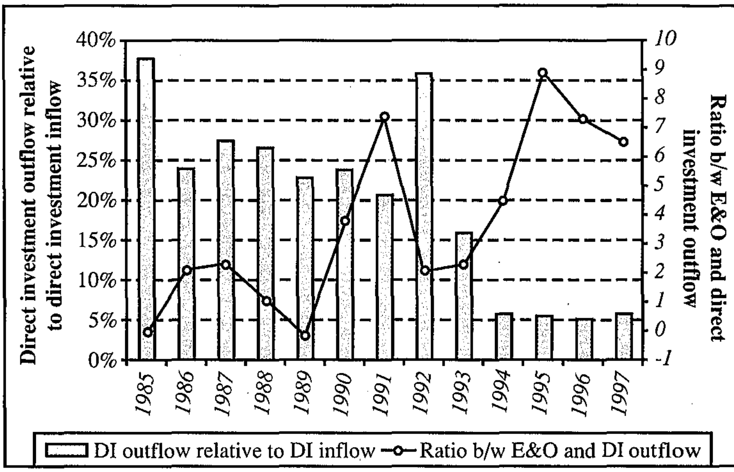
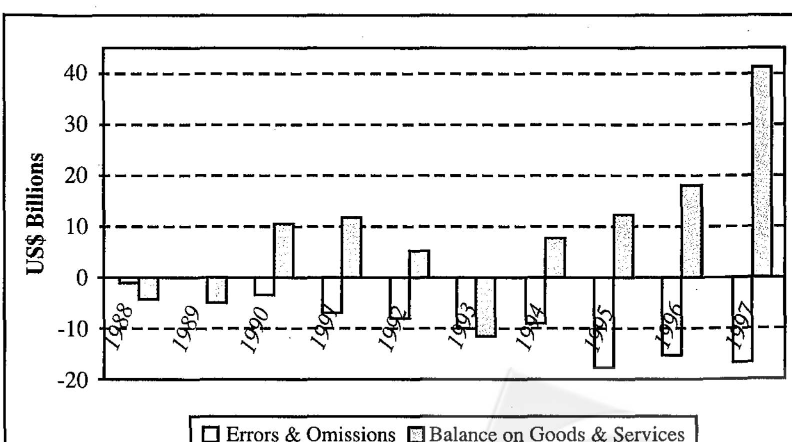
[10]Statistics source: "Asian Economic Survey 1998-99: China," *Asian Wall Street Journal* (Hong Kong), October 26, 1998.

Chart 2
China's Direct Investment Flows and E&O Account



Sources: International Monetary Fund's *International Financial Statistics*, various issues.

Chart 3
China's E&O Account versus Balance on Goods and Services



Sources: International Monetary Fund's *International Financial Statistics*, various issues.

between E&O and registered direct investment outflow from about 2:1 in 1992-93 to more than 6.5:1 in 1995-97. The ballooning E&O figures indicate serious capital flight and rampant import smuggling.

Paradoxically, before 1998, the Chinese monetary authorities had tolerated this flight to some extent. Apart from concerns over administrative costs of full implementation of all rules, the macroeconomic consideration perhaps dominated policies toward foreign exchange management. Until 1998, foreign exchange controls appeared to be "too effective" for the needs of macroeconomic management. From 1990 through 1997, China had trade balances in all but one year (1993). The trade balance on goods and services in 1997 reached US$40 billion, more than five times the balance in 1994 (see chart 3). Under the post-1994 foreign exchange regime, most of this amount has had to be sold to state banks. This, together with the surge in foreign direct investment, would inevitably cause upward pressure on the *renminbi* and force the PBOC to passively issue notes. This would frustrate the government's tight money policy for engineering a macroeconomic "soft-landing" during 1994-96.[11] In 1997, when some preferential treatments toward foreign-funded enterprises doing export business were to be phased out, there were also concerns that an appreciating *renminbi* might further undermine export incentives.[12]

Against this background and on top of lax controls over capital flight, the PBOC announced in September 1997 a further relaxation of foreign exchange controls, i.e., to allow Chinese exporters to hold foreign exchange in bank accounts and convert it according to need.[13] The step was consistent with China's long-term move toward full convertibility of the *renminbi*.

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[11]See Liu Guoguang et al., eds., *Jingji lanpishu: 1997-nian Zhongguo jingji xingshi fenxi yu yuce* (Economic bluebook: Analysis and forecasts of China's economic situation 1997) (Beijing: China Social Sciences Press, 1997), 260.

[12]Ding Lu and Zhimin Tang, *State Intervention and Business in China: The Role of Preferential Policies* (Cheltenham, U.K.: Edward Elgar, 1997), 23-29.

[13]Karby Leggett and Peter Wonacott, "China Unveils Foreign Exchange Rules," *Asian Wall Street Journal*, September 26, 1997.

Tightening Controls: For Now or for Good

When the Asian financial crisis deepened in 1998, however, effective capital account controls suddenly became vital to keeping the public confidence in the *renminbi.* As suggested by the experience of those Asian economies badly hit by the financial crisis, premature opening of the capital account sector could be very risky to a developing economy with a weak and unsophisticated financial sector.

Capital flight through regulatory loopholes, however, directly threatens the *renminbi*'s stability. In the first half of 1998, utilized foreign direct investment inflow was US$27.42 billion and trade surpluses reached US$31.38 billion. Foreign exchange reserves, however, increased by only US$700 million to US$140.6 billion. Meanwhile, E&O in balance of payments account increased to a record US$18.3 billion, more than the whole year figure of US$16 billion in 1997.[14] There were three factors that contributed to this leakage of foreign exchange reserves in official statistics. The first was the rampant smuggling that resulted in underreporting of imports and exaggerating of trade surplus figures. The second was the widespread practice of illicit foreign exchange purchase and payment through the banks using falsified trade documents. The final factor was the banking system's delay and failure in collecting or settling the foreign exchange earnings from the export firms. By mid-1998, the Chinese authorities were alarmed that "crimes relating to fraud, retainment, and transfer of foreign exchange" had "greatly increased as a result of the further development of the Asian monetary crisis" after fall 1997.[15] Estimates hold that at least US$30 billion in trade earnings was not repatriated back to China. Beyond state control there is also resident-held foreign exchange amounting to about US$80 billion.[16] A major lesson Chinese policymakers have learned from the 1997-98 Asian currency turmoil is that the fear of devaluation may

[14]Lu Ning, "Massive Capital Flight from China Suspected," *Business Times* (Singapore), October 22, 1998.

[15]*China Economic News*, no. 44 (November 16, 1998): 1.

[16]Zhou Ruipeng, "Chinese People Hold US$80 Billion," *Lianhe zaobao* (United Morning Post) (Singapore), September 30, 1998.

be self-fulfilling through a combination of capital flight, currency attack, and market panic if the foreign exchange mechanism so allows.

The domestic macroeconomic situation in 1998 also justifies tighter controls over foreign exchange settlement. Since 1997, the Chinese economy has been characterized by supply glut and falling prices, symptoms of insufficient effective demand.[17] As an increasing domestic money supply has become necessary to keep the economy growing, passive issuance of notes through foreign exchange earning purchase is no longer a concern to the central bank. On the other hand, capital flight and smuggling are also accompanied by bureaucratic corruption that the top leadership has vowed to eradicate.[18] Continued tolerance to corruptive practices would not be politically viable.

In September 1998, the State Council announced a series of measures on reinforcing management of foreign exchange and foreign debts.[19] In October, the Standing Committee of China's National People's Congress amended China's criminal code to include foreign exchange dodging and foreign exchange purchasing by deception as punishable crimes. The committee also imposed heavier punishment toward foreign exchange-related crimes so that they may be subject to at least five-year imprisonment.[20]

To a large extent, the tightening of foreign exchange control since then is merely a reimposition of the already existing rules or plugging the loopholes in these rules. For instance, a new regulation in November 1998 banned the corporation-to-individual or individual-to-individual transfer of funds in foreign exchange bank accounts.[21] This measure was meant to prevent selling and buying foreign exchange between enterprises or individuals without settling through the banks. Meanwhile, the PBOC reiterated its longstanding policy that requires all foreign debts to be registered

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[17]For more details, see "Why the Spending Goes Low?" *China Economic News*, no. 23 (June 22, 1998); "Must the Present Falling Prices Be Doomed to a Tragic Deflation?" ibid., no. 34 (September 7, 1998).

[18]"Exchange Move Helps Fight Graft," *Hong Kong Standard*, September 30, 1998.

[19]*Jinrong shibao*, September 28, 1998.

[20]*Ming Pao* (Hong Kong), October 28, 1998.

[21]Karby Leggett, "Chinese Banks Impose Currency Rules," *Asian Wall Street Journal*, November 12, 1998.

with it. Under the registration rule, domestic firms with foreign exchange-denominated loans cannot purchase foreign exchange to make payments until their loans come due. This is to forestall accelerating demand for foreign exchange among debtors. The new measures promulgated recently mainly aim to reduce the chance of foreign borrowing being undetected in disguised forms, such as import letters of credit of longer-than-necessary terms, and illegal foreign exchange remittance covered by fake customs documents.[22]

The most draconian action was the SAFE's one-month ultimatum demanding domestic enterprises to repatriate all illegally acquired foreign exchange back to China before the end of October to avoid severe punishment. A total of 958 companies admitted to illegal foreign exchange transactions worth a total of US$2 billion and HK$92.57 million before the deadline expired.[23] This action was nonetheless in line with the existing principle of immediate settlement.

There are, however, some new regulations that have the effect of increasing the transaction costs of foreign trade by causing delays in foreign exchange payment and settlement. For instance, the government now requires that all letters of credit be registered. SAFE approvals are required for all import letters of credit over ninety days, rather than the previous one hundred and eighty days.[24] The sudden increase of administrative load has made it difficult for the SAFE to meet all the applications efficiently.

To clamp down on fake customs documents, the new rules require confirmation of bank documents by customs officials for all import payments worth above US$100,000. Chinese banks were reportedly too chilled by the new or reimposed restrictions to make payment promptly on letters of credit for imports or sell foreign exchange to importers for paying obligations abroad on time. The more complicated administrative process has led some banks to fail to pay under letters of credit within seven working days after presentation of proper documents, in breach of UCP 500

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[22] *Jinrong shibao*, September 28, 1998; *China Daily* (Beijing), September 28, 1998.

[23] "China's [Foreign Exchange] Clampdown Raises Reserves by US$2b," *Business Times*, November 18, 1998.

[24] "China Payments, Trade Hit by [Foreign Exchange] Clampdown," ibid., December 1, 1998.

(Uniform Customs and Practices 500) issued by the International Chamber of Commerce.[25]

The effects of tightening controls are mixed. According to the Chinese Customs, from 1996 to October 1998, more than five thousand forged declaration forms, involving US$8.5 billion, were discovered.[26] After months of stagnation, China's foreign exchange reserves shot up by US$2.6 billion to US$143.7 billion in the month of October, a development the PBOC attributed mainly to the return of illegally acquired foreign currency prior to the October 30 deadline.[27]

On the other hand, the overzealous imposition of controls has caused settlement delays and increased transaction costs, which have apparently contributed to the recent slowdown of foreign trade among other factors. Compared to the same month of a year earlier, China's exports fell sharply by 17.3 percent in October and 9.7 percent in November before a 4.3 percent rise in December. The four consecutive months of negative growth in exports reduced growth for 1998 to only 0.5 percent. Imports dropped 9 percent in October, climbed up 2.1 percent in November, and dropped again by 7.4 percent in December as compared to the same month of a year earlier. The overall imports in 1998 dipped 1.5 percent.[28]

To protect the credibility and creditworthiness of China as a trading partner, China has ordered its customs offices to ensure that confirmation take no more than three working days. Meanwhile, Beijing has announced a plan to issue digital identity cards (ICs) to foreign trade enterprises.[29] With the ICs, banks and foreign exchange bureaus will be able to authenticate import declaration forms by verifying related information through a unified national network linking customs offices. The IC plan was designed to eliminate foreign exchange fraud without sacrificing current ac-

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[25]*Business Times*, December 1, 1998.

[26]*China Economic News*, no. 44 (November 16, 1998): 1.

[27]*Business Times*, November 18, 1998.

[28]Ibid., November 26, 1998 and January 13, 1999; *Ming Pao*, December 11, 1998; "Statistical Communiqué of the PRC on the 1998 National Economic and Social Development," *China Economic News*, March 22, 1999.

[29]*China Economic News*, no. 44 (November 16, 1998): 2; *Business Times*, November 26, 1998.

count transaction efficiency. This new import checking system has been test operated in Beijing, Shanghai, and Guangzhou as early as November 1998 and has been officially implemented nationwide since January 1999. Even with successful implementation of the plan, it may take months for China's regulators, banks, and customs offices to improve their administrative efficiency in implementing the new or reimposed rules.

Conclusions

The Chinese monetary authorities were quick to dismiss any concerns about a possible retreat to overall foreign exchange control. A spokesman for the State Administration of Foreign Exchanges described the rules and regulations issued in September 1998 as "merely supplements or revisions to the foreign exchange law and regulations in force in the light of the law violations discovered in the general check after the convertibility of the *renminbi* under the current account."[30] In retrospect, China's foreign exchange policy change in 1998 did not undermine the nature of the contemporary foreign exchange management regime, i.e., a system of current account convertibility with strict controls over cross-border capital flows.

For the near future, the pace of Asia's bottoming out of the crisis is crucial to the strengthening of public confidence in the *renminbi*. Although most of Asia's crisis-hit economies have displayed promising signs of recovery in the first half of 1999, public confidence in the *renminbi* remains weak. This can be observed in the persisting gap between the official market rate (US$1 = Rmb 8.28) and the black market rate (US$1 = Rmb 9.00 approximately) from 1998 through the first half of 1999. Official crackdown has so far failed to choke off the black-market transactions for foreign currencies. A remarkable development of this market is that the illicit foreign exchange transactions have evolved from the street-corner hide-and-seek dealings to the systemically-organized transactions through the networking of wholesaler-retailers-customers.[31] Meanwhile, the trading at

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[30]*China Economic News*, no. 40 (October 19, 1998): 9.
[31]This observation was made by the author during a trip to China in June 1999.

China's official foreign exchange markets has continuously slid from a peak of US$19.69 billion in the third quarter of 1997 to US$9.07 billion in the fourth quarter of 1998, a worrying sign for effective maintaining of foreign exchange transactions within the official market.[32]

The public confidence in the *renminbi* has been influenced by China's stagnant export performance. In 1998, China's exports grew only 0.5 percent and its overall foreign trade fell 0.4 percent, registering the country's first trade contraction since 1983. The trade surpluses managed to register a 7.9 percent record rise for the whole year mainly thanks to the fall of imports. In the first quarter of 1999, however, China's exports fell 7.9 percent while the imports rose by 11.6 percent, compared to the same period a year earlier.[33]

Facing such an environment, Chinese policymakers have two options. One is to allow a greater play of market forces in foreign exchange transactions by loosening the country's currency controls. This would inevitably result in a devaluation of the *renminbi* which would be expected to boost China's exports. The other option is for the government to maintain a tight grip on currency transactions while providing stimulus for export businesses through other policy measures.

The developments in the first half of 1999 suggest that China has opted for the latter. To boost exports, Beijing has taken the following measures: (1) opening the coastal and inland cities to foreign trading joint ventures (instead of confining them only to Pudong in Shanghai and Shenzhen); (2) increasing by sevenhold the number of large state-owned enterprises allowed to register for foreign trading; and (3) reforming the licensing administration as well as minimizing the number of products that require import or export licenses.[34]

In early June 1999, Beijing took another significant step to tighten its control over foreign exchange transactions. The state-owned Bank of China (BOC), the country's leading dealer in foreign currencies, announced that, as of June 10, it would close all *renminbi* accounts held by foreign banks and

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[32]*Asian Wall Street Journal*, June 4-5, 1999, 3.

[33]*Business Times*, April 13, 1999.

[34]*Straits Times* (Singapore), January 30, 1999.

stop accepting *renminbi* transfers from banks overseas. The move essentially means all conversion of the *renminbi* would have to be done in the mainland and that the small amount of the *renminbi* exchanged overseas by tourists and banks which have accounts with the BOC would have to be funneled through the BOC and its subsidiaries. This announcement in effect ended a modest experiment in foreign exchange liberalization, introduced in mid-1998, which permitted foreign banks to buy Chinese currency from offshore branches of the BOC.[35] The ban on offshore *renminbi* transactions aims at reducing the amount of foreign exchange hidden from the SAFE and plugging the loophole for capital flight through such transactions.

On this track, China's foreign exchange control is unlikely to be relaxed in the foreseeable future unless the public confidence in the *renminbi* is strong enough to eliminate the gap between the black market and official rates. From the Chinese policymakers' perspectives, there are good reasons to maintain control and keep the *renminbi* strong and stable. China's relatively improved economic performance in the recent years and continued current account surpluses have provided the bottom-line support for the *renminbi*'s strength. With the world's second largest foreign exchange reserve of US$146.6 billion (in the first half of 1999), Beijing possesses the ammunition as well as leverage to act as a price setter in the official *renminbi* market. The lessons of the 1997-98 Asian financial crisis also have cautioned China's policymakers not to give up their grip over capital account transactions too early and too easily. A strong *renminbi* is also believed to have played a role in keeping China an attractive host for foreign direct investment in the region. Finally, since China's exports carry an import-content ratio as high as 50 percent, the impact of effective exchange rate movements of the *renminbi* on China's export prices was actually negative during the 1997-98 Asian financial crisis.[36] This implies that China might not have gained much in export competitiveness even if it had devalued the *renminbi* during the crisis.

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[35] *Asian Wall Street Journal*, June 4-5, 1999, 3.

[36] See Ding Lu and Kaysong Tan, *Impact of Exchange Rate Changes on Export Competitiveness and Trade Welfare during the Asian Financial Crisis* (Singapore: Center for the Advanced Studies, forthcoming in 1999).