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Capital Account Liberalization: Does Advanced Economy Experience Provide Lessons for China?

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The initial post–World War II pursuit of capital account liberalization (CAL) by advanced economies was Europe-centric, with roots in a broader political–rather than economic–agenda of greater European integration. In continental Europe, CAL was addressed mostly through the adoption of multilateral instruments and codes. In contrast, CAL by the United States and United Kingdom was pursued unilaterally, motivated by their status as global reserve currency issuers and global financial centers. China's situation is fundamentally different. China today has no equivalent to the European political motivation for CAL or the domestically driven financial motivation of the United States or the United Kingdom. And while China may have long-term aspirations to be a global reserve currency issuer, the extent to which it internationalizes its currency is constrained by powerful domestic economic and political interests that continue to benefit from an export-led growth model underpinned by a pegged and undervalued exchange rate, both of which are difficult to maintain with an open capital account. Alongside China's overarching concern with the maintenance of financial and economic stability, these factors imply a different path for China than paths taken by advanced economies, with significant acceleration in the gradual pace of liberalization unlikely without accelerated development of domestic constituencies that traditionally support CAL.

Postwar Motivations for Capital Account Liberalization in Advanced Countries

As in China today, advanced economy views on the degree of CAL in the immediate post–World War II period grew out of the widespread desire to maintain fixed exchange rates. Reflecting the economic disruption caused by competitive devaluation in the interwar years, the postwar Bretton Woods architecture prioritized the liberalization of trade (that is, *current* account transactions), a mandate given to the General Agreement on Tariffs and Trade (GATT), and the maintenance of fixed exchange rates and commitment to current account convertibility (that is, access to foreign exchange for payments and transfers associated with current account transactions), mandates given to the International Monetary Fund (IMF). Full current account convertibility had been achieved in most advanced economies by 1958; full capital account convertibility took an additional 30 years.

Institutional Underpinnings of Postwar Capital Account Liberalization in Advanced Economies

Exclusion of capital account convertibility from the original Bretton Woods architecture, (and the IMF's *Articles of Agreement* (1945), specifically) reflected several factors: (i) the rela-

tive importance of current account transactions in overall global financial flows between countries; (ii) the desire for fixed exchange rates to avoid competitive devaluations; and (iii) British fear of large-scale repatriation of overseas sterling balances, (particularly from India and Argentina). These factors help explain why the right to impose capital controls was explicitly embedded in the original IMF Articles. Keynes, in particular, considered the right to control capital movements as a permanent rather than transitional arrangement (James 1996, 38). The right to regulate capital, particularly short-term capital, was subsequently included in the European Economic Community's Treaty of Rome (1957).

The establishment of codified CAL frameworks was at least initially driven largely by the pursuit for European integration and the desire to establish a single market. The objective was formally set out in 1950 by the Organization for European Economic Cooperation (OEEC)—precursor to the Organisation for Economic Co-operation and Development (OECD). But the Treaty of Rome, which established the European Economic Community, provided for freedom of capital movement within Europe "only to the extent necessary to ensure the proper functioning of the Common Market." This was in contrast to free movement of goods, services, and people. The CAL objective was partial, restricted to longer-term "productive" capital (for example, foreign direct investment [FDI]), and was maintained by the OECD following its creation in 1961. The carry over to the OECD is not surprising given that the OECD's initial membership was heavily dominated by Europe: members of the OEEC plus Canada and the United States.[1] For the next quarter century, the predominant orthodoxy among European policy makers was supportive of liberalizing longer-term capital (that is, FDI), but not all capital flows.

The OECD's *Code of Liberalization of Capital Movements,* adopted in 1961 and heavily based on the OEEC's 1959 code of the same name, initially maintained a country's right to impose controls on capital movements, particularly short-term flows. It focused on liberalization of "productive" capital, excluding short-term flows, until 1989. Adhering members could enter reservations against any item in the code.[2] Despite its initially narrow scope and framework of reservations, it did encourage CAL in countries *seeking* OECD membership. Japan, for example, was requested to ease FDI controls before attaining membership in 1964. Reflecting the objective of partial CAL, capital controls were still common in Europe into the 1980s, with a more rapid move to full CAL only beginning later in the decade.[3]

The apparent contradiction between the establishment of multilateral frameworks for CAL and the prevalence of capital controls in advanced economies for much of the 30 years following the end of the war reflects, to some extent, differences in approach to CAL between the (largely) Anglo Saxon countries, which tended to pursue more rapid unilateral liberalization,[4] and continental Europe (most clearly embodied by France), which pursued a more managed, codified, and institutional approach. The momentum for CAL that picked up in the second half of the 1980s can largely be attributed to a significant shift in, if not outright reversal of, French policy toward CAL, derived from its experience with controls in the early part of the decade. In contrast, (largely) Anglo Saxon countries tended to pursue CAL unilaterally. For the United Kingdom and the United States, this partly reflected their status as global financial centers and, in the case of the United States, as the predominant reserve currency issuer, with powerful domestic financial interests supporting CAL.[5]

Liberalization of Short-Term Flows

As noted, momentum for CAL (particularly of short-term flows) picked up in the late 1980s following the reversal of French opposition to full CAL, which came in response to France's unsuccessful experience with capital controls in the early part of the decade. In 1986, reflecting changed French views, the EC proposed adopting as liberal as possible a capital account regime. In 1988, it adopted a directive[6] enshrining the principle of full CAL between member states while retaining a time-bound safeguard clause. In 1991, the Maastricht Treaty solidified commitment to CAL.[7] In 1989, the OECD code was amended to include virtually all capital flows, explicitly acknowledging that full CAL was a valid goal and the hallmark of a fully developed economy. This change validated earlier CAL by states such as the United Kingdom, the United States, Germany, and Canada; it also served as an impetus to CAL for other members, and as an inducement to more ambitious CAL, including in countries seeking OECD membership in the 1990s. By 2005, the more liberal regime governed 70 to 80 percent of world capital flows (Abdelal 2007, 12).

Liberalization and Financial Sector Development

Experiences of advanced economies with CAL have shown that financial innovation reacts swiftly to opportunities presented by deregulation, creating new and more complex instruments and markets, and making the maintenance of controls increasingly difficult. This is consistent with the OECD finding that once a critical level of financial development is achieved, evading remaining controls in periods of stress becomes easier (OECD 2002, 9). Innovations in communications technology have also made efforts to control capital flows more difficult. Reflecting this development, the move away from using controls gained momentum throughout the 1990s, particularly in OECD countries.

China and the Political Economy of Capital Account Liberalization

The experiences of advanced economies have limited parallels to China's situation. China does not seem to possess the

same political agenda and objectives that provided the initial motivation for CAL in continental Europe, nor are there similarly powerful domestic financial interests pushing for CAL (including of short-term flows) such as those in place in both the United States and the United Kingdom. However, over time, these may emerge as China allows greater internationalization of its currency and develops its private domestic financial sector. This suggests that the pace of China's CAL might most effectively be accelerated through reforms that contribute to the development and empowerment of supportive domestic constituencies, including among savers, consumers, and the domestic (that is, mainland) private financial sector.

Elements of China's 12th Five Year Plan are consistent with building domestic constituencies for greater CAL. Indeed, in his address to the National People's Congress, Premier Wen Jiabao vowed to continue "to energetically develop financial markets and encourage financial innovation," and the Five Year Plan explicitly commits to push forward RMB capital account convertibility and expand the scope of cross-border yuan trade.[8] However, at the same time, Wen expressed the government's intention to "closely monitor and control cross-border capital flows and prevent the influx of hot money."[9]

In support of gradual CAL, the Chinese government expanded the size of its Qualified Foreign Institutional Investor (QFII) system, allowing more than 100 international institutions to invest in China's securities market. At end 2010, total quota approved for QFIIs had reached US$19.7 billion, with a government commitment to expand to US$30 billion. However, in relative terms, the size of this program is quite small, amounting to less than 2 percent of total stock market holdings. The Qualified Domestic Institutional Investor (QDII) program, which sanctions approved banks, trust companies, fund houses, securities firms, and insurance companies to invest abroad in approved overseas markets, is also expanding, but at end 2010, only 95 Chinese institutions had been granted QDII status, with a total quota of US$68.4 billion. The bond market remains heavily regulated, with issuers of domestic bonds limited to domestic institutions (KPMG 2011a).

To a significant extent, the commitment to CAL is being pursued through efforts to internationalize the RMB by making Hong Kong SAR, China, an RMB offshore clearing center.[10] The pool of offshore RMB deposits held in Hong Kong SAR has grown nearly tenfold since 2009 (KMPG 2011b). Hong Kong SAR is also the channel through which RMB-denominated bonds (so called dim sum bonds) are issued: issuance of dim sum bonds has expanded rapidly. Bringing RMB onshore from Hong Kong SAR involves a number of administrative hurdles; however, while many of these hurdles may not be excessively onerous, their existence and the quantity of business the current liberalization approach brings to banks and other financial institutions operating in Hong Kong SAR risk creating vested interests in Hong Kong SAR that may not be supportive of more ambitious CAL on the mainland.

More generally, there are many financial institutions and economic agents in China—both in the private and public sectors—that benefit from the closed system and that are unlikely to welcome the increased competition that greater openness would bring. This is an inevitable consequence of any heavily regulated system. The current Five Year Plan asserts that public ownership will continue to play a "dominant" role in the economy, including in the financial sector, which constrains the scope for an emerging domestic private financial sector to become a sufficiently powerful constituency in support of more rapid CAL. It is therefore unclear the extent to which financial sector development alone in China will build a constituency for greater openness unless it is accompanied by a broader liberalization of the financial sector. Perhaps as domestic and international pressures on the RMB to appreciate continue and the exchange rate becomes more volatile, the hedging needs of Chinese institutions—both public and private—may foster demand for greater financial sector and capital account liberalization.

At the same time, the Chinese authorities have expressed the desire to see the RMB become a major global reserve currency over the longer term. But CAL is widely accepted as a precondition for currency internationalization, which itself is a necessary step toward reserve currency status. Recent debates within the IMF and under the French presidency of the G-20 on the composition of the special drawing right (SDR) currency basket and prospects for RMB inclusion in the basket have, if anything, reinforced the importance of full capital account convertibility as a precondition for a global reserve currency.[11] Chinese officials have not disputed the criticality of this requirement; however, when there is a perceived tension between the speed of CAL and broader considerations of stability (financial and social), stability has typically taken precedence. Moreover, if global economic growth slows and remains sluggish, Chinese policy makers are likely to move with additional caution in pursuing greater openness and the move away from an export-led growth model. This does not bode well for an accelerated pace of CAL, despite professed longer-term ambitions for the RMB as an international reserve currency.

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Notes

1. Canada already had a relatively open capital account (and a floating exchange rate) and the United States, as predominant issuer of global reserve currency, also pursued a liberal regime (Abdelal 2007, 7–8).

2. The code is nonbinding and relies on a combination of transparency regarding restrictions and peer pressure to achieve liberalization.

3. http://europa.eu/legislation_summaries/internal_market/single_market_capital/l24405_en.htm.

4. This may have reflected a lesser affinity for managed, technocratic mechanisms.

5. While sterling had been a major reserve currency, this in part reflected a colonial legacy where colonies had been required to accept sterling as payment. With independence, former colonies increasingly chose the U.S. dollar.

6. Council Directive 88/361/EEC, in effect in July 1990.

7. The treaty stated that "all restrictions on the movement of capital between Member States and between Members States and third countries shall be prohibited."

8. The 12th Five Year Plan for National Economic and Social Development (2011–15), chapter 48, section 3, adopted by the National People's Congress in March 2011.

9. Wen Jiabao, "Report of the Work of the Government," delivered at the Fourth Session of the Eleventh National People's Congress, March 5, 2011.

10. Kenen (2011, 11) notes that a precondition for successful currency internationalization is that "the government must first remove all restrictions on the freedom of any entity, domestic or foreign, to buy or sell its currency, whether in the spot or forward market."

11. The communiqué of the G-20 Leaders Summit (2011) in Cannes states: "We agree that the SDR basket composition should continue to reflect the role of currencies in the global trading and financial system. The SDR composition assessment should be based on existing criteria, and we ask the IMF to further clarify them. To adjust to currencies' changing role and characteristics over time, the composition of the SDR basket will be reviewed in 2015, or earlier, as currencies meet the existing criteria to enter the basket."

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