China's Progress Towards Capital Account Convertibility

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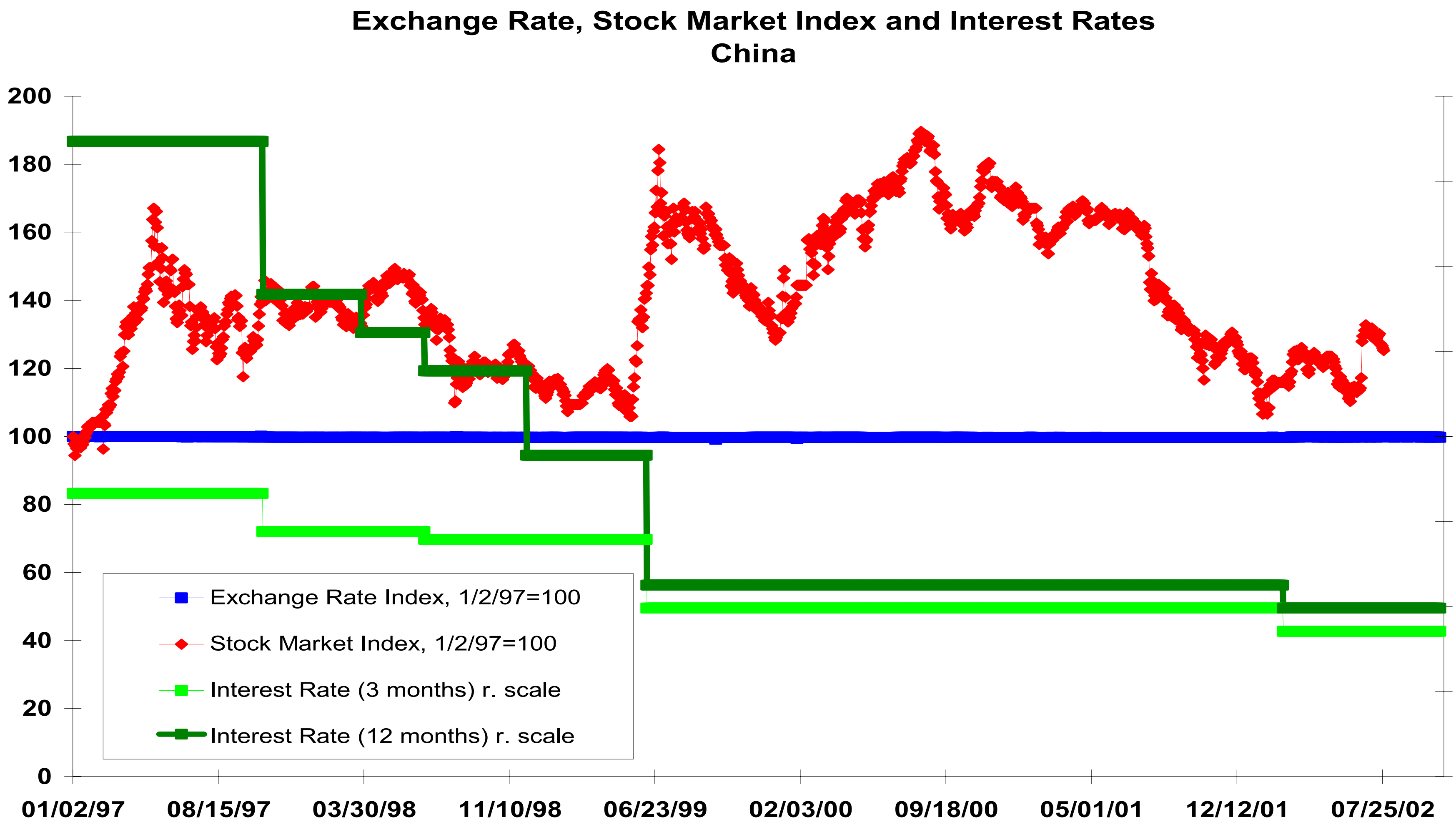
Preview

- The current state of the convertibility of the Renminbi
- The implications of the full capital account convertibility
- The benefits and costs of full convertibility
- The Chinese balance of payments situation
- Evolution towards nearly full functional convertibility

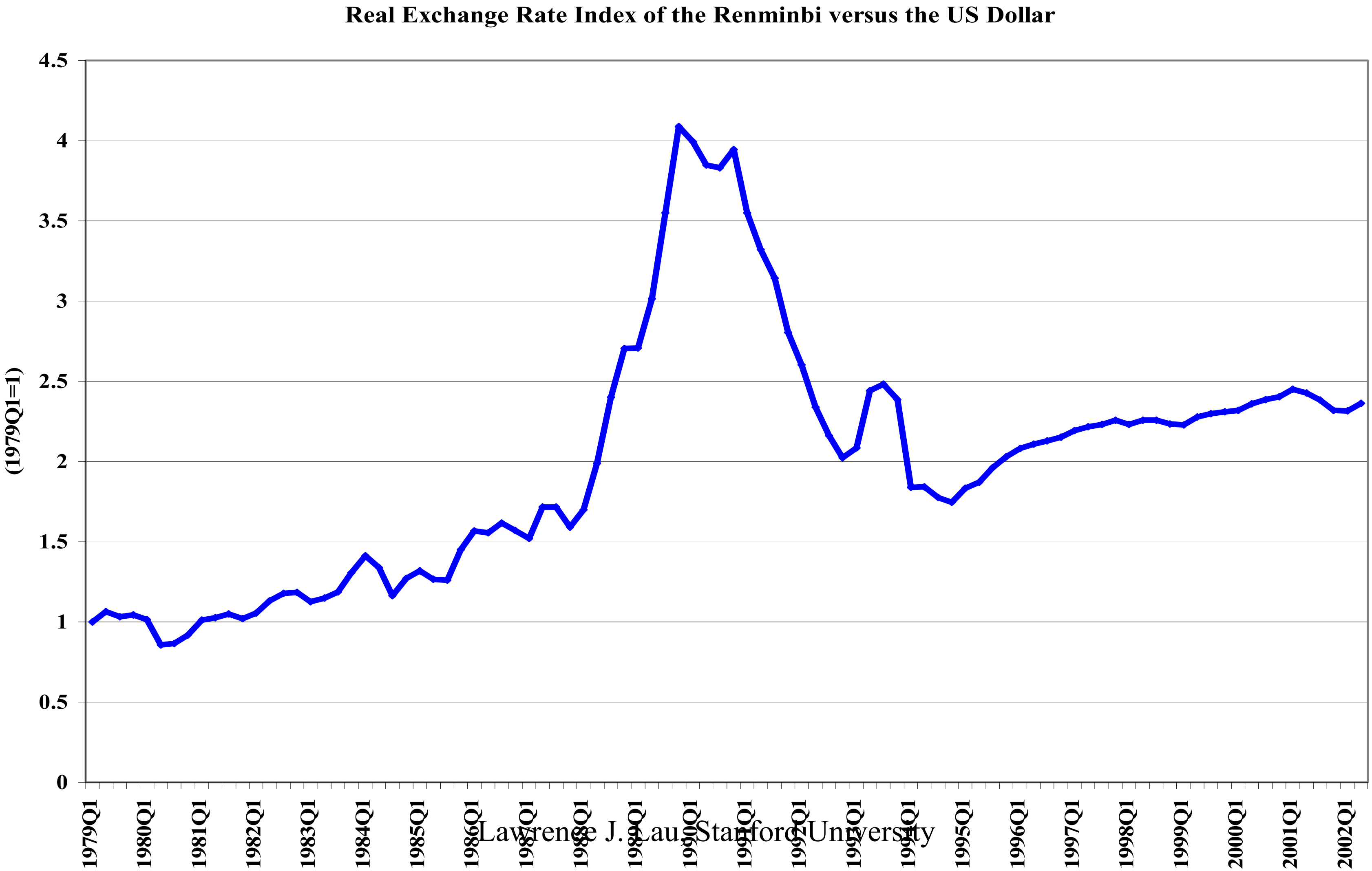
The Renminbi

- The Renminbi trades within a narrow band around 8.3 Yuan/US$.
- In real terms, it has appreciated against the US$ by 28% since 1994Q1, when it first unified the exchange rates at 8.7 Yuan/US$.
- It is officially a managed floating exchange rate; but in practice, it has been effectively pegged since 1997.
- The exchange rate of the Renminbi is not only a relative price between domestic Chinese and foreign goods and services, but also serves as an indicator of the value of the currency to Chinese citizens, who use the Renminbi not only as a medium of exchange, but also as a store of value. As such, the value of the Renminbi must be perceived by the Chinese citizens as being stable. The exchange rate is often viewed as an indicator of its value. (The Chinese citizens have attempted to flee from the Renminbi once before, in 1988, on account of the then high rate of inflation.)
- It has also increasingly become a reference anchor for the currencies of some of the ASEAN countries.

The Exchange Rate, the Interest Rates and the Stock Market Index



Real Exchange Rate Index of the Renminbi



What Do We Mean by Convertibility?

- Is the currency accepted by non-residents and foreign nationals? Are these non-residents and foreign nationals willing to hold the currency, for whatever length of time, in their portfolios? Currently residents and nationals of Hong Kong, Myanmar, Singapore, Taiwan, Vietnam and the areas on the Sino-Russian border appear willing to accept and to hold the Renminbi.
- Are these non-residents and foreign nationals willing to hold the currency long-term? (Then it begins to have the potential of becoming a reserve currency.)
- Is the central bank legally obligated or committed to repurchase any currency issued by it that is offered for sale by non-residents and foreign nationals with acceptable foreign currencies such as the US$, the Euro and the Yen? If this were true, it would greatly enhance the willingness of non-residents and foreign nationals to accept and to hold the Renminbi. However, the People's Bank of China, the central bank, is neither legally obligated nor committed to repurchase any Renminbi held by non-residents or foreign nationals, except under certain conditions. (For example, a foreign direct investor in China is permitted to sell the Renminbi that the investor has earned in exchange for foreign currency.) Many non-residents and foreign nationals hold the Renminbi not because it can be exchanged for another foreign currency at the People's Bank on demand but because they believe it will be accepted by others.

What Do We Mean by Convertibility?

- Is the central bank legally obligated or committed to sell foreign currency to its own nationals on demand? The People's Bank of China is committed to selling foreign currency to Chinese nationals for all legitimate current account purposes, including payments for services, subject to some quantitative limitations. However, it is not yet possible for Chinese nationals to purchase foreign exchange at the People's Bank of China for the purpose of capital transactions. The exceptions are Chinese enterprises that plan to make direct investments abroad. They will be allowed to purchase the foreign exchange upon the approval of their investment applications by the relevant ministries and commissions.
- Is the central bank legally obligated or committed to sell the local currency to its own nationals in exchange for acceptable foreign currencies? The People's Bank of China is committed to purchasing all major foreign currencies tendered by Chinese nationals, individuals and enterprises, with Renminbi, provided that the Chinese nationals are the real, rightful owners of the foreign currencies. (For example, they cannot, in principle, be acting as a conduit for foreign nationals.)

Current Account Convertibility for Both Goods and Services Has Been Achieved

- Current account convertibility was largely achieved in 1994, subject to restrictions and other non-tariff barriers on the imports of goods and services. As long as an importer has an import permit, if required, he or she can always purchase the necessary foreign exchange from the People's Bank of China, the central bank. Certain imports of services, e.g., individual expenditures for tourism, are subject to quantitative limits (e.g., US$2,000 per tourist). However, these limits have also become increasingly liberal. A Chinese student planning to study abroad can apply to the People's Bank of China to purchase up to US$20,000 per year for the purpose of payment of tuition fees and room and board.

Long-Term Capital Account Convertibility Has Been Achieved for FDI and for Loans

- Long-term capital account convertibility has also been achieved for foreign direct investment (FDI), both inbound and outbound, subject to the approval of the underlying direct investment project by the appropriate authorities. It has become increasingly easy for domestic Chinese enterprises to obtain approval for making direct investments overseas. Repatriation of principal and profits of approved FDI has always been permitted.
- Long-term loans from foreign and multilateral financial institutions do not have convertibility problems either, provided that they have been approved by the People's Bank, in advance. Domestic Chinese commercial banks have significant under-utilized foreign-currency-denominated deposits, held by Chinese enterprises and households, that can be used for making foreign-currency-denominated loans (assuming that the maturity structure can be matched). Total foreign-currency-denominated deposits at Chinese commercial banks are on the order of US$100 billion.
- The Chinese Government, however, maintains a policy of balancing foreign assets with foreign liabilities as a hedge against possible unilateral freezing or seizure of Chinese assets abroad by foreign governments. Liabilities of Chinese nationals to foreign entities are perceived as a potential offset to any overseas Chinese assets unilaterally frozen or seized.

What Remains to be Achieved for Full Capital Account Convertibility? (1)

- Long-term Renminbi-denominated loans from Chinese financial institutions to borrowers outside of China. At this time, it is not clear that there is a strong demand for borrowers outside of China to borrow Renminbi to be used outside of China. Nor is it clear that the Chinese government wants to encourage such loans. However, long-term direct (and potentially portfolio) foreign investors may borrow Renminbi long-term from Chinese financial institutions to finance their investment in China, using foreign-currency-denominated collaterals such as certificates of deposits or letters of credit.
- Long-term portfolio investment, both inbound and outbound, in either equity or debt instruments. These flows have yet to be liberalized, but it can be easily achieved by the use of "pre-commitment" devices or vehicles such as "Qualified Foreign Institutional Investors (QFII)" (for foreign investors to invest in the Chinese stock or bond markets), "Qualified Domestic Institutional Investors (QDII)" (for Chinese domestic investors in invest in overseas markets), "Foreign Depository Receipts (FDR) of Chinese stocks," "Chinese Depository Receipts (CDR) of overseas stocks," and closed-end mutual funds publicly listed on respectively overseas and Chinese markets. These devices all share the feature that the inflow or outflow of foreign exchange needs to take place only once (at least until repatriation) effectively insuring that the capital flows are indeed long-term. The investors, however, may be short-term because they can get in and out on their home public markets in their respective home currencies at any time. They are not affected by either existing or potential capital control.

What Remains to be Achieved for Full Capital Account Convertibility? (2)

- The first vehicle for the U.S. public to invest in Japanese equity was the Japan Fund, initially set up as a closed-end mutual fund listed on the New York Stock Exchange. The first vehicle for the U.S. public to invest in Taiwan equity was the Taiwan Fund, initially set up as and continues to be a closed-end mutual fund listed on the New York Stock Exchange.
- Other vehicles for Chinese portfolio investors can include, for example, Renminbi-denominated bonds issued by foreign and multilateral financial institutions such as the Asian Development Bank and the World Bank and perhaps even selected foreign countries and publicly traded on Chinese markets, the initial proceeds of which can be converted into foreign exchange on a one-time basis by the People's Bank for the benefit of the issuer.
- Eventually, all long-term capital flows, including both direct and portfolio investments and loans, will be convertible in both directions.

What Remains to be Achieved for Full Capital Account Convertibility? (3)

- Short-term foreign-currency-denominated loans from foreign and multilateral financial institutions, that are trade-related, so that they are self-liquidating (e.g., a loan that is used to finance the imports of micro-processors to be installed into personal computers and is repaid upon the sale or exports of such personal computers), have been and eventually will be fully liberalized.
- However, short-term foreign-currency-denominated loans that are not trade-related, and hence non-self liquidating, may receive much closer scrutiny. A Tobin-like tax on such short-term loans is possible. The key determining factor is the predictability of such short-term capital flows, whether they will be called or renewed or roll over upon maturity. The fear is that these short-term flows are likely to enter into or exit from China at the most inopportune time, potentially triggering or aggravating any crisis.

What Remains to be Achieved for Full Capital Account Convertibility? (4)

- Short-term portfolio investment, both inbound and outbound, in either monetary, equity or debt instruments, is the most difficult, because they are potentially the most footloose.
- However, for quite some time now, Chinese nationals have been permitted to hold and maintain foreign-currency-denominated deposit accounts at Chinese commercial banks. The owners of these accounts can convert their funds, in whole or in part, from foreign exchange to Renminbi, but not vice versa.
- The Chinese government is unlikely to permit large pools of "hot money," to flow in and out of China at will, raising and lowering the exchange rate as they enter and exit, in the foreseeable future. The potential benefits of such flows to the Chinese economy are rather dubious, but the potential costs in terms of their disruption of the foreign exchange market and the exchange rate can be quite significant.
- There is, however, a deep and thriving black market for foreign exchange in China, with currently an apparent excess supply of foreign exchange. The black market exchange rate is almost identical with the official exchange rate.

The Goal of Chinese Foreign Exchange Policy (1)

- The goal of Chinese foreign exchange policy in the short and intermediate runs is to help maintain and support Chinese economic growth by promoting international trade and investment while at the same time minimizing the sensitivity and vulnerability of the Chinese economy to external disturbances and preserving autonomy in Chinese macroeconomic policies. In general, fluctuations in the foreign exchange rate discourage long-term cross-border investments as well as trade arrangements. Increasingly global division of labor and the fragmentation of the supply chain expose enterprises in all countries to much greater exchange rate risks. There is thus a greater premium for maintaining stability of the exchange rates in order to facilitate both long-term trade and investment.
- Chinese exchange rate management aims at achieving a stable and sustainable long-term equilibrium in the supply and demand of foreign exchange, driven by the relative rate of inflation as well as changes in relative productivity, so that relative competitiveness may be maintained. Since the rates of Chinese inflation, both targeted and actual, have remained low, and the real wage rate of entry-level unskilled Chinese workers has remained fairly constant, there has not been a significant change in relative competitiveness to warrant an adjustment of the exchange rate as yet.

The Goal of Chinese Foreign Exchange Policy (2)

- The preference is to maintain and sustain long-term equilibrium in the foreign exchange market by making appropriate, gradual, and sometimes ad hoc adjustments in the foreign exchange flows and not rely exclusively on the changes in the spot exchange rate. The central bank's responsibility is to smooth the foreign exchange adjustment process, minimize overshooting and undershooting, and discourage short-term speculation.
- Lastly, one must not lose sight of the fact that the Renminbi is used as a store of value by Chinese citizens. Public confidence in the Renminbi can be best maintained if it does not appear to lose value against other foreign currencies. However, appreciation, while it may boost public confidence in the Renminbi, may deprive some unskilled Chinese workers of the opportunity for employment in the non-agricultural sector (See the discussion below).

The Implications of Full Capital Account Convertibility

- One of the questions that are frequently raised is when the Renminbi will become fully convertible.
- Full convertibility is not the same as a freely floating exchange rate. It is perfectly possible to have one without the other.
- It is also useful to bear in mind the "impossible trinity": that is, it is impossible for an economy to have complete capital mobility, interest rate autonomy, and a fixed exchange rate all at the same time. Full convertibility implies complete capital mobility, which implies that one must give up either interest rate autonomy or a fixed exchange rate or both.
- If a stable exchange rate and interest rate autonomy are considered desirable, then one would not be able to have complete capital mobility or equivalently full convertibility.
- It is therefore under less than full convertibility for short-term capital flows that it has been possible for the Chinese economy to maintain a stable exchange rate and yet still retain a degree of autonomy on the short-term domestic rate of interest. The limited autonomy is achieved through the residual control over the inflows and outflows of unpredictable short-term "hot money".

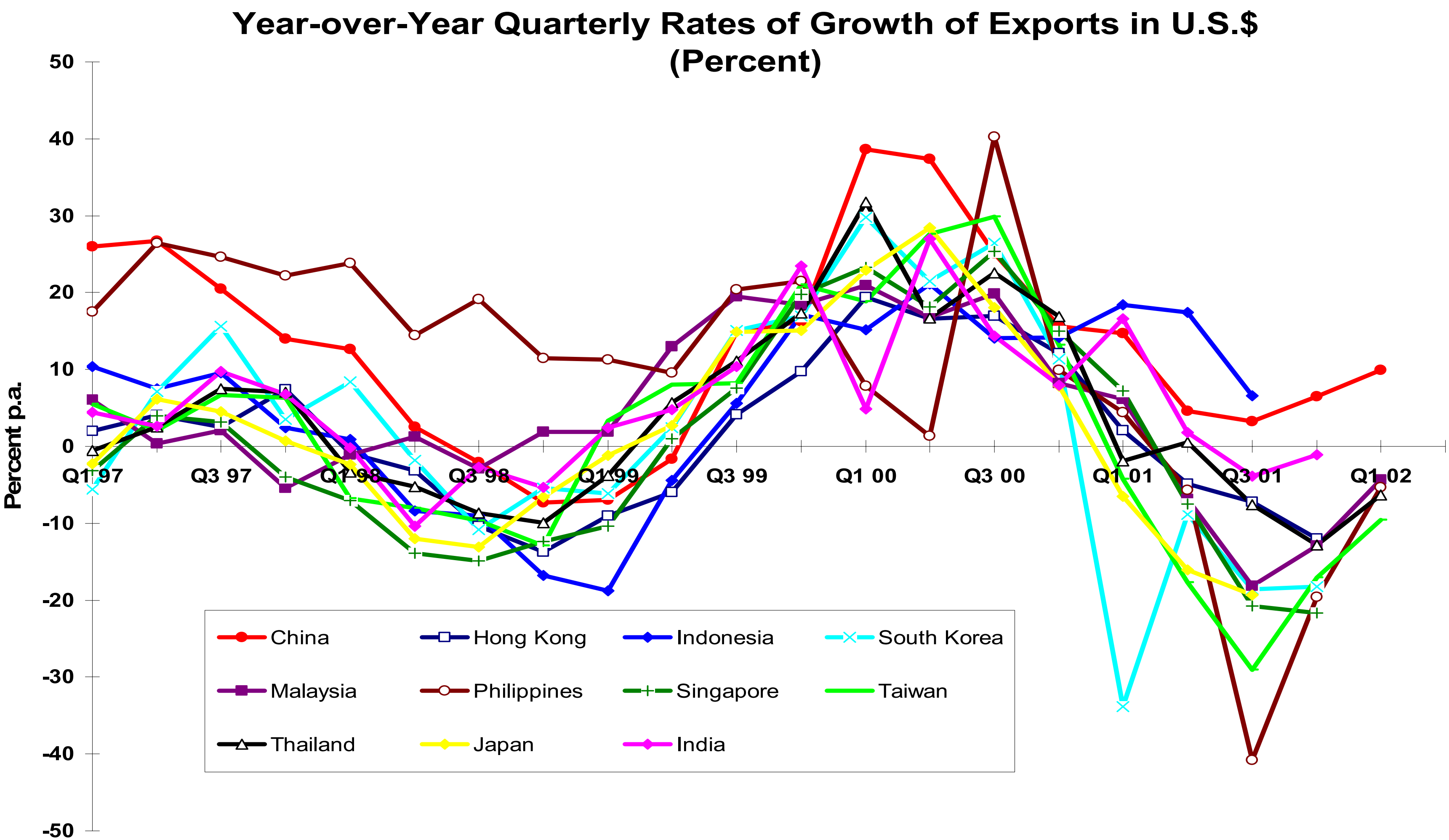
The Benefits and Costs of Full Convertibility

- The usefulness of (non-trade related) short-term capital inflows
  - The adequacy of domestic savings
- The problem with short-term foreign-currency-denominated loans
  - The matching of currency
  - The matching of maturity
  - The feasibility of maturity transformation
  - The compound risk of currency and maturity mismatch
  - The macroeconomic mismatch of maturity
- The benefits of foreign portfolio investment
  - Improvement of market regulation
  - Improvement of corporate governance
  - Improvement of information disclosure and transparency
  - Benefits depend on portfolio investors being relatively long-term
- The unpredictability of short-term capital flows

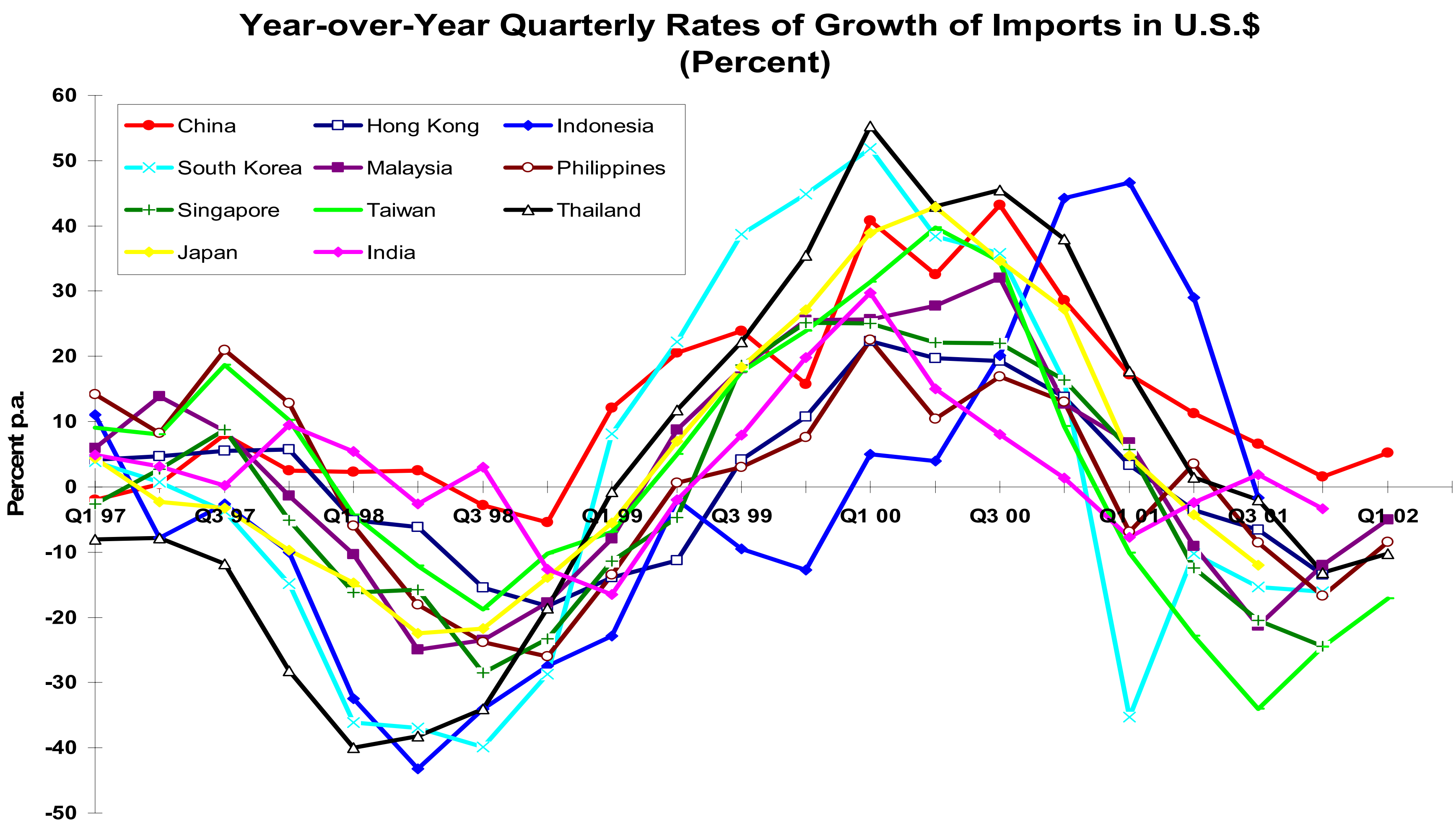
The Relative Insensitivity of Chinese GDP to External Disturbances

- One reason why China does not need to adjust its exchange rate continuously is the relative insensitivity of its economy to external disturbances. Despite significant fluctuations in Chinese exports and imports over the last decade, the rate of growth of Chinese real GDP has remained remarkably stable at between 7% and 8%. This insensitivity is actually typical of large continental economies such as the United States and India.
- Chinese exports are approximately 25% of Chinese GDP, but the value-added component of Chinese exports is only approximately 30%, resulting in an export-generated value-added to GDP ratio of approximately 7.5%. With exports generating such a small share of Chinese GDP, even large fluctuations will have relatively small impact on the rate of growth of Chinese real GDP. For example, the contribution of net exports of goods and services to Chinese economic growth of 2002 may be estimated at approximately 1%.
- Foreign direct investment (FDI) accounts for approximately 10% of gross domestic investment in China, a relatively small proportion.
- Essentially, the Chinese economy has become mostly internal-demand driven. To adjust the exchange rate too frequently in response to temporary changes in the external equilibrium is to let the tail wag the dog.

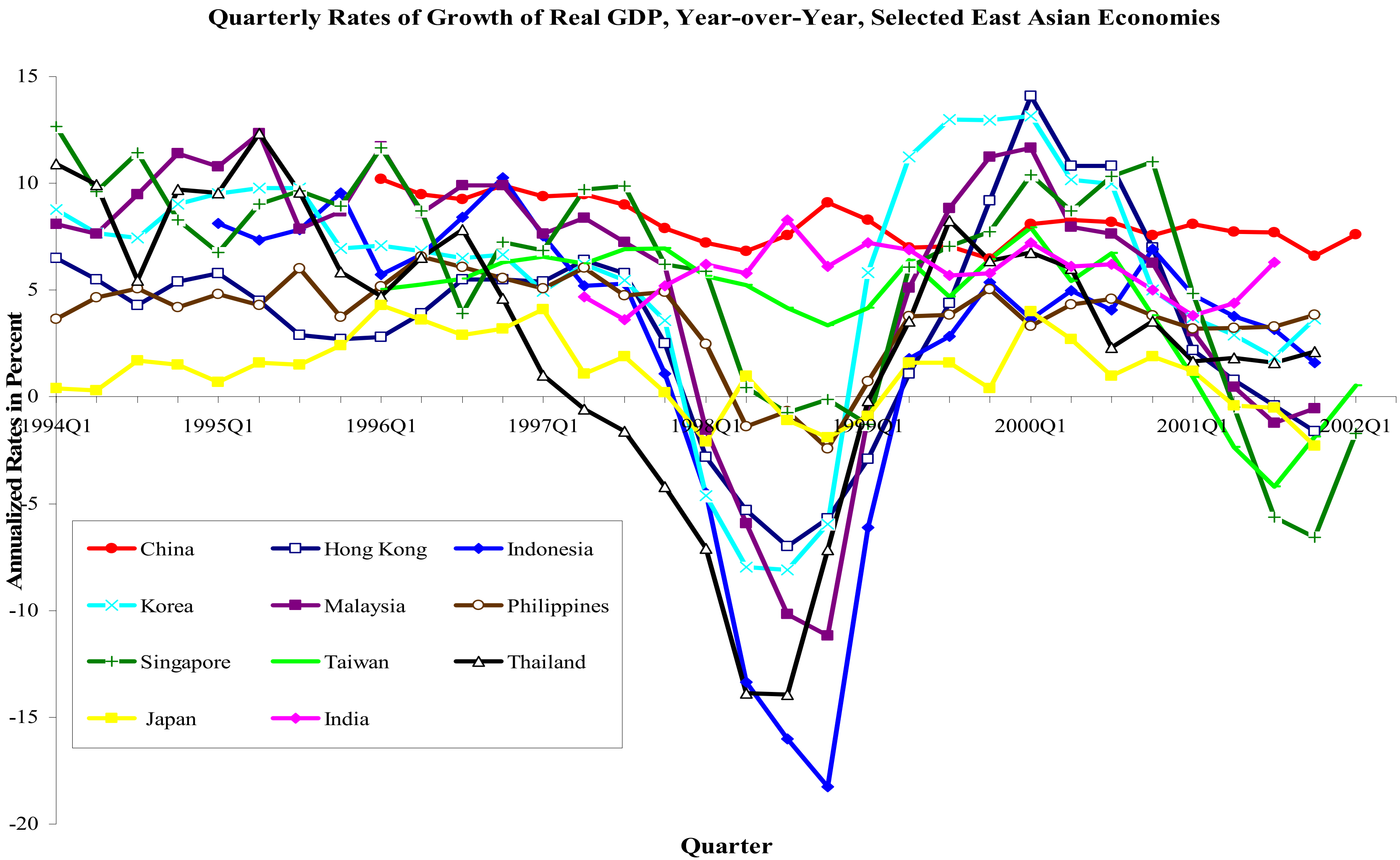
Quarterly Rates of Growth of Exports: Selected East Asian Economies



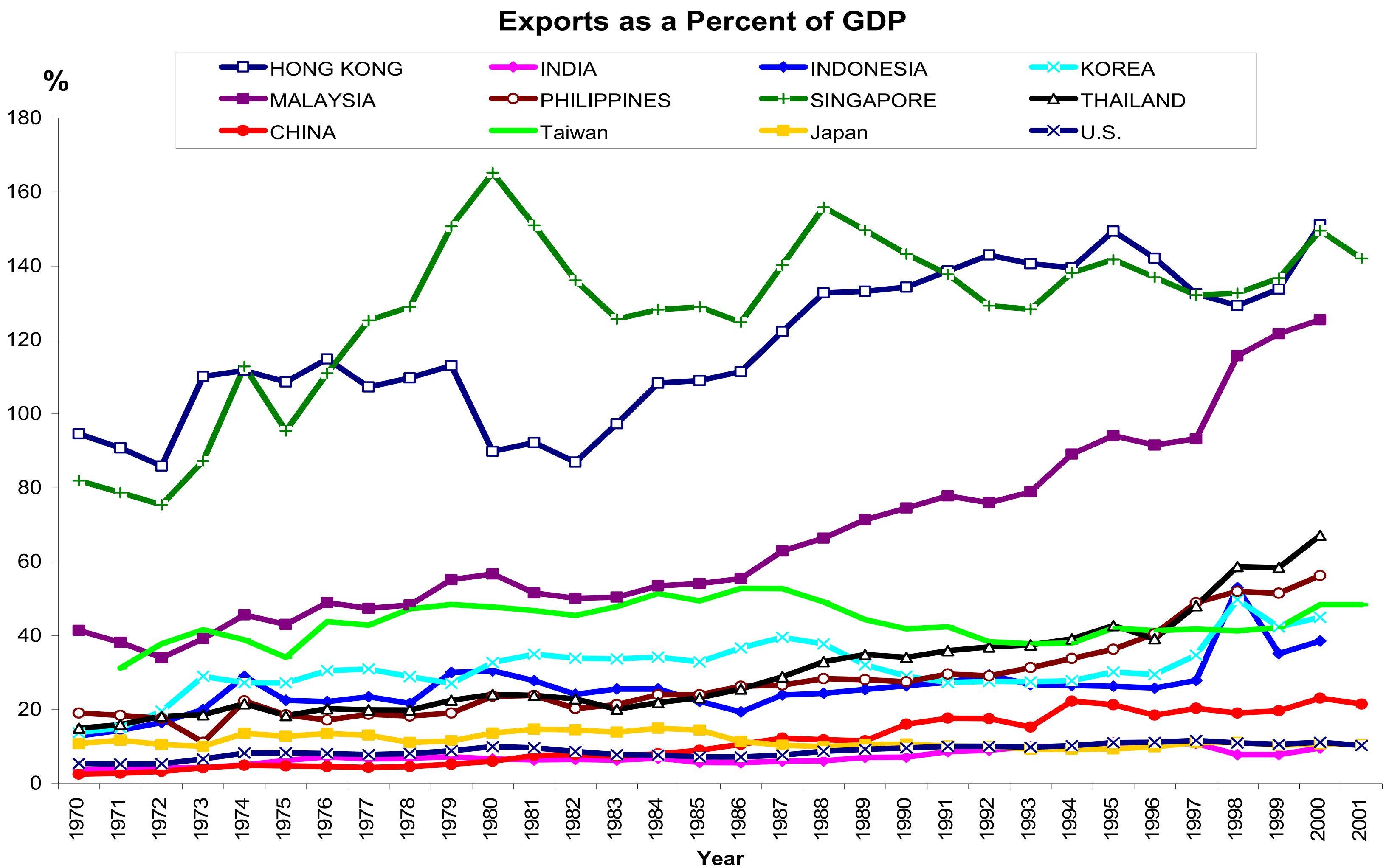
Quarterly Rates of Growth of Imports : Selected East Asian Economies



Quarterly Rates of Growth of Real GDP: Selected East Asian Economies



Exports as a Percent of GDP: Selected East Asian Economies and U.S.



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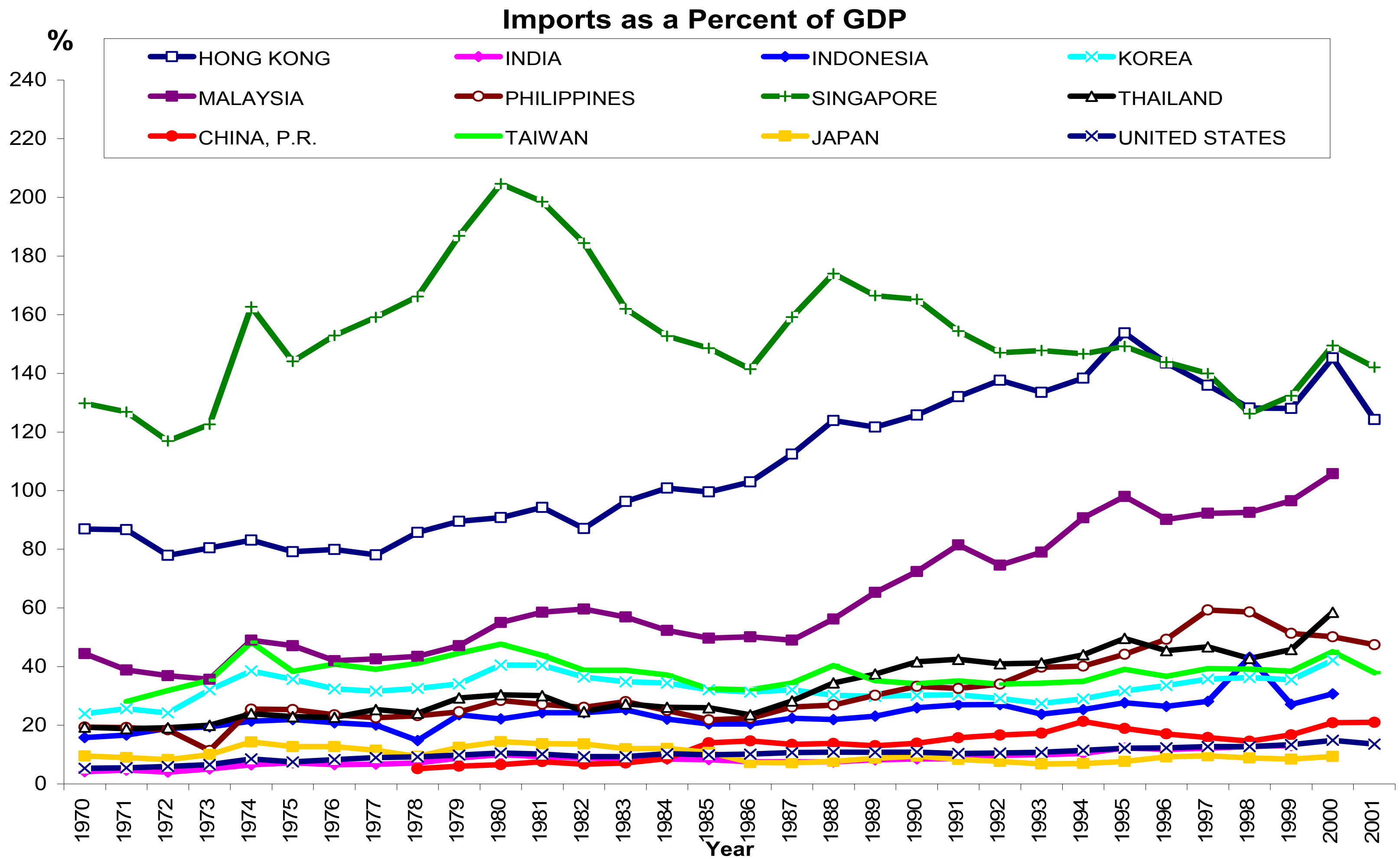
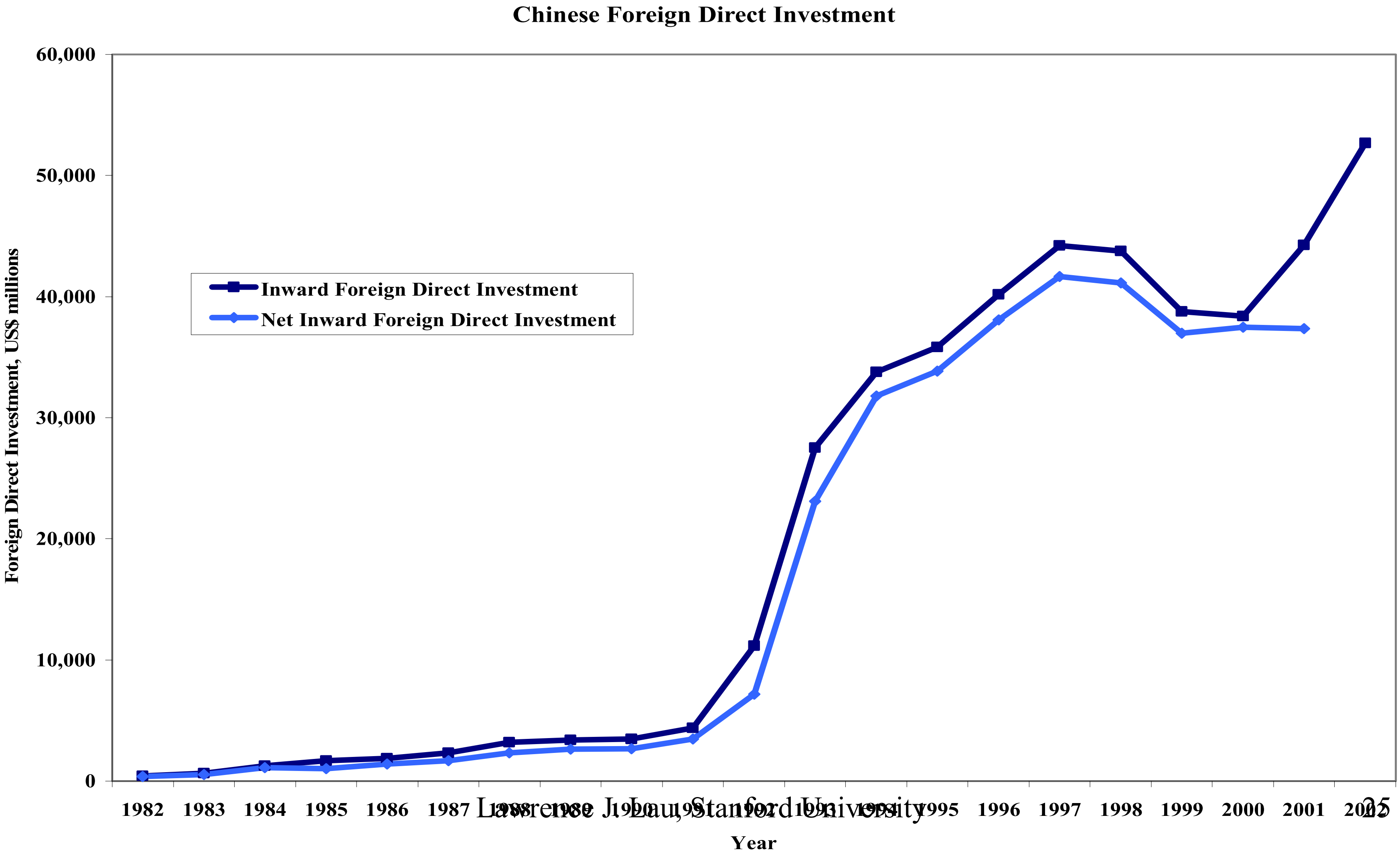


Foreign Direct Investment (FDI)

- FDI, at US$50 billion a year, amounts to approximately 10% of the annual Chinese aggregate gross domestic investment of approximately US$500 billion. Moreover, a significant proportion of it is what is known as "recycled" or "round-tripped" investment ultimately originated by Chinese entities and individuals. Quantitatively, FDI is not critical to the Chinese economy.
- Qualitatively, FDI is probably more important because it brings in technology, know-how, business methods, management techniques and markets that will otherwise be unavailable in China.
- China became the World's leading recipient of FDI for the first time in 2002, with US$52.7 billion, overtaking the United States with approximately US$44 billion. However, its share of total World FDI is still relatively low—approximately 10%.
- FDI has been responsible for most of the growth of Chinese exports (and imports). However, the nature of FDI has also changed--from export-oriented to domestic-market oriented; from light industry to heavy and high-technology industries; and from small projects to large projects.

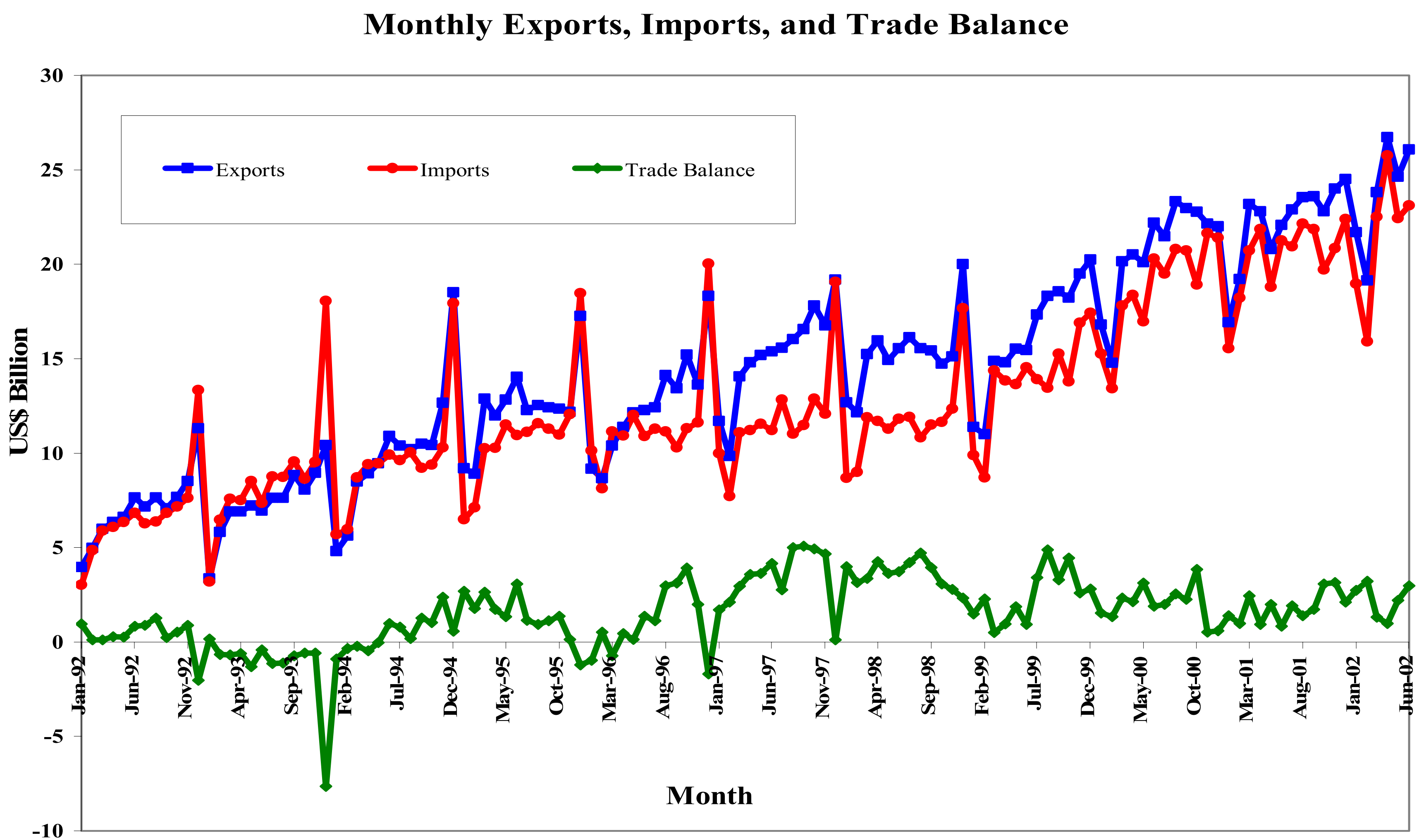
Chinese Foreign Direct Investment



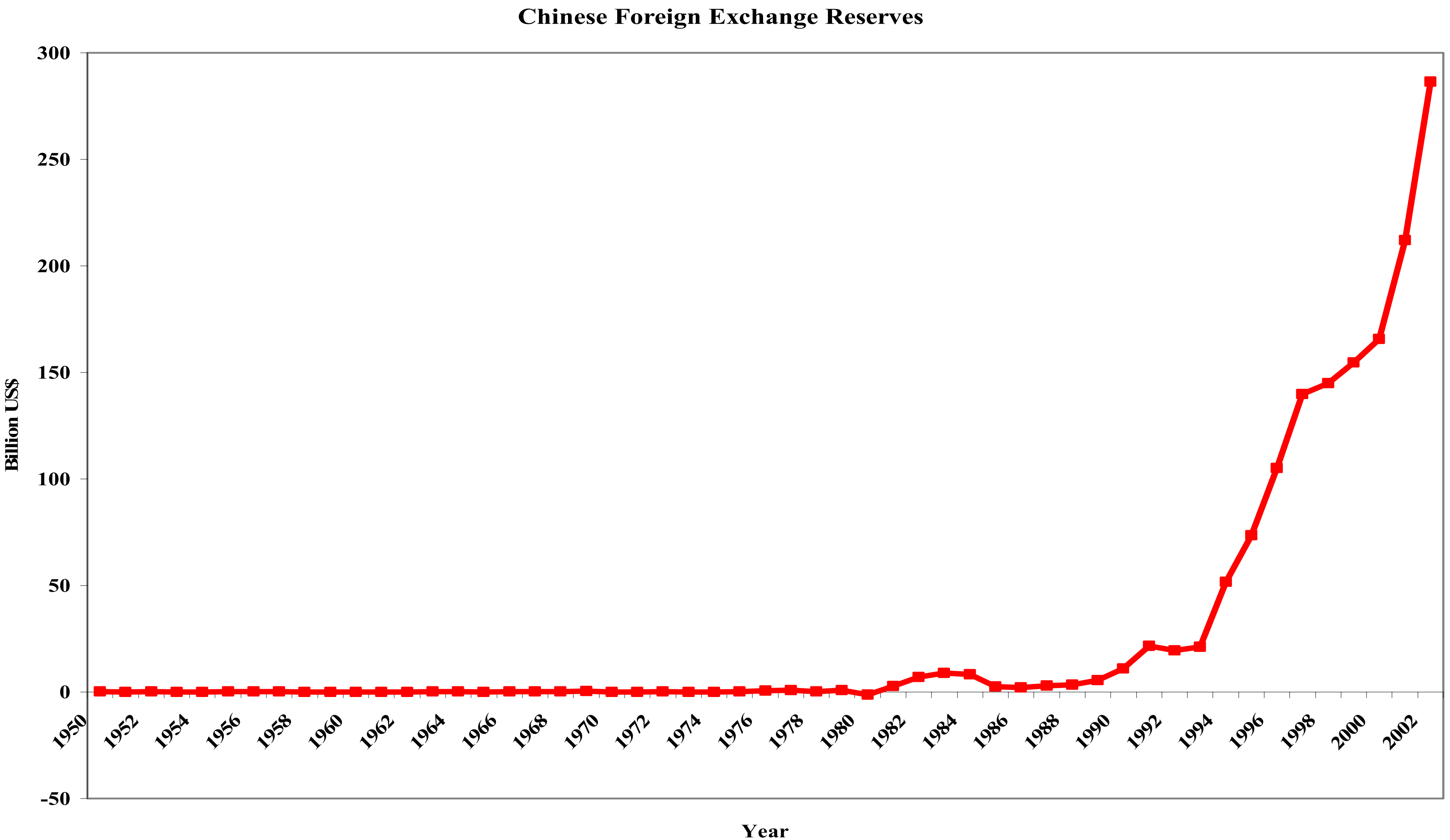
Exports, Imports and Foreign Exchange Reserves

- Trade with East Asian countries, both exports and imports, have been increasing at double-digit rates.
- In 2003/M1-2, exports increased 32.9% and imports increased 57.1% YoY, resulting in a deficit for the first time since 1993.
- Chinese tourists traveling abroad exceeded 20 million in 2002; the tourism component of the balance of payments turned negative in 2000 and remained so.
- Official foreign exchange reserves continued to rise, reaching US$286.4 billion as of the end of 2002.

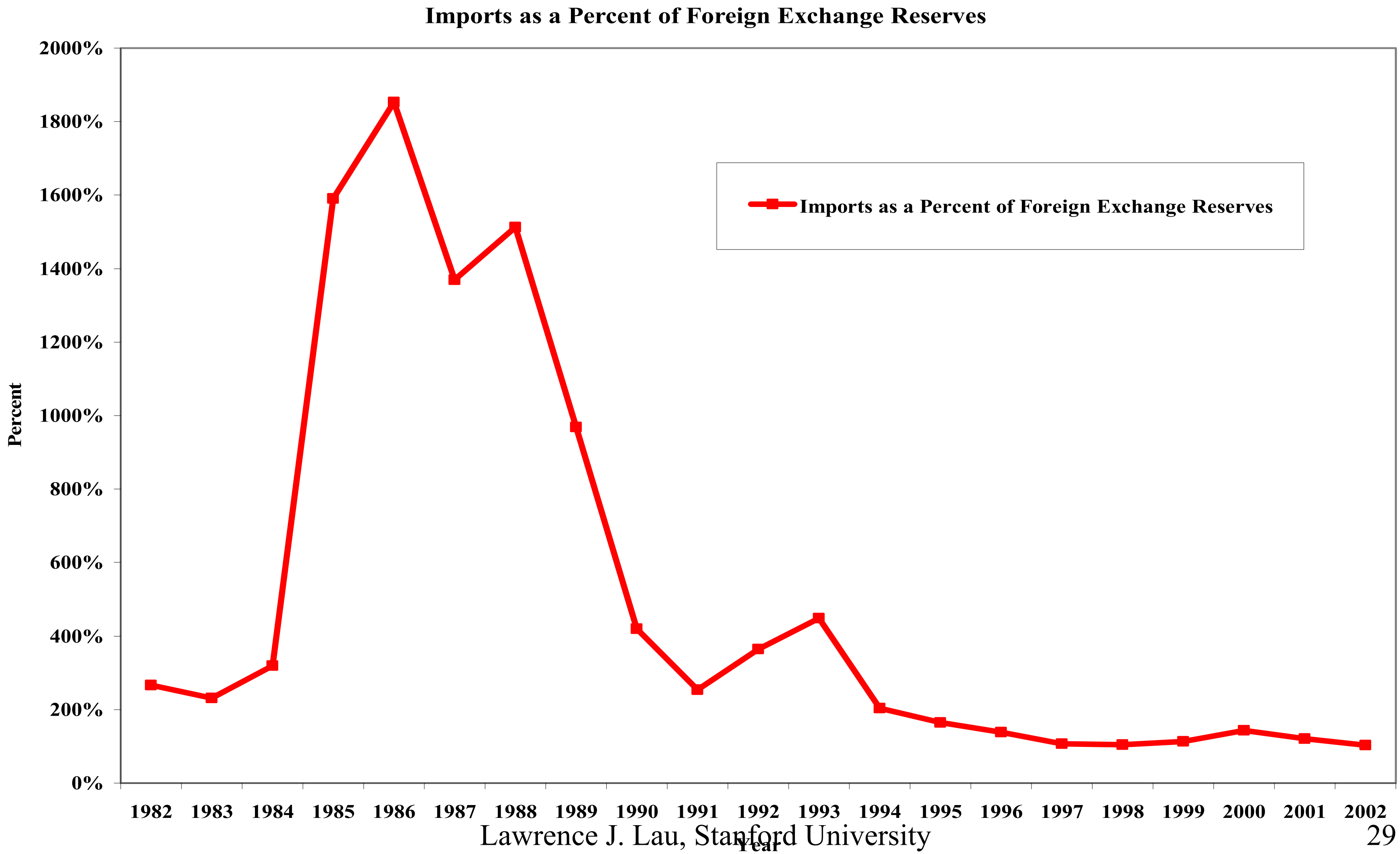
Monthly Exports, Imports and Trade Balance: Official Chinese Data



Chinese Foreign Exchange Reserves



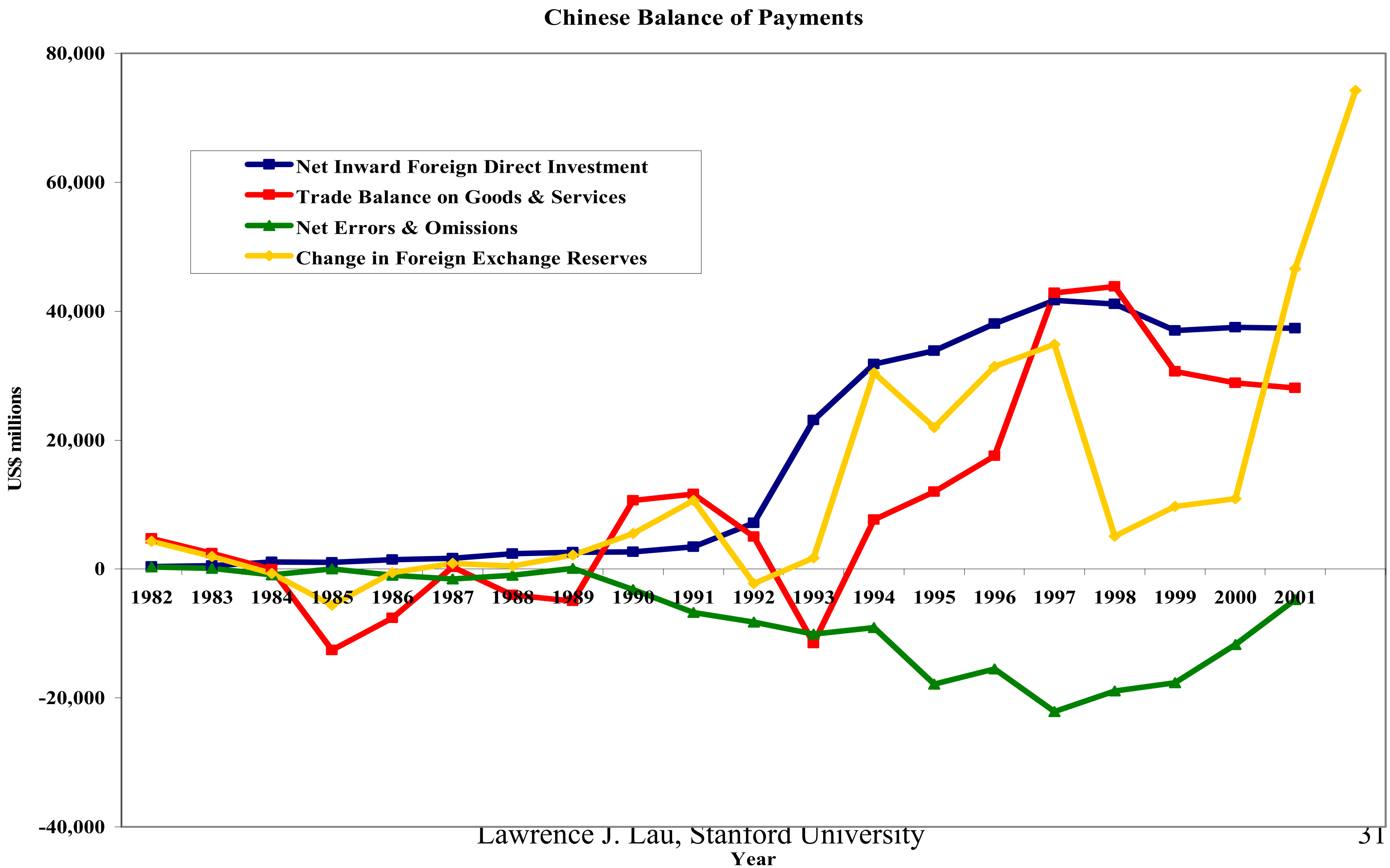
Imports as a Percent of Foreign Exchange Reserves



A Current Account Deficit for China? (1)

- A stable exchange rate requires an ex ante equilibrium of overall inflows and outflows. It is, however, impossible to determine whether the Renminbi is over- or under-valued as long as capital controls and interest rate controls exist. In addition, Chinese accession to the World Trade Organization is likely to increase imports more than exports in the short and intermediate runs, thus resulting in an eventual decrease in its net trade surplus. Rapid increases in oil imports also foreshadow a significant narrowing of the trade surplus in the future.
- China had a surplus in trade in goods of some US$30 billion in 2002, and a surplus in trade in goods and services of perhaps US$20 billion (it has a persistent deficit in trade in services). In the first two months of 2003, China has actually run a trade deficit in goods, the first time since 1993.
- China has net inflows of foreign direct investment of approximately US$52.7 billion in 2002. Of this amount, perhaps between a third and 40% may be round-tripped FDI, that is, Chinese investment masquerading as foreign direct investment. "Real" FDI may be estimated at US$35 billion per year.
- Errors & Omissions, normally a large negative item, reflecting capital flight and other leakages (payments for smuggled imports, financing of round-tripped investments, for example) have been declining in absolute magnitude very rapidly.

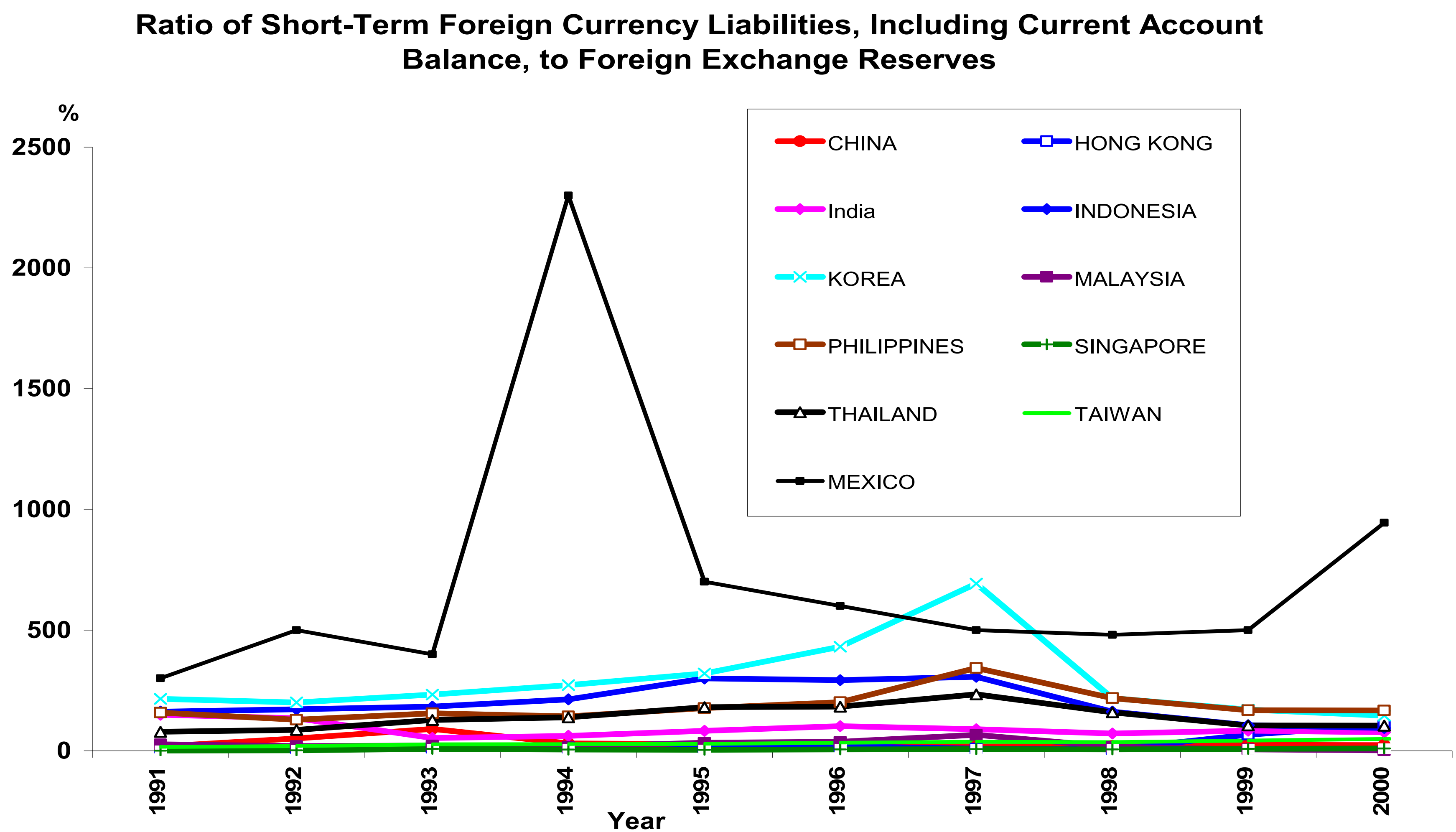
Changes in Chinese Foreign Exchange Reserves



A Current Account Deficit for China? (2)

- Based on these data, it would appear that China can, at this time, afford to run a current account deficit of up to US$30 billion a year, without any reduction in the level of official foreign exchange reserves, and without any impact on the Renminbi exchange rate. By running a trade deficit in goods, it will be able to avoid an over-accumulation of foreign exchange reserves, which in turn accelerates the domestic money supply and leads to external pressure to appreciate the currency.
- China should avoid falling into the same mercantilist and protectionist trap that has helped to lead to over a decade of stagnation of the Japanese economy. The Yen/US$ exchange rate would have been much lower had Japan not run such consistently high trade surpluses and accumulated such a large hoard of foreign exchange reserves over the last half century.
- A stable exchange rate also requires stable expectations, which in turn depends on the ratio of short-term liquid and liquefiable liabilities to foreign exchange reserves. On this count, Chinese reserves are ample and no speculative attack against the Renminbi is likely at this time. If anything, there is pressure for the Renminbi o appreciate.

Ratio of Liquefiable Foreign Exchange Liabilities, Including Current Account Balance, to Reserves



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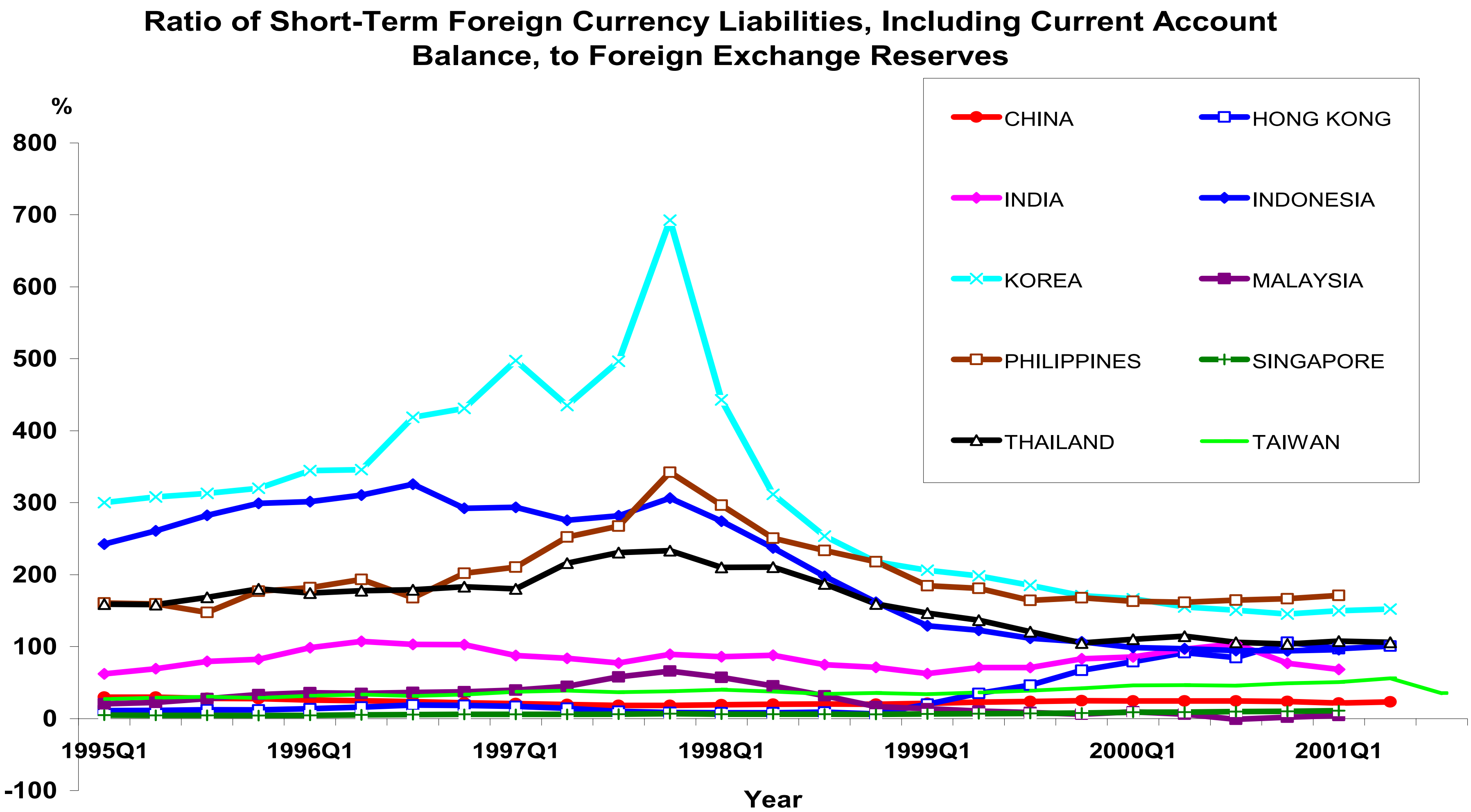

Possible Measures for Reducing the Rate of Accumulation of Foreign Exchange

- The Chinese government can increase its imports of critical raw materials by building up strategic reserves, e.g., oil.
- The Chinese government can also encourage outbound foreign direct investment, e.g., investment in natural resources.
- The Chinese government can effectively reduce the actual inflow of foreign capital by encouraging and facilitating the financing (with recourse) of foreign direct investment (and potentially foreign portfolio investment) with Renminbi-denominated loans by Chinese commercial banks.
  - These loans will be either guaranteed by the foreign parents of the borrowing entities or collateralized by foreign-currency denominated instruments such as certificates of deposits or letters of credit.
  - Such a program provides a natural hedge for foreign investors against fluctuations in the Renminbi exchange rate.

Possible Measures for Reducing the Rate of Accumulation of Foreign Exchange

- The Chinese government can also facilitate the exit (with repatriation of principal and profits) of foreign direct investors by allowing foreign-invested enterprises to make initial public offerings (IPOs) of their stocks on Chinese stock exchanges. (Currently, many direct investors exit indirectly by selling the shares of the offshore companies (e.g., Cayman Island companies) controlling their direct investment in China directly to other purchasers for foreign exchange thus bypassing the convertibility problem altogether.)
- The Chinese government can encourage and facilitate the establishment of a bond market in Hong Kong, serving Asian, multilateral and other issuers of U.S.$-denominated securities. This will help make more instruments available for Chinese outbound long-term portfolio investment.
- The Chinese government can begin to experiment with the acceptance of the currencies of selected countries for payment for Chinese exports (initially up to a ceiling amount). For example, a pilot program may be set up with ASEAN countries.

The Impact of a Real Exchange Rate Appreciation

- There is an estimated 150 million persons strong "reserve army of the unemployed" in the rural areas in China, or almost half of the total "employment" in the agricultural sector.
- This unskilled "surplus labor" is willing and able to work in the non-agricultural sector at a constant subsistence real wage rate in Renminbi terms.
- At the current Renminbi-US$ exchange rate, some, not all, of this "globally substitutable" unskilled labor is gainfully employed by enterprises supplying exports to the rest of the world.
- As long as the real exchange rate between the Renminbi and the US$ remains unchanged, the employment of the unskilled labor can continue and perhaps even expand.
- However, a significant real exchange rate appreciation by the Renminbi will imply a higher real wage rate of unskilled labor in US$ terms, since the subsistence real wage rate cannot be lowered.
- The higher real wage rate will essentially price the "globally substitutable" Chinese unskilled labor out of the world market. (The Chinese unskilled labor faces s kinked labor demand curve from the rest of the world.) It will thus worsen the unemployment and underemployment of labor in the rural areas and retard the movement of surplus unskilled labor from the agricultural sector to the non-agricultural sector.
- For example, if the rate of Chinese inflation is significantly higher than that of the U.S., so that there is effectively real exchange rate appreciation if the exchange rate remains unchanged, the nominal wage rate of unskilled labor will rise to maintain its value in real Renminbi terms, and the nominal exchange rate of the Renminbi will have to fall in order that Chinese unskilled labor can remain globally competitive in real US$ terms. An equilibrium is reached with the real exchange rate remaining constant.

The Impact of a Real Exchange Rate Devaluation

- What is the impact of a devaluation of the real exchange rate of the Renminbi, as for example, through a devaluation of the nominal exchange of the Renminbi vis-à-vis the US$ with the Chinese and U.S. rates of inflation being the same. Such a devaluation will make Chinese unskilled labor even cheaper to the rest of the world. It may be thought that such a real exchange rate devaluation will result in increased employment of unskilled labor in China.
- However, this is not likely to be the outcome. While competitors in the unskilled labor market are not likely to raise the real wage rates in US$ terms if China raises its real wage rate through a real exchange rate appreciation, they are likely to match any Chinese reductions in its real wage rate in US$ terms. This can take the form of competitive devaluation. The end result is likely to be little or no change in the relative competitiveness of unskilled labor across countries. Moreover, the overall global demand for unskilled labor is most likely limited. Thus, each country is unlikely to see any increased employment of its unskilled labor but there will be a reduction in the real wage rate in US$ terms for all. (Recall the kinked demand paradigm mentioned above.) Since everyone active in the unskilled labor market is aware of this, all of them will try to avoid this outcome. Thus, countries are unlikely to rely on a real exchange rate devaluation to boost the employment of unskilled labor.
- Note that this line of reasoning argues against changes in the real exchange rate, but does not necessarily argue against changes in the nominal exchange rate. For example, if the U.S. rate of inflation is much higher than that of the Chinese, it may make sense for the Renminbi to appreciate so as to maintain the real exchange rate at the same parity.
- As long as the real exchange rate between the Renminbi and the US$ remains unchanged, the employment of the unskilled labor can continue and expand with the growth in the Chinese as well as the world economy.
- A further argument against a real exchange rate devaluation is that it delays the migration of industries from the higher-cost (and higher-income) regions of China to the lower-cost (and lower-income) regions of China. It also delays the upgrading of industries in the higher-income regions into higher-value-added activities.

Evolution Towards Nearly Full Functional Convertibility

- Greater liberalization of the current account, e.g., further reducing non-tariff trade barriers, raising the ceilings for foreign exchange purchases by Chinese tourists.
- All long-term capital flows, including both direct and portfolio investment and loans by financial institutions, will eventually be fully convertible.
- Short-term non-self-liquidating foreign-currency denominated bank loans may be subject to a Tobin-type tax to encourage a lengthening of the average maturities.
- Short-term investment flows ("hot money"), both outbound and inbound, may be permitted, subject to a "rest period". (Chile has in the past imposed duration requirements on portfolio inflows; Switzerland has tried negative nominal rates of interest.) The objective is to raise the transactions cost of short-term non-trade-related capital flows.
- Renminbi-denominated bank accounts may become available for residents of Hong Kong.
- The more successful the central bank is in the maintenance of a stable managed floating exchange rate that reflects relative price and productivity changes, the more likely and sooner there will be close to full convertibility.

Concluding Remarks: The "Small Whimper" Rather Than the "Big Bang" (1)

- The various devices or vehicles for portfolio investment flows in both directions serves several useful purposes.
- (1) It enables portfolio investment flows without the central bank having to give up control over both the timing and the volume of the flows. In particular, the central bank can manage the flows so as to maintain the overall balance of payments in equilibrium at the prevailing exchange rate.
- (2) By using publicly listed and traded vehicles, the liquidity needs of the portfolio investors both inside and outside China can be readily accommodated.
- (3) These devices and vehicles may be viewed as pilot projects for eventual full convertibility. In particular, their performance on the respective Chinese and overseas public markets can reveal very valuable information. For example, if a closed-end fund investing in Chinese stocks and listed on the New York Stock Exchange consistently trades at a premium to its net asset value, a strong excess demand for Chinese equity is indicated. Similarly, if a closed-end mutual fund investing in an Standard & Poor 500 basket of stocks and listed on the Shanghai Stock Exchange consistently trades at a premium, it indicates a large pent-up demand by Chinese portfolio investors for U.S. equity. Any steps taken towards full convertibility must take such information into account so as to assure smoothness and stability.

Concluding Remarks: The "Small Whimper" Rather Than the "Big Bang" (2)

- Over time, the number and size of these vehicles can be adjusted. If and when full capital convertibility occurs, it will hopefully be a relative non-event, as Chinese portfolio investors that wish to hold overseas assets would have already had ample opportunities to do so, albeit in Renminbi. Likewise overseas portfolio investors that like to hold Chinese stocks have already been able to do so. The arrival of full convertibility will therefore hopefully be a "small whimper" rather than a "big bang."

Concluding Remarks: The Renminbi as a Reserve Currency

- With the increasingly close economic relations between China and the ASEAN countries in both international trade and investment, in the longer term, it is probably in the interests of China to make the Renminbi an alternate reserve currency, like the U.S. Dollar and the Euro, or at least the core of an Asian reserve currency, playing the same role as the Deutsche Mark to the Euro in stabilizing the relative exchange rate parities within East Asia (other than Japan)
- This will take at least a couple of decades to accomplish. It will probably begin as a mutual support program for the currencies of some of the countries in the China-ASEAN free trade area, possibly leading to a system of relatively fixed parities first, and then eventually to a formal or informal Asian currency snake, and perhaps ultimately to an Asian currency area.
- In order for the Renminbi to play the role of an alternate reserve currency, it will most likely require the removal of all or most restrictions on short-term capital flows, both inbound and outbound. Instead of trying to keep the Renminbi away from foreign hands, one would want to make as much of it as possible available to all who are willing to accept and to hold the currency, This will mean compromises on the part of the Chinese government between the maintenance of control and predictability of the exchange rate and the promotion of the widest possible usage of the Renminbi (as befits a reserve currency). Fortunately, that choice does not need to be made any time soon.