

Analysis on the Financial Conditions of Free Convertibility of RMB Capital Account

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Abstract—An important issue of RMB internationalization is the free convertibility of RMB capital account, or the opening of capital account. While planning the free convertibility schedule of capital account as a whole, policymakers must satisfy the relevant conditions of financial market in order to control risks. In China, a prominent concern is that once the capital account can be converted freely, the scale and structure of capital flows will change. Especially when the domestic bond market is underdeveloped, a slight carelessness and a large debt capital inflow will inject great instability into the economy. Therefore, the author hopes to explore the key issues in the internationalization of RMB. This paper discusses the financial conditions of RMB capital account convertibility, finds out the advantages and disadvantages of the current reality, reflects on the existing problems and development direction of China, and gives some suggestions.

Keywords—internationalization of RMB; opening of capital account; financial market conditions

I. INTRODUCTION

The realization of free convertibility of capital account can attract foreign investment and make residents have more diversified investment portfolios. More importantly, the free convertibility of capital account can promote the effective circulation of cross-border capital and accelerate the development of China's capital market. Therefore, it is of great significance to study what kind of financial market conditions can contribute to the realization of full free convertibility of RMB capital account.

II. THE DEFINITION AND CURRENT SITUATION OF CAPITAL ACCOUNT IN CHINA

There is no uniform definition of capital account convertibility internationally. The author agrees with Guan Tao's definition of free convertibility of capital account given in 2001. The definition holds that capital account convertibility means "avoiding restrictions on cross-border capital transactions and related payments and transfers, avoiding discriminatory monetary arrangements, and avoiding taxation or subsidies on cross-border capital transactions".

As early as the 1990s, China has already completed the convertibility of current account. Nowadays, the RMB has been convertible freely in border trade, tourism, personal

consumption and other fields in China's neighboring countries, the Asian region and even the whole world. However, the opening of capital account is still in a gradual process.

III. ANALYSIS OF FINANCIAL MARKET CONDITIONS FOR PROMOTING CAPITAL ACCOUNT OPENING

A. Insufficiency of Current Financial Market Conditions

There are four reasons for prudent liberalization of convertibility of capital account and proper capital control: firstly, capital control is used to limit capital outflow due to current account deficit; secondly, limit capital inflow to prevent excessive speculation, excessive asset appreciation and excessive domestic liabilities; thirdly, to improve the structure of capital flow; fourthly, policy makers adhere to independent monetary policy and choose the former between floating exchange rate policy and free capital flow according to The Impossible Trinity. From the perspective of China's national conditions, the current capital control is not aimed at the current account deficit, that is, the first of the four reasons mentioned above. What's need to pay more attention to is the excessive inflow of capital after the liberalization of capital account, and the impact of the liberalization of capital account on the structure of capital flow, which are the second and third reasons.

As mentioned above, China's current imperfect financial system can hardly guarantee that the structure of capital flows will not be skewed after capital account liberalization and that long-term investment will not be replaced by short-term speculation. Firstly, the scale of the capital market is limited and it is difficult to bear the huge fluctuation of asset prices after the capital account is converted freely. Secondly, market participants in China react slowly to changes in exchange rates and interest rates. Under this lagging effect, it is necessary to carry out appropriate capital controls to provide space for them to respond. Finally, China's financial institutions lack competitiveness in the international market, so capital controls can protect infant industries and maintain their survival.

Improving the construction of domestic financial market is an important prerequisite for the conditional and complete liberalization of capital account. To sum up, the author agrees with appropriate capital control and carefully promotes the convertibility process of capital account.

B. China's Financial Market Construction

Because of the shortcomings mentioned above, the construction and improvement of financial markets should be speeded up. The construction of financial market includes not only the domestic market, such as the promotion of interest rate marketization, the development and perfection of bond market, the establishment and perfection of financial derivatives, but also the offshore market, such as the establishment and perfection of channels for investing in Chinese financial products, and the reduction of exchange rate risks in international trade.

Since 1996, China's interest rate liberalization has gone through the abolition of the upper limit of interbank loan interest rate, the abolition of repurchase interest rate control and the abolition of foreign exchange interest rate control, until 2004, the abolition of the upper limit of loan interest rate and the lower limit of deposit interest rate. This last step of interest rate liberalization is also the most risky step, so there has been no progress in more than ten years. But this decade is by no means idle. Shibor, the benchmark interest rate, has taken shape. On May 10, 2015, the People's Bank of China issued a document that raised the bank regulation scope of savings interest rate from 130% to 150% of the benchmark interest rate. A deeper and more complete marketization of interest rate is just around the corner. Only by cultivating the benchmark interest rate with high controllability and good stability can the interest rate marketization be further carried out.

China's bond market has made rapid development in the past decade, but according to the statistics of the International Monetary Fund, in 2017, the global GDP was 80.684 trillion US dollars, China's GDP was 12.238 trillion US dollars, and China's GDP accounted for about 15.168% of the world's GDP. According to the statistics of the Bank for International Settlements (BIS), the global outstanding debt is about 160 trillion US dollars in 2017, but at the exchange rate of 1:6.8, the outstanding debt in China's bond market is 6.563 trillion US dollars in 2017, accounting for less than 4% of the global market. Obviously, the scale of such bonds cannot meet the financing needs. A large number of small and medium-sized enterprises are facing financing difficulties. At present, the financing of enterprises relies too much on the commercial bank system. The insufficient size and immature development of the bond market is an important problem facing the construction of China's financial market. The possible consequence is that once the capital account is opened, a large number of hot money will pour in to make up for the vacancy, greatly increasing the stock of our foreign debt and causing economic instability. Therefore, speeding up the construction of bond market is the key to the smooth realization of capital account opening.

IV. SUGGESTIONS ON PERFECTING CHINA'S FINANCIAL MARKET

The process of RMB internationalization can be decomposed into many quantifiable steps, such as the gradual liberalization of capital convertibility projects and the establishment of financial system including financial

market and regulatory system. A problem, such as the scale of bond market is still very small, the derivatives of financial markets are not perfect, and the offshore market such as forward exchange rate offshore market is still limited. Due to the existence of these problems, appropriate capital control is still necessary at present, so Li Daokui (2008) proposed the dual track of RMB internationalization. On the one hand, capital control should be gradually relaxed, on the other hand, an offshore RMB market should be built and the efficiency of the financial system should be improved internally and gradually implement the free convertibility of capital account externally. On this basis, the author puts forward the following specific countermeasures and suggestions to promote the gradual free convertibility of RMB capital account.

Firstly, the order of convertibility of capital account should be reasonably planned. The realization of full convertibility of capital account is a gradual process. An ideal order of opening up is: first, liberalization of long-term and short-term capital transactions, and then liberalization of related financial services and foreign exchange, and finally, liberalization of foreign exchange transactions without transaction background. However, capital flows have their own laws and are constrained by specific domestic and foreign environments, so there is no standard way and template for capital account liberalization, nor a unified order to ensure the smooth completion of capital account liberalization practice in various countries. The path of capital account opening that suits China's national conditions should be chose and the order of capital account convertibility opening should be adjusted at any time according to the changing macroeconomic situation and environment at home and abroad.

Secondly, the matching policy of convertibility of capital account should be improved. Deepening the reform of interest rate marketization and establishing floating exchange rate system are important supporting measures to realize the free convertibility of capital account. Among them, interest rate marketization reform should be carried out on the basis of controlling interest rate risk. The construction of floating exchange rate system should proceed from improving the supply and demand of foreign exchange market and perfecting the formation mechanism of RMB exchange rate. Relevant supporting policies also include strengthening cooperation among departments. The Development and Reform Commission, the People's Bank of China, the Securities Regulatory Commission, the Banking Regulatory Commission and the SAFE should work together for the free convertibility of RMB capital items, improve the efficiency of examination and approval, and reduce the administrative costs of financial institutions.

Thirdly, accelerate the construction of mature bond market and financial derivatives market. At present, enterprises rely too much on commercial banks for financing, which invisibly increases the risk of the banking system and limits the ability of SMEs to obtain financing. Once the capital account is liberalized, excessive debt inflows will destabilize the economic system. The sound financial

derivatives market is of great significance for hedging risks and enhancing the liquidity of the financial system.

V. CONCLUSION

China's special national conditions in studying the opening of capital account must be aware of. At present, the domestic financial market is far from perfect, and the free convertibility of capital account cannot be achieved overnight. For example, the current bond market is limited in scale, small and medium-sized enterprises are difficult to borrow, and private lending is prevalent. Once capital is liberalized, there will be a large inflow of debt, injecting instability into the economy. However, China has overcome some unfavorable factors in the process of capital liberalization happened in many countries. Such as, the ideal environment for capital account liberalization is that the government has solved its debt problem. China's long-term current account surplus is export-driven, so in the liberalization of China's capital account, there is no need to face the problem of high government debt.

The internationalization of RMB will go through a long process of internal and external reforms in addition to enhancing the strength and international competitiveness of China's own products. This may be a difficult process, but I believe that with the lessons of history and the mature financial system of developed countries as a reference, smart policymakers will be able to avoid many avoidable setbacks in the reform and development.

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