

Foreign Exchange Control in China



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FOREIGN EXCHANGE CONTROL IN CHINA

2ND EDITION

by

Tu Hong

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An expert in foreign exchange control policies and regulations in China, Tu Hong has been invited to speak in numerous foreign exchange administration seminars in China attended by professionals and high-level executives from multinational companies, financial institutions and foreign investors to China.

PREFACE

The world economy has gone through both liberalisation and globalisation in the past three decades. Although the globe is currently experiencing serious economic downturn, its tendency still remains unchanged. The economies of many countries have become more open to each other as well as more interdependent. At the same time, cross-border fund and capital movements arising from international trade and investments have become more and more frequent. International fund and capital movements need a free payment system, but exchange restrictions still exist even though the world economy tends towards liberalisation and globalisation.

At present, each country legislates its own currency policies within its jurisdiction and imposes direct or indirect restrictions on foreign exchange. These legislations and restrictions are complicated and disperse, causing great difficulties to international trade and investments. Knowledge of exchange control measures and rules is therefore vital to the facilitation and participation in fund and capital movements at both the international and national levels for any commercial entity or individual involved.

Foreign exchange control in China

The economic environment in the People's Republic of China has undergone profound changes over the past 30 years. The policy of reforming and opening to the outside world has been adopted since 1979 and the economic structures have gradually evolved from a centrally-planned economy to a market economy. In the course of this evolution, foreign exchange control policies have played a leading role assuring stable, continuous and healthy economic development.

It is clear that China is increasingly turning into a commercial market with enormous potential. After its accession to WTO in 2001, China has enjoyed a dramatic increase in foreign trade and foreign direct investments. China's foreign trade volume went up from US\$510 billion in 2001 to US\$2,562 billion in 2008. Foreign direct investments in China exceeded US\$108 billion in 2008 after China became the largest foreign direct investment host country instead of the United States of America in 2002.

China is providing a gigantic chance as well as a challenge to the world. However the reality is that not all foreign entities will be successful in China. Only the entity that is both realistic and far-sighted will successfully grasp the chance. And for a foreign entity to be able to grasp the chance successfully, it is crucial that it carefully studies and becomes familiar with all relevant policies of China. These relevant policies constitute the "game rules" in China with foreign exchange control policy being one of the most important and complicated aspects of these game rules. The more familiar the foreign entity is with foreign exchange control rules of China, the more benefits it will reap and the earlier it will do so compared with its competitors.

The law is stated as at 31 December 2008.

Tu Hong

**I dedicate this book to my mother and my wife
for their unflagging support.**

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PART I — AN INTRODUCTION TO FOREIGN EXCHANGE CONTROL

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Chapter 1

History and evolution

¶1-100 Introduction

Foreign exchange control, also known as foreign exchange administration, refers to the adoption of measures by the central government or currency authority of a country or region (hereinafter called “exchange authority”) in relation to foreign exchange income and expenditure, selling and buying, pricing, settlement and market, effected through legislation or promulgation of relevant regulations, stipulations or decrees in order to carry out the intended foreign exchange administration, coordination, organisation or restriction.

Foreign exchange control has a long history and exists in almost every country. All countries, whether developed or developing, implement foreign exchange control directly or indirectly to realise relevant macroeconomic goals.

As early as 1944 at the establishment of the International Monetary Fund (IMF), in order to stabilise the exchange rates of its member countries, IMF began to collect statistics of its members’ balance of payments. Also, to unify statistical standards and provide guidelines to its member countries, IMF edited and published five editions of the *IMF Balance of Payments Manual* (BPM) in 1948, 1950, 1961, 1977 and 1993 respectively. Currently the fifth edition of this manual (BPM5) is effective. In the manual, IMF defines relevant terms such as balance of payments, system of national accounts, current account, capital account, etc. Member countries must compile their statements of balance of payments based on these unified terms and report the status of these statements to IMF. IMF thereby supervises its members’ relevant policies and provides loans to those which are in an adverse balance of payments situation so as to maintain the stability of their exchange rates.

Because the international economic and financial environment has changed significantly since BPM5 was published in 1993, The IMF Committee on Balance of Payments Statistics has released the sixth edition of the *Balance of Payments and International Investment Position Manual* (BPM6) in early 2009, which updates BPM5. BPM6 is expected to go into effect gradually from 2009.

All countries deliberately interfere or do not interfere with market exchange rates in order to promote their exports through the depreciation of their currencies, thereby accelerating economic growth. As a matter of fact, the relevant laws, stipulations and decrees relating to foreign exchange control are so extensive and multifarious that few people can comprehend and put them into practice quickly. To counter this situation, IMF, as the supervisory

organisation in charge of international foreign exchange control affairs, has been editing and publishing the *Annual Report on Exchange Arrangements and Exchange Restrictions* since 1950, and introducing and imposing foreign exchange control arrangements and restrictions on IMF member countries and regions. These arrangements and restrictions will hopefully ensure the smooth running of each country's currency, banking and finance operations and keep the equilibrium of balance of payments.

In many ways, foreign exchange control arrangements and restrictions are used in practically every national economy, including China. However, considerable differences exist among national laws and regulations depending on the different levels of economic development.

¶1-200 History of foreign exchange control in the world

The conversion of currencies and the corresponding foreign exchange control policies originated from international trade. The history of international trade is more than one thousand years, but the history of foreign exchange control is only about 95 years. The wide time gap between the history of international trade and practice of foreign exchange control is due to the developments of transnational trade and the relative monetary system. The rest of this section provides a brief history of international foreign exchange control. A good understanding of the historical background of foreign exchange control from the international perspective will assist readers in gaining a better understanding of the origin and evolution and therefore policies of foreign exchange control in China.

Gold standard monetary system

Before the First World War in 1914, leading countries in the world adopted the gold standard monetary system wherein currencies could be exchanged for gold freely according to the rate stipulated by a particular country's law and wherein currencies could be freely circulated, exchanged, imported and exported. Settlement for international trade was practically unrestricted. That is to say, almost no foreign exchange control existed at the time.

After the First World War broke out, some countries scrambled for gold in preparation of the war. Gradually the free international circulation of gold was suspended. The gold standard monetary system was soon abandoned due to the great differences between the gold reserves of different countries. The paper currency began to circulate instead of gold, and almost every belligerent state prohibited the free trading of foreign exchange so as to prevent itself from outflow of funds and enormous exchange rate fluctuations. Gold export was also forbidden.

After the Great Recession from 1929 to 1933, the United States of America (US) gave up the gold standard monetary system, indicating the complete collapse of this system. From then to the end of the Second World War, the international monetary system was thrown into confusion, and the typical foreign exchange control method was depreciation of the main currencies. This is the initial stage of foreign exchange control in the world.

Bretton Woods System

Two world wars directly resulted in the appearance and expansion of foreign exchange control. After the Second World War broke out, with the collapse of the gold standard monetary system, the international financial market was in serious disorder. In view of the chaotic situation, 44 countries took part in the *Bretton Woods* conference held in the US. In this conference, IMF was established and a new monetary system emerged with the IMF Agreement going into effect.

The new system is called the *Bretton Woods System* and the US dollar (USD) became the core of this system. Arrangements included linking the USD with gold and linking other currencies with the USD. The exchange rates of these other currencies were decided according to their gold content. These exchange rates were the official rates which were relatively fixed.

All the foreign exchange rates of the currencies linked to the USD were only allowed to float within a very narrow range: up and down at no more than 1% respectively. If the market rate of a currency fluctuated beyond this range, the central bank of the country of that currency was to interfere with the markets to keep the exchange rate stable. A member of IMF could apply for USD loans from IMF to keep the equilibrium of the balance of payments.

However, with the rapid economic development of other countries such as Germany and Japan, the US could not provide enough gold to maintain the exchange rate of the USD, and had to devalue the USD with a big margin in 1960 and 1963 respectively. The *Bretton Woods System* began to collapse in August 1971 with the announcement by the US that the exchange of the USD to gold was to be terminated.

During the period of time when the *Bretton Woods System* was operating smoothly, foreign exchange control measures were concentrated in the management of the exchange rates and foreign exchange and gold reserves so as to adjust the balance of payments. At the same time, the foreign exchange reserves of many countries were diversified from the unitary USD to multi-currencies on a large scale.

The floating exchange rate system

In October of 1973, with the complete termination of the official exchange system from the USD to gold under the *Bretton Woods System*, international foreign exchange control was characterised by some new features. First, many

countries adopted the floating exchange rate system though others continued with the fixed exchange rate, and fluctuations in the exchange rates fell to a large extent. Second, IMF, the international foreign exchange supervisory organisation, adopted more policy principles which related to the macroeconomy instead of principles previously adopted which mainly concentrated on the area of balance of payments. These changes indicated that mutual harmonisation of different countries in macroeconomy was the crux of the stability of the exchange rates. Third, the debt crisis of Latin America in the 1980s and the Asian financial crisis in 1997 showed that no enforcement method other than that of international cooperation could keep the exchange rates stable. Finally, due to the acute fluctuations of the exchange rates and the lowering of transparency of countries influenced by the fluctuations, risk exposure required all kinds of risk management tools, so derivatives and structured products were used in order to hedge the relevant risks. This situation greatly increased the difficulties of foreign exchange control.

The floating exchange rate system has operated for 35 years now, accompanied by liberalisation and globalisation of the world economy. But international foreign exchange remains a formidable challenge not only to China but also to the rest of the world.

¶1-300 History and evolution of foreign exchange control in China

China possesses a long history exceeding 2000 years from 221 BC when the Qin Dynasty first unified the whole of China. However, compared with agriculture, trade in China is not as developed. Before 1949 when the People's Republic of China (PRC) was founded, there was almost no systematic and independent foreign exchange control due to wars and colonisations. After the founding of PRC, the new government of China learned from the Soviet Union and adopted a centrally-planned economy system. The planned economy existed until 1978 when China began its reformation and opening to the outside world and began to transform from a planned economy to a market economy. The transformation period lasted about 15 years until 1993. From then on, China has adopted its current foreign exchange control system based on IMF standards and terms.

The history of foreign exchange control in China from 1949 happened in three stages:

- (1) Stage One from 1949 to 1978;
- (2) Stage Two from 1979 to 1993; and
- (3) Stage Three from 1993 to the present time.

Stage One: 1949–1978

In the two years following the founding of the PRC in 1949, the new government adopted a series of measures to establish China's foreign exchange control system. The People's Bank of China (PBC) was designated as the government agency to implement foreign exchange control. In 1953, with the initiation of the planned economy, foreign exchange control compliance in the planned economy was gradually shaped. China then implemented a "centralised administration, uniform operation" foreign exchange control policy. The major points of this policy included the following:

- The central government was to monopolise foreign trade and foreign exchange. Imports and exports were to be conducted by national foreign trade companies. All foreign exchange banking businesses were to be processed by the Bank of China (BOC), which at the time was a department of PBC.
- All foreign exchange income was to be sold to the central government. Any company, factory or other institution or individual was not allowed to possess foreign exchange unless prior approval was obtained.
- According to the policy of "imports subjected to exports, expenditure subjected to income", the State Planning Committee compiled the national imports and exports plan and the corresponding foreign exchange expenditure and income plan and allocated foreign exchange to parties which needed foreign exchange on a national level. Under these circumstances, the balance of payments of China could always be kept in equilibrium.
- The exchange rate of the Renminbi (RMB) to USD was fundamentally fixed at 2.4618 until 1973 when the *Bretton Woods System* collapsed. After 1973, with the floating exchange rate adopted by most countries and in order to avoid exchange risk of the export income, China implemented a relatively flexible exchange rate pricing system. Based on a basket of a few currencies, the RMB exchange rate was promptly adjusted according to the latest change in the floating exchange rate in international financial markets.
- Other than short-term borrowings from the Soviet Union, China implemented an extremely conservative policy whereby no foreign investment or foreign debt was allowed.

The above policies played a leading and positive role in the planned economy, but were inefficient as there was too much centralisation of foreign exchange control.

Stage Two: 1979–1993

With the initiation of reformation and opening to the outside world, the PRC took its seats (previously held by the Republic of China (Taiwan)) in IMF and the World Bank in 1980. Foreign exchange control in this period was in line with the macroeconomic policies of China. China adopted a combination of planned measures and measures suitable for the market:

- China's exchange authority was formally established in 1979. Then it was known as the State Administration of Exchange Control (SAEC), the predecessor of the State Administration of Foreign Exchange (SAFE).
- The policy of allowing foreign exchange to be retained instead of the previous "centralised administration, uniform operation" policy was adopted. Certain local governments and enterprises were allowed to retain a portion of the foreign exchange which they earned from exports, etc, though the foreign exchange must still be sold to the central government. If these local governments or enterprises needed to effect foreign exchange payments, they could buy foreign exchange against the RMB and quota certificates would be issued to them according to the retained proportion of the foreign exchange they earned. No prior approvals from SAEC were required.
- The foreign exchange swap market was established in 1980 to enable enterprises which hold quota certificates to buy foreign exchange with RMB or sell surplus foreign exchange in this market for RMB. The swaps were limited to swaps of foreign exchange and RMB; swaps between foreign currencies were still processed by the banks.
- A dual exchange rate system resulted from the above two points: the official exchange rate for buying foreign exchange with the bank against quota certificates and the swap exchange rate for buying foreign exchange in the swap market. The swap exchange rate was initially set by the central government but subsequently determined by the market. Both rates were pegged against the USD.
- From 1979 some financial institutions (trust companies (eg CITIC), financial companies or leasing companies) other than BOC were allowed to deal with foreign exchange by PBC. By 1986, all commercial banks were allowed to carry out foreign exchange business which had been monopolised by BOC before.
- Control measures over the capital account were adopted. China began to encourage foreign direct investment and foreign debts. Foreign debts were initially jointly managed by the State Planning Committee, the Ministry of Finance (MOF) and SAEC and subsequently solely managed and supervised by SAEC from 1986. All foreign debts required the prior approval of SAEC. Foreign investment enterprises (FIEs) could reserve their foreign exchange and open foreign exchange accounts without