OMFIF OFFICIAL MONETARY AND FINANCIAL INSTITUTIONS FORUM

# CAPITAL ACCOUNT LIBERALISATION IN CHINA

# 中国资本账户自由化

## Guidelines from Global Experience

## ——来自外国经验的比较分析

English Version

英文版

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# Contents

# China Navigating a Unique Path Drawing Parallels from Global Experience

John Nugée, Deputy Chairman, Advisory Board

**It is a pleasure to write this foreword to OMFIF's latest report in our series on China and the renminbi, this time considering the issue of capital controls through the experience of other countries which have liberated or otherwise removed them.**

It has been a commonplace for some time among economic commentators to talk of the 21st century as Asia's century, the century when the centre of global economic power will be located in the East. And central to most people's assumptions has been the thought that, for this to be achieved, it is inevitable that China will play the leading role.

But until now, and despite the Chinese economy's breakneck pace of growth and rise to the second in size only after the US, financial interaction between China and the rest of the world has had to operate through the screen of capital controls.

The authorities have made these controls more flexible and have allowed more activity to pass through them as the Chinese economy has developed and matured, but they remain in place. And as long as they do, China's ability to fulfil its full economic potential both at home and in the global economy is restrained.

China has never denied that its ultimate aim is the end of all capital controls. But nor has it been in any hurry to remove them. The challenge for the Chinese leadership is twofold. First, all of history and the experience of many other countries, some of which is detailed in this report, suggest that it is both very difficult and immensely damaging to reimpose controls that have been loosened too soon or too fast. But second, neither history nor other countries' experience can offer much precedent to guide them: China is sui generis. Never in the modern age has a developing economy been at the same time the second largest in the world.

China's solution to this has been, as so often, to move gradually – to 'cross the river by feeling the stones' – and to try controlled experiments, which if they work, are helpful, but if they do not, have limited capacity to cause damage. The Qualified Foreign Institutional Investor (QFII) and Qualified Domestic Institutional Investor (QDII) initiatives should be seen in this light, as should the creation of the CNH (offshore renminbi) market in Hong Kong. These have offered insights for China into possible ways forward, without committing the authorities beyond a point of no return.

But small controlled experiments can achieve only so much, and the current leadership is rightly considering larger steps. No other country is an exact parallel to China, but we hope that the examples in this report of how others have tackled the issues will be of interest to audiences both in Beijing and beyond.

**John Nugée**, has worked extensively in and with the official sector during his career, the major part of which was spent at the Bank of England where his last post was as Chief Manager of the Reserves. He also worked at the Hong Kong Monetary Authority, European Investment Bank and European Investment Fund. From 2000 to 2013 he worked at State Street Global Advisors (SSgA). Nugée has written widely on economic and political themes, including for OMFIF in his previous capacities, and he continues to write for OMFIF in his role as Sen-ior Adviser.

# At the Forefront of World Agenda
# Long March to Convertibility Remains on Track

David Marsh, Chairman, OMFIF

**Relaxing capital controls dividing China's financial and capital markets from the rest of the world has moved to the forefront of an important agenda not just for the international monetary system but also for the future shape of the global economy. Freeing capital controls – in a way that still has to be mapped out in detail – forms an integral part of the reforms President Xi Jinping and Premier Li Keqiang intend to implement over the coming decade. This is a long march that remains on track.**

The Third Plenum of the Chinese Communist Party's 18th Central Committee in November 2013 set the groundwork for an unleashing of market forces unprecedented in the history of the world's second-largest economy. The Beijing leadership has made noticeable efforts in recent years to speed up progress by exploring international case studies. Capital liberalisation is an important component of the debate about internationalising the renminbi. The process will lead to the Chinese currency circulating with steadily greater freedom on foreign banking and financial markets and to be used in larger volumes and in a greater variety of international transactions.

This development will progressively extend possibilities for Chinese investors – both the public and private sector – to invest abroad. China can be expected steadily to strengthen its own financial markets and banking infrastructure and to allow foreign investors increasing access to onshore investments. This will both be a source of growth for the domestic economy and promote new earnings possibilities for banks and financial companies that may otherwise suffer from declining subsidised profits as part of general liberalisation measures.

Capital account liberalisation brings problems as well as benefits. Beijing appears to have concluded that the advantages outweigh the costs.

Liberalisation would set down a convincing and consistent framework for China's financial interactions with the rest of the world. In past decades, foreign critics (especially from Europe, but also from developing countries such as China) have regularly assailed the US for profiting from the alleged 'exorbitant privilege' stemming from the dollar's role as a reserve currency. A greater role for the renminbi can potentially lower the inconveniences for China of the 'exorbitant privilege' – and allow the Chinese to capture some of its benefits.

With capital account convertibility, Chinese government authorities, banks and enterprises would have access to renminbi financing from foreign sources to help fund international and domestic activities. And liberalisation would permit some of China's excess savings and pent-up demand for investments to be channelled abroad to damp the risks of over-heated domestic asset prices.

Destabilisation can ensue, too, if too much capital leaves the country or risky excesses of renminbi build up on foreign markets. China's leaders wish to keep these opposing forces in balance – and a study of foreign countries that have previously tackled similar dilemmas can help immeasurably.

**David Marsh** worked for more than 20 years as a reporter for wire services and newspapers in Europe, including Reuters and the Financial Times. He then turned to a career in investment banking. Currently he serves as chairman of the advisory board of London and Oxford Capital Markets PLC, co-chairman of Official Monetary and Financial Institutions Forum(OMFIF), and chairman of SCCO International, a German management consultancy group.

# Chinese and Foreign Think Tank Cooperation Providing Credible Financial Policy Consultation

Wang Wen, Executive Dean, RDCY

Because China is the world's second largest economy, and the country with the greatest potential for financial development, China's financial account liberalization is now the focus of the world's attention.

However, the 2007 world financial crisis origined from Wall Street is not completely over. The preliminary 2014 economic data from emerging market countries with liberalized capital accounts is not optimistic. How, and to what extent China should liberalize its capital account is an ever more challenging test of Chinese policy maker's strategic planning capabilities. It is also cause for think tanks both at home and abroad to work together to provide constructive solutions.

The current financial crisis has provided three basic lessons for us all.

First, within the traditional Western financial framework there exists a severe theoretical oversight. Systemic, long term hidden risk and entropy has been underestimated to the extent that almost no one is able to accurately predict this and next financial catastrophes.

Second, the present development trajectory of finance is still leading itself astray from the needs of the real economy. Public opinion is permeated with voices who claim that the dominant financial elite have exacerbated global inequality among the rich and the poor, and this can easily lead to collective anxiety about the potential end of human progress.

Third, within the interdependent global economy the role of financial liberalism has still not been adequately understood. In such a case the future opening up of the last great “untapped plot of financial territory” in China, appears to be even more sensitive and uncertain.

Whether China’s capital account liberalization could be succeed is relevant not only to the interests of China and the Chinese people. It is also of great importance to the question of continued global peace and prosperity.

Regarding this, our report proposes that over the past 35 years China’s capital account liberalization has been undertaken gradually, and it is to be fully completed within the next five years. China is open to referencing any other country’s experience with “protective opening up” that increases financial openness while guaranteeing that the level of openness remains within a range that the country can realistically sustain, regulate and control.

Increasing financial efficiency, providing financial stability and the ability to manage crises is the basic operational guarantee of a high quality Chinese financial system. It is also the basic premise of success provided by countries with open financial systems.

This should be the basis from which Chinese financial policy makers begin to reflect, and is the reason Chinese and foreign think tanks should cooperate to provide credible financial policy consultation during this process.

**Wang Wen** is Executive Dean of Chongyang Institute for Financial Studies, Renmin University of China (RDCY). He is Standing Director of World Socialism Research at the Chinese Academy of Social Sciences and Visiting Professor at the Liberal Arts School, Capital University of Economics and Business. He previously worked as Chief Op-eds Editor and Editorial Writer at Global Times. Wen studied at the Lanzhou University, Hong Kong Baptist University, the Johns Hopkins University-Nanjing University and Peking University.

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Gabriel Stein, OMFIF's Chief Economic Adviser, is Managing Director of Stein Brothers, an economic research and public affairs consultancy he founded in 1982. He is Special Adviser at Oxford Economics and Visiting Professor at the Department of Economics at Royal Holloway, University of London. In 1991, Stein joined Lombard Street Research to help set up the company's World Service and went on to become a Director in 1995. Stein obtained a master's degree from the Stockholm School of Economics and holds an MA in Military History from the University of Buckingham.

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# China's Capital Account Liberalization Gradually Moving Toward Complete Openness

Tu Yonghong, Deputy Director of the International Monetary Institute, RUC

Opening the capital account is an important mission of China's economic reforms and an indicator representing the level of China's openness. While transitioning from a planned economy to a market-based economy, the Chinese government has chosen a gradual mode of reform. Correspondingly, China's mode of capital account liberalisation has also been gradual. The opening of trade and direct investment accounts came first, followed by accounts that could be arbitraged or speculated on, while others are still left closed.

During the planned economy era, the mandatory planning and management of China's foreign exchange reserve balance of payments was highly concentrated. There was not only no foreign debt, but also no foreign direct investment, and the capital account was very strictly controlled. In 1978 China began the gradual loosening of FDI regulations that allowed for the establishment of the first foreign invested enterprise. To satisfy the demand for imports, the Chinese government created 10 foreign borrowing enterprises and unified financing from international finance markets. In 1985, the government eliminated internal trade settlement pricing, and began to enforce a single exchange rate for the renminbi, this in effect set the course for the convertibly of the renminbi capital account.

The 1984 Mexican debt crisis and the subsequent declarations of 37 developing countries that they could not repay foreign debts was a strong warning to China. The Chinese government quickly rolled out the 'Regulations on Foreign Debt Administration,' which monitored and regulated the scale, use, and ability to repay foreign debts for enterprises. For 30 years China has never defaulted on foreign debt and maintained an excellent market reputation.

In 1992 Chinese leader Deng Xiaoping's South Tour Speeches reasserted China's belief in developing the productive force and the market economy, bringing China's reform and opening up into a new stage of development. In 1994 the Chinese government canceled controls over foreign exchange in the current account, implementing a foreign exchange settlement system for imports and exports, with free convertibility for foreign exchange receipts and payments created by enterprise's trading.

This foreign exchange regime reform greatly stimulated the participation of enterprises and pushed forward powerful progress in trade and the economy (see Charts 1 and 2). The renminbi exchange rate also underwent a big reform establishing a single and managed floating exchange rate regime based on market supply and demand. Local governments increased the introduction of foreign capital, and foreign direct investment was basically completely opened, with no restrictions placed on the ability of foreign invested enterprises to borrow from abroad. Just when China was preparing to further liberalise the capital account to participate in the convergence of capital in emerging markets, the 1997 Asian financial crises erupted.

The over borrowing of Southeast Asian countries, currency mismatch of bank assets and liabilities, the implicit guarantees offered by governments and the rigidity of mechanisms gave hot money the perfect opportunity for arbitrage. Southeast Asian economies under attack experienced currency devaluation crises. Falling stock market and real estate prices exceeded 2/3, losing over 10 years of economic growth in the process and forcing the governments of many countries to step down.

The cost of opening the capital account too quickly in these countries caused the Chinese government to more carefully approach the opening of its own capital account, highly value strengthening controls over short term capital flows, prohibit the purchase of foreign exchange for the advance redemption of loans, and strike against unpermitted capital withdrawals via phony foreign currency transactions through trade channels. The Chinese capital and financial account balance turned negative, reaching $6.3bn in 1998 (see Chart 4).

After China joined the WTO in 2001 it dramatically reduced tariffs, opened the services market, and worked hard to acclimate itself to the new rules of international trade. Through FDI and technology transfer, completely entering into the global division of labour and innovating in production, organisation and management, the international competitiveness of Chinese enterprises continuously increased, with growth in import and export trade increasing by more than 30% every year.

Since 2002, the current account and capital account have both maintained large surpluses, causing China to accumulate the world's largest amount of foreign exchange reserves (See Charts 3, 4 and 5). Because the supply of foreign exchange reserves greatly exceeds demand for them, the pressure on the renminbi to appreciate is huge. In 2005 the Chinese government again reformed the renminbi exchange rate regime, emphasising a renminbi exchange rate determined by market supply and demand; from here the renminbi entered into a period of appreciation (See Chart 6).

In order to increase the productivity of capital and give full play to the capital advantage of China's growing income, Chinese firms felt a strong impetus to invest abroad, and residents also had demand to invest in foreign markets to receive a higher return on investments. In 2002 the liberalisation of the Chinese capital account took a giant step from FDI to securities exchange. At first, on the foundation of FDI the Chinese government encouraged Chinese businesses to 'go out' and advance direct investment abroad. From 2001 to 2007, the net amount of Chinese FDI increased from \$37.4bn to \$139.1bn (See Chart 7).

Second, opening the securities market and implementing the Qualified Foreign Institutional Investor (QFII) and Qualified Domestic Institutional Investor (QDII) plans permitted foreign capital to enter the Chinese capital market within a confined range, permitted Chinese residents to invest in securities markets abroad, and individual investment income could be freely converted and transferred across borders. By 2007 the Chinese securities investment balance was \$16.4bn (See Chart 9).

A major reason for the 2008 international financial crisis was that Wall Street financial institutions raised leveraged rates without constraints in order to maximise profits. Such action resulted in inflating real estate prices, mortgage bonds and other asset bubbles, the bursting of which led to the financial crisis. In fact, the massive inflow of international capital is a necessary condition for raised leveraged rates and expanded risk from Wall Street. Even in developed countries such as the US, without effective guidance and management of cross-border capital flows, this would ultimately end with the occurrence of a financial crisis.

An important lesson for China is that in the process of promoting capital account liberalisation it should focus on monetary security and financial security while improving its macroeconomic policy and management ability according to the needs of economic development in international markets and the allocation of resources in order to acclimate to the rhythm of capital account liberalisation. In the post-crisis era, in order to eliminate the hazards of an unreasonable international monetary system on its trade and economic development and to improve monetary and financial security, starting in 2009 China launched cross-border trade settlements in renminbi. As of the end of 2012, the cumulative bank cross-border renminbi trade settlement business reached 2.94tn Yuan, accounting for14% of China's total trade volume. In January 2011, the Chinese government abolished limits on individual foreign direct investment. As a result, individuals are free to choose foreign currency or local currency to conduct foreign direct investment like companies do. In 2012, renminbi cross-border direct investment reached 284.02 bn Yuan, an increase of 173.15bn Yuan or 156% compared with 2011. In addition, the control over domestic borrowing from a foreign source has also been substantially eased. Multinational corporations are allowed to issue renminbi bonds abroad and foreign financial institutions are allowed to enter China's financial markets with their renminbi reserves. In 2011, the scale of Chinese foreign debt grew to $695bn (See Chart 8).

China has already exhibited the Lewis Turning Point. The export-driven economic model that has relied on cheap labour has almost come to an end, as export growth has fallen from 30% before 2008 to an average of 7% in 2012. If there is no stimulus for exports, the contribution of exports to China's economic growth will become smaller and smaller, and thousands of people could lose their jobs.

Among the three major elements of productivity, land and labour are low in mobility. The only factor that has high mobility is capital. Through capital flows, a country can allocate land and labour anywhere in the world to organise production as well as provide goods and services. Within the development trend of international trade, multinational corporations are the organisers of international production and trade; in other words, trade follows the footsteps of capital. The increase in foreign investment is accompanied by more frequent capital flows and larger volume of trade. Free movement of capital is large-scale, high-speed, high-impact and difficult to control. It is very likely to impact financial markets, breed asset bubbles, increase exchange rate volatility and bring financial crises to the countries with fragile financial markets and poor macroeconomic management capacity.

Therefore, many developing countries are imposing necessary controls on capital flows and China is no exception. So far, among the IMF statistics of 46 capital accounts, half of them are not currently traded in Chinese financial markets including securities and financial derivatives. In addition, Chinese currency is not freely convertible. Although China's capital account controls set up a firewall against the Asian financial crisis and the US subprime mortgage crisis, it also cut the channel for China to allocate global resources with capital and sacrificed the function of capital factors.

The constraints on the capital account and capital flows have incurred high costs for China in the current international economic restructuring. Four significant costs have stood out. First, China's high household savings rate signifies superior investment ability, so capital has become China's new international comparative advantage. Without alleviating controls over capital accounts, the comparative advantage of capital cannot come into full play. Thus, China will not harvest due benefits from the international division of labour.

Second, China is currently undergoing a transition in its economic growth model. The pressures of eliminating pollution and protecting the environment are overwhelming, justifying adjustment in its stock of assets. Putting constraints on the foreign investments of domestic individuals and enterprises will undoubtedly hinder the pace of China's industrial restructuring.

Third, the international financial securitisation and direct financing in the market are the main channels for capital flows because they have the advantages of simplicity and low cost. Currently, the US and Europe have an almost zero interest rate while the Chinese domestic lending rate has a difference of about 5%. There are many restrictions on issuing corporate bonds abroad and companies have to bear higher interest costs, adversely affecting their profitability.

Fourth, with the introduction of the US 'Revitalise American Manufacturing and Innovation Act,' a number of multinational companies have begun to shrink their investment in China and have shifted production to the US, taking away China's export opportunities as a result. In the global market where trade is driven mainly by capital, limiting China's capital flows would in fact weaken the incentives for import and export; therefore, China is likely to face tremendous unemployment pressure.

Currently, there are a considerable number of people who are fearful about China's domestic capital account liberalisation and worry that capital account liberalisation might force the country to repeat the mistakes of Thailand and other Southeast Asian countries in the 1990s. The potential emergence of the financial crisis would ruin the outcome of years of reform. In fact, this fear has exaggerated the risks of capital account liberalisation without weighing risks and benefits as well as opportunities and challenges. A major function of finance is to manage and configure risk and derive revenue and efficiency from it. As the saying goes, 'Great skill brings along superior courage.' As long as we have the skills for the management of capital account liberalisation, risk associated with capital account liberalisation is controllable. France, Germany, Japan and other countries did not experience financial crises for a long period of time after capital account liberalisation.

It is worth mentioning that the Chinese government is very careful on capital account liberalisation. After liberalising the current account, it has taken the government 20 years to prepare for capital account liberalisation, during which several major financial crises took place in developing countries and developed countries. China has learned a lot of valuable experience and lessons from these crises and has applied the experience to establish an effective mechanism for capital flow management.

Since the launch of cross-border renminbi trade settlement in 2009, the control over capital accounts in Hong Kong has been greatly relaxed. Hong Kong’s offshore renminbi market exchange rates and interest rates have not fluctuated significantly. The Chinese government has truly experienced arbitrage capital flows and has worked out a number of practical methods in guiding capital liquidity.

In conclusion, China is holding a firm attitude towards capital account liberalisation and has established a gradual liberalisation model that is compatible with economic development and financial market liberalisation. Because the interest rate liberalisation, exchange rate marketisation and renminbi internationalisation have laid a solid foundation for the orderly flows of capital, and full liberalisation of China’s capital account is expected within the next five years.

Capital account management by the Chinese government will undergo significant changes. Similar to developed countries such as Britain and the US, the implementation of a negative list management system will be implemented. Other than expressly limiting a handful of short-term speculative bond trading and derivatives trading, China will enable other capital projects to be freely traded.

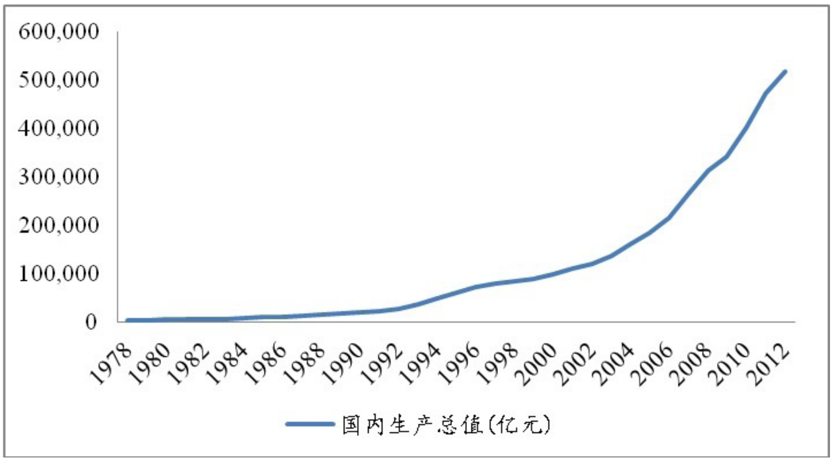



Chart 1: China's GDP, hundred million, RMB

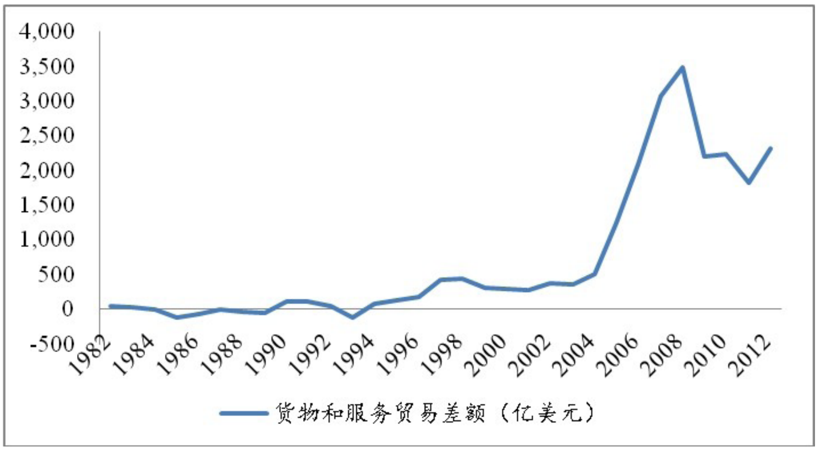



Chart 2: China's trade volume, hundred million, US Dollars

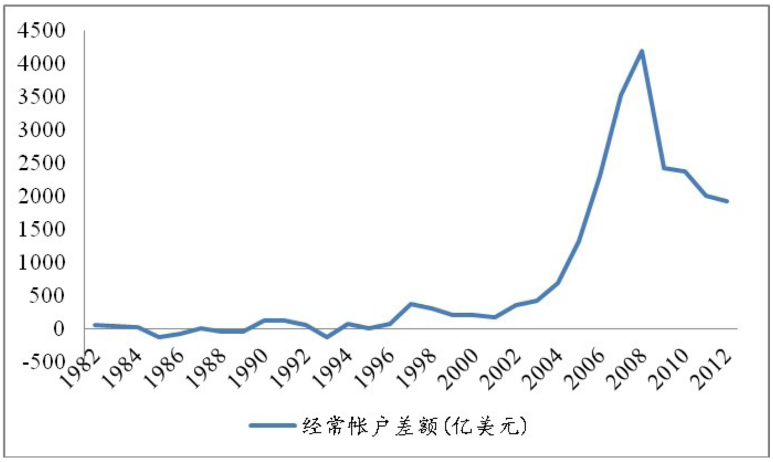



Chart 3: Chinese current account balance, hundred million, US Dollars

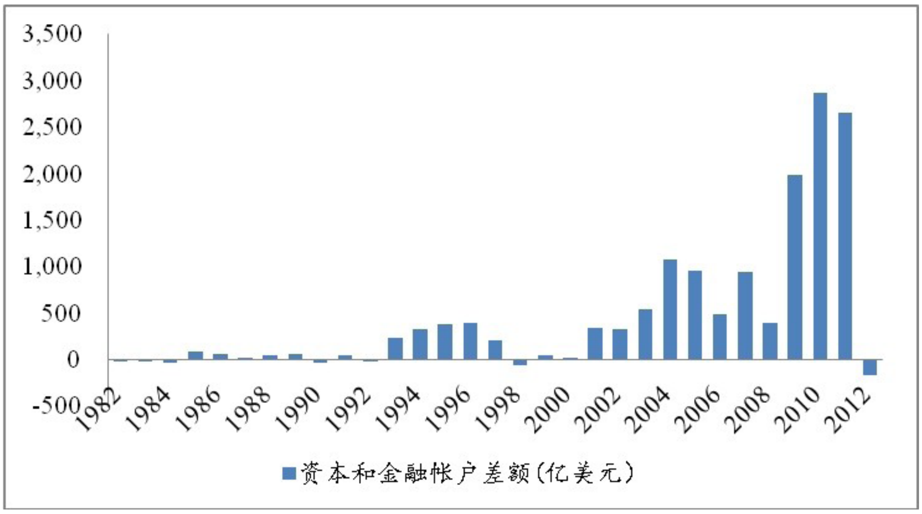



Chart 4: Chinese capital and financial account difference, hundred million, US Dollars

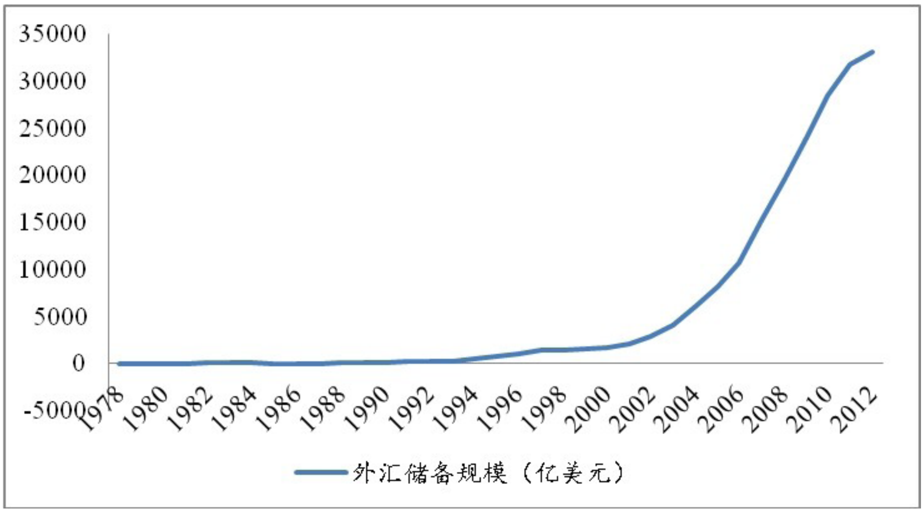



Chart 5: China's foreign exchange reserves, hundred million, US Dollars

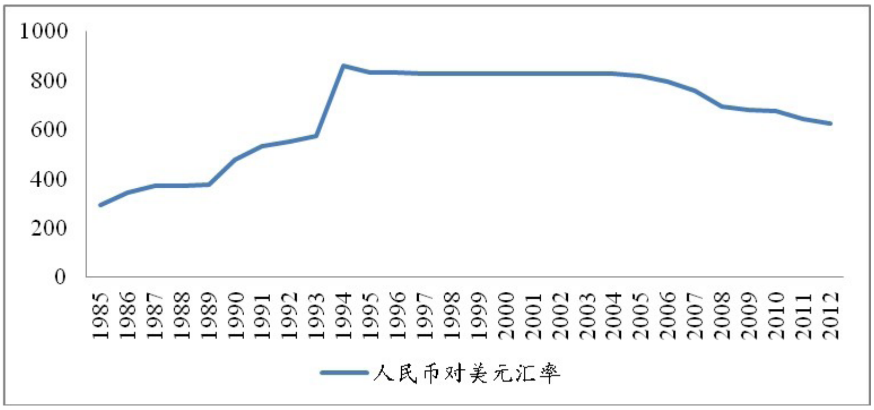



Chart 6: RMB exchange rate (to 100 US Dollars)

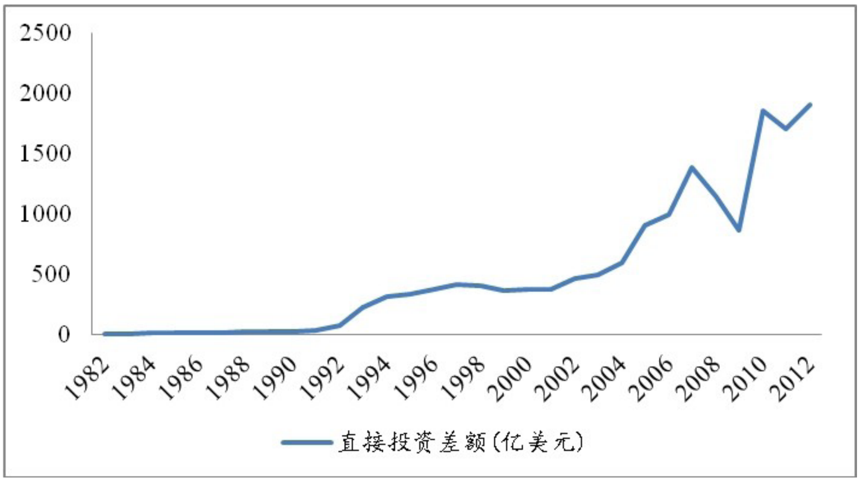



Chart 7: Chinese direction investment, hundred million, US Dollars

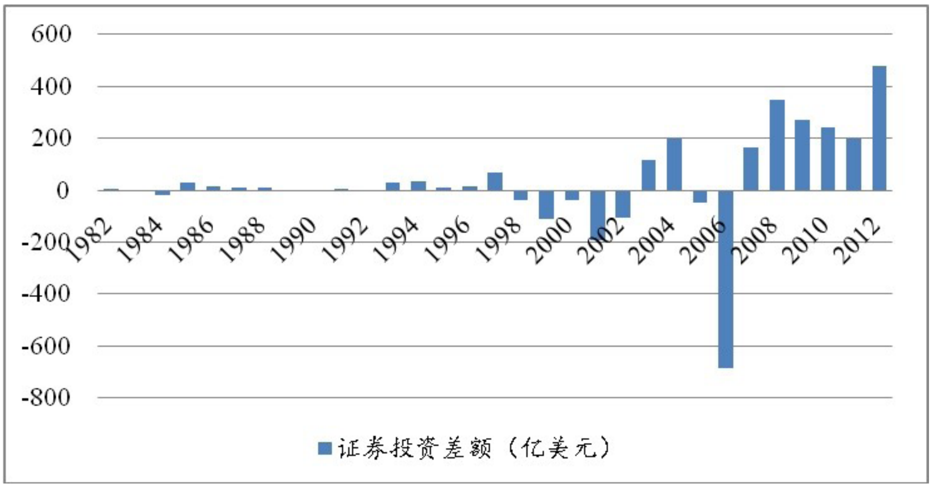



Chart 8: Chinese securities investment balance, hundred million, US Dollars

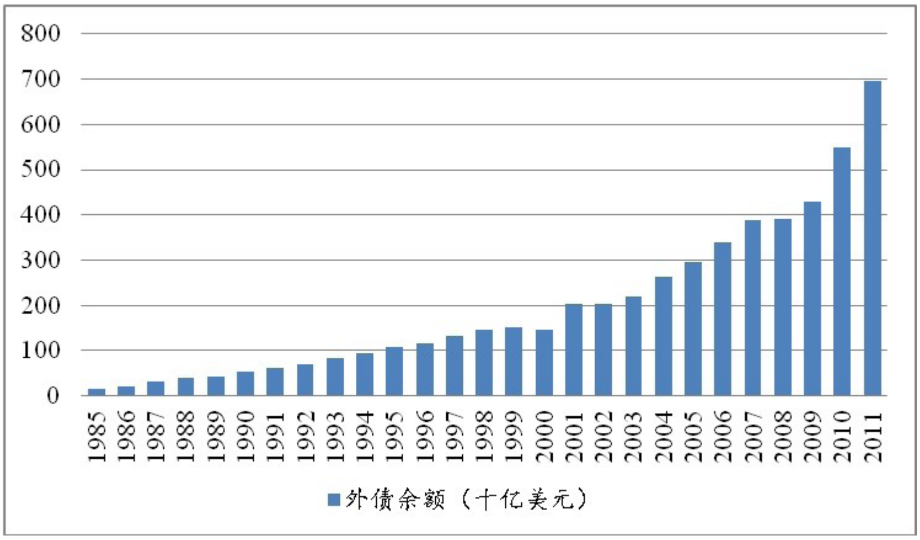



Chart 9: Chinese foreign debt balance, US Dollars bn

# The Lessons of Liberalisation
# Seven Case Studies to Help Guide Beijing

Gabriel Stein, Chief Economic Adviser, OMFIF

**In today's globalised and integrated world, the position of China is somewhat of an anomaly. It is the second largest world economy and should at some stage become the largest. It is the world's biggest importer of a number of commodities and it is the world's biggest exporter of various categories of manufactured goods.**

Yet its financial markets remain heavily regulated and underdeveloped and its capital account remains closed. However, in both cases, there has been substantial reform; moreover, the Chinese leadership continues to show in word as well as in deed that remains committed to financial market and capital account liberalisation.

Reforming an economy the size of China's is fraught with difficulty. Yet China has an immense advantage in that this is a path trodden by many other countries in the past. There have been plenty of reports and conferences discussing how to reform and liberalise the capital account, illustrating examples from other countries and drawing conclusions for China.

This report takes a slightly different tack. We look at a number of countries from several different continents – two developed (Sweden and the UK), four emerging market economies (Malaysia, Mauritius, Mexico and South Africa) and one that has moved from being an emerging economy to being a developed one (Israel). We focus on what happened to a number of variables – primarily the exchange rate, capital flows and inflation – after a country liberalised its capital account.

Every country is unique. But there are still general lessons that are applicable elsewhere. From the countries covered in this report, we believe that the following eight points represent the most important lessons:

1.Liberalising financial markets while keeping the capital account closed is likely to lead to a domestic asset price bubble as credit becomes more freely available but the opportunities for investment remain unchanged. This was a key reason behind the Swedish bank crash in the early 1990s.

2.Attempting a ‘big bang’ liberalisation, without having domestic institutions ready for the ensuing strains, will cause a crisis, as shown by Israel’s first failed attempt at capital account liberalisation in the 1970s.

3.Both the Mexican and Israeli experiences show that capital account liberalisation can lead to large inflows and large outflows of capital. What matters is not the flows but how the authorities react to them.

4.The key lesson from the Mauritian experience – which is relevant as Mauritius is attempting to position itself as a financial centre, in a comparable way to China’s ambitions for Shanghai – concerns the adoption of a flexible exchange rate regime. This was one reason why the Mauritius rupee weathered liberalisation well, appreciating somewhat in 1995 and 1996 and then moving sideways.

5.The authorities should be prepared for unpredictability. A common experience is the impossibility of predicting which way the exchange rate will move following capital account and exchange rate liberalisation. Britain, whose post-Second World War history was punctuated by sterling crises, saw its currency rise following the removal of exchange controls.

6.Global economic developments over the past six years have challenged the prevailing view that capital controls are generally detrimental. However, the South African experience shows that refraining from imposing capital controls in response to cyclical conditions is beneficial. This is not least because whatever seeming good such controls are perceived to do, they will eventually need to be reversed, causing further cost and dislocation. This reinforces one of the lessons from the Mauritius experience, namely the importance of not going back on reform once it has begun.

7.One development common to almost all countries is that the rate of inflation eased in the immediate aftermath of capital account liberalisation. This is in some cases (e.g. Sweden) understandable in that there was a substantial economic downturn. But it also happened in countries like Malaysia or Mexico.

8.A further experience common to all the countries we have tracked is that almost regardless of the circumstances, deregulating the capital account and freeing the exchange rate will boost equity prices. This is regardless of whether it is a question of accelerating an existing trend (e.g. Sweden or Mexico) or reversing a fall (e.g. Mauritius). The UK is something of an outlier in that, after the freeing of exchange controls in 1979, it took longer for equity prices to pick up speed – but this is partly because the of the severity of the then UK downturn.

# 1 SWEDEN

Like other developed economies, Sweden was part of the post-war Bretton Woods system. In common with the situation in other Nordic countries, capital controls were accompanied by strict controls on the banking sector, including restrictions on lending rates, ceilings on bank deposit rates, limits on the amount of lending, while the activities of foreign banks were limited or even barred.

When the system broke down in the early 1970s, Sweden retained capital and foreign exchange controls. Financial markets remained tightly regulated until the early 1980s. Beginning in 1982, gradually deregulation began. The first easing of foreign exchange regulations occurred in 1987, with full deregulation in 1990. The fixed exchange rate regime remained, however, and was abolished only after the disastrous attempt to defend the Swedish krona in the autumn of 1992, which ended with a 30% devaluation and a switch to a flexible exchange rate.

## Analysis

Prior to liberalisation, Sweden generally ran a very small capital account deficit of between SKr1-2bn, less than 1% of GDP. Similarly, the current account tended to be in balance in the early 1980s, although this was very much due to a series of devaluations in the late 1970s and early 1980s, culminating in a 16% devaluation of the krona in 1982.

By the middle of the decade, the currency had stabilised again. However, although this was at an overvalued level, which tended to keep down prices of imported goods, inflation remained a problem, with the rate generally being above 4%. This led to higher interest rates – Swedish money market interest rates were raised into the low double digits at a time when German interest rates were in the high single digits, providing attractive yields for foreign investors.

Beginning with the first exchange rate liberalisation in 1987, capital hence began to flow to Sweden, with the financial account going from balance in 1986 and 1987 to inflows of SKr55-65bn (about 0.5% of GDP) in 1989 and 1990. Although the pegged exchange rate held, equity prices surged on the back of a housing boom and of capital inflows.

When full capital account liberalisation followed in 1990, it was too late to stave off the housing bust. The Swedish economy went into deep decline, with nominal GDP contracting for three consecutive years (the worst result since the 1920s) and the banking system imploding. In 1992, the fixed exchange rate was abandoned after a disastrous attempt at defending it at the cost of 500% interest rates.

Following full capital account liberalisation, the effects were generally benign, although since this occurred in the midst of a deep depression, it is difficult to disentangle the results from the eventual recovery. However, by 1993, the exchange rate began to recover and both the current and capital accounts swung back into surplus (where they remain). Although the rate of inflation dropped rapidly, interest rates remained elevated until the mid-1990s.

## Lessons

Liberalising financial markets while maintaining foreign exchange regulations risks causing a domestic asset price bubble, as households and companies can borrow more freely but can find only domestic outlets for their money.

Once foreign exchange regulations are abolished, countries can no longer defend a fixed exchange rate using interest rates alone.

In a deregulated market, it is crucial that countries establish the necessary institutions and regulations to enable a reasonably smooth aftermath.

An important precondition for satisfactory economic performance after exchange controls have been removed is that public finances should be on a sustainable path.

Chart 10: Capital account, SKr bn

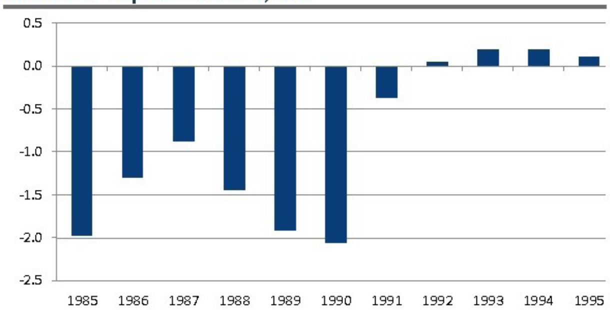



Chart 11: Financial account, SKr bn

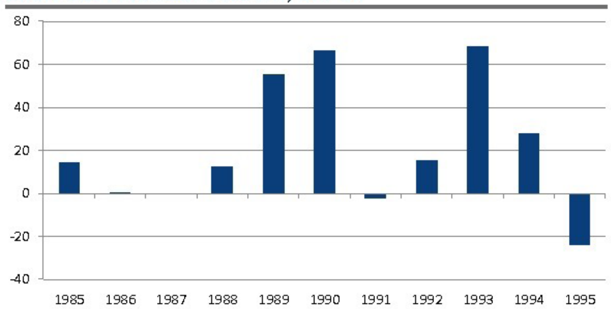



Chart 12: Current account, % of GDP

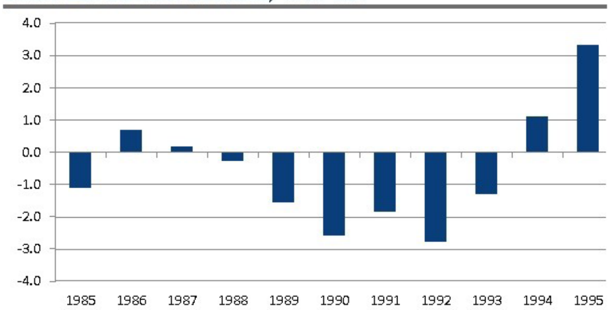



Chart 13: Nominal effective exchange rate

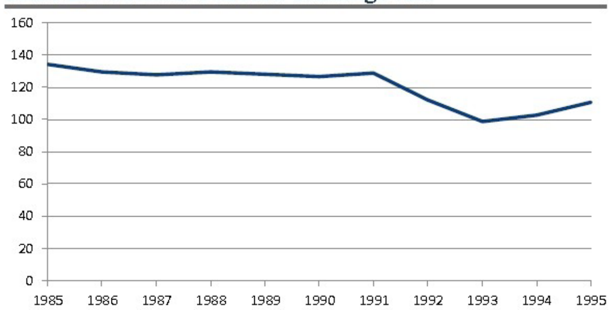


Chart 14: Inflation, annual, %

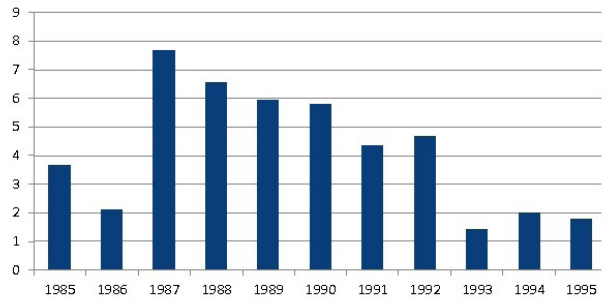



Chart 15: Equity prices, index 2005=100

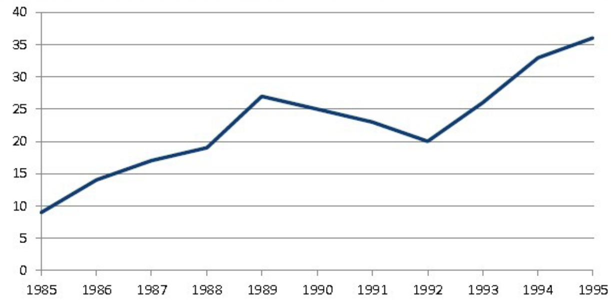



Chart 16: Yield on long-term government bonds, %

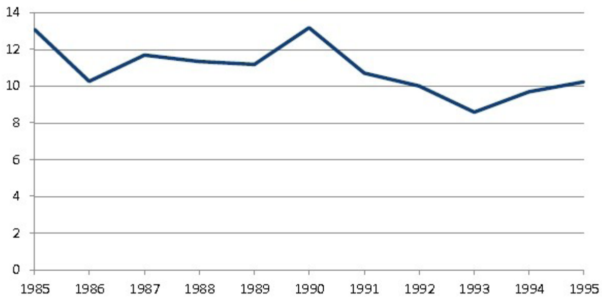
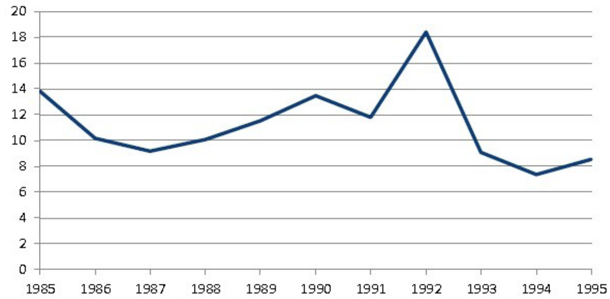



Chart 17: Money market interest rates, %



# 2 UNITED KINGDOM

For the UK, the post-war period was generally one of long-term decline, interrupted by brief bursts of growth. Successive governments were eager to maintain the sterling's role as a major reserve currency, second only to the dollar.

But this was incompatible with domestic weakness and led to repeated sterling crises and devaluations in 1949 (from $4.03 to $2.80) and in 1967 (to $2.40). In 1966, pressure on the pound led to a tightening of exchange controls.

When the Bretton Woods system dissolved in 1971, the pound was allowed to float, but exchange controls lasted until 1979. The British case is significant in that removal of the exchange controls did not lead to a currency crisis.

## Analysis

UK exchange controls were completely abolished in October 1979. This was catalysed by the newly-elected Conservative government of Margaret Thatcher in May 1979. However political events were not the only reason, a programme of liberalisation had been underway for some time. One problem with measuring the effect of the freeing of the currency is that the UK at the time was in a deep economic crisis, which only began to recede about 18 months later.

During the early to mid-1970s, the effective exchange rate of the pound steadily weakened. This had a beneficial impact on the current account, which went from a deficit of 4% of GDP in 1974, to being roughly in balance (defined as a balance of less than 1% of GDP either way) in 1976 and remaining there until 1980. The capital account went from a sizeable surplus (£4bn in 1974) to an equally large deficit by 1977 and remained in deficit over the next nine years.

In the second half of the1970s, Britain's economic situation deteriorated sharply and in November 1976 the government had to ask the IMF for a $3.9bn loan to shore up the balance of payments. Initially, this enabled inflation to be brought down below 10%, but by 1979 it had shot up again to close to 20%. Higher interest rates, notably at the shorter end, were putting upward pressure on sterling, yet capital outflows intensified. The impact of the removal of exchange controls was not what had been expected. Where there had been fears of a sharp fall in sterling, the effect was the opposite. The nominal effective exchange rate rose and stabilised. In 1979 itself, the capital account moved almost into balance, although over the next two years outflows accelerated. Inflation eventually began to come down, dropping to around 5% by 1982, as did interest rates.

Some of these effects were due to the government's policy of combatting the recession by a sharp tightening of fiscal policy. Sterling's performance was markedly affected by a development over which the UK government had no control – the rise in oil prices after the Iranian revolution in 1978-79 and the subsequent Iran-Iraq war. This had a beneficial effect on the currency at a time when the UK was starting to build up North Sea oil production. The famous contractionary budget in 1981 of Chancellor of the Exchequer Geoffrey Howe, which included a near-doubling of VAT, represented the peak of fiscal tightening. Although almost universally condemned, this marked the start of the recovery. Share prices, which had been trending upwards, accelerated their rise.

Chart 18: Capital account, £m

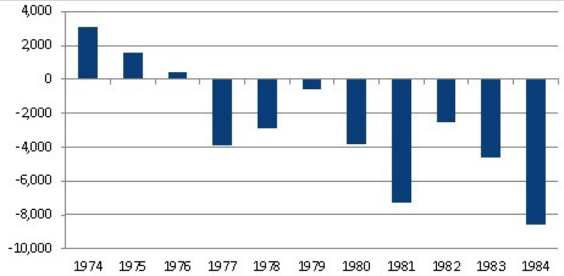



Chart 19: Current account, % of GDP

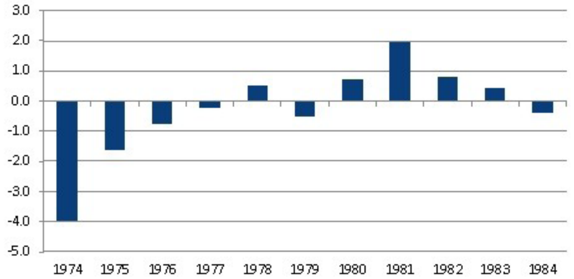



Chart 20: Nominal effective exchange rate

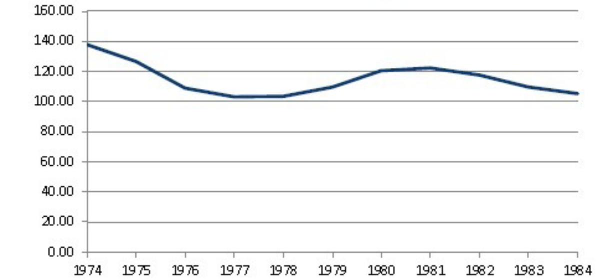



Chart 21: Inflation, annual, %

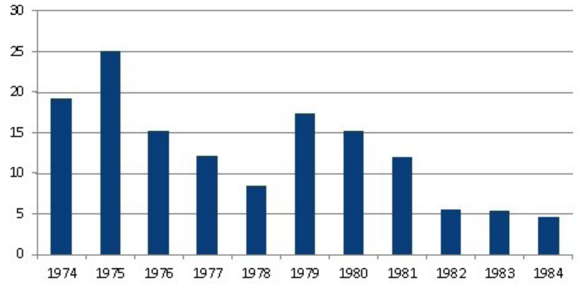



Chart 22: Equity prices, index 2005=100

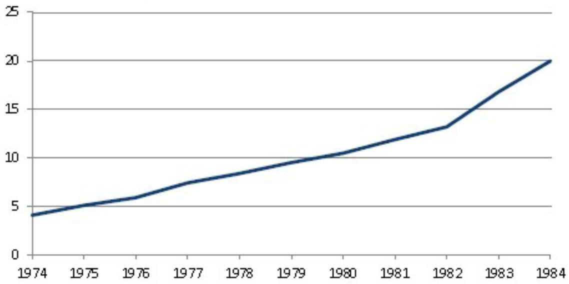



Chart 23: Yield on long-term government bonds, %

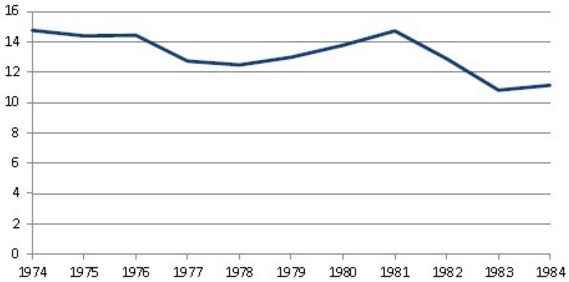
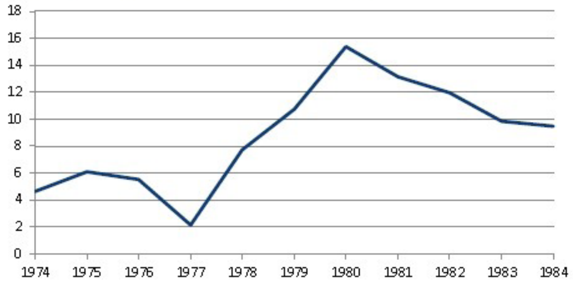



Chart 24: Money market interest rates, %



## Lessons

The timing of the liberalisation, juxtaposed with the late 1970s recession and the early 1980s recovery, makes it difficult to gauge its exact impact. However there are some conclusions of relevance to China. One is that it is almost impossible to predict how a currency will move if exchange controls are abolished.

In view of Chinese financial repression – with interest rates on deposits low or even negative in real terms in order to transfer resources from the household to the corporate sector – it could be argued that a removal of capital controls will lead to a substantial outflow of funds. Households might seek higher returns on their savings abroad – no doubt assisted by an evermore sophisticated financial service sector. But there is an equally strong case for arguing that there will be large inflows of capital, as foreign investors, now assured of ease of both entry and exit, seek higher returns in China.

What ultimately matters for the economic impact of an exchange rate is not so much its level (unless extreme) as its stability. From the British perspective, perhaps the most important conclusion, was that the abolition of exchange rate controls did not lead to a sterling crisis, as had been widely feared. The current account deficit turned into a surplus, even as capital inflows boosted the stock market.

However, the coincidence of the recession makes it difficult to say how much of the change in the current account was due to the respective effects of the fall in sterling that followed the IMF package, the liberalisation of exchange controls, and the improved economic conditions that began fairly soon afterwards.

# 3 ISRAEL

The Israeli experience of capital account liberalisation should be of particular interest to China. First, because Israel is one of a handful of countries that has taken the step from emerging to developed market status and has done so not least by moving rapidly up the value-added stream (for example from low-value agriculture to high-tech in a number of fields like IT, medicine, agribusiness and military hardware).

Second, the Israeli economy was dominated for many years by a Socialist mind-set with heavy regulation, not only with regard to the foreign sector but also for the domestic economy.

Third, Israel provides a classic case of how not to liberalise the capital account. In 1977, there was an attempt at a sudden 'big bang' liberalisation, with no preparation. This failed and was reversed in 1979, after causing rapidly accelerating inflation, which led to the Israeli bank crash of the early 1980s. A second attempt began in 1987 and was spread over 18 years, reaching completion in 2005 when the exchange rate was completely liberated.

## Analysis

Israel has historically tended to run a current account deficit, offset by a capital account surplus, the latter boosted by US aid and reparations from Germany. Capital inflows fell sharply in the early 2000s, for which a primary cause was the bursting of the dotcom bubble, in which Israel high-tech companies had attracted large investments from abroad. Following the final liberalisation capital inflows accelerated. It should be noted that barriers to long-term capital inflows were the first to be eased and then removed when the reform process started. Barriers to short-term inflows were removed, although more gradually.

In general, the Israeli process initially concentrated on making it easier for the business sector and for non-residents to deal across borders, with less scope for non-corporate residents. However, beginning in 1989, barriers to capital outflows were also gradually removed. As a result, capital flows increased in both directions, although net inflows were larger. The nominal effective exchange rate of the shekel fell by more than 20% from 2000-05, heavily linked to the dotcom bust. The exchange rate began to recover in 2006, the year after final exchange controls were removed.

The weaker currency helped the current account to move from a deficit of close to 2% of GDP in 2000 to a surplus of close to 5% by 2006. Equity prices benefited strongly from the removal of controls on inward portfolio investment. It is more difficult to gauge the impact on interest rates, since prior to and parallel with the capital account liberalisation, Israel was in the process of finally taming its longstanding inflationary problem. In the mid-1990s, inflation was close to or around 10%. By 1999, it dropped to 1.3% and since then it has averaged 2%. In line with this decline, short- and long-term interest rates fell sharply over this period.

## Lessons

The lessons from the Israeli experience of two attempts at dismantling controls are that the authorities should avoid the temptation to opt for a ‘big bang’ reform unless domestic institutions are fully prepared. Unless this condition is fulfilled, as the first episode showed, the switch from a regulated to an unregulated capital account will cause substantial problems. By contrast, the second attempt at liberalisation – gradual and over a longer period of time – proceeded remarkably smoothly.

This highlights another useful lesson. Capital account liberalisation is frequently feared as destabilising. But this appears mainly because it tends to occur at times of crises, and also because at times of crisis, governments tend to restrict capital flows in the belief that it will help them overcome domestic problems or isolate their economies from global events. The Israeli experience shows that, given the right sequencing, capital account liberalisation can proceed smoothly.

The period 1987 to 2005 encompassed severe fluctuations for the world economy, including the post-dotcom downturn which hit hard the key Israeli high-tech sector. Despite this, because Israel put into place the appropriate environment to cope with the change, it managed to weather the transition without undue difficulty.

Chart 25: Capital account, $m

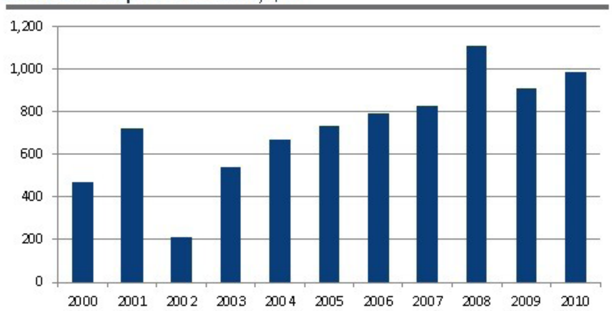



Chart 26: Financial account, $m

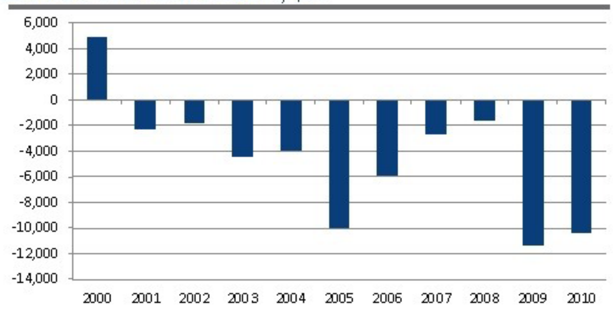



Chart 27: Current account, % of GDP

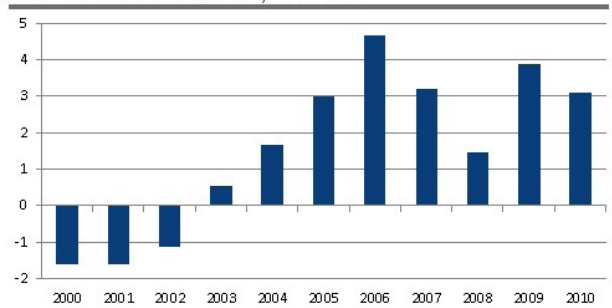



Chart 28: Nominal effective exchange rate

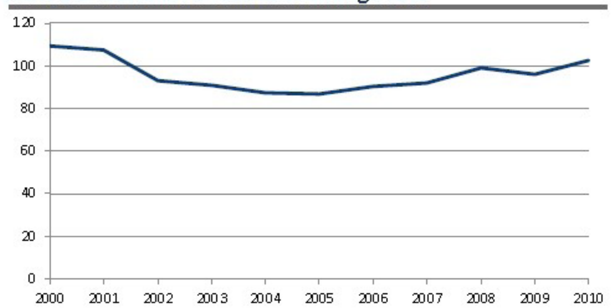


Chart 29: Inflation, annual, %

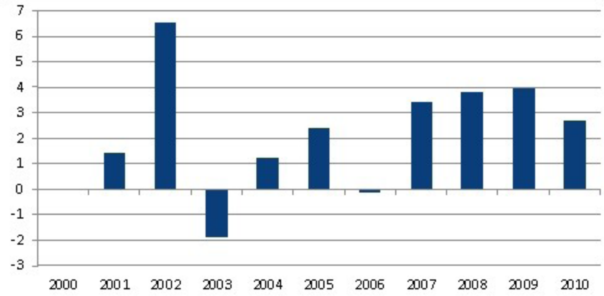



Chart 30: Equity prices, index 2005=100

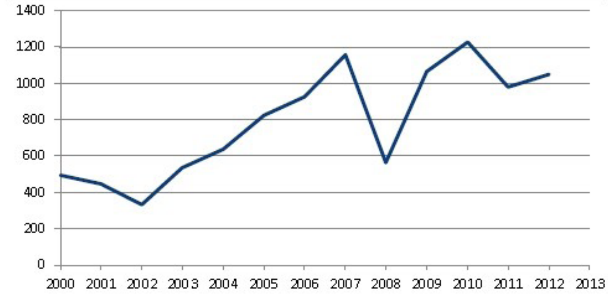



Chart 31: Yield on long-term government bonds, %

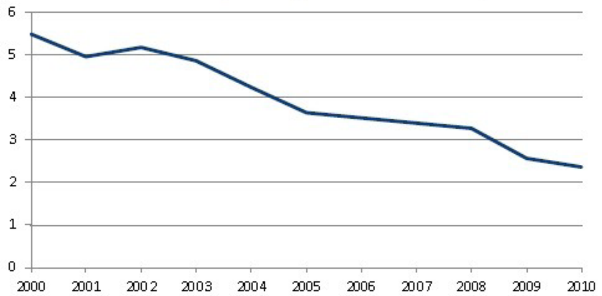
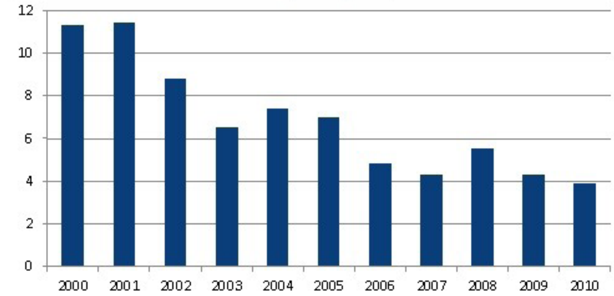



Chart 32: Short-term treasury bill yield, %



# 4 MALAYSIA

Between 1990 and 2012, Malaysian GDP grew by an annual average of 6%, above the global average. Growing integration with the global economy was accompanied by a policy environment conducive for trade and foreign direct investment (FDI) inflows.

In addition, Malaysia's steady development has to a certain extent been facilitated by higher and more diverse sources of investment flows. This is attributed to capital account liberalisation efforts over the years aimed at lowering the cost of conducting business, increasing efficiency and competitiveness, and developing the domestic financial system.

## Analysis

Given the highly volatile nature of capital flows, a rapid move to liberalise capital flows without appropriate safeguards entails risks to macroeconomic and financial stability. Hence, Malaysia's capital account liberalisation efforts have been undertaken in a gradual and sequenced manner, particularly following the country's experience during the Asian financial crisis in 1997.

Malaysia has always taken a pragmatic approach with respect to its policy options. This is evident in the country's implementation of selective exchange control measures during the Asian financial crisis to mitigate the impact on the real economy. Most importantly, alongside capital flow liberalisation measures, policy-makers embarked on structural reforms to strengthen the resilience of the domestic financial sector.

Measures to liberalise capital flows in Malaysia began from as early as the 1970s. The two most important phases of Malaysia's experience with capital account liberalisation are 1990-99 and from 2000 up to the current period. Throughout both phases, Malaysia's capital account has been relatively open with no systematic restrictions on foreign investment, except in 1994 and the 1997 crisis. Between 1991-96, widening interest rate differentials and Malaysia's strong growth prospects attracted substantial FDI averaging RM14bn annually. This was accompanied by high short-term capital inflows with an annual average of RM10bn. With most of these inflows channelled into the equity market, the equity index recorded an increase of approximately 120% between 1990-96.

Strong domestic investment activity was reflected in current account deficits while real GDP growth accelerated to 9.5% per annum during this period. These large inflows resulted in ample domestic liquidity, which contributed to high domestic credit growth and exerted upward pressure on domestic asset prices. As a result, the central bank introduced several temporary administrative measures during this period aimed at containing speculative activity by discouraging short-term capital inflows. This was reinforced by macroprudential measures to limit excessive risk-taking behaviour by banks.

The 1997 crisis saw a sharp and sudden reversal of capital flows. Equity markets fell significantly, while real GDP contracted by 7.4% in 1998. The current account swung into a surplus as investment by both the public and private sector declined. The steady shift towards greater capital account liberalisation efforts was temporarily suspended during the Asian financial crisis as policy-makers introduced selective exchange control measures in order to preserve macroeconomic and financial stability.

## Lessons

The period of capital account liberalisation leading up to the 1997 crisis highlighted several important lessons for Malaysia. First, liberalisation efforts need to be accompanied by strong macroeconomic fundamentals and robust financial institutions. Second, deeper and well-developed financial markets facilitate orderly financial adjustment which will help mitigate the impact of any adverse shock from sudden movements in capital flows. Third, amid increasing regional financial integration, the crisis underscored the need for real-time surveillance and cross-border cooperation in managing flows, particularly in Asia.

Chart 33: Capital and financial account, RM bn

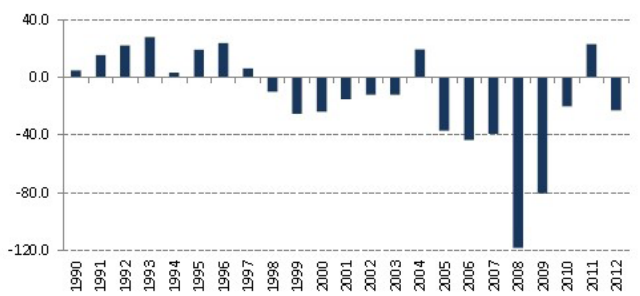



Chart 34: Current account, % of GDP

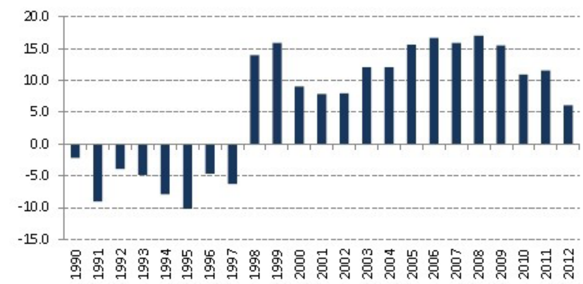



Chart 35: Nominal effective exchange rate

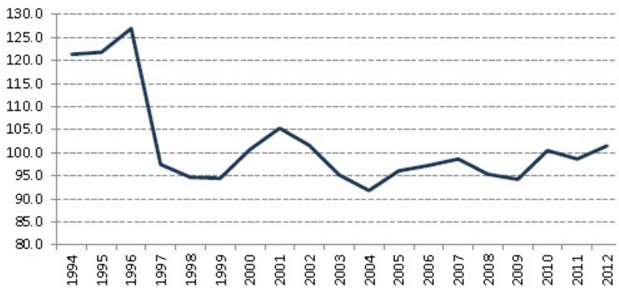



Chart 36: Inflation, annual, %

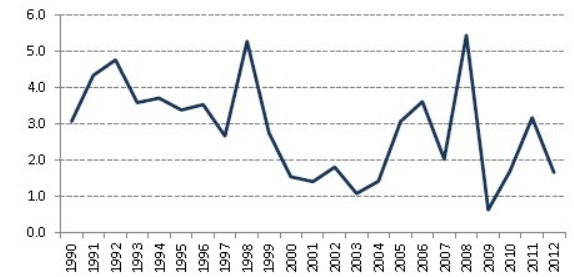



Chart 37: Equity prices, index 1990=100

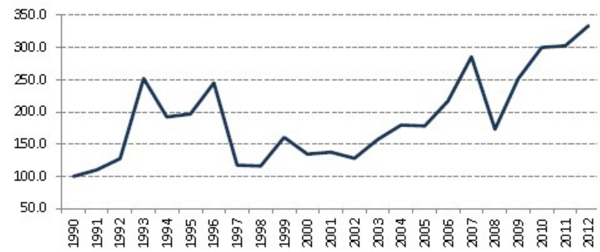
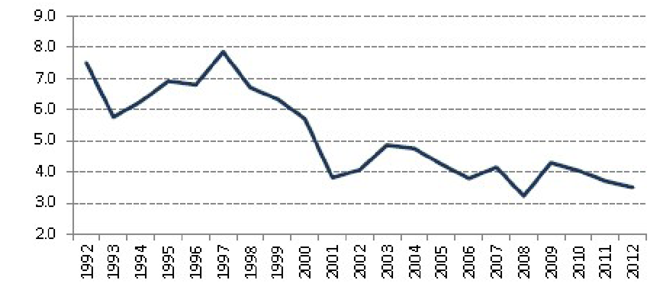



Chart 38: Yield on 10-year government bonds, %



The selective exchange control measures introduced at the peak of the crisis were designed to achieve the specific objectives of containing speculative capital flows and restoring stability in the financial markets. The controls did not disrupt or dislocate genuine trade-related activities or FDI flows. As the economy began to stabilise, these measures were subsequently removed.

Beginning in 1999, foreign exchange administration liberalisation measures were introduced in stages. The only exchange control measure that remains until today is the non-internationalisation of the ringgit, which has been retained as a safeguard against speculative attack on the economy.

Alongside the gradual removal of exchange controls on non-resident flows post-crisis, Malaysia took steps to gradually liberalise its resident outflows. This facilitated orderly financial adjustment by allowing greater two-way capital flows, which is particularly beneficial during periods of large non-resident inflows. While net FDI inflows remain large, investment overseas by Malaysian companies have also been on a rising trend, as these companies seek to diversify their existing operations and tap into profitable opportunities in other regions. This has been facilitated by the further liberalisation of foreign exchange administration rules since 2005 to promote international trade and investments, thereby enhancing the competitiveness of the economy.

Malaysia experienced a steady resumption of capital flows, particularly from 2004 onwards. Alongside greater financial sector liberalisation, policy-makers introduced wide-ranging structural reforms to further reinforce the resilience of the system to withstand sudden adverse economic and financial shocks.

Top priority was accorded to strengthening the financial sector through enhancing the regulatory and supervisory framework and improving the effectiveness of macro-prudential surveillance. Greater emphasis was placed on developing financial markets. Consequently, the domestic bond market grew from 85.5% of GDP in 2001 to 107.3% as at end-2012, while the size of the domestic equity market expanded from 131.9% of GDP to 155.7% during the same period.

Amid growing linkages with global financial markets, the domestic financial sector is inevitably influenced by external developments. The domestic economy and financial system have exhibited considerable resilience to shocks arising from heightened capital flow volatility, as evident during the recent global financial crisis. Despite significant net portfolio outflows of RM85bn in 2008 (11% of nominal GDP), financial stability was always preserved.

This was evidenced by a strong risk-weighted capital ratio of 14.9%, a compression of credit spreads, a continued strong expansion of financing extended by the banking system and a low net non-performing loan ratio of 1.8% in 2009. While real GDP declined by 1.5% in 2009, it swiftly rebounded to register a strong growth of 7.4% in 2010. This resilience of the Malaysian economy to the recent crisis underscores the positive outcome of the continuous reforms undertaken over the past decade in strengthening macroeconomic fundamentals and the domestic financial system, amid an increasingly liberalised capital account.

# 5 MAURITIUS

In spite of several handicaps like limited natural resources, remoteness from major markets, a small domestic market and vulnerability to cyclones and external shocks, Mauritius, a small island economy in the south-west Indian Ocean, has achieved a per capita GDP that is one of the highest in Africa.

There was no big bang approach to liberalisation of the external account. The country pursued a gradual approach, achieving full current account convertibility in September 1993. It abolished all exchange controls in July 1994.

In 1968, Mauritius was, by all measures, a poor country with per capita income of less than $200. Responding to the deterioration in public finance and external positions, from 1977 to 1986 the authorities adopted comprehensive macroeconomic and structural adjustment measures supported by the IMF and the World Bank.

By 2012, for a population of nearly 1.3m, GDP per capita increased to around $8,700. Real GDP has grown, on average, by 5.2% per annum over the last two decades, one of the most remarkable policy-driven economic transformations in modern history. In the wake of the global and financial crisis, although growth has slowed down to around 3.2% in 2013, the Mauritian economy has shown signs of resilience.

## Analysis

Mauritius inherited exchange controls from the British upon independence in 1968. Over the period spanning the late 1980s and early 1990s, the authorities embarked on a gradual process of liberalisation of current account transactions, starting with travel and emigration allowances, cash gifts and other current account transactions. This process was accompanied by the adoption of appropriate macroeconomic and structural adjustment policies and a continued build-up of foreign exchange reserves.

The process reached an important milestone in September 1993 when Mauritius accepted the obligations under Article VIII of the IMF's Articles of Agreement and all current account transactions were liberalised. In relation to capital account transactions, the only restriction which still remained was a 15% tax on some capital remittances. In July 1994, all remaining controls on capital account transactions were lifted and an inter-bank foreign exchange market was set up, with greater scope assigned to market forces in the determination of the value of the rupee.

Mauritius has traditionally run a current account deficit. This reached a peak of 6.5% of GDP in 1994. Following full capital account liberalisation, the capital and financial account of the balance of payments posted significant surpluses over several years. The liberalisation of capital movements did not result in any dramatic movements in the exchange rate or in international reserves.

As the economic environment and the structure of financial markets changed, the procedures by which monetary policy was implemented also evolved. In the light of the imperfections thrown up by the system of credit ceilings, the Bank of Mauritius embarked on a phased programme of monetary policy reforms. It switched from direct to indirect monetary control, in line with the general move towards increased reliance on market forces, economic liberalisation and prudential regulation and away from directives, controls and subsides.

During the 1980s, the authorities gradually liberalised deposit and lending interest rates, permitted greater competition in the banking system and gradually phased out the sectoral allocation of credits. Legislation was enacted to set up a stock exchange in March 1989. The Mauritius stock market was opened to foreign investors following the lifting of the foreign exchange controls in 1994.

Mauritius has had experience over the years with different exchange rate regimes, including pegs to the pound sterling, to the SDR and to a trade-weighted basket of currencies. Perhaps the most successful reform has been the adoption of a flexible exchange rate regime. This removed from the public domain the drama and stigma of large ad hoc devaluations witnessed in 1979 and 1981.

The flexible exchange rate regime has helped export-oriented sectors of the economy such as the Export Processing Zone and tourism to strengthen international competitiveness, helping a general transformation of the economic and financial position. Unemployment was reduced from a peak of 22% in 1983 to 4% in 1987. Reflecting the market-based philosophy promoted by the Bank of Mauritius, all government debt instruments are issued through auctions.

Chart 39: Capital and financial account, $m

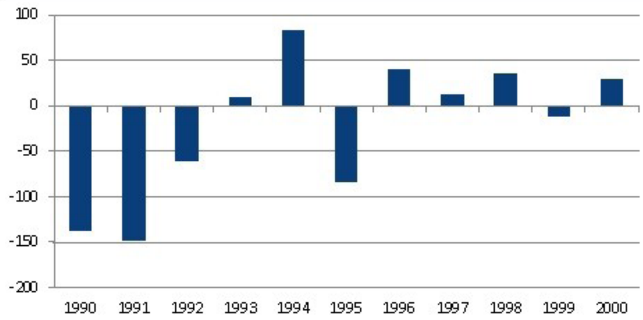



Chart 40: Current account, % of GDP

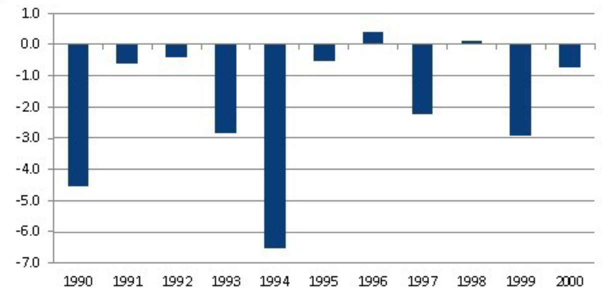



Chart 41: Nominal effective exchange rate

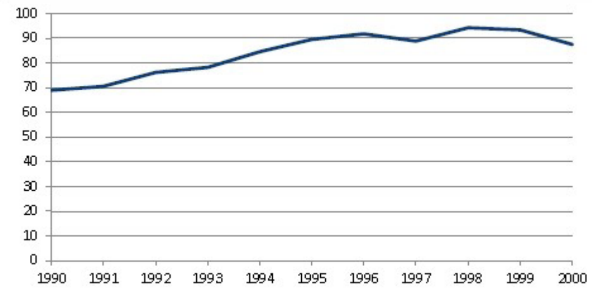



Chart 42: Inflation, annual, %

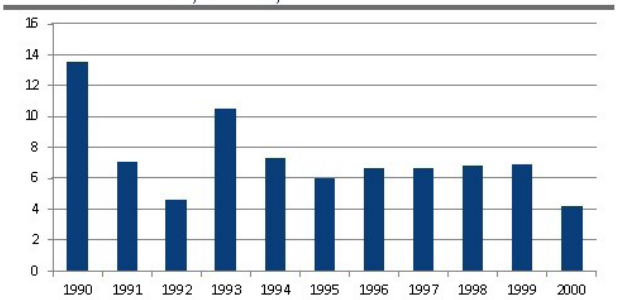



Chart 43: Equity prices, index 1989=100

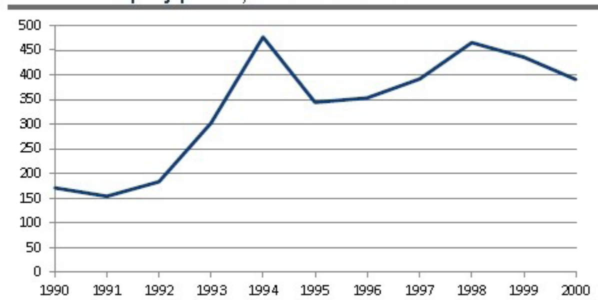



Chart 44: Yield on Long-term government bonds, %

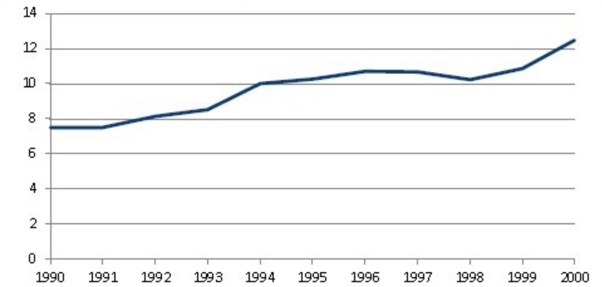
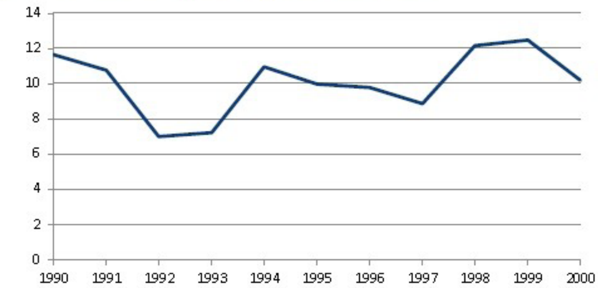



Chart 45: Money market interest rates, %



## Lessons

Mauritius adopted a gradual approach to external account liberalisation. There was no big bang approach and the abolition of exchange controls did not lead to any currency crisis.

There was an appropriate sequencing of policies leading to full current account convertibility in September 1993 and culminating in the abolition of exchange controls in July 1994. This process of external account liberalisation was undertaken against the background of prudent macroeconomic adjustment and structural policies aimed at promoting macroeconomic stability.

The adoption of a flexible exchange rate regime was arguably the most important economic reform. A market-based philosophy aimed at promoting greater efficiency in allocating financial resources, highlighted by the auction process for government debt, have all supported the process of external account liberalisation.

Mauritius has never gone back on economic reforms undertaken. Over the years, in spite of government changes, the direction and thrust of economic reforms has been maintained.

In recent years Mauritius has shown significant capital inflows and overall balance of payments surpluses. This has been accompanied by continued build-up of international reserves as well as an appreciation of the domestic currency.

There is an important lesson with regard to statistics. Prior to external account liberalisation, proper mechanisms are needed for the collection of statistics (e.g. through surveys) for balance of payments purposes. Particularly if past practices relied significantly on data culled from exchange control records, methods for compiling balance of payments data must be put on a new footing in the post-liberalisation era.

# 6 MEXICO

In this context, Mexico is in many ways an unusual country. The peso was originally floated in 1976, although that float quickly turned 'dirty' with frequent intervention. The Mexican debt crisis of 1982 led to new controls. Thereafter, capital account liberalisation began again as a long drawn-out process stretching over much of the 1980s and early 1990s.

Mexico has a long history of relative openness – not unrelated to the vicinity of the US as a source of capital. Yet in spite of this, the liberalisation process ran into trouble in 1994, the so-called 'tequila crisis.'

The liberalisation process was a specific cause of this episode, through the decision in 1991 to allow foreigners unfettered access to peso-denominated government debt. As it happens, this was the year when the Controlled Exchange Market was eliminated, with the abolition of all controls on foreign exchange transactions.

## Analysis

As capital account liberalisation progressed, the capital account moved a deficit of $5bn in 1987 to a surplus of $5bn in 1988, rapidly rising to reach around $35bn. in 1994. By 1989, economic activity had recovered from the 1982 crisis, and GDP grew steadily, even though the – growth rate of 3-4% per annum was unspectacular by emerging markets standards. Inflation had come down from triple figures to less than 20% and the exchange rate had stabilised.

Greater access to the American market through the maquiladora enterprise zones (as of 1985 the largest source of foreign exchange) boosted activity and negotiations on free trade in North America – which culminated in the signing of the NAFTA treaty in 1994 – implied that the good times would continue.* Large inflows of money, falling inflation and healthy public sector balances confirmed the strength and stability of the Mexican economy.

Although the Mexican authorities generally welcomed the capital inflows, concern about the massive purchases of short-term dollar-denominated CDs led to a cap (10%) on foreign liabilities relative to total bank liabilities and rules for setting aside a share (15%) of foreign liabilities in risk-free assets. This briefly dampened the inflows in 1993, but banks adjusted their balance sheets and capital once again flowed in.

Two factors triggered the 1994 crisis. One was the tightening of US monetary policy beginning in January 1994. The second was the assassination in March that year of Luis Colosio, presidential candidate and expected winner in the year's presidential election. The sudden reappearance of political risk, coupled with attractive investment opportunities elsewhere, caused an outflow of capital and drained Mexican foreign exchange reserves.

The government accepted this but also offered foreign investors the option of switching from peso-denominated to dollar-denominated short-term paper. The combination of falling reserves and large foreign currency liabilities proved unsustainable. In December 1994 Mexico devalued, with the decline in the peso ultimately reaching 50%. Over the next two years, capital flows to Mexico all but dried up. The exchange rate eventually stabilised but inflation accelerated sharply.

* Maquiladora are free-trade zones where factories import material and equipment on a duty-free and tariff-free basis for assembly, processing, or manufacturing and then export the assembled, processed and/or manufactured products, sometimes back to the raw materials' country of origin.

### Lessons

The Mexican experience once again highlights the need for careful sequencing of capital account liberalisation. It shows the danger of the authorities' being lulled into a false sense of security by the ostensibly good behaviour of one type of indicator. A key lesson is that the tequila crisis could have been avoided if the authorities, faced with large outflows and downward pressure on the currency, had either let the currency float or tightened monetary policy. Instead, the authorities, while allowing foreign exchange reserves to fall, attempted to 'sterilise' the outflow by expanding domestic credit, while at the same time piling up short-term foreign exchange liabilities.

Capital account liberalisation can lead to both large inflows and large outflows – in the case of Israel, it did both. The Mexican experience underlines that it is not the flows that matter; what matters is how the monetary authorities react to them.

Chart 46: Capital and financial account, $m

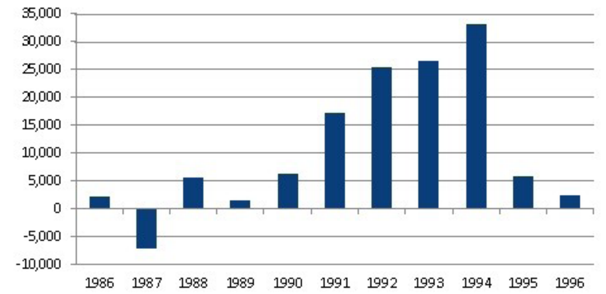



Chart 47: Financial account, $m

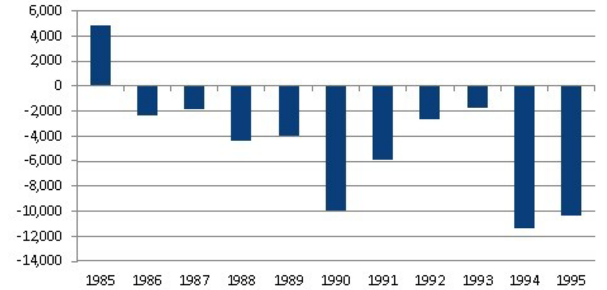



Chart 48: Current account, % of GDP

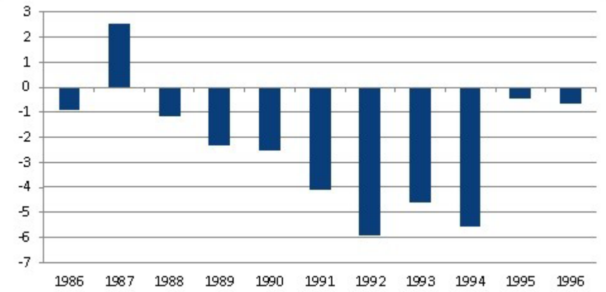



Chart 49: Nominal effective exchange rate

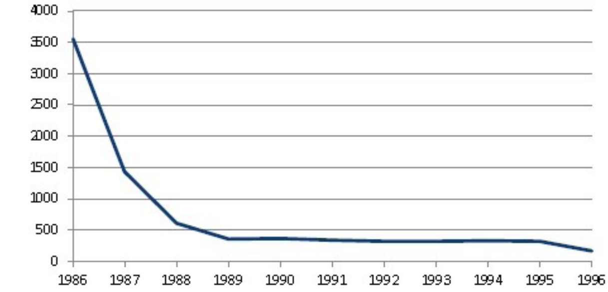



Chart 50: Inflation, annual, %

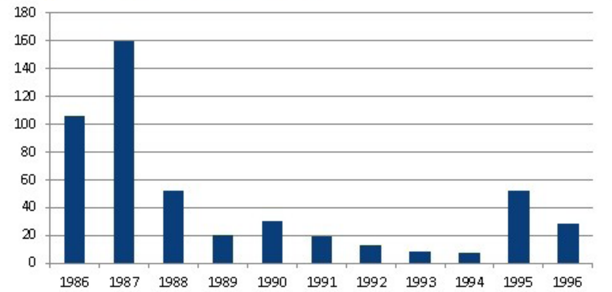



Chart 51: Equity prices, index 2005=100

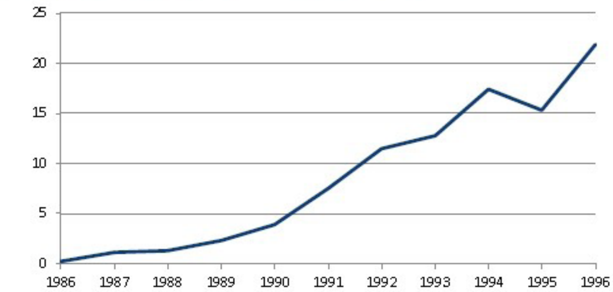



Chart 52: Yield on 10-year indexed government bonds, %

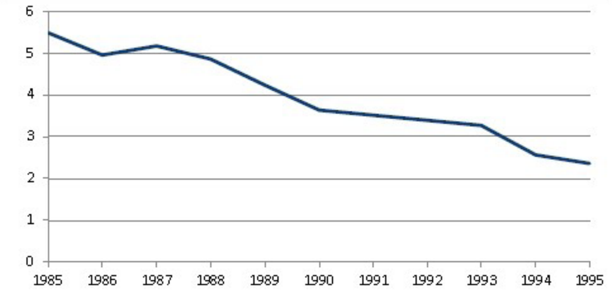
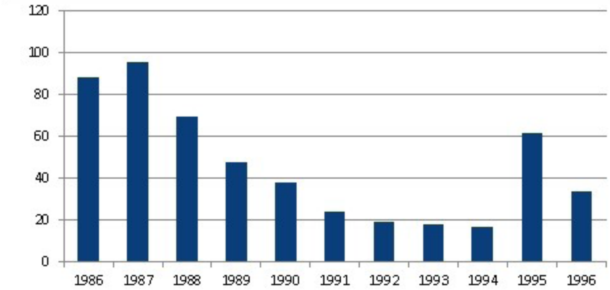



Chart 53: Short-term treasury bill yield, %



# 7 SOUTH AFRICA

South Africa has for some time now chosen the option to gradually relax its capital controls. This came about in part, due to the political dispensation the country opted for in 1994 and also due to increased reintegration of its economy with the global economy. The phased-in introduction of a more liberal capital flow regime assisted many South African companies in preparation for participating in the international economy.

It is safe to say that the gradual easing of capital controls, in many ways, has assisted South African companies in surviving the two financial crisis – the 1997 Asian financial crisis and the 2008 global financial crisis – and the fallout from them both. The South African development is still very much an ongoing process.

## Analysis

Since the start of the capital control relaxations the majority of the foreign capital that South Africa attracted was in the form of portfolio investment – often short-term capital, prone to flight tendencies in periods of global volatility. The effect of this has been twofold. First, the current account has shifted from a surplus of around 1% of GDP in the early 1990s, to a deficit oscillating around 5% of GDP in the 2000s. Second, and as a consequence of the first point, the capital account has moved into surplus; but the financial account has been extremely volatile, with large movements on an annual basis.

The volatility of short-term financial flows is also visible in the exchange rate. Using the broad nominal effective exchange rate published by the Bank for International Settlements, the rand has over the past 20 years gone from an index of 207 (1994) to 81 (2001), back to 133 (2004) and then down again to 83 (2012). Inflation has performed fairly well over the period, from just below 10% in the early 1990s, to 2.4% in 1999, and 5.4% in 2012 (except in 2008 which was due to backward linking of the component series and the advent of the new CPI index).

Part of the reason for the more recent bout of internal and external volatility was the decision by the South African authorities to eschew the use of capital controls in the wake of the Great Recession. This has also meant that, in spite of the capital gyrations, South African equity prices have generally trended up over the entire period.

## Lessons

The gradual approach of gradual exchange controls relaxation has proved to serve the country well over the past decades. South Africa has been very discretionary in its timing and usage of exchange controls. Immediately after the 2008 financial crisis, several developing countries experienced significant exchange rate appreciation due to short-term portfolio inflows.

While the challenges facing these economies were somewhat similar, the policy responses for each differed quite significantly. The response typically depended on the institutional factors underlying the flows but also on the monetary and exchange rate regime in place in a specific country.

South Korea introduced a new tax on foreign currency borrowing while Brazil adopted new reserve requirements on domestic banks’ foreign exchange positions and Chile’s central bank intervened in the foreign currency market. After careful consideration, South Africa refrained from reaction on cyclical conditions and avoided the cost associated with the reversal of short-term controls.

Chart 54: Capital account, $m

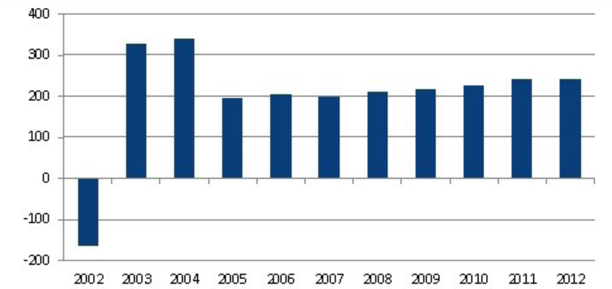



Chart 55: Financial account, Rnd bn

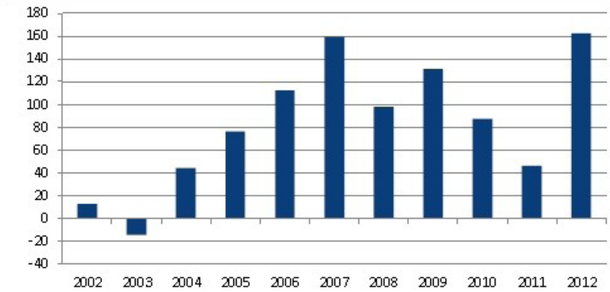



Chart 56: Current account, % of GDP

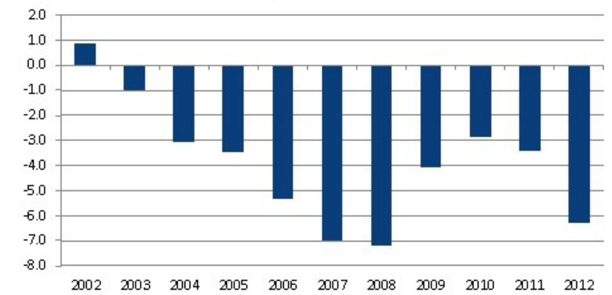



Chart 57: Nominal effective exchange rate

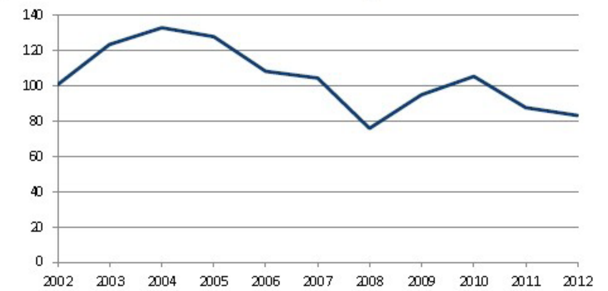



Chart 58: Inflation, annual, %

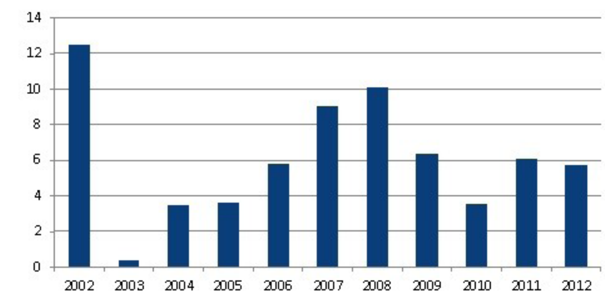



Chart 59: Equity prices, index 1989=100

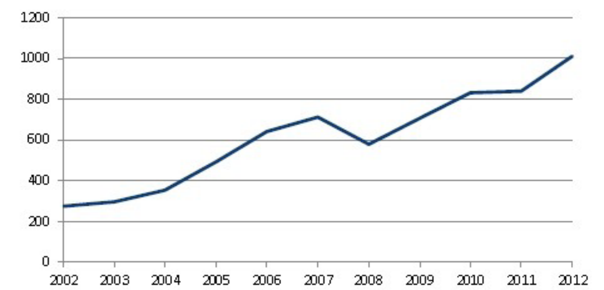



Chart 60: Yield on medium-term government bonds, %

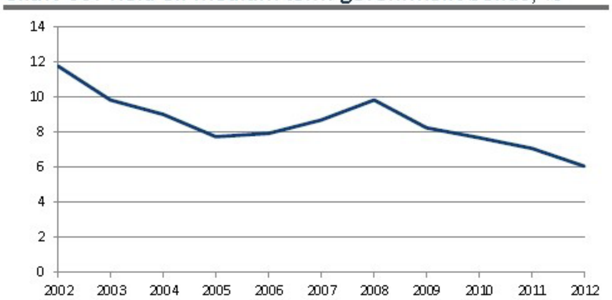
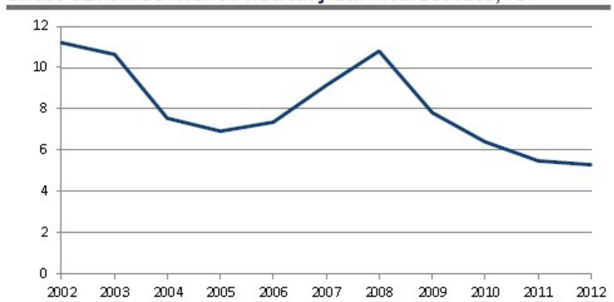



Chart 61: Three-month treasury bill interest rate, %



## Chongyang Institute for Financial Studies, Renmin University of China (RDCY)

Chongyang Institute for Financial Studies, Renmin University of China (RDCY) , founded on January 19, 2013, is a modern Think Tank which was jointly established by Renmin University of China and Chongyang Investment Ltd., a private equity fund based in Shanghai. Prof. Chen Yulu, president of Renmin University of China and member of the monetary committee of People's Bank of China, is the Dean of RDCY.

The tenet of RDCY is "to be based on Renmin University of China and have a world-embracing view, to grasp finance and have an overall perspective of the situation, to focus on academy and pay close attention to reality, to offer policy recommendations to the nation and serve the public". RDCY strives to cultivate and provide a large batch of financial elites for China. It aspires to construct a modern Think Tank with Chinese characteristics, casting high light on the research and dissemination of the "Great Finance". It aims to achieve aspirations of serving the country with finance and knowledge.

## The Official Monetary and Financial Institutions Forum (OMFIF)

The Official Monetary and Financial Institutions Forum is an independent globally-operating financial think-tank and a platform for confidential exchanges of views between official institutions and private sector counterparts. OMFIF's focus is economic and monetary policy, asset management, and financial supervision and regulation.

## International Monetary Institute of Renmin University of China (IMI)

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**Chongyang Institute for Financial Studies, Renmin University of China (RDCY)**

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