How would Capital Account Liberalisation Affect China's Capital Flows and the Renminbi Real Exchange Rates?

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Summary

Despite sizable foreign exchange reserves in China, there are concerns that relaxation of capital account controls could lead to large capital outflows and hence significant downward pressures on the renminbi exchange rates. Assuming the renminbi will have achieved convertibility under the capital account by the end of this decade, and a simultaneous process of domestic and external financial liberalisation, this paper studies how capital account liberalisation would affect China's international investment positions and the renminbi exchange rates.

Based on the experiences of 25 representative major economies, our analysis shows that China's outward FDI would increase significantly with capital account liberalisation, partly reflecting that a deeper domestic financial market would help domestic corporations undertake cross-border mergers and acquisitions. However, the FDI in net terms would maintain a liability position due to a large initial stock of inward FDI. The outward portfolio investment position would increase at a fast pace, reflecting domestic investors' intention of diversifying portfolio risks. The inward portfolio position would increase at a relatively slower pace. The foreign exchange reserves would continue to rise to about USD 6,300 billion in 2020, but will decline as a share of GDP.

The private sector would turn its net liability position into a balanced position, and the official sector would reduce its NFA position significantly, relative to the country's GDP. Because of the increasing importance of private sector foreign claims and the decreasing importance of official foreign reserves, China would be able to earn higher net investment income from abroad. Overall, China would continue to be a net creditor and the NFA position as a share of GDP will remain largely stable through this decade. As capital account liberalisation affects the exchange rates of a currency mainly through its impact on the NFA position, this suggests the renminbi exchange rates are not particularly sensitive to capital account liberalisation. The impact of expected growth differential between China and its trading partners would dominate and continue to support the renminbi.

If the renminbi becomes a major reserve currency, more foreign portfolio liabilities may be accumulated. This could result in a somewhat smaller net foreign portfolio investment position, but the renminbi real exchange rate will likely continue to be on a moderate appreciation trend owing to the better economic outlook. Even though real exchange rate appreciation does not need to be realized through the appreciation of the nominal exchange rate, the longer-term tendencies for the real exchange rate to appreciate indicate that there will unlikely be intense depreciation pressures on the renminbi in nominal terms.