

# The Full Convertibility of Renminbi: Sequencing and Influence

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## Summary

This paper discusses the sequencing of Renminbi's full convertibility and its possible impact on both the economies of mainland China and Hong Kong. China's accession to the World Trade Organization (WTO) will effectively push the process of adopting Renminbi's full convertibility. Foreign banks will be allowed to issue corporate loans in foreign currency immediately upon entry. They will be allowed to make corporate loans in local currency within two years of entry and to deal with individual Chinese customers within five years after entry. Some commentators have thus pointed out that this means the Renminbi will soon become a fully convertible currency. We disagree with this viewpoint as it blurs the distinction between capital account convertibility and full convertibility of the Renminbi. It also confuses removing restrictions on capital account transactions with removing restrictions on the exchange of foreign currencies for the purpose of capital account transactions. Parenthetically, the 'capital account' mentioned in this paper refers to both the 'capital account' and the 'financial account' defined by the IMF's Balance of Payments Manual (IMF, 1993).

Our study points out that the whole course of adopting Renminbi's full convertibility should be broken down into three major stages in principle. The first stage is adopting current account liberalization, which had been established by 1996. The second is adopting capital account liberalization that is currently going on. The third is adopting Renminbi's full convertibility that will take place in the future. As to the course of adopting current account liberalization and the course of adopting capital account liberalization, each should be further broken down into two successive steps. The first step is removing restrictions on current account or capital account transactions. The second step is removing restrictions on the exchange of foreign currencies for the purpose of international transactions of the current account or capital account, namely establishing current account or capital account convertibility respectively.

This paper shows that the three concepts of current account convertibility, capital account convertibility and Renminbi's full convertibility are different, and that the practices of removing restrictions on transactions and on the exchange of foreign currencies are also different. This paper analyzes various restrictive legal rules now existing in China about

capital account convertibility and points out that there is a long way to go for China before removing these restrictions completely.

Adopting Renminbi's full convertibility will have extensive effects on the economy of mainland China. In order to analyze these effects, we develop an open economy macro model of China. Through model-based analysis, we identify a number of necessary conditions for the full convertibility of Renminbi, including appropriate macroeconomic policy, microeconomic reform of enterprises, financial system reform, market-oriented interest rate reform and more flexible exchange rate policy. Renminbi's full convertibility and hence the promotion of economic development in mainland China will also have extensive effects on Hong Kong's economy. These effects, generally speaking, are conducive to promoting Hong Kong's economic development, though it may also produce certain pressure on the transition of Hong Kong's economy.

This paper comes to the conclusion that there does not exist a uniform or fixed sequence in adopting the full convertibility of a currency due to the differences between countries. At the same time, based on the common practice and basic sequence taken by most countries in the world, drawing on the experience and lessons from other countries' practice and given the fact that China is a large developing country, we also conclude that a progressive and prudent sequential process is needed for the full convertibility of Renminbi.