

# **China's Capital Controls – Through the Prism of Covered Interest Differentials**

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## **Summary**

How effectively China could restrict free capital flows is critical for its ability to manage its exchange rate and domestic economy. The proposed project studies the RMB covered interest differential that is closely related to capital control effectiveness. It is found that the differential is not shrinking over time and, in fact, appears larger after the global financial crisis than before. That is, capital controls in China are still substantial and effective. In addition to exchange rate changes and volatilities, the RMB covered interest differential is affected by credit market tightness indicators. The marginal explanatory power of these macroeconomic factors, however, is small relative to the autoregressive component and the dummy variables that capture changes in China's policy. The autoregressive component represents a regular element of the RMB covered interest differential that is attributable to its own history though this element is not associated with the selected macroeconomic variables. One possible interpretation is the prominence of market stickiness and persistence that follow from China's gradualism approach to reform. The question is not whether to reform or not; the relevant questions are on the speed and the extent of the reform program. Thus, it warrants future study on economic factors of China's capital controls.