



Zhou Xiaochuan on Currency Convertibility

Previously whilst considering whether financial reform has stalled, as some maintained after the Financial Work Conference, we looked at the recent interview given to *Caixin* by central bank governor Zhou Xiaochuan. His **robust comments on financial reform** in general and interest rates in particular show that it is **still well on track**.

As far as FX liberalisation is concerned, Zhou lays out his understanding very clearly, drawing a distinction between the short-term impact of FX movements on production schedules and the longer-term structural impact on reallocation of the factors of production. Zhou said that “**worrying too much about exchange rate adjustment and trade balance** issues is **inappropriate** and **useless** because there is a process for resource allocation and adjustment. In reality, **China has significantly developed towards equilibrium**, although there will be fluctuations” he asserted.

In particular, the movement towards equilibrium shows in the current account surplus, which peaked at around 10% of GDP in 2007-2008 before narrowing to around 3% in 2011. Zhou notes that as the Renminbi closes in on an equilibrium level, it should “experience two-way expectations and two-way volatility” – as it did for part of 2011.

Zhou’s **remarks show he thinks the Rmb’s equilibrium is closer than the consensus believes**. What follows from that is the potential for convertibility of the currency. The timing depends on other reforms being in place and bedded down. Furthermore Zhou said that “in the past, there was an argument that full convertibility was understood as the highest standard.” However “in reality, international organisations have not clearly defined this. Most developed countries are not 100% convertible, maybe they only reach 80 or 90%.”

Zhou Xiaochuan points out that “retaining necessary oversight is not an obstacle to the realisation of convertibility”. An internal IMF opinion in 2010 said that “to maintain macro-economic stability, it is rational for countries to implement a certain

degree of management or employ temporary management measures for a capital account, especially for unusual short-term capital flows.” i.e. the Dirty Floats common in the rest of Asia are accepted, within reason.

Zhou outlines three principles to consider in the development of policy goals regarding convertibility. “First, prudent macro-economic management of private and public debt must be implemented to prevent broad mismatches of currencies. Second, necessary oversight of cross-border financial transactions must be carried out. Currently, there are three oversight aspects that are internationally recognised and for which there are consensus: money laundering, terrorist financing, and excessive use of tax havens must be prevented. Third, short-term, cross-border, speculative cash flows must be properly managed.”

He also underlines how far China has come in meeting the requirements for currency convertibility. “Discounting the above factors, comparing the 40 sub-items relating to capital account convertibility required by the IMF, one finds that, in fact, we are not far from the goal of capital account convertibility.” There are two remaining difficulties to be resolved (though not major ones in the scheme of things) – concerns about overseas investment by Chinese companies and residents as well as the ability of foreign companies to raise equity financing in China, “though the CSRC is paying efforts to study the issues and the overall trend is to gradually liberalise. From this point of view, **we are not far from current account convertibility**. There is another prerequisite for capital accounts convertibility, which is for the yuan exchange rate to be close to the equilibrium exchange rate... If the difference is too great, the hole for arbitrage will be relatively deep.” – **Two-way movements in 2011 suggest this is not so: hence convertibility per se is not a problem.**

View: Beijing is not scared of currency convertibility. It just first wants to get all the reforms sequenced correctly. It, not the US, will determine when that is.