Treasury Efforts Yielding Results on China Currency

> "With steady progress clearly being made, the most effective way at this time to achieve the goal of a flexible, market-based exchange rate in China is to maintain the persistent engagement we have established rather than through a trade petition. Economic isolationism does not work and it's a path we will not follow."
>
> -- Treasury Secretary John Snow, April 28, 2004

Overview

During a period of unprecedented engagement by senior USG officials, together with Treasury's ongoing technical dialogue, the Chinese have undertaken a number of significant measures to facilitate its transition to a flexible, market-based exchange rate regime. China has reduced barriers to capital flows to deepen markets involving foreign currency transactions. It has worked to strengthen its banks and bank supervision, and to prepare these institutions for exchange rate flexibility. And China has taken steps to develop financial products and markets to support foreign exchange trading, hedging of exchange rate risk, bond financing in local currency, and more market oriented monetary policy tools. These are key steps in China's progress toward a flexible, market-based exchange rate regime.

Capital Account Liberalization

An important part of China's strategy to prepare for a more market-based exchange rate is to expand capital flow transactions to increase the depth and liquidity of foreign exchange markets, making them more efficient at transmitting price signals. Moreover, reducing the asymmetry of China's restrictions on capital flows (there are currently more controls on outflows than inflows) reduces strong upward pressures on the balance of payments and the risk of a sharp swing in the currency's value following the move to a more flexible regime.

- ✓ In August 2004, China permitted domestic insurance companies to invest up to 80 percent of their current foreign currency holdings in overseas debt and money markets, effective immediately.
- ✓ In July 2004, China announced it would allow its national social security fund to invest in overseas capital markets.
- ✓ In 2003, China announced policies to encourage foreign direct investment (FDI) outflows including decentralization of approval authority for outward FDI and streamlining regulation for FDI approval.
- ✓ In 2003, the limit was raised on foreign currency allowed to Chinese travelers and declaration procedures were simplified.

Financial Sector Reform

A well-supervised, well-capitalized, and well-managed domestic banking system is important to help ensure that removing controls on capital flows and interest rates is done in a manner that safeguards financial stability. Letting market forces play a greater role in determining interest rates is a crucial component of a more market-based exchange rate regime, as exchange rate movements often reflects differences in interest rates between countries. As China gradually introduces measures to further liberalize capital flows, it has taken important steps to strengthen its banks and bank supervision and prepare these institutions for exchange rate flexibility.

- ✓ The banking regulator has adopted a new supervisory strategy. Though implementation is in the early stages, new guidelines outline a comprehensive, risk-based approach that emphasizes adequate governance and internal controls at banks.
- ✓ The regulator announced new capital adequacy rules and new five-category loan classification guidelines for commercial banks, more in line with international best practices. While full implementation is required by 2007, some banks are reporting financial data based on these standards now.
- ✓ The government has taken actions to restructure two of the largest state-owned commercial banks. The December 2003 capital injection and June 2004 auction of non-performing loans aimed at strengthening the balance sheets. In March, the authorities formulated guidelines on corporate governance for the two banks, which include assessing managers' performance based on their attainment of financial benchmarks.
- ✓ In December 2003, China's central bank gave banks greater leeway in determining lending rates.

Foreign Exchange Market and Financial Product Development

Foreign exchange trading systems and financial instruments for managing and hedging foreign exchange risk are critical elements of a market-based flexible exchange rate regime. China is taking steps to encourage foreign and domestic banks to offer foreign exchange services and to develop a foreign exchange derivatives market (for financial products such as futures and forward contracts). Foreign exchange derivatives depend on market participants' ability to borrow and lend in both local and foreign currency, and China is taking further steps to develop its domestic bond markets. Development of local currency bond markets will reduce the risk to firms' balance sheets of currency fluctuations and give the central bank the tools to move away from a monetary policy framework based on a pegged exchange rate towards a framework where market based interest rates play a greater role in achieving price stability.

- ✓ In August 2004, The Shanghai Futures Exchange (SFE) announced it will cooperate with NYMEX (New York Mercantile Exchange) on physical delivery futures contracts, clearing procedures and risk management (including comprehensive training). Fuel oil futures will be initiated by SFE at end of August. This step will help deepen knowledge of derivatives instruments in general and how to trade, process and clear these types of financial transactions in China.

- ✓ In June 2004, China's foreign exchange operational center in Shanghai announced it would collaborate with the Chicago Mercantile Exchange to develop new products to hedge foreign exchange risk using derivatives (such as futures and forward contracts).
- ✓ In June 2004, China's banking regulator permitted foreign banks to offer foreign currency financial products to local and foreign businesses.
- ✓ In February 2004, the Ministry of Finance announced it will expand the maturity structure of its benchmark yield curve by adding two points for two- and five-year treasury bonds. It is also an interim step toward greater market-determined domestic interest rates. Also, a benchmark interest rate yield curve is needed to price forward contracts.
- ✓ In November 2003, China announced plans to allow renminbi trading and deposits in Hong Kong.

<u>Financial Services Opening</u>

Opening the Chinese banking sector further should encourage competition in financial (including foreign exchange) services. Foreign financial institutions also bring in state of the art expertise in managing foreign exchange risk.

- ✓ In September 2004, China will streamline the application process for foreign banks regarding new entry or expansion of business, and incorporate prudential rule changes to ensure national treatment.
- ✓ Effective August 2004, China permits GMAC and its Chinese partner's joint venture to start operations to extend auto-loans. Ford Motor's financial unit was approved to setup operations.
- ✓ Over the past year, China has lowered capital requirements for bank branches. In September 2004, China will permit foreign banks to open multiple bank branches a year (rather than just one).
- ✓ In December 2003, China's bank regulator announced modest measures to allow foreign banks more local currency business and larger stakes in joint venture banks.

<u>Current Account Reform</u>

China is taking steps to increase the amount of foreign exchange earnings firms can retain and to reduce export tax subsidies. Concrete efforts to reduce strong upward pressure on China's balance of payments will facilitate a move toward a more flexible exchange rate.

- ✓ Effective May 1, 2004, all enterprises authorized to conduct current account transactions may retain foreign exchange revenue equivalent to 50 percent of their foreign exchange export earnings (up from 20 percent). These lower "surrender requirements" give firms more leeway to hold investments overseas.
- ✓ In January 2004, China approved plans to reform its export tax rebate system by adjusting rebate rates on certain exports. This step helps to reduce the tax incentives to exporters.