

Estimating China's de-facto capital account convertibility

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Abstract

China's capital account convertibility is presently not well understood. A relatively closed de jure regime sits in contrast with a de facto regime that exhibits distinct signs of being quite open. This paper seeks to shed light on this issue by using an econometric model to predict the level of capital flows that would be expected if China had a fully open capital account. The results show that over 2001-2003, observed capital flows were around 85 percent of the predicted value, suggesting that China's capital account over a one year time horizon is already quite open. Short run convertibility would expectedly be less than this figure. Thus, the results carry the connotation that the cost of capital controls in terms of allocative inefficiency over the medium and long run is likely to have been modest while some unwarranted short run volatility has been avoided. Nonetheless, the results do not leave room for policy complacency. As China continues to implement its WTO commitments in addition to other arrangements such as the Common Economic Partnership Agreement with Hong Kong, short run convertibility is presently on the rise. This makes implementing policies that are prerequisites for full convertibility a matter of urgency.

JEL classifications – F36, F37

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