Legal Reforms of China’s Foreign Exchange Market

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Obscure Competition of the Future? USD vs. RMB

Recent news about Chinese currency market expansion was not unanticipated in the international economic community. Nonetheless, it spurred intense focus in the media and endured a sensational anxiety among intelligentsia. In the course of a few years, China has been holding its fist tight with the United States in its continuing debate over Chinese currency exchange-rate policies. Notwithstanding, the two largest economies continue their most effective collaboration and lucidly overlook the sentiments of occasional disagreements. Chinese President Hu Jintao in his responses to the Washington Post and the Wall Street Journal wrote: “China and the United States have major influence in international affairs and shoulder important responsibilities in upholding world peace and promoting common development. . . . China will stay firmly committed to the basic state policy of opening-up. China will continue to improve laws and regulations… and facilitate the growth… by offering […] a stable and transparent legal and policy environment, a consistent and open market environment as well as a standardized and efficient administrative environment”.

Last year marked a legendary reform of China’s Yuan (also known as Renminbi, “RMB”) regulation policies. In addition, China started the 2011 year with remarkable shifts in its virtually unprecedented currency regulations by allowing customers to complete their trade transactions in Chinese currency, an alternative to international transactions between

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Chinese parties that in the past were conducted strictly in U.S. Dollars (USD).

It is widely known that China's economic rise was accomplished in part because of its ponderous government control of currency policies. China has been successful to maneuver the Yuan by pegging it against the U.S. Dollar and instituting trade arrangements between the two nations. Three decades ago, the Chinese Yuan had virtually no value and, in effect, was almost unknown among world economies\(^2\). In order to maintain its pegging system, the Chinese central government in the 1990s adopted a “central control” policy, which was designed to regulate the domestic exporters' foreign-currency earnings. These exporters could not use their foreign-currency earnings in either domestic or overseas markets freely. According to the policy, the exporters’ foreign-currency profits had to be sold to the designated banks in China\(^3\). China’s Forex reserves soared more than 2.5 trillion in 2010\(^4\), 70% of which, according to some economists’ estimations, are in U.S. Dollars\(^5\). The Chinese government realizes that keeping such high reserves in the country is imprudent and, perhaps, even catastrophic\(^6\), and, thus, addresses this issue in a responsible manner\(^7\). To minimize the risk of the extended foreign currency reserve, the Chinese central government began foreign exchange administrative reforms. The main areas of these reforms are outlined as following: (i) foreign exchange in trade; (ii) foreign exchange in external guarantees; (iii) foreign exchange in capital investments;\(^8\) and, in addition, (iv) China amended its foreign exchange law and promulgated an emergency clause to safeguard the Chinese financial markets.\(^9\) The ultimate goal of Chinese foreign exchange reforms is to allow the free conversion of RMB into other currencies for all lawful purposes, including the free convertibility of the capital


\(^6\) Id.

\(^7\) See Id.


\(^9\) Id. art. 32.
discussions: major areas of new reforms

i. legal reforms of foreign exchange in trade

the trade credit registration management system (“tcrms”)

in 2008, china’s state administration of foreign exchange (“safe”) issued guidelines, which required an importer and exporter to register the deference payment through the tcrms on-line platform set up by the safe. this applies if a deferred payment for import (including payment by tt and collection, but excluding letter of credit), or advance payment from export, or deferred receivables from export, has occurred or is going to occur in the future.11

1. the deferred payment registration

in accordance with the guidelines, the importers must ascertain that they register their contract with the tcrms within 15 working days after signing of the contract, if the date of payment in foreign currency is later than the actual import date of the goods for more than 90 days.12

2. the advance payment registration

in order to prevent explicit inflows of liquid currency into the chinese market, safe guidelines also control advance contract payments. under the guidelines, exporters are required to register their contract and advance payment with the tcrms within 15 working days after signing the export contract, or 15 workings days after receiving the advance payment.13 the advance payment will be kept in a to-be-inspected account, which the

11 notice of the state administration of foreign exchange, the ministry of commerce and the general administration of customs on printing and distributing the measures for the on-line inspection of the collection and settlement of foreign exchange in export (no. 29 [2008] of the state administration of foreign exchange, effective as of jul. 14, 2008), available at http://www.lawinfochina.com/law/display.asp?db=1&id=6868&keyword=measures for the on-line inspection of the collection and settlement.
12 notice of the general affairs department of the state administration of foreign exchange on distributing the operating guidelines for the trade credit registration management system (deferred payment section) (no. 157 [2008] of the general affairs department of the state administration of foreign exchange, effective as of sept. 26, 2008), art. 9, available at http://www.lawinfochina.com/law/display.asp?db=1&id=7112&keyword=trade credit registration.
13 notice of the state administration of foreign exchange on the implementation of registration administration of enterprises’ external credits under the item of trade in goods (no. 56 [2008] of the state administration of foreign exchange, nov. 15, 2008), art. 3, available at http://www.lawinfochina.com/law/display.asp?db=1&id=7141&keyword=trade credit registration.
14 notice of the state administration of foreign exchange about implementing the measures for the on-line inspection of the collection and settlement of foreign exchange in export (no. 31 [2008] of the state administration of foreign exchange, effective as of jul. 2, 2008), art. 3, available at http://www.lawinfochina.com/law/display.asp?db=1&id=6867&keyword=measures for the on-line inspection of the
exporter cannot use until the cargo is *de facto* exported\(^\text{15}\).

3. *The deferred receivable registration*

If the foreign exchange payment date, as stipulated in an export contract is deferred for over 90 days, the exporter shall register the contract within 15 working days from the day of signing the contract\(^\text{16}\).

4. *Verification and writing-off reform of foreign exchange payments for import*

In order to diminish the gap between import and export volume, the Chinese government alleviated its control over the foreign exchange payments for import contracts. Last year SAFE classified all importers in accordance with their qualifications into three categories, i.e. Class A, Class B and Class C\(^\text{17}\). The importers of Class A are those with good records of legal compliance, as well as sound business practice record; the importers of Class B are those with qualified record of legal compliance; and, the importers of Class C are those with a legal violation record. Inevitably, the importers of Class C will be subject to a stricter scrutiny by the authorities. Accordingly, these groups have to undergo the classified management procedures, which include examination, registration and individual reporting of foreign exchange payments in import trade\(^\text{18}\). The SAFE may require that Class C importers report foreign exchange on a case-by-case basis\(^\text{19}\).

II. *The reform of the external guarantee.*

Earlier in 2010 the Chinese government mitigated restrictions on the external guarantees provided by a Chinese domestic institution (guarantor) for an overseas organization (beneficiary) in the form of surety, mortgage, pledge, etc.\(^\text{20}\). External guarantees were also made available to the Chinese domestic beneficiaries where the debtor is an overseas institution.

1. *External guarantee provided by a domestic bank.*

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\(^{15}\) Id.


\(^{18}\) Id.

\(^{19}\) Id.

(i) To arrange **financing external guarantees** a Chinese domestic bank must apply for external guarantees balance quota from the local SAFE branches\(^{21}\). A debtor is not subject to such conditions due to its equity relationship with the domestic bank, net asset proportions, and profits and losses\(^{22}\).

(ii) There are no quota restrictions on the Chinese domestic banks for **non-financing external guarantees**\(^{23}\). Certain organizational requirements, however, apply. For instance, a non-financing external guarantee can be provided by a domestic bank only if the debtor or the beneficiary is a corporation legally formed and registered in China; or at least one of the foreign companies is formed by a Chinese domestic institution, or in which a Chinese domestic institution owns shares thereof\(^{24}\).

2. **External guarantees provided by corporations (including non-bank financial institutions)**

   (i) Qualified corporations may apply for external guarantees balance quota\(^{25}\). Other non-qualified corporations must apply, on individual basis, for an approval from a local SAFE branch before they can provide an external guarantee to a beneficiary\(^{26}\).

   (ii) Debtor, as well, must qualify for external guarantee provided by a non-bank institution. The debtor must be a corporation legally formed and registered within China; or an overseas institution which is formed by a Chinese domestic organization, or in which a Chinese domestic institution directly or indirectly holds shares\(^{27}\).

   (iii) In case if external guarantee is provided by a corporation, debtor must be a domestic or overseas enterprise formed by a guarantor, or in which the guarantor directly or indirectly holds shares under the prescribed procedures\(^{28}\).

III. **The reform of capital investments**

1. **QFII**

   According to new SAFE regulations, qualified foreign institution investors (“QFII”), are permitted, subject to approval, to open a foreign exchange account, as well as specially designated RMB account, to buy “A” type shares on the Chinese stock markets\(^{29}\).

\(^{21}\) Id., art. 3.

\(^{22}\) Id., art. 10.

\(^{23}\) Id., art. 3.

\(^{24}\) Id., art. 11.

\(^{25}\) Id., art. 13.

\(^{26}\) Id. art. 13.

\(^{27}\) Id., art. 14 (1) (a).

\(^{28}\) Id.

\(^{29}\) Reply of the State Administration of Foreign Exchange on Approving the QFII Investment Quota of Stanford University and Its Opening of a Foreign Exchange Account and Special RMB Account (No.339 [2006] of the State
2. **Foreign-currency earnings**

A triumphal reform of China’s foreign exchange control was pioneered on January 1 of this year. According to this reform, Chinese qualified exporters may now keep their foreign-currency earnings overseas instead of remitting them back to China or converting them into Yuan in designated domestic banks\(^{30}\).

3. **Currency trade and swap agreements**

In 2009 China signed Yuan-denominated swap agreements with a handful of its most synergetic trade partners totaling RMB100 Billion\(^{31}\). In December 2010, China and Russia were poised to take an important step in their expanding economic relationship by openly trading the counterpart’s currency (RMB and Ruble) in their domestic markets. This is believed to be an important milestone for the two countries’ financial markets\(^{32}\).

4. **Foreign Investment in RMB**

Starting in January 2011, the Central Bank of China allows Chinese investors to invest overseas in RMB currency (including establishment of enterprises, mergers and acquisitions)\(^{33}\). Prior to that, the investors had to exchange RMB into foreign currencies before investment.

**IV. Safeguarding the Economy**

Emerging growth of international investment institutions\(^{34}\) and unstable financial markets spur legitimate concerns by the Chinese government. In order to safeguard its domestic economy from domestic and international fraud and financial manipulations, China recently amended its Foreign Exchange law.

*Emergency Clause of Foreign Exchange Law*

According to Article 32 of China’s Foreign Exchange law, the SAFE may regulate, adjust, or control the foreign exchange market commensurate with the market fluctuations.
and prerequisite of the monetary policies. The details of the SAFE adjustment measures (e.g., restrictions on capital, transaction size, or imposition of a special capital income tax) are not specified in the law and, rather, ambiguous.

**Case Analysis**

Novel reforms already start to kick off in China. In December 2010, a large manufacturer Dongguan Xinya Electronics Co., Ltd., from the economically advanced Guangdong region, was punished for receiving “unlawful” advance payments from overseas in the total amount of USD 4,381,500 without carrying out true transactions. The SAFE imposed the fines on the manufacturer because “[it] failed to write the advance payments off accordingly within 6 months after receipt of the payments in accordance with the law.” The investigation, initiated under the SAFE, did not disclose the amount of the fine imposed on this manufacturer.

**Conclusion**

Notwithstanding the peculiarity of China’s reforms, it is certainly aimed at inevitable growth and starting a new era for Chinese currency and financial markets. In a recent interview, Li Xiaoing, general manager of the Bank of China in New York, stated: “[the bank’s goal is to become] the renminbi clearing center in America.” Shifting to the number two largest economy in the world added unfaltering advancement to Chinese enthusiasm. China’s initiation of its freer currency trade in the United States, as well as in other developed economies, will have an unprecedented impact on the global economy.

International institutions, i.e. the World Bank, International Monetary Fund etc., will need to develop a new strategy to administer China’s fiscal policies. Former “techniques” of subtle political influence by international financial institutions which failed to work in South America in late 90s will not make a play in China. Its “socialist economy” proclaimed in the PRC’s Constitution may, at the end of the run, make a paradoxical example of an

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37 See Lingling Wei, Id. 1.
unthinkable achievement. While the rest of the world is in desperation to trim down its indebtedness, China is actively practicing “expansionism”\textsuperscript{40}, and, along the line, aiming to compete with the U.S. Dollar\textsuperscript{41}.

Dr. Ron Paul, former American presidential candidate, in his speech before the U.S. House of Representatives calls for the end of the “dollar hegemony” blaming the malady of the American economy on it\textsuperscript{42}. Competition of RMB and the Dollar may result in a new global economic order, which may benefit not only the Asian economy, but also the rest of the world. To achieve this goal and in order to prevent a similar catastrophic event of 1997 in Asia, the Chinese government launched legal reform of foreign exchange laws and regulations. The Emergency Clause, newly implemented in China, may play a significant role during the internationalization of RMB. George Soros once said: "Playing by the rules, one does the best he can, irrespective of the social consequences. Whereas in making the rules, people ought to be concerned with the social consequences and not with their personal interests"\textsuperscript{43}. Just as the well-respected Mr. Soros, China too believes in overall collective advantage, and, as can be drawn from the above analysis, with the due respect for rules.

\textsuperscript{40} Expansionism – the doctrine of expanding the economic influence of the country.
\textsuperscript{41} See Lingling Wei, Id. 1, 35. “In time, a globally traded yuan could emerge as a store value on par with dollar, euro and yuan”.