New forex rules seek to balance capital flow

China's revised foreign exchange rules, announced last week, have been taken as an enhanced effort to curb speculative capital inflow, but analysts said they mainly aimed to balance capital outflow and inflow and fill the loopholes in the previous forex regime.

The new rules, which went into immediate effect on Wednesday, will play a role in curbing the influx of speculative capital, analysts said.

The new regulation provides heavy penalties for improper currency transfer and conversion, among other moves. Analysts said they were intended to respond to the fast growth in the country's foreign reserves, which have amounted to about $1.8 trillion, part of which is believed to be speculative money eyeing exceptional returns as the yuan appreciates.

The regulation stipulates that the authorities would impose penalties of up to 30 percent of the capital involved in any unauthorized inward or outward foreign currency transfers; in severe cases, the penalties could be more than 30 percent - but lower than the amount of the involved capital.

For those who fail to use the capital in the way they claimed, such penalties also apply.

Economists said that as China de-pegged the yuan from the dollar in July 2005 and allowed it to appreciate gradually, a large amount of foreign speculative capital has managed to flow into the country to seek higher returns. Domestic traders, for example, can inflate their export claims so that they can settle more foreign currency as trade revenues.

Such capital could also flow in disguised in foreign direct investment funds, analysts said. In the first half of this year, China's realized foreign investment was 52.39 billion yuan, up 45.6 percent year-on-year, while the newly approved foreign investment projects dropped by 22.1 percent. Although the conflicting data is attributed to the increasing investment scale of individual investment projects, there may be some speculative capital flowing in as investment funds, said Bian Xubao, a macroeconomic analyst from Qilu Securities.

After such money enters, it often goes into the real estate or the stock market, pushing up asset prices. Once such capital starts to flow out of the country, it could incur asset price declines and could possibly lead to a financial crisis, as in the case of the 1997-98 Asian financial turmoil.

Such capital, also called "hot money", could inflate the country's money supply, increasing price pressure when China is fighting inflation.

Such "hot money" has started to flow into China in large scale since 2003, said Lu Zhengwei, an economist from Industrial Bank. Divided on the exact amount of such capital, economists estimate that such capital could amount to several hundred billions of dollars or even up to $1.75 trillion in their wildest estimates.

The new rules, amending those set in 1997, give authorities more control over trade transactions, allowing them to check invoices to ensure the trade revenues are not being inflated as an excuse to bring unauthorized money into the country. Authorities are also allowed to expand reporting requirements for financial institutions, thus enhancing monitoring of illegal capital inflows.

The regulation also stipulates that when the country's international payments suffer severe imbalances or the national economy encounters a serious crisis, the country can take necessary safeguard measures to tackle the situation.

"It is the first time the country put in place the mechanism of dealing with an international payment crisis," said Zhao Qingming, an analyst with China Construction Bank. The recent financial woes in the US, the eruption of financial crisis in Vietnam and the recent signs of increasing inflow of speculative capital make such a mechanism very important, he said.

An important part of the new rules deals with outflow of capital, which used to be strictly controlled.

China used to lack foreign exchange reserves in the early years of its economic reform and opening up. The previous 1997 regulation, therefore, stipulates mandatory settlements of foreign currencies to increase foreign exchange reserves.

Now that China's foreign exchange reserves have become a headache contributing to many liquidity-related problems, such as inflation, the new regulation formally eased the control.

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