

# **One Country, Two Currencies**

**How did China come close to and then miss full convertibility of Renminbi?**

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Draft: January 8, 1996

This paper was presented at the Pacific Rim Allied Economic Organizations 2nd Biennial Conference "Economies in Transition," Hong Kong, January 10-15, 1996 in a section organized by CEP.

\*The author would like to thank section participants for their helpful comments and would acknowledge financial support from the Research Grant Committee of Hong Kong for this work, which is part of a project on Money and Banking in China.

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### ***The Issue of Full Convertibility***

In October 1993, after a brief visit to China and Hong Kong, Milton Friedman predicted that Hong Kong dollar, which has been linked to U.S. dollar at 7.8 H.K. dollar per U.S. dollar through a currency board system since 1982, will be replaced by the Chinese currency Renminbi in two years after 1997 when Hong Kong is to be handed back to China from Britain. On the other hand, in December 1995, Chinese government was planning to make Renminbi convertible at least for current account transactions in 1996 and fully convertible by the year 2000. Since Hong Kong dollar is certainly a fully convertible currency, China's plan to make Renminbi fully convertible could be seen as an attempt to close the difference between Renminbi and Hong Kong dollar at least with regard to currency convertibility. Milton Friedman's prediction represents probably the most pessimistic view on the future of the monetary system in Hong Kong and in China which is in sharp contrast with the Chinese government's optimistic plan.

If the Hong Kong dollar monetary system represents one of the most important institutions of capitalism in Hong Kong, then the current Renminbi monetary system could be seen as the foundation for the socialist market economy in China. The intervention to business by the government through monetary, fiscal, banking and other financial policies is minimized under a currency board system in Hong Kong while maximized under a central bank system with dominant state commercial banks and state-owned enterprises in China. The currency board system in Hong Kong works smoothly with a private property economy while the current Chinese central bank system is essential for a mixed economy with a dominant state ownership of property and heavily regulated markets.

Theoretically it can be argued that the currency board system in Hong Kong is more competent than the Chinese central bank system in dealing with the problems of inflation, unemployment, growth and development in a mixed economy<sup>1</sup>. But it is difficult to provide clear empirical support for or against the two monetary systems. Inflation in Hong Kong has been close to 10% for almost ten years. Unemployment in Hong Kong is rising now. Growth of GDP in Hong Kong is slower than that in China. Economic development in Hong Kong has been impressive but so does that in China. So what are the problems with Renminbi and the Chinese monetary system? Why should we care about the issue of replacing Hong Kong dollar with Renminbi or Renminbi with Hong Kong dollar?

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<sup>1</sup> See Steve H. Hanke, Lars Jonung and Kurt Schuler, Russian Currency and Finance: a currency board approach to reform, London and New York: Routledge, 1993.

What is the fundamental purpose for making Renminbi fully convertible? What is the best approach toward full convertibility of Renminbi?

To answer the above questions, we have to consider the problems of the state-owned enterprises and state banks in China and the nature of its mixed socialist market economy. The core problems in a mixed economy can be summarized as a privatization of property rights and a socialization of property obligations under a dominant state ownership of enterprises and banks. More specifically, the state-owned assets are in danger of dissipation through rent-seeking and corruption while state-owned liabilities are accumulated and centralized due to socialist concerns about unemployment and stability. As a result, the public sector has more liabilities than assets. When the public liabilities are due, the government has to print money or borrow to finance the imbalance of assets and liabilities. The central bank and state-owned commercial banks are not only essential in control over loss of state assets and accumulation of state liabilities but also indispensable in financing the gap between assets and liabilities in the state sector. It is the mis-match of assets and liabilities or the separation of property rights and property obligations that requires a reform of the Chinese monetary system as well as the ownership structure of the state-owned enterprises and banks. Making Renminbi fully convertible is one important component in the broad transition from a centrally planned economy to a free market economy where assets and liabilities are properly

matched and property rights and property obligations are inseparable.<sup>2</sup>

Full convertibility of Renminbi under a fixed or stable exchange rate requires a stable Renminbi monetary system that is basically free from the pressure of high inflation and the associated pressure for currency devaluation since capital would simply flight out of the country under the mixed condition of full currency convertibility at a fixed exchange rate and strong inflation and devaluation pressure. Chinese households are still keeping their Renminbi deposits in the state banks because they have no choices of converting Renminbi at present fixed official rate into Hong Kong dollar or U.S. dollar and the state banks are paying a real interest rate as high as 12% for three year fixed deposits and government bonds even at the cost of systematic losses in the state banking sector. To eliminate inflation and devaluation pressure in China for a reasonably long period, it is necessary to achieve some reasonable success in the reform of the large state-owned enterprises and state banks so that they can balance their own accounts or match their own assets and liabilities without explicit or implicit subsidies from the banking system through bad loans and low lending rate loans. China has still a long way to go in meeting that condition in

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<sup>2</sup> These issues can not be discussed in detail in this short paper. Please see two papers by Andrew Sheng and Geng Xiao: "Property Rights and Economic Transition Revisited: The Case of China," manuscript June 1995 and "Separation of Property Rights and Property Obligations: Socialism, Capitalism, and Socialist Market Economy," manuscript, January 1995.

spite of its most visible success in the marketization, in the non-state sector, and in the development of coastal regions through joint-ventures with foreign investors. Inflation has been falling in recent months due to tight control on the total amount of loans in the state controlled banking system. However, the problems of inter-firm debts, non-performing loans and losses by state-owned enterprises are still as serious as before. In short, China does not seem to have the necessary conditions to make Renminbi fully convertible under a fixed exchange rate now. Few would misread this reality. Instead, the debate is centered on what is the best approach toward full convertibility of Renminbi at a variable but reasonably stable exchange rate in the near future.

The rest of this paper compares two approaches to full convertibility of Renminbi: one could be called "one country, two currencies" with the second currency being Hong Kong dollar; the other could be named as "one country, one currency." What makes this comparison interesting and relevant is that the "one country, two currencies" approach was actually practiced quietly in China for its foreign trade and investment sector for about fifteen years before January 1994 when it was replaced with the "one country, one currency" approach by a dramatic reform in foreign exchange control system.

### ***One Country, Two Currencies: The Quiet Practice during 1979-1993***

As early as in 1979 when the State Administration of Foreign Exchange Control was established, foreign invested enterprises were allowed to open foreign exchange accounts. They can deposit

their earnings of foreign exchange from exports and use them to buy imports and to pay wages and dividends to foreigners. Those Chinese enterprises and work units which could earn foreign exchange were also allowed to keep portions of their foreign exchange in quota or in cash so that they can use it to buy imports or to sell the foreign exchange quota or cash at the swap centers. The enterprises and work units had to sell the rest of the foreign exchange earnings above the retention limits to the state banks at the over-valued official exchange rate. The retention rate was usually 25% for foreign trade enterprises, 30% to 40% for non-trade units, and 100% for military and other special units.<sup>3</sup> In 1979, the retained foreign exchange was only 1 billion U.S. dollar or about 5.4% of the total foreign exchange earnings. By 1985, the foreign exchange retention increased to 9.36 billion U.S. dollar or about 31.1% of the total earnings. During 1979-1985, the total retained foreign exchange earnings by the local governments, central ministries, and enterprises amounted to 44.4 billion U.S. dollar. During 1986-1993, both the retention rates and the total amount of retained foreign exchange increased dramatically although the exact amount can not be easily found in published statistics. What we know is that the transaction volume in the foreign exchange swap centers increased

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<sup>3</sup> See Yi Yanlin, Exchange Rate: Unification of Multiple Rates and Proper Regulation, in Chinese, China Fiscal Economics Publisher, 1993. All statistics cited in this section are from Yi's book except otherwise noted.

from 4.2 billion U.S. dollar in 1987 to 25.1 billion in 1992.<sup>4</sup> The gap between official and swap market rates also gradually converged from more than 60% in 1988 to less than 4% in 1991.<sup>5</sup>

Also, starting from 1980, individuals could keep 30% to 50% of their foreign exchange income and remittances from their relatives abroad in cash while selling the rest to the state banks. Since 1985, individuals could even open foreign exchange accounts in the state banks from which they could deposit and withdraw all of their foreign exchange in cash in accordance to certain regulations. Since 1993, each individual could also legally bring 6000 yuan Renminbi across the border which led to a market for Renminbi for mainland Chinese visitors and local retail shops in Hong Kong.

Moreover, many firms in the services sector such as hotels, shops and restaurants were charging their customers Hong Kong dollar or U.S. dollar directly, especially in southern China. About one quarter of Hong Kong currency or about Hong Kong dollar 14 billion was circulating in southern China before 1994.

Hence, during 1979-1994, Hong Kong dollar or U.S. dollar was used as a medium of exchange, a unit of account, and a store of value by the foreign trade and investment enterprises and some Chinese individuals, parallel with the Chinese currency Renminbi. China had adopted unconsciously both a central bank and a currency

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<sup>4</sup> The data here is from William H. Overholt, China: The Next Economic Superpower, page 104.

<sup>5</sup> The data here is form Nicholas Lardy, "Chinese Foreign Trade," The China Quarterly, 1992, page 708.

board for monetary transactions. Those producers, importer-exporters, and joint ventures which accumulate dollar from export and use dollar to import have little foreign exchange risk! They are using two monetary systems: the dollar and the yuan. The two systems are linked by more than 100 gradually developed regional dollar-yuan swap centers participated by thousands of ultimate users of dollar and yuan. Under this system, Renminbi is clearly not fully convertible at the fixed official exchange rate but is fully convertible at the variable swap center rate for those who could participate in the swap markets. For some enterprises participating in foreign trade and investment, they just use dollar as a medium of exchange, a unit of account, and a store of value and have little exchange risk. For others that only export or only import, their exchange risk is defined by the imperfect but active and rapidly expanding dollar-yuan swap markets. Foreign investors and domestic enterprises complained about the imperfection of the swap markets but participated voluntarily the swap transactions. Foreign trade and investment in China grew unprecedently during 1991-1994.

The foreign exchange retention and swap market system effectively created a dual-currency system or "one country, two currencies": Renminbi for domestic trade and production and dollar for foreign trade and investment. The two currencies are linked by decentralized and voluntary swap markets. The dual-currency system has incentive compatibility. The dollar and the quota for dollar are held in the accounts of the individual firms. They can decide whether, when and how much to buy and sell dollar

in spite of various transaction costs. The system of one country-two currencies would work particularly well with a Chinese-Hong Kong joint-venture. The venture would do all domestic business in yuan and all international business in dollar. It would keep two accounts and convert yuan to dollar or dollar to yuan at the swap centers.

However, the dual-currency system has several problems. The multiple exchange rates between Renminbi and dollar due to fragmented swap markets and the existence of a fixed official exchange rate create opportunities for speculation and corruption. Another drawback often pointed out by government officials is the volatility of the swap market exchange rates. The most important concern by the government however is the fear of not able to control and regulate the use of dollar as a medium of exchange and a store of value and the problem of capital flight. According to China's balance of payment in 1992, capital inflow was 30.2 billion dollar while capital outflow was 30.5 billion. But there was an error term equivalent to 8.4 billion capital outflow. Hence, in 1992, when China had an unprecedented foreign direct investment, the balance of payment account still showed a net capital outflow of about 10 billion dollar. Moreover, most of the 10 billion dollar net capital outflow could not be traced in government's account and can only be published as an error term.<sup>6</sup>

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<sup>6</sup> See Guo Shuqing, "Renminbi Convertibility and the Reform of Foreign Exchange Control System," Reform, 1993, No. 5, page 98-105.

### ***One Country, One Currency: The 1994 Reform***

The new foreign exchange control mechanism introduced in 1994 was designed, intentionally or not, to deal with the above problems while ignoring the incentive advantage of the dual-currency system. It unified the official and swap market exchange rates so that speculation and corruption relating to exchange rate differentials are eliminated. It stabilized the exchange rate at a narrow range around 8.4 yuan per dollar by restricting the participants to the inter-bank foreign exchange market to a few designated state banks and the central bank. Most dramatically, it replaced the dollar-yuan system with a one currency system by requiring all domestic enterprises to sell all of their current and past foreign exchange earnings to the state banks at the unified exchange rate which was set at the prevailing swap market rate at the end of 1993. The enterprises when need foreign exchange have to buy from the state banks with proper documents showing legitimate use of foreign exchange for current account transactions.

The reform was surprisingly successful from the government point of view. Exchange rates have been unified and stabilized since 1994 at about 8.4 yuan per dollar. Renminbi actually appreciated in 1995 from about 8.45 yuan per dollar to 8.3 yuan per dollar when inflation was about 25% in 1994 and 15% in 1995. Foreign exchange reserve increased from about 21.2 billion U.S. dollar in 1993 to 51.6 billion in 1994 and 70 billion by the end of September 1995.

However, the success of recent reform in foreign exchange control also brings about some problems. If inflation continues at the currently 15% rate, Renminbi has to depreciate to allow exporting any profits. At present, the government can control imports more or less effectively through regulations as well as the general austerity program but can not control the losses from exporting due to the inflation which increases Renminbi cost of producing export products which was close to 8.4 yuan per dollar in Shanghai area in mid 1995.<sup>7</sup>

One of the major reasons for strong Renminbi since 1994 are due to a sharp devaluation of about 30% from the official exchange rate at the beginning of 1994, a strong performance of export and foreign direct investment and an effective control on import. Under the new foreign exchange control mechanism, the firms earning foreign exchange from their export have to sell all their foreign exchange earnings to the state banks. So, the supply of dollar in the inter-bank market is directly related to export performance and foreign direct investment. Another source of dollar to the inter-bank market in 1994 is the one-time adjustment by firms clearing their retained foreign exchange earnings accumulated in the past. These two factors pushing Renminbi up have by now largely disappeared or will disappear soon. The stock of foreign exchange held by the enterprises in the past should have been all transformed into official reserve by now. The flow

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<sup>7</sup> This number was obtained during a field trip to Shanghai area in June 1995.

supply of foreign exchange may decline relative to demand since China's export growth rate has been falling month by month since early 1995 while the recent cut in import tariffs would increase demand for import in the future.

Fortunately, the demand for foreign exchange is still weak at present due to the government's austerity program, which reduces demand for import, and to high interest rates on Renminbi deposits, which discourages holding of foreign exchange. However, these two factors supporting a strong Renminbi depend too much on the government short-term measures to control inflation and maintain a stable currency. The trouble is the government has not yet found effective and lasting ways in eliminating inflation pressure arising from the imbalance of state assets and liabilities.

The cost of maintaining the current exchange rate may increase sharply. The state-owned exporters will complain about a lack of profitability. The state banks holding dollar will also complain for a lack of Renminbi fund. In mid 1995, the central bank changed the rule from buying all dollar above certain level from the state banks to buying dollar only up to certain level. The state banks now have to keep the rest of dollar in their own accounts at no interest earnings. If Renminbi continues to appreciate, then the state banks holding large amount of dollar will lose profits. On the other hand, depreciation of Renminbi will bring profits for the central banks and the state banks due to their holding of dollar on their own accounts. But, depreciation of Renminbi is likely to lead to a relaxation of

Renminbi credit which would fuel inflation and lead to further pressure for depreciation of Renminbi!

A crucial point is that a breakup of the dual-currency system, which was used to separate monetary transactions in the domestic sector and in the foreign trade and investment sector in the past, has artificially forced a close link between domestic and international economic activities and the associated monetary transactions. The sharp increase of reserve from 21.2 billion dollar in 1993 to 51.6 billion dollars in 1994 without comparable sterilization has produced an artificial shock to the Renminbi money supply. The increase of 30.4 billion dollar in reserve in 1994 is equal to an increase of 252 billion yuan Renminbi reserve at an exchange rate of 8.3 yuan per dollar or 43% of the Renminbi currency in circulation in 1993. The shock has been moderated by a tight monetary policy since 1993 but has been felt strongly nevertheless in 1994 and 1995. This kind of monetary link may not be helpful to an economy where foreign trade and investment fluctuate. Here, Hong Kong's experience seems very useful. Due to geographical, economic and political reasons, Hong Kong has to face with a fluctuating foreign trade and investment. It has been forced to link its Hong Kong dollar with the U.S. dollar at the costs of losing its own monetary instruments. Scholars and policy makers have overlooked the possibility that the dual-currency system practiced in China before 1994 could have reduced the impact of the fluctuating foreign trade and investment on the domestic Renminbi monetary system. Under the dual-currency system, an increase in export and foreign direct investment can be

channeled more easily to demand for import since the increase in dollar supply would not be immediately transformed into yuan supply. The present one currency system is very much like the fixed exchange rate regime practiced in many countries under the Bretton Woods system during 1960s and 1970s which could easily translate fluctuations in balance of payments into domestic business cycles without careful monetary management like sterilization.

The lack of sterilization in China's monetary management could be solved in principle as the monetary officials become familiar with the tools for managing a modern monetary system. However, the following incentive problem is much more serious and more difficult to deal with under a one-currency system.

The current one-currency system created extra exchange risk for both firms and the state banks by eliminating any opportunities for voluntary or contractual allocation of exchange risk. It eliminated the contractual, voluntary and symmetric transactions at the swap markets for domestic enterprises and added two non-contractual, coercive, and asymmetric transactions between the enterprises and the state banks. The transaction cost saved in the contractual transactions at the swap market may be more than offset by the cost the enterprises have to incur in the coercive selling of their foreign exchange to the state banks and a rationing of foreign exchange from the state banks.

It is possible that when foreign exchange is in shortage, the state banks, under the direction from central or local governments, may give preferential treatment to some firms or

industries in accessing to foreign exchange. The problem of eating from the common rice wok may happen again since the reserve in the central banks and the foreign exchange in the accounts of the state banks are all state property without specific use rights assigned to specific enterprises. Who is going to benefit from the common rice wok? The one who can buy exchange from the state banks at the government controlled fixed rate. In this case the rights to use precious exchange are very likely to be privatized to bank officials and their friends.

When foreign exchange is in over supply, then enterprises would voluntarily sell exchange to the state banks at the government controlled fixed rate. The state banks have to buy all of the exchange even if they are losing profits for holding the exchange on their own accounts. Now, the obligations to assume the exchange losses or risks are concentrated and socialized through the state banking system.

Hence, it is the separation of rights and obligations or the privatization of exchange use rights and socialization of exchange loss obligations that distinguishes the current system from the previous dual-currency system. Under the dual-currency system, the bulk of the foreign exchange is held by thousands of enterprises. The central bank and the state commercial banks do not hold transaction, production, or investment demand for foreign exchange nor the associated risk.

### **Conclusion**

Ironically, a less risky and faster way than the current government approach toward full convertibility of Renminbi during

the transition may be to go back to a revised version of the dual-currency system which allows limited use of Hong Kong dollar in the foreign trade and investment sector. Only a few changes are necessary. The government could allow the enterprises and the banks to open dollar accounts and let themselves to decide whether, when, and how much to sell and buy dollars. The government could also relax the restrictions on entry into the inter-bank market for foreign exchange and let the inter-bank market rate be real free market rate. Renminbi would become fully convertible when the above voluntary buying and selling of dollar are allowed.

However, the full convertibility under a dual-currency system does not mean that anyone can buy any amount of dollar at any time at a fixed exchange rate from the state banks. Not at all. The government and the state banks have no obligations to sell any amount of exchange at a fixed rate. The government would not defend a fixed exchange rate nor assume any risk from exchange rate fluctuations. All exchange risk has to be assumed voluntarily by specific individuals and enterprises, be they speculators or ordinary producers, traders and investors. There will be no shortage or oversupply of dollar nor central bank reserve but there will be a fluctuating exchange rate in the inter-bank market, a cost for true convertibility.

The fluctuation of exchange rate however would not necessarily lead to capital flight under the dual-currency system. When foreign investors and domestic enterprises can use a fully convertible currency such as Hong Kong dollar in parallel with

Renminbi, they would feel much safer than under an one-currency fixed exchange rate regime since they could simply ignore Renminbi if the exchange rate fluctuates too much and use only dollar. As a result, China will be able to attract foreign investment just as Hong Kong does. The capital flight observed in 1992 seems better explained as a flight of state-owned capital not private capital. Otherwise we can not explain the surge of foreign direct investment into China at the same year.

The use of Hong Kong dollar as a parallel currency fully convertible with Renminbi at variable market rate in China would facilitate greatly economic integration between China and Hong Kong and foreign trade and investment. In a practical sense, China has been using Hong Kong dollar as a parallel currency for many years through the presence in Hong Kong of the Bank of China, CITIC and many other state-owned enterprises. These China funded banks and enterprises in Hong Kong have to follow Hong Kong's legal and business rule and practice and are certainly using Hong Kong dollar as a currency. The Bank of China has recently jointed other two major local Hong Kong banks in issuing Hong Kong dollar bills. On the other hand, all of the China funded banks and enterprises have extensive business relations with Chinese banks and enterprises in the mainland. It is inevitable that they have to use two currencies. In the past, only a few mainland Chinese banks and enterprises were granted permissions in opening branches in Hong Kong. In recent years, their number and capital have increased significantly. After 1997, they will continue to rise. This kind of free-riding on Hong Kong's capitalist institutions by

the China funded banks and enterprises in Hong Kong has benefited economic development in both China and Hong Kong. Legalizing the use of Hong Kong dollar in China would be a natural extension of the above free-riding exercise and would benefit China on a much larger scale than the presence of Chinese banks and enterprises in Hong Kong.

A practical problem under the dual-currency system is how for the state banks to manage the dollar deposits by individuals and enterprises. In the past, the state banks in China could use their dollar deposits for a limited amount of dollar loans, sell them in swap centers in China, or put them in Hong Kong's money market to earn interest. These banking services for the dollar accounts are not much different in nature from those for Renminbi accounts. The banks can make dollar losses if the dollar loans turn bad or if dollar depreciates in the swap centers or if the trading in Hong Kong monetary market is not profitable. This kind of dollar losses is not a result of the dual-currency system. The state bank losses from both dollar and Renminbi banking services have to be traced to the ownership and management problems. Although the government can not print dollar bills to cover the dollar losses, it could still print Renminbi to buy dollar and bail out the dollar business of the state banks.

Hence, it should be emphasized that the one country-two currencies system, although helpful to China's transition to a market economy, could not substitute fundamental reform of the Chinese state-owned banks and enterprises. China funded banks and enterprises in Hong Kong could be as efficient as other local

private banks and enterprises but they are fundamentally different from local private banks and enterprises. When they are making losses, they may be bailed out by the Chinese government although they are using Hong Kong dollar and following all the capitalist rules and practices. Ownership matters here. It's not just organizational rules, market institutions and competition.

The change from currently involuntary selling and buying of dollar to voluntary exchange of dollar and yuan among the enterprises and state banks, or the practice of one country-two currencies, is a simple but useful step in transition to a free market economy. This conclusion is not a policy advice from blackboard economists nor an imagination from experiences of a capitalist economy. It is based on China's own precious experiences just a few years ago. Many Chinese practitioners derived the same conclusion from their common sense economics.<sup>8</sup>

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<sup>8</sup> From my personal contacts with Chinese banking officials, I learnt that conclusion and suggestions similar to this paper have been expressed in various internal reports in China, although without systematic analysis presented in this paper. In September 6, 1995, Hong Kong Economic Journal

Against Milton Friedman, I predict that China will not replace Hong Kong dollar with Renminbi in two years after 1997. Instead, we will see "one country-two currencies" to be as well practiced in China as "one country-two systems" in Hong Kong after 1997

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(page 17) even reported a government plan to allow firms to open dollar accounts in the state banks. But so far, the reported plan has not yet been implemented according to my knowledge.

