Foreign Direct Investment in the PRC: Foreign Exchange Reform and Business Risk

DANIEL KAM-TONG, LI; GORDON R. WALKER; MARK A. FOX; SHU-KEUNG, LAU AND T.K.P. LEUNG

Daniel Kam-Tong, Li, Lingnan College, Hong Kong; Gordon R. Walker, Canterbury University, New Zealand; Mark A. Fox, Lincoln University, New Zealand; Shu-Keung, Lau, Lingnan College, Hong Kong; T.K.P. Leung, Hong Kong Polytechnic University

In September 1995, the State Council of the PRC promulgated the Ninth Five-Year Plan and Long-Term Targets for the Year 2010, aimed at achieving a transition from a planned economy to a socialist market economy thereby affirming an open market policy in order to boost the confidence of foreign investors. The plan outlines the overall targets for the period 1996 to 2010 and the blueprint for economic development and reform over the next five years from 1996 to 2000. Under the Eighth Five-Year Plan, the PRC undertook a range of reforms in the areas of foreign exchange, fiscal policy, taxation, banking, foreign trade, planning and enterprise in 1994. Foreign exchange reform is the spearhead of the PRC's market-opening policy and forms a key component of the strategy for the reform and development of the banking sector. It introduces new regulations and a change of policy for foreign investors' participation in the foreign exchange market. The ramifications of these reforms will influence foreign investors' strategies for foreign direct investment (FDI) in the PRC.

Under the Eighth Five-Year Plan, the PRC Government's economic reform strategy includes goals such as full alignment with the global economy, internationalisation of the Renminbi (RMB) and fulfilment of the requirements of Article 8 of the International Monetary Fund Agreement. On 25 December 1993, the State Council of the PRC promulgated a Notice for Further Reform of Foreign Exchange Control System which stated that the realisation of full exchangeability of RMB was the ultimate goal for the foreign exchange control system. Subsequently, on 1 January 1994, the PRC replaced the fixed and managed exchange rate system of the RMB with a floating exchange rate system. The move constituted an important step in China's economic reform process.

The conversion to a floating exchange rate system brought about sharp exchange rate fluctuations with an initial volatility range of 50 per cent. The peculiarities of China's economy include high inflation, high economic growth and high unemployment. The inflation rates in July 1995 and as at 31 December 1995 were 21.3 and 14.8 per cent respectively (which could be deemed as an improvement compared with 27.2 per cent at the peak in 1994). The growth rate of Gross Domestic Product (GDP) in the first six months of 1995 was 10.3 per cent. If purchasing power parity holds good in the PRC then the RMB is likely to devalue in the long run due to high inflation. On the other hand, the current bank interest rate is in the 11 to 15 per cent range (this means the real interest rate is negative). According to the Fisher Effect and the International Fisher Effect, the RMB should have faced a high devaluation pressure. However, in 1995, the RMB was stable and even slightly appreciated in terms of nominal exchange rate on a-to-off US dollar and other leading currencies. This was due to strong economic growth and a large balance of payments surplus.

If the PRC's economic situation worsens then multinational corporations (MNCs) with FDI in China will be faced with higher business risk arising from foreign exchange exposures, that is, economic exposure, transaction exposure and translation exposure. Typical instances of added business risk to some of the quality China-based enterprises (CBEs) arising from foreign exchange exposures which are equally applicable to foreign MNCs are discussed below.

During July to September 1995, all CBEs listed on the Hong Kong Stock Exchange ('HKSE') in the form of H shares had declared their interim results for the period ended 30 June 1995. These reports revealed that over 65 per cent of these companies ran their business with a decline in profitability. For example, the profits of the Guangzhou Shipyard International Co. Ltd and Shanghai Hai Xing Shipping Co. Ltd declined by 66 per cent and 72.7 per cent respectively. Their managements attributed the profit decline to the strength of RMB which substantially affected their profit margin. In the case of Guangzhou Shipyard International Co. Ltd, the interim report for the period ending 30 June 1995 showed that over 90 per cent of its turnover was derived from export sales. Although turnover rose by 40 per cent as compared with the same period in the preceding year, profit declined by 66 per cent due to the appreciation of RMB by an average of 3.38 per cent in the nominal rate. This appreciation of RMB is actually a de facto appreciation of about 20 per cent, namely, China's inflation rate less the US inflation rate plus the RMB's appreciation in the nominal exchange rate. The remaining 35 per cent of companies made good progress in their business with high profit growth. Typical examples are the Shanghai Petrochemical Co. Ltd and Yizheng Chemical Fibre Co. Ltd with profit growth of 56.2 per cent and 82 per cent respectively.

Table 1 shows 1995 interim results for CBEs listed on the HKSE. There were significant discrepancies between the percentages of turnover and net profit of some of the companies in Table 1. Table 2 shows the percentage changes.

Most of the companies in Table 2 will declare their final annual accounts for the year ending 31 December 1995 in April 1996. Some will report in May 1996. Jilin Chemical Industrial Co. Ltd and Yizheng Chemical Fibre Co. Ltd
Table 1

<table>
<thead>
<tr>
<th>Company</th>
<th>Earnings per share RMB Yuan</th>
<th>Rise / (Decline)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Maanshan Iron &amp; Steel Co. Ltd</td>
<td>0.006</td>
<td>-93%</td>
</tr>
<tr>
<td>Shanghai Hai Xing Shipping Co. Ltd</td>
<td>0.020</td>
<td>-85%</td>
</tr>
<tr>
<td>Kunming Machine Tool Co. Ltd</td>
<td>0.017</td>
<td>-74%</td>
</tr>
<tr>
<td>Guangzhou Shipyard International Co. Ltd</td>
<td>0.098</td>
<td>-66%</td>
</tr>
<tr>
<td>Tiangbao Brewery Co. Ltd</td>
<td>0.057</td>
<td>-48%</td>
</tr>
<tr>
<td>Luoyang Glass Co. Ltd</td>
<td>0.200</td>
<td>-38%</td>
</tr>
<tr>
<td>Dongfang Electrical Machinery Co. Ltd</td>
<td>0.080</td>
<td>-27%</td>
</tr>
<tr>
<td>Beiren Printing Machinery Holdings Ltd</td>
<td>0.126</td>
<td>-21%</td>
</tr>
<tr>
<td>Tianjin Bohai Chemical Industry (Group) Co. Ltd</td>
<td>0.059</td>
<td>-18%</td>
</tr>
<tr>
<td>Zhenhai Refining &amp; Chemical Co. Ltd</td>
<td>0.110</td>
<td>-8%</td>
</tr>
<tr>
<td>Yizheng Chemical Fibre Co. Ltd</td>
<td>0.225</td>
<td>+43%</td>
</tr>
<tr>
<td>Shanghai Petrochemical Co. Ltd</td>
<td>0.184</td>
<td>+49%</td>
</tr>
<tr>
<td>Chengdu Telecommunications Cable Co. Ltd</td>
<td>0.083*</td>
<td></td>
</tr>
<tr>
<td>Jilin Chemical Industrial Co. Ltd</td>
<td>0.196*</td>
<td></td>
</tr>
<tr>
<td>Harbin Power Equipment Co. Ltd</td>
<td>0.464*</td>
<td></td>
</tr>
</tbody>
</table>

* Listed on HKSE in December 1994. No comparative figure.

Table 2

<table>
<thead>
<tr>
<th>Company</th>
<th>Change in turnover</th>
<th>Net profit RMB Yuan 100 million</th>
<th>Change in net profit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shanghai Petrochemical Co. Ltd</td>
<td>+36%</td>
<td>12.08</td>
<td>+56%</td>
</tr>
<tr>
<td>Yizheng Chemical Fibre Co. Ltd</td>
<td>+45%</td>
<td>8.36</td>
<td>+82%</td>
</tr>
<tr>
<td>Zhenhai Refining &amp; Chemical Co. Ltd</td>
<td>+38%</td>
<td>2.56</td>
<td>+16%</td>
</tr>
<tr>
<td>Tiangbao Brewery Co. Ltd</td>
<td>+24%</td>
<td>0.5150</td>
<td>-50%</td>
</tr>
<tr>
<td>Guangzhou Shipyard International Co. Ltd</td>
<td>+40%</td>
<td>0.4838</td>
<td>-66%</td>
</tr>
<tr>
<td>Kunming Machine Tool Co. Ltd</td>
<td>+44%</td>
<td>0.0415</td>
<td>-74%</td>
</tr>
<tr>
<td>Shanghai Hai Xing Shipping Co. Ltd</td>
<td>+6.4%</td>
<td>0.5051</td>
<td>-73%</td>
</tr>
<tr>
<td>Maanshan Iron &amp; Steel Co. Ltd</td>
<td>-3.9%</td>
<td>0.4001</td>
<td>-93%</td>
</tr>
</tbody>
</table>

declared their final annual accounts for the year ending 31 December 1995 on 25 and 26 March 1996 respectively. The net profit of Jilin Chemical Industrial Co. Ltd was RMB Yuan 0.744 billion, a growth rate of 23.59 per cent which was lower than that expected by most financial analysts. The net profit of Yizheng Chemical Fibre Co. Ltd was RMB Yuan 1.213 billion, a growth rate of 24 per cent which was much lower than the growth rate of 82 per cent in the first half year as revealed by the interim report. Management expressly attributed the profit declines to lower margin profit as a result of lower export prices and higher production costs due to the strength of RMB, high domestic inflation and the higher cost of imported petroleum raw material.

On 26 March 1996, the date after the filing of final annual accounts by the Jilin Chemical Industrial Co. Ltd, the 'H Share Index' (the share index especially for those state-owned enterprises listed on the HKSE), had dropped from 858.95 to 849.67, a drop of 3.5 per cent with an average company P/E ratio of 7.71. The Hang Seng Index dropped 1.145 per cent with an average company P/E ratio of 13.64. These figures demonstrate investors' pessimistic expectations of the business performance of CBEs listed on the HKSE.

The above examples illustrate the existence of business risks and opportunities peculiar to different industrial sectors. Some industries will benefit from China's high economic growth and tremendous market potential. Other industries will suffer from unfavourable side effects such as the high inflation rate, current strength of RMB, business credit problems arising from the huge amount of backlogged accounts receivable and payable among state-owned enterprises, and the high nominal interest rate. It is noticeable that the accumulated amount of backlogged accounts receivable and accounts payable as at 31 March 1996 was estimated as 17 per cent of China's GDP.

The peculiarities of China's business environment mean that there are a number of advantages and disadvantages relating to the floating exchange rate system which should be of interest to foreign MNCs. These are discussed below.

A COMPARISON OF THE FIXED AND FLOATING EXCHANGE RATE SYSTEMS

The fixed exchange rate system

Under the fixed exchange rate system the RMB continuously devalued during the 1980s. The criteria for these devaluations were noticeably different from those adopted by most western countries. Western countries (operating a
fixed exchange rate system) will typically devalue on the basis of factors such as: growth in money supply, government deficits, financing-level trends, domestic wage levels and changes in productivity. By contrast, the only criterion adopted by the Chinese Government to determine the degree of devaluation of the RMB was the cost of exports in terms of RMB Yuan for exchanging one US dollar. For example, in January 1981 the exchange rate of RMB was Yuan 1.52/US$1. The cost of exports rose in January and October 1985 and the exchange rate was devalued to Yuan 2.79/US$1 and Yuan 3.21/US$1 respectively. In June 1986, the exchange rate was further devalued to Yuan 3.73/US$1, and remained unchanged until December 1989.

The Foreign Exchange Adjustment Centre

In order to facilitate the transition from a fixed-rate system to floating-rate system, a Foreign Exchange Adjustment Centre (FEAC) was established in early 1986 in the Shenzhen Special Economic Zone. The Centre was established with the approval of the People’s Bank of China, and is under the management of the Finance and Trade Office of the Shenzhen Municipal People’s Government. The Centre is accessible to both state-owned enterprises and enterprises with foreign investment in China. Enterprises may exchange currencies at the Centre without going through the People’s Bank of China or the State General Administration of Exchange Control (SGAEC).

With the establishment of the FEAC there were two foreign exchange rates – the official fixed exchange rate and the FEAC rate. In April 1988, the spot rate of the foreign exchange adjustment centre was Yuan 4.20/US$1 which was basically equivalent to the cost of exports in terms of Yuan exchanged for one US dollar. On 31 December 1993 – the eve of the implementation of the floating exchange rate system – the official fixed exchange rate was Yuan 5.80/US$1 while the FEAC rate was Yuan 8.70/US$1, an exchange rate differential of approximately 50 per cent.

In 1988 FEACs were set up in most large cities of the coastal areas. A headquarters was set up in Beijing. The practice of the Centre is as follows:

- MNCs with foreign investment in China adjust their foreign exchange with other MNCs and SOEs adjust with other SOEs.
- Foreign exchange transactions are handled through the Adjustment Centre without the buyer meeting the seller face-to-face.
- The exchange rate of RMB against foreign currencies is determined by the Centre according to the quoted bank rate in the light of the daily demand and supply situation for the various currencies involved and with reference to the conversion rate for foreign exchange retained by SOEs.

The floating exchange rate system

Prior to the introduction of the floating exchange rate system there were two exchange rate systems – the official fixed exchange rate system and the FEAC rate system – which operated simultaneously. On 1 January 1994 the floating exchange rate system commenced operation replacing the existing system. The short and long-term goals of the floating exchange rate system are as follows:

Short-term goals

At present foreign exchange controls on most current account items of the balance of payments (namely trade items and trade-related service items) have been abolished to facilitate the exchangeability of RMB. The government’s direct intervention on the foreign exchange market will be minimised and replaced by indirect intervention through macro-economic policies, that is, policies relating to trade, finance, industry and investment.

Long-term goals

The long-term goals of the floating exchange rate system are convertibility of the RMB in the local foreign exchange market and internationalisation of the RMB; thereby facilitating full alignment of the Chinese economy with the global economy, and fulfilling the obligation of Article 8 of the International Monetary Fund Agreement. These goals could also meet part of the requirements for the PRC to apply for membership of the General Agreement on Tariffs and Trade (‘GATT’).

NEW POLICY FOR FOREIGN INVESTORS: THE CANCELLATION OF FOREIGN EXCHANGE CERTIFICATES

From 1 April 1980, the People’s Bank of China issued Foreign Exchange Certificates (FECs), for foreigners’ purchase of commodities and services in PRC. The underlying purpose was foreign exchange control. Before 1 January 1995, foreign investors were not allowed to take RMB out of the PRC. Instead, they took out FECs. As a result of the foreign exchange reform foreign investors can now take out RMB cash with an upper limit of RMB6,000.

On 28 December 1993, the People’s Bank of China announced via the Notice for Further Reform of Foreign Exchange Control System that:

1. with effect from 1 January 1994, they would no longer issue the FEC;
2. with effect from 1 January 1995, they would cease the exchangeability of FEC; and
3. foreign investors could convert an FEC back into US dollars before a deadline of 30 June 1995 at an exchange rate of RMB Yuan 5.80/US$1 which was the closing official rate as at 31 December 1993.

---

ADMINISTRATIVE PROCEDURES FOR THE FLOATING EXCHANGE RATE SYSTEM

In order to achieve the above goals, the following foreign exchange control procedures have been implemented:

1. Abolition of both the fixed exchange rate system and the Foreign Exchange Adjustment Centre rate system. The new floating rate system is operated on the basis of market supply and demand. Hence, China is in a position to meet the membership requirements relating to foreign exchange system for both the IMF Agreement and GATT. At the very least, the move to a floating exchange rate system will strengthen the PRC's relationship with these two organisations. In the meantime, it provides a solid foundation for the free exchange and internationalisation of RMB.

2. Abolition of direct intervention in the foreign exchange market.

3. The operation of foreign exchange services by banks. Commercial and professional banks have been permitted to operate some foreign exchange business, including: the acceptance of foreign currency deposits; purchase and sale of foreign currencies; and the provision of foreign currency loans. The provision of such services by banks helps provide a favourable financial environment for export business to reinforce competitive conditions.

4. Establishment of the interbank foreign exchange market. Prior to the implementation of the floating-rate system, the foreign exchange market was constituted by the FEACs over the 18 large coastal cities which operated for spot transactions only. The spot rate of the RMB was fixed by the State General Administration of Exchange Control, taking into account the export cost in terms of RMB exchanged for one US dollar. Under the floating-rate system, the foreign exchange market is now constituted by those banks approved for foreign exchange business, which now form the foreign exchange interbank market and the retail market. The main features of this market are listed below:

   - The interbank market and retail market: as with the global foreign exchange market, the market in the PRC consists of two tiers, the interbank or wholesale market and the client or retail market which is supervised by the People's Bank of China through the SGAEC.
   - The Foreign Exchange Centre: the Foreign Exchange Centre was established under the Ordinance of Foreign Exchange Centre promulgated on 28 February 1994. The Foreign Exchange Centre is a non-profit making legal entity with 200 members which functions as an organiser, intermediary and the management of the interbank market. The Centre enacts and enforces regulations and codes of trade from time to time to sustain a fair and transparent market operation. The centre also provides centralised trading facilities to its members, such as a computerised clearing and settlement system, and a screen-based system for quotation, information and surveillance. The exchange rate: The People's Bank of China quotes the RMB mid-rate against the US dollar daily. This rate is determined by reference to the rate of the preceding date. As to the rate of RMB against the various currencies, the People's Bank of China will also quote daily with reference to the global foreign exchange market situation. The authorised banks for foreign exchange business declare bid and offer quotations to their customers individually with a restricted spread and floating range.

NEW REGULATIONS FOR FOREIGN ENTERPRISES: THE ANNUAL FOREIGN EXCHANGE AUDIT

To cope with the further relaxation of foreign exchange controls, the SGAEC promulgated the Provisional Regulations on Annual Audit of Foreign Exchange for Foreign Enterprise on 13 January 1995. The broad contents of the regulation are as follows:

Implementation

The SGAEC and its local branch offices appoint Chinese Certified Public Accountants to act as their representatives to undertake the annual audit of foreign exchange. The audit result is then submitted to the SGAEC for scrutiny. For audit quality assurance, the SGAEC may undertake direct spot checks.

Content of annual foreign exchange audit

Audit work falls into the following broad categories:

1. the current status of the Certificate of Registration for Foreign Exchange of Foreign Enterprise;
2. the situation of all foreign exchange accounts and transactions;
3. the balance between foreign exchange income and payment;
4. the purchases and sales of foreign currencies and their utilisation;
5. the situation of liabilities denominated in foreign currencies;
6. import and export business transactions;
7. the obligation of the foreign enterprise under its commercial contracts taking into account the Memorandum and Articles of Association, the degree of

---

6 Ibid.
7 Ibid.
8 Ibid.
utilisation of capital employed, the ratio of local sales to
total production/import and the like;
(8) proper submission of statutory required reports and
statements;
(9) any other transactions involving foreign exchange.

The timing and the administrative control
procedures of SGAEC

The regulations require foreign enterprises to submit the
audited foreign exchange report to the SGAEC by 31 March
annually. Two weeks later (but before 30 April), foreign
enterprises can then submit the Certificate of Registration
for Foreign Exchange of Foreign Enterprise to the SGAEC
for renewal.

Those foreign enterprises which have failed in the audit
will not be allowed to participate directly in the foreign
exchange market. They must first apply for approval from
SGAEC for every foreign exchange transaction.

THE IMPACT OF THE FLOATING
EXCHANGE RATE SYSTEM

Positive effects for foreign direct investment

There are a number of advantages and disadvantages to
the foreign exchange system reform. For example, on
31 December 1993, the eve of the execution of the floating-
rate system, the official fixed rate of RMB was Yuan
5.80/US$1. On 1 January 1994, under the floating-rate
system, the exchange rate of the inter-bank market and
retail market was Yuan 8.70/US$1 which represented a
devaluation of approximately 50 per cent. The underlying
rationale of the Chinese government for this large
devaluation can be summarised as follows:

- Stabilise the exchange rate and minimise speculative
activities. The large devaluation could minimise specula-
tive activities in the newly formed foreign exchange
market thereby sustaining a more stable exchange rate
trend. During the one and a half years ending 30 June
1995, the exchange rate of Yuan vis-à-vis the US dollar
and most leading foreign currencies was very stable and
even appreciated by 3.58 per cent against the US dollar.

A further nine months later, as at 23 March 1996,
the Yuan had appreciated further by 14.54 per cent
from Yuan 8.39/US$1 to Yuan 7.17/US$1 as a result of
excessive demand for Yuan by foreign investors for their
investments in the PRC. In 1995, FDI continued to
grow with 37,126 newly established foreign enterprises
and foreign investment contracts amounting to
US$90.3 billion. FDI also hit an historical record high
of US$37.7 billion in 1995, which reflected a growth
rate of 12 per cent in comparison with 1994. Hence, the
large devaluation on 1 January 1994 could be treated as
a provision for offsetting the aforesaid appreciation pres-
sure as a result of excessive demand for the Yuan by FDI.

- Adjustment for the nominal exchange rate equivalent
to the cost of exports. Such a devaluation could bring the
RMB down to a more realistic value thereby providing
foreign enterprises and SOEs room for profit mark-up
and competitive pricing.

- Strengthen the competitive conditions of export products.
Devaluation could provide SOEs with scope for profit
mark-up and competitive pricing in a highly inflation-
ary situation. During 1995 export growth rate has been
as high as 32 per cent with total exports amounting to
US$ 280.85 billion, while foreign exchange reserves (as
at 31 March 1996) accumulated to US$ 80.83 billion,
the fourth highest in the world. As a consequence,
enterprises with foreign investment and SOEs have
benefited.

- Provision of competitive conditions for international
trade for joining GATT: Devaluation has served to pro-
vide competitive conditions for international trade for a
successful membership application of the General
Agreement on Tariffs and Trade.

Furthermore, the long-term goals of the floating rate
system will provide substantial benefits to foreign MNCs
and SOEs. The long-term goals of the economic reform
process will create improved business opportunities for both
the foreign MNCs and SOEs. Thus foreign investors can
more effectively take advantage of their intangible capital in
the form of technological know-how, organisational skills
and general marketing skills. Also, due to the devaluation
of RMB, their return on investment will be higher. In turn,
the pay back period will be shortened.

Adverse impact on foreign MNCs' FDI

The floating-rate system may bring about a number of
adverse impacts to some industrial sectors. These must be
addressed for the benefit of foreign investors, SOEs and
ultimately the PRC's economic reform as a whole. The main
adverse impacts are:

- Foreign exchange exposure. Under the fixed and man-
aged exchange rate system, the devaluation of RMB
was more predictable. Under the floating exchange rate
system, there are no forward, futures or options markets
for the application of contractual hedging techniques to
protect against foreign exchange risk, that is, economic
exposure, transaction exposure and translation exposure.
Also, swap agreement techniques, that is back-to-
back or parallel loans, currency and credit swaps are
prohibited by the PRC's foreign exchange control
system.

Thus, operating strategies become the only means for
foreign MNCs and SOEs to protect against foreign
exchange risks such as use of the Reinvesting Centre,
accounting practices such as Leads and Lags and retin-
ing the transfer of funds between independent firms and
between affiliates. Hence, MNCs and SOEs will be
faced with greater foreign exchange risk under the
new system.

- Real value appreciation of RMB due to the net capital
inflow of the balance of payment. The inflation rate of
the PRC declined from 27.2 per cent, the peak in 1994, to
21.3 per cent in July 1995. If purchasing power parity,
the Fisher Effect and the International Fisher Effect
hold exactly good, then the RMB should devalue in line
with the high inflation rate. But the nominal rate has
appreciated from Yuan 8.6800/US$1 in April 1994 to
Yuan 8.3180/US$1 on 11 September 1995 by 4.17
per cent. The de facto appreciation of RMB in real value

9 Note 3 above.
vis-à-vis US dollar would be about 22.87 per cent, namely, the PRC’s inflation rate of 21.3 per cent plus appreciation in nominal value of 4.17 per cent less US inflation rate of 2.6 per cent in September 1995.

Real value appreciation

The main reasons for the real value appreciation of the RMB are attributable to the excessive demand for the RMB as a consequence of the following:

* Net capital inflow of balance of payments. In view of China’s high economic growth, tremendous market potential, opportunities for foreign investors to take advantage of their intangible capital in the form of technological know-how, organisational skills and general marketing skills, an increasing number of foreign MNCs undertake direct foreign investment in the PRC. During the last 16 years, more than 250,000 foreign enterprises have been established in China, and the accumulated amount of FDI as shown in the capital account of the balance of Payments as at 31 January 1996 reached US$135 billion. As a consequence, demand for RMB increases which causes the RMB to strengthen. In turn, export-oriented businesses lose their competitive pricing advantage.

* Macro-economic adjustment. Due to the contraction of bank credit and money supply, most foreign MNCs and SOEs have experienced a shortage of RMB. To solve their cash-flow problems, they may sell their foreign currencies in exchange for RMB. Such action strengthens RMB. This situation is particularly disadvantageous for those enterprises whose business is export oriented. As a result of the strength of RMB they could lose their competitive pricing advantage.

* Export business has lost the industrial protection previously granted under the fixed exchange rate system. Under the fixed exchange rate system, export businesses, especially those of SOEs, were protected by the devaluation of the RMB. Under the floating exchange rate system, the devaluation practice has been abolished. In turn, export-oriented enterprises lose industrial protection provided by RMB devaluation. This poses a new business risk to those direct foreign investments with export orientation. For example, there are 15 China-based enterprises listed on the HKSE. Most of their businesses are export oriented. Between July and September 1995, they declared their interim reports. Twelve showed a decline in profit after tax; six of these sharply declined in the range of 48 per cent to 93 per cent.

* Increased credit risk. In the PRC most enterprises are state-owned. As mentioned above, they are no longer protected by the RMB devaluation policy. Also, their financial situation is generally worsening because of credit contraction under macro-economic adjustment. They are experiencing cash-flow problems which in turn bring about a backlog of accounts receivable and accounts payable. As at 31 March 1996, the accumulated backlog of accounts receivable and accounts payable was estimated as 17 per cent of PRC’s GDP. Ultimately, the resulting credit risk (bad and doubtful debts) will be borne by the banking system and those MNCs who have a business relationship with SOEs.

* Adverse effect on profit tax. Since 31 December 1993, the eve of the execution of the floating exchange rate system, the official fixed exchange rate of RMB has devalued by 43.41 per cent from Yuan 5.8000/US$1 to Yuan 8.3180/US$1 (the closing floating exchange rate as at 11 September 1995). The implication is that MNCs and SOEs will be liable for higher profit taxes due to a larger amount of sales turnover.

* Change in industrial structure. The RMB is overvalued due to the net capital inflow of balance of payments and the contraction of credit for macro-economic adjustment. The combination of import restrictions and the overvaluation of RMB will cause a severe impact on those enterprises whose business relies heavily on imported raw materials. Also, those enterprises with low operational efficiency will be eliminated as a result of losing industrial protection through RMB’s devaluation. In turn, this will bring about credit problems to the banking system. This will become an added business risk to those MNCs whose operations rely heavily on imported raw materials.

CONCLUSION AND RECOMMENDATIONS

There are advantages and disadvantages relating to the PRC’s reforms of the foreign exchange system. If the long-term goals of the floating exchange rate system are achieved, then the beneficial effects derived from the new system will outweigh the adverse impacts. The long-term goals are for the RMB to be freely convertible in the local foreign exchange market and then internationalised, thereby fulfilling the requirements of Article 8 of the International Monetary Fund Agreement and hence meeting part of the prerequisites for the PRC’s application for membership of the General Agreement on Tariffs and Trade. As a consequence, the PRC’s economy will become more fully aligned with the global economy whereby creating better business opportunities for MNCs and SOEs. In turn, foreign MNCs could take advantage of their intangible capital more effectively in the form of technological know-how, general marketing skills and organisational skills.

There are a number of adverse impacts arising from the floating exchange rate system. The adverse impacts include: foreign exchange exposure; export businesses losing the industrial protection previously granted under the fixed exchange rate system; increased credit risk; adverse effect on profit tax; and change of industrial structure. Some suggestions for tackling these adverse impacts are suggested below.

Establishment of the forward, futures and option markets for managing the foreign exchange exposure

At present, there are a number of technical problems preventing the PRC from establishing a foreign exchange futures and options market. But, at the least, the interbank and retail foreign exchange markets have the preconditions for the establishment of a forward market such as the volume of transactions, number of currencies and sufficient facilities. Currently, the spot market is handling 22 leading foreign currencies. The transaction volume has also grown

Relaxation of foreign exchange controls on foreign exchange swaps

The foreign exchange swap is an effective technique for managing foreign exchange exposure. This is an agreement between two parties to exchange a given amount of one currency for another and, after a period of time, to give back the original amounts swapped. The most common types of foreign exchange swap arrangements are the 'back-to-back' or 'parallel loan', the 'currency swap', and the 'credit swap'.

The foreign exchange swap is prohibited under the Provisional Regulations on Foreign Exchange Control of the People's Republic of China promulgated by the State Council at the end of 1980.

Under the floating exchange rate system, foreign exchange risk becomes an added business risk to foreign MNCs and the SOEs. There is an urgent need to abolish this part of foreign exchange control thereby facilitating the exchangeability of RMB as well as mitigating foreign exchange risks faced by enterprises.

Flexible regime of bank credit contraction

According to the Financial Statistics Report of the People's Bank of China for the period January to June 1995 announced on 24 July 1995, the growth rate of M2 was 32.8 per cent which was slightly higher than the 25 per cent goal. The adverse variance of 7.8 per cent could be attributable to two main reasons, namely: (1) the worsening backlog of accounts receivable and accounts payable among SOEs; and (2) the net capital inflow of the balance of payments. It may be justifiable selectively to relax credit contraction with a view to mitigating the potential credit crisis among SOEs due to their backlog of accounts receivable and accounts payable. Otherwise, the credit crisis will become an added business risk to foreign MNCs who have a business relationship with SOEs.

Selective relaxation of import restriction

As discussed previously, export businesses had been protected by the continuous devaluation of RMB since January 1981. The only criterion adopted by the PRC Government to determine the degree of devaluation of RMB was simply the cost of exports in terms of RMB Yuan for exchanging one US dollar thereby allowing a profit margin for export business. Under the floating exchange rate system, export businesses are no longer protected by such RMB devaluation policy and are suffering from the relative appreciation of RMB. It may be advisable to have a selective relaxation of import restrictions, for example, the reduction of customs duties on raw materials to those industries whose export business relies heavily on imported raw materials. Otherwise, there will be a drastic change in industrial structure as a result of the elimination of less competitive export business resulting in an added business risk to the foreign investor.

Further cancellation of foreign exchange restrictions and scrutiny on current account items of balance of payments

To expedite RMB's free exchangeability through market forces, it is advisable to cancel the foreign exchange quota for trade account or current account items completely and, subsequently, capital account items. On 6 February 1996, the State General Administration of Exchange Control declared that on 1 April 1996, foreign exchange controls on trade or current account items will be further relaxed but that capital items will remain under tight control. Instead, the PRC could utilise macro-economic instruments such as import quota, customs duties and customs tariffs, to sustain and adjust the balance of payments.

Expedite the legislation for the foreign exchange market

Legislation for the standardisation and legalisation of the foreign exchange market would provide a solid foundation for the surveillance, efficient market operation, investor protection and development of the foreign exchange futures and options markets (for example, the Foreign Exchange Centre Operation Regulation, the Foreign Exchange Centre Memorandum and Articles promulgated on 28 February 1994).

Generalise the level of knowledge about foreign exchange

The mechanisms of foreign exchange under the newly established floating exchange rate system are still unfamiliar to most SOEs. It is advisable to generalise the level of their knowledge (for example, of foreign exchange exposure, foreign exchange risk management, hedging instruments, relevant regulations, Purchasing Power Parity, Fisher Effect and Interest Rate Parity) as a means of preventing uninformed speculation.
