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China Adopts a More Balanced Foreign Exchange Control

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China Adopts a More Balanced Foreign Exchange Control

On 5 August 2008, the PRC State Council adopted the second amendment of Foreign Exchange Regulations of the People's Republic of China (the new rules). The new rules adopt a more balanced control mechanism for both inflow and outflow of foreign exchanges in China, and tighten supervision of the cross-border capital flows.

Background

The Foreign Exchange Regulations of the People's Republic of China were first issued by the PRC State Council in January 1996 and subsequently amended in January 1997 (the old rules). The old rules laid down the fundamental foreign exchange policy and legal framework in China:

- The Chinese currency renminbi (RMB) is freely convertible for current account transactions, whereas any conversion between RMB and foreign exchanges for any capital account transactions require State Administration for Foreign Exchange (SAFE) approval or registration.
- All foreign debt is subject to planning and monitoring at the macroeconomic level.
- At the microeconomic level, domestic Chinese enterprises must sell foreign currency revenue to banks unless otherwise approved by SAFE.

Also, because of the shortage of foreign exchanges at that time, the old rules maintained a strict control on the outflow of foreign exchanges but adopted a flexible approach to facilitate the inflow of foreign exchanges.

However, as a result of the pressure arising from the large size of China's foreign exchange reserves accumulated in the course of China's economic reform and expansion in the past 10 years, the new rules adopt a way of balancing the administration of foreign exchanges by tightening restrictions on foreign exchange inflow and relaxing the approach to foreign exchange outflow, even though the fundamental foreign exchange administration framework established by the old rules remains unchanged.

Major Changes Brought by the New Rules

The new rules attempt to further facilitate cross-border trade and investments, improve the mechanism to decide the RMB exchange rate on the basis of market supply and demand, strengthen the monitoring of the cross-border flow of foreign exchanges, and enhance the investigation and sanctions on unlawful activities related to the foreign exchanges. Major changes brought by the new rules include the following.

Balanced Control of the Inflow and Outflow of Foreign Exchanges

The new rules tighten the administration of the inflow of foreign exchanges and direct that all foreign exchange revenues under the current account transactions shall be supported by real and lawful underlying transactions. At the same time, the new rules also enhance the administration of the usage and conversion of foreign exchange revenues under the capital account transactions by subjecting the usage of conversion of such foreign exchanges to strict scrutiny and imposing severe sanctions on the unlawful inflow, conversion and usage of such foreign exchanges.

It is also notable that the new rules allow foreign exchange revenues of Chinese organisations and individuals to be either remitted back to China or deposited overseas, subject to the relevant conditions and terms as approved by or registered with SAFE, in contrast to the old

rules, which required a mandatory return of such foreign exchange income back to China. In addition, the new rules reiterate the latest policy of SAFE by permitting foreign exchange income under current account transactions to be either retained in such a foreign currency or converted into RMB, while according to the old rules, such retaining was generally prohibited.

The new rules also add a new regulation which provides that Chinese organisations (including banks and non-financial enterprises) may provide loans to overseas borrowers subject to the relevant approvals and registration at SAFE. Moreover, according to the new rules, Chinese organisations or individuals may use their self-retained foreign exchange capital or purchase foreign exchange capital from the banks to carry out direct overseas investments or invest in overseas securities, subject to the approval and registration formalities of SAFE or its local counterparts.

Tightened Supervision on Cross-Border Capital Flows

The new rules direct that SAFE maintain constant watch and supervision over the international revenues and expenditures of the State, and publish the statistics of such international revenues and expenditures on a regular basis. Additionally, the new rules direct that all financial institutions engaged in the foreign exchange business shall report to SAFE all relevant information regarding their customers' foreign exchange revenues and expenditures and the status of the foreign exchange accounts. Moreover, all domestic Chinese organisations with foreign exchange operations shall provide their financial statements and data sheets to SAFE.

Based on the above provisions, SAFE may carry out a comprehensive supervision on the cross-border capital flows. Meanwhile, the new rules direct SAFE to establish information sharing and supervision mechanisms with other relevant government departments of the State Council of China.

It is also worth noting that, in the event that the international revenues and expenses suffer or may suffer a material unbalance, or the national economy encounters or may encounter a severe crisis, the State may adopt necessary safeguard or control measures in running the international revenues and expenses according to World Trade Organisation rules.

Enhanced Monitoring and Enforcement

The new rules further clarify and itemise various inspection measures and grant extensive authorities for SAFE to enforce its supervision and inspection powers, including conducting an on-site inspection; investigating relevant institutions or individuals; examining and copying the transaction documents, financial accounts and other relevant data; seizing documents and data which may be transferred, concealed, damaged or destroyed; inquiring into the bank accounts of the party involved in the illegal act of foreign exchange; and applying to People's Court for a freeze or seizure order to attach any illegal funds, assets or any important evidence of the suspected institutions or individuals.

The new rules also stress the due process requirement for the above supervision and inspection powers. According to Article 34 of the new rules, SAFE authorities shall conduct supervisory inspections or investigations in a lawful manner, and there shall be two or more SAFE officials in the supervisory inspections or investigations who shall show their work certificates. Where there are fewer than two persons conducting the supervisory inspection or investigation, or such persons fail to show their work certificates, the entity or individual under the supervisory inspection or investigation shall have the right to refuse to co-operate in such supervisory inspections or investigations.

It must be pointed out that the new rules basically repeat the severe sanctions imposed by the old rules against the illegal usage of the foreign exchanges, and extend such sanctions to the unlawful usage of the RMB Capitals converted from the foreign exchanges.

Conclusion

The fast-changing foreign exchange rules and regulations have always been a major concern for foreign investors in China, particularly given the severe administrative sanctions imposed by the SAFE authorities for any non-compliant activities. Foreign investors intending to make investments in China should keep a close eye on foreign exchange related policies and regulations in order to avoid any regulatory risks.