subscribe

Client Alert

pillsbury

Corporate & Securities | Finance

August 21, 2008

China Revises Foreign Exchange Regulations

by Joseph W. K. Chan and Greg L. Pickrell

On August 5, 2008, China promulgated the revised Regulations on the Administration of Foreign Exchange ("New Regulations"), which became effective on the same date. China's foreign exchange regulations were first promulgated in 1996; they have not been revised since 1997.

Background

After the reform and development in the past decade, China has undergone fundamental changes in its economy and currency. The convertibility of the renminbi ("RMB"), China's legal currency, has increased; the RMB is now freely convertible for revenue accounts.[1] In terms of its balance of international payments, China now boasts the world's largest foreign exchange reserves, currently standing at $1.68 trillion and increasing at an average rate of $38 billion per month in the past year. Inflow and outflow of international capital have been significant as well. These changes, amongst others, have necessitated the current revision of the foreign exchange regulations, which are intended to consolidate the many changes stemming from China's currency and foreign exchange reform in the past decade, address the current situations of China's financial and currency markets, and provide a legal basis for future monetary and foreign exchange policies.

Balance of Payments—Inflow

Given the pressure emanating from the size of China's current foreign exchange reserves, one of the goals of the Chinese government is to achieve balance of payments through administration of foreign capital entering into or leaving China. The New Regulations tighten or reinforce restrictions on the inflow of foreign exchange and its conversion into RMB. In contrast, previous foreign exchange restrictions focused on the outflow of foreign exchange, which would be preceded by conversion of RMB income into foreign exchange.

[1] Revenue account item, or revenue account income, refers to income that is of a recurring nature, such as income derived from trade. Capital account item, or capital account income, in contrast, refers to income derived from inflow and outflow of investment or debt capital.

Revenue Account Income. The New Regulations expressly stipulate that foreign exchange payments of revenue accounts must have a genuine and legitimate basis and that the banks handling such transactions must verify the genuineness and consistency of the transaction documentation. This requirement resonates with a series of initiatives of China's State Administration of Foreign Exchange ("SAFE") in collaboration with the Ministry of Commerce and General Customs Office of China to tighten authenticity review of exports[2] in July 2008.

The New Regulations also restate a recent significant change to the revenue account administration rules. Prior to August 2007, only a portion of the revenue account income may be retained in such an account. Pursuant to a notice issued on August 13, 2007, 100% of revenue account income can now be retained; the recipient of such income is no longer obligated to convert such income into RMB. The New Regulations provide an option for businesses to either retain such income in the account or convert it into RMB.

Capital Account Income. The New Regulations integrate a long-standing principle that conversion of foreign exchange income in capital accounts into RMB must be based on pre-approved underlying transactions.

With regard to foreign currency debts, the New Regulations retain the existing requirement that such debts be registered with a SAFE branch. It would appear that foreign currency debt registration will continue to further SAFE's policy of monitoring foreign currency inflow, especially in view of the influx of the so-called "hot money" that is of a debt nature. False trades and false direct investments are generally believed to be the principal forms of "hot money" in recent years. Some suspect that such debts have been disguised as revenue account incomes, such as advance payments of purchase price in export trades.

The new revenue account administration rules and the integration of the existing capital account administration rules into the New Regulations evince the Chinese government's determination to prevent an influx of international short-term speculative funds.

SAFE will be responsible for overseeing and enforcing these provisions. The New Regulations bestow on SAFE specific powers for such purposes, including, for example, entering relevant business premises to collect evidence, interrogating relevant organizations and individuals, and reviewing and copying relevant financial/accounting documents and information. The New Regulations set forth penalties for violators, including confiscation of all illegal income and imposition of fines.

Balance of Payments—Outflow

In contrast to the restrictions on the inflow of foreign exchange discussed above, China appears to have taken a relaxed approach to the outflow of foreign exchange. For both revenue accounts and capital accounts, the New Regulations keep the rules on RMB conversions for overseas payment obligations and foreign direct investment repatriations. However, with regard to foreign exchange incomes of domestic Chinese organizations or individuals that are maintained offshore, the New Regulations suggest a fundamentally different policy from 10 years ago. Under the New Regulations, domestic Chinese organizations or individuals may now keep their foreign currency incomes offshore.

[2] These three authorities jointly issued the "Measures on Computerized Verification of Inflow and Conversion of Export-Generated Foreign Currency (出口收结汇联网核查办法, the "Measures") on July 2, 2008. Pursuant to the Measures, foreign currency income from exports, including advance payments in foreign exchange, must first be remitted to a special verification account for authenticity verification by the handling bank before such income can be converted into RMB.

Offshore Direct Investments by Chinese Residents

The New Regulations also speak to offshore direct investments by Chinese organizations or individuals. They restate the pre-approval and registration requirements on such investments set forth in a SAFE notice issued in November 2005 (commonly known as "SAFE Circular 75"). The pre-approval and registration of such investments are measures intended to help China reduce the pressure of excessive foreign exchange inflow following certain offshore direct investments by Chinese residents and appreciation of the RMB. According to media reports, the Chinese government may soon promulgate foreign exchange regulations on offshore direct investments by domestic Chinese organizations to implement the New Regulations.

Since the issuance of SAFE Circular 75, the pre-approval and registration of offshore direct investments by Chinese residents has been a highly arbitrary process. Not long ago, a notice issued by the People's Bank of China on the administration of individually owned foreign exchange makes the registration only available to "qualified" overseas investment projects. In contrast, the New Regulations do not explicitly set any registration threshold for offshore direct investments, rousing speculation that a more relaxed registration regime, at least for individual Chinese investors, may be contemplated.

Exchange Rate

As it plays an increasingly important role in the world's economy, China has changed its RMB exchange rate system; China will no longer link the RMB solely to the U.S. dollar, although the United States remains the largest export destination of China. The New Regulations stipulate that the exchange rate system of the RMB will be an administered floating system based on market supply and demand, and SAFE may make adjustments to the foreign exchange market according to market changes and China's monetary policies. Going forward, the exchange rate of RMB may be administered with reference to the U.S. dollar as well as other major foreign currencies.

Monitoring Cross-Border Capital Flow

Addressing the volatile nature of the global financial markets, the New Regulations seek to strengthen the monitoring of cross-border capital flow and establish an emergency mechanism for the balance of payments in order to stabilize China's economy and prevent financial crisis. In line with the principles and rules of the World Trade Organization, the New Regulations provide that China may take necessary protective or restrictive measures with respect to its balance of payments in the event that there is or may be a serious imbalance of international payments or a national economic crisis.

Enforcement

For better enforcement of China's foreign exchange policies, the New Regulations include certain provisions on the supervision and administration of foreign exchange, including certain specific regulatory powers of SAFE delineated above. The New Regulations also set forth various penalty provisions for violations of the law.

Conclusion

The New Regulations reflect the current direction of China's monetary and foreign exchange policies. The promulgation of the New Regulations shows China's determination to enforce such policies for purposes

of its economic security and financial stability. Foreign investors who currently maintain or contemplate investments in China are advised to keep abreast of these policies and regulations, which evolve often, in order to avoid or minimize regulatory risks associated with their investments in China.

For further information, please contact:

Joseph W. K. Chan (bio)
Shanghai
+86.21.63351128
joseph.chan@pillsburylaw.com

Greg L. Pickrell (bio)
Silicon Valley
+1.650.233.4674
greg.pickrell@pillsburylaw.com

This publication is issued periodically to keep Pillsbury Winthrop Shaw Pittman LLP clients and other interested parties informed of current legal developments that may affect or otherwise be of interest to them. The comments contained herein do not constitute legal opinion and should not be regarded as a substitute for legal advice.
© 2008 Pillsbury Winthrop Shaw Pittman LLP. All Rights Reserved.