

CHINA ALERT

CHINA AMENDS FOREIGN EXCHANGE REGULATION

On August 5, 2008, the State Council of China promulgated the Amended Regulation on Administration of Foreign Exchange (“Amended FOREX Regulation”), which took effect on the same day.

The first FOREX Regulation was promulgated on January 29, 1996, and later amended on January 14, 1997. It is the fundamental regulation governing administration of foreign exchange matters in China. Like this original FOREX Regulation, the Amended FOREX Regulation maintains the principles that foreign exchange payment under current account is permitted, and that foreign exchange receipts and payments under capital account are subject to strict scrutiny.

On the other hand, during the past decade, China has undergone fundamental economic changes and now boasts the world’s largest foreign exchange reserves (more than US\$1.8 trillion by June 2008).¹ The exchange rate between the Chinese renminbi (RMB) and the U.S. dollar also surged from 1:8.27 by May 27, 2005, to 1:6.8183 on September 27, 2008. Billions in “hot money” flew into China to try to take advantage of the RMB’s appreciation.

The Amended FOREX Regulation reflects the Chinese government’s policies in this new environment to reinforce the government’s administration of not only the outflow but also the inflow of foreign exchange. The Amended FOREX Regulation includes measures to monitor the inflow of current account foreign exchange into China, to restrict settlement of capital account foreign exchange into RMB, to relax the previous requirement that foreign exchange income should be sold to banks and to grant power to government agencies—mainly the State Administration of Foreign Exchange (SAFE)—to supervise and administer foreign exchange activities in China.

The key changes reflected in the Amended FOREX Regulation are summarized as follows.

1. CURRENT ACCOUNT

The Amended FOREX Regulation maintains the principle that the Chinese government does not restrict foreign exchange remittances for current account transactions.² Compared to the

¹ See information posted at the official website of State Administration of Foreign Exchange (SAFE) http://www.safe.gov.cn/model_safe/tjsj/tjsj_detail.jsp?ID=1104000000000000.19&id=5.

² Article 5 of the Amended FOREX Regulation.

original FOREX Regulation, the Amended FOREX Regulation adds requirements that the transactions should be true and legitimate and that banks should verify the truthfulness of the underlying documents, as well as consistency between such documents and the relevant transactions. It also states that the government has the authority to monitor and inspect the implementation of the foregoing requirements.³ This truthfulness requirement actually is not new and has been reflected in various foreign exchange regulations.⁴ It is believed that the truthfulness and verification requirement are safeguards against the “hot money” that has been flowing—and will continue to flow—into China. In addition to the requirements stated in the Amended FOREX Regulation, other measures recently taken by the Chinese government include the establishment of a network to inspect and monitor the receipts of foreign exchange for exportation and settlement of such foreign exchange to RMB (in order to monitor and restrict the inflow of “hot money”),⁵ as well as a registration requirement on the receipts of advance payments for exports and postponed remittance of payments for imports (e.g., advance payments by foreign buyers for exportation of goods are deemed as foreign debts related to trade, and contracts providing advance payments or Chinese exporters’ actual receipts of advance payments should be registered with SAFE).⁶

The Amended FOREX Regulation relaxes the previous requirement that all current account foreign exchange income should be sold to banks or deposited in foreign exchange accounts,⁷ and allows Chinese entities to keep their foreign exchange income in their bank accounts.⁸ This relaxation was actually stated in a regulation promulgated by SAFE in August 2007 that allowed Chinese entities to retain foreign exchange income generated from current account transactions without any cap.⁹ These measures reflect that the Chinese government is gradually allowing private savings of foreign exchange, which may help to slow down the accumulation of foreign exchange reserves by the Chinese government.

2. CAPITAL ACCOUNT

The Amended FOREX Regulation maintains the requirement that the following foreign exchange capital account transactions are subject to approval by, or registration with, the Chinese government —

- foreign direct investment in China (i.e., the foreign exchange registration of foreign invested enterprises (FIE));
- issuance or trade of securities or derivatives by foreign entities or individuals in China;
- overseas investment (including direct investment and issuance or trade of securities or derivatives) by Chinese entities or individuals;
- Chinese entities’ foreign exchange borrowings;

³ Article 12 of the Amended FOREX Regulation.

⁴ Such as the *Circular on Issues Related to Sale or Payment of FOREX for Non-Trade Transactions Not Explicitly Provided in Current Laws or Regulations* promulgated by SAFE on March 6, 2003, and the *Circular to Adjust Policies on Administration of Current Account FOREX* promulgated by SAFE on April 13, 2006.

⁵ See *Measures to Verify and Monitor the Receipts and Settlement of FOREX For Exportation* promulgated by SAFE, the Ministry of Commerce and the General Customs Administration on July 2, 2008.

⁶ See the *Circular Regarding Certain Issues Related to Implementation of the Registration Administration of Foreign Debts Related to Trade of Goods*, promulgated by SAFE and effective as of July 14, 2008.

⁷ Article 10 of the *FOREX Regulation*, promulgated by the State Council and amended in 1997.

⁸ Article 13 of the *Amended FOREX Regulation*.

⁹ See the *Circular regarding Chinese Entities’ Retaining FOREX Income under Current Account*, promulgated by SAFE on August 12, 2007.

- Chinese entities' security interest to foreign parties;
- Chinese entities' loans to foreign parties, except for financial institutions whose business scopes have allowed them to do so;
- maintenance of capital account foreign exchange income or the sale of such foreign exchange to banks;
- other capital account foreign exchange payments subject to governmental approval as required under Chinese law.¹⁰

There are several noteworthy changes:

1. Compared to the previous FOREX Regulation, the Amended FOREX Regulation no longer requires SAFE to verify the sources of foreign exchange that a Chinese entity will use for its overseas investment so as to facilitate overseas investment.¹¹
2. The government exercises control over the scale of foreign debts.¹² In particular regarding FIEs in China, which used to be allowed to have foreign debts up to the difference of their total investment and their registered capital, this "control over the scale" provision indicates that in order to decrease the amount of foreign exchange flowing into China, the Chinese government may take actions to allow FIEs to have foreign exchange borrowings only up to the amount of its total investment, minus its registered capital, and further minus its RMB borrowings (if any).
3. The Amended FOREX Regulation no longer requires that capital account foreign exchange income should be sold to banks, but the retention of such foreign exchange income or its conversion into RMB is still subject to approval by the government.¹³ A relevant change is that the Amended FOREX Regulation does not require that Chinese entities or individuals remit income generated overseas back to China. Instead, the Amended FOREX Regulation leaves the door open to the possibility that, depending on circumstances, the Chinese government may allow such income to be retained outside of China.¹⁴ Currently some regulations explicitly require the remittance of such overseas income back to China (such as the famous Decree No. 75 regarding round-tripping investment by Chinese entities or individuals, promulgated by SAFE in October 2005). When and how overseas income may be retained overseas will depend upon the specific detailed regulation(s) to be issued by the government.

In addition to the changes reflected in the Amended FOREX Regulation, nearly one month after the Amended FOREX Regulation became effective, SAFE issued a new regulation (i.e., Circular 142)¹⁵ on August 29, 2008, to control settlement of capital account foreign exchange to RMB. Circular 142 explicitly states, inter alia, that FIEs cannot settle their registered capital from foreign exchange to RMB for activities beyond their business scope, for equity investments in China, for the purchase of non-self-use real estate properties, or for investment in securities (unless they otherwise comply with the relevant law). Before Circular 142, FIEs' settlement of their registered capital from foreign exchange

¹⁰Articles 16 to 22 of the Amended FOREX Regulation.

¹¹Article 17 of the Amended FOREX Regulation and Article 21 of the FOREX Regulation promulgated and amended in 1997.

¹²Article 18 of the Amended FOREX Regulation.

¹³Article 21 of the Amended FOREX Regulation.

¹⁴Article 9 of the Amended FOREX Regulation (cf. Articles 9 and 19 of the *FOREX Regulation* promulgated and amended in 1997).

¹⁵The *Circular on Relevant Operational Issues Related to Improve the Administration of Settlement and Payment of FIEs' FOREX Registered Capital* ("Circular 142"), promulgated by SAFE on August 29, 2008.

to RMB was not subject to governmental approval. Apparently, these changes were instituted for the purpose of preventing “hot money” from flowing into Chinese markets in the name of foreign direct investment, preventing FIEs from using funds in areas that the Chinese government intends to cool down (such as real estate and the stock market) or in areas that are different from the business of FIEs (such as an FIE’s equity investment in a different business sector). This new regulation will help the government obtain more accurate statistical data regarding foreign direct investments in China.

3. FINANCIAL INSTITUTIONS

While the Amended FOREX Regulation contains only three articles regarding the foreign exchange business of financial institutions, for the first time Chinese law states that SAFE will administer the overall foreign exchange positions of financial institutions.¹⁶ This actually means that in addition to administration by the People’s Bank of China (PBOC) and the China Banking Regulatory Commission (CBRC), financial institutions’ foreign exchange business will be subject to control by SAFE. Nonetheless, the Amended FOREX Regulation does not provide any detail regarding how SAFE will administer the foreign exchange positions, and it is expected that it will take time for SAFE to reach an agreement with other government authorities on detailed administration measures.

4. GOVERNMENT’S POWER TO SUPERVISE AND TO TAKE ACTIONS AT EMERGENCIES

The Amended FOREX Regulation adds six articles granting power to SAFE to supervise and administer the foreign exchange activity of financial institutions, entities and individuals.¹⁷ Such power is extensive, including the authority to make on-site inspections of financial institutions, to investigate and collect evidence, to question entities and individuals who have foreign exchange expenditure or income, to review and copy relevant documents related to violation of foreign exchange regulations, to request financial statements from Chinese entities that have foreign exchange activities, etc.¹⁸

Furthermore, the Amended FOREX Regulation states that, in case of severe imbalance (or potential severe imbalance) of receipts/payment or domestic economic crisis (or potential crisis), the Chinese government may take necessary protective or control measures.¹⁹

CONTACT INFORMATION

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¹⁶Article 25 of the Amended FOREX Regulation.

¹⁷Articles 33 to 38 of the Amended FOREX Regulation.

¹⁸Articles 33 and 35 of the Amended FOREX Regulation.

¹⁹Article 11 of the Amended FOREX Regulation.