

# The Impact of International Capital Flow on the Effectiveness of China's Monetary Policies

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**Keywords:** International capital; Capital flow; Monetary policies; Effectiveness impact

**Abstract:** The liberalization of international capital flows already became one of the important features of world economic development while international capital flows turned into a vital content and the most powerful driving force of economic globalization. The scale and structure of international capital flows have a wide-ranging and far-reaching influence on the world economy and the economies of various countries. Therefore, analyzing the degree of capital flow in a country is very necessary for analyzing the effectiveness of monetary policies. Based on this, this work first explored the influence mechanism of international capital flows on the transmission channels of monetary policies, and finally summarized how international capital flows affected the effectiveness of China's monetary policies. The research results of this work have important practical significance for controlling China's financial risks and maintaining economic health, sustained and rapid growth.

## 1. Introduction

Under open conditions, by virtue of the characteristics of profitability of capital which is in the form of currency or factors of production such as labor, means of production, science and technology, these capitals will move from countries or regions with low returns to countries or regions where returns are high. Correspondingly, the international changes of capital under such conditions are called international capital flows. With the reform and opening up, China's foreign economic exchanges have increased rapidly. Besides, the employ of foreign capital became a basic national policy of China and China has gradually turned into the hot spot for international investment. Since 1993, China has ranked first among other developing countries and second in the world in absorbing foreign direct investment, and its foreign debt balance grew rapidly as well [1]. However, China started late in the aspect of foreign investment with slow development, and the scale of capital outflow was also small and low-level, which was extremely disproportionate to Chinese international status and overall national strength. Nevertheless, the academic circles at home and abroad have not yet fully unified the definition of the effectiveness of monetary policies. Related scholars generally define it from the following three levels: The first is whether monetary policy can affect the real economy [2]. Second, how does the monetary policies influence the actual economic variables. The third is how the monetary authority uses monetary policies tools to achieve established goals.

## 2. The Influence Mechanism of International Capital Flow on Intervention Channels of Monetary Policies

### 2.1. Interest rate channel

The interest rate channel is regarded as one of the most important channels. The reduction in interest rates implies that people can borrow money at a lower cost, namely, the public's financing costs are decreased thus to make the public spend more money on investment, and the total output of society will also increase sequentially. However, it is worth noting that the growth in the money supply is not the central bank's intention. Accordingly, the central bank used to take the measures of opening market operations or raising the statutory deposit reserve ratio to recover part of the supply. Due to the increase of the real interest rate, the cost of public financing will raise relatively,

and the public's investment funds will be cut down as well, thereby offsetting part of the effect of increasing the money supply of interest rates, business investment, and high output.

## **2.2. Exchange rate channel**

The basic train of thought of the exchange rate transmission channel is as follows: Total output will change with the transformations in net exports, and net exports are directly determined by the exchange rate of the domestic currency. Meanwhile, differences in domestic and foreign interest rates will lead to changes in the exchange rate of the domestic currency, and variations in domestic interest rate will change owing to transformations in the domestic money supply. In the circulation of capital, the net inflow of a variety of international capitals is going to result in a passive increase in China's money supply, which in turn will cause the real interest rate to fall. Consequently, investors will go to the foreign exchange market under the effect of interest rate parity, which will further reduce the value of the local currency.

## **2.3. Credit channel**

Credit transmission channels mainly refer to the fact that when bonds, stocks and bank loans in the economy cannot be completely replaced, the source of bank credit funds is closely related to changes in the money supply, which in turn affects credit, and further leads to impact on the monetary policies transmission mechanism of consumer demand and investment. In conclusion, there are two key transmission channels for credit transmission, namely balance sheet and bank credit. The massive expand in the net inflow of international capital has caused a continuous increase in bank deposits, which will develop the amount of loans in a sense, and this will stimulate public consumption and corporate investment, so that there will be a continuous growth in total output.

## **3. How International Capital Flows Affect the Effectiveness of China's Monetary Policies**

Although the Chinese government claims that China implements a system of managed floating exchange rate, it is over-managed and insufficiently floating. The exchange rate transmission mechanism of monetary policies is not able to be established in China. As a result, the current impact of international capital flows on Chinese monetary policies is mainly manifested in the money supply, currency value of RMB, monetary policies and prices [3].

### **3.1. The impact of international capital flows on money supply**

Under a floating exchange rate system, capital flows will not cause fluctuations in the reserve currency, because changes in the exchange rate offset the impact of capital flows on the reserve currency. On the other side, when there is capital inflow from abroad (such as direct investment), the supply of foreign exchange in the foreign exchange market expands under a fixed exchange rate system, and the exchange rate of the domestic currency tends to appreciate as well. At this time, in order to maintain the stability of the exchange rate, the central bank has to intervene in the foreign exchange market to prevent the appreciation of exchange rate. Moreover, the central bank sells the local currency to absorb excessive foreign exchange supply to prevent the exchange rate appreciation of the local currency, which will cause the inflow of international capital and convert it into the central bank's foreign exchange reserves. As international capital flows in, the central bank actually assumes the task of stabilizing the exchange rate, which makes the People's Bank of China have to passively adjust the reserve currency to preserve the stability of the exchange rate along with capital flows. In this respect, while the central bank buys foreign exchange to stabilize the exchange rate, a large amount of money flows into the market, thus affecting the release of base currency. The increase in the base currency will double the money supply through the currency's multiplier effect, which will further lead to an growth in the domestic price level and even result in inflation.

### **3.2. The impact of international capital flows on RMB currency value**

A large amount of international capital has flowed into China, which is manifested by the increase in foreign currencies and the relative decrease of the RMB. In the foreign exchange market, the demand for domestic currency is greater than the supply, and the external performance is the appreciation of the RMB. Affected by changes in supply and demand factors, foreign investors are trying their best to purchase Chinese assets, and the foreign exchange market of RMB under the fixed exchange rate system is immediately under pressure from exchange rate appreciation. In addition to supply and demand factors, James Tobin's asset structure balance model believes that when a huge amount of foreign capital flows in, investors will change their asset portfolio structure, which will affect the exchange rate through transformations in the financial market, leading to the appreciation of exchange rate. The premise of this theory is that investors can freely choose local currency or foreign currency assets. On the surface, China does not own this condition at the present, but China's large amount of disintermediation capital and underdrain hot money widen the extent of the freedom of asset choice for some investors, eventually causing the appreciation in exchange rate.

### **3.3. The impact of international capital flows on prices**

The impact of short-term and long-term capital flows on price fluctuations may be different. This is actually not related to the term structure. It can also be said that the impact of the two on price fluctuations changes over time. It is aggregate demand and aggregate supply that determines the price fluctuations. Therefore, international capital flows mainly affect the above two factors, thus to affect the prices. The influence channels of international capital flows on prices include the followings: direct shocks, indirect shocks and psychological expectations. Firstly, direct shock refers to the direct entry of international capital into a certain commodity market, which causes abnormal price fluctuations of such commodities. Secondly, indirect shock refers to the fact that in order to cope with the increase in funds outstanding for foreign exchange that brought about by international capital inflows, the People's Bank of China has adopted currency offsetting interventions such as bills to stimulate aggregate demand and raise commodity prices. Lastly, psychological expectations represent the fact that a large amount of international capital enters a certain market or region due to the profit-seeking instinct, which will bring about a herd effect, attract more and more capital to enter, and finally cause a severe shock on prices.

### **3.4. The impact of international capital flows on monetary policies**

The central bank's monetary policies independence has been severely damaged. The imbalance of the exchange rate caused by international capital flows is inevitable and frequent. Since China essentially implements a fixed exchange rate system, the central bank's monetary policies must be committed to maintaining exchange rate stability to a large extent. Various forms of international capital inflows have caused the domestic money supply to increase in an endogenous manner. The People's Bank of China passively regulates the RMB, and has to invest a large amount of base currency to absorb the inflow of dollars and adopt a series of macro-control measures to offset the inflationary pressure caused by this. Besides, the gradual opening of the capital market made the operation of monetary policies more difficult [4]. From an international perspective, the flow structure of international capital has gone through the development process of "international bond investment-international bank loans-international direct investment-international securities investment". In terms of attracting foreign investment, the traditional model of relying only on preferential direct investment policies has been unable to satisfy the requirements of the new trend of international capital flows. Since the results of monetary policy transmitted to the securities market are not as predictable as the money market, and the multiplier of pledged loans and the degree of virtual capital inflation are difficult to estimate, the increase in the amount of money is no longer dependent on monetary policies' willingness. There is no doubt that it is more difficult for the central bank to regulate the total amount of money in society through basic money.

Increased sources of international capital flows and difficulties in supervision make it more

tough to implement monetary policies. The massive entry of foreign financial institutions and the acceleration of the internationalization process of my Chinese financial institutions have provided more channels and opportunities for international capital to enter and exit China. With the raising in the number of overseas study, employment, and immigrants, income repatriation has become an important form and channel for capital to flow into China [5]. As China's capital accounts have not yet been fully opened, some short-term capitals often disguise themselves as business projects, or take a series of measures including using underground banks and doing laundry to escape management and enter Chinese market. The increase in the source and the acceleration in the speed of capital flows has made it more difficult to accurately count and effectively monitor capital flows. Meanwhile, the objectives of monetary policies and the effect of policies are hard to be determined as well.

#### **4. Summary**

The analysis of the effectiveness of monetary policies is of great significance to the formulation of China's monetary policies and the development of the national economy. International capital flows affect the effectiveness of China's monetary policies in various of ways. Accordingly, it is necessary to strengthen the supervision of international capital flows, gradually improve the forward-looking and scientific nature of China's formulation and implementation of monetary policies, and finally give full play to the role of monetary policies to enable China to develop national economy well and quickly.

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