FINANCIAL REFORMS, DIVIDED INTERESTS, AND TIPPING POINT POLICY-MAKING: RENMINBI INTERNATIONALIZATION AS A NEW CATALYST FOR STRUCTURAL REFORMS IN CHINA

by

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Abstract

China's RMB has been making quiet march onto the world stage, first into focus in the aftermath of the 2008 financial crisis, and notably gathering pace after 2012. By examining the seeming puzzle of why RMB internationalization, after a long albeit methodical trudge, accelerated after 2012, this paper seeks to offer a theory that could explain the motivations behind China's pursuit of RMB internationalization. I argue that the existing approaches to this question, which primarily looks to the traditional economic factors such as relative national economic fundamentals, cost/benefit of currency internationalization, and impact of external shocks, fall short of explaining the timing, pace and trajectory of the RMB internationalization process. I maintain instead that the source of the dynamics driving RMB internationalization should be located in the structure of political decision making and political imperatives of the key players in the decision making process.

This paper contends that RMB internationalization should above all be viewed in the broad context of China's next round of reforms that centers on liberalizing the financial sector and developing the capital markets. Putting Chinese political decision making in the perspective of fragmented authoritarianism, this paper argues that with the balance of power of interest group coalitions favoring status quo or change in a deadlock, a lever is needed to break the stalemate and tip the balance toward reforms. Recognizing the need for financial reforms as China increasingly reaches the limit of its export-led growth model, political entrepreneurs at PBOC, under the personal leadership of Governor Zhou Xiaochuan and buttressed by the superior institutional resources and capacity, promoted RMB internationalization as the key lever to redistribute incentives and realign underlying coalitions. Capitalizing on favorable changes at the party's top taking place post the power transition, which brought about a degree of centralization of the financial policy decision making that wasn't available previously, Zhou Xiaochuan

and his fellow political entrepreneurs were able to push forward RMB internationalization more effectively that both exposed the need for further financial sector reforms and generated broader support to tip the balance of power toward reforms.

Preface

This dissertation is original, unpublished, independent work by the author, Wanting Lu.

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Dedication

To My Parents and Loved ones

1. Introduction

Ever since the People's Bank of China (the "PBOC") Governor Zhou Xiaochuan in 2009 called for replacing the existing international reserve currency (the U.S. dollar) with a new global system based on special drawing rights, echoed by similar calls from Nobel Laureate Joseph Stiglitz, Renminbi ("RMB")'s internationalization—and what it could mean for the established economic order—has captured the world's attention.[1] Beyond the media hype that inevitably accompanies the rise of a new international currency, however, important questions remain: Why does China pursue the internationalization of RMB? How does China's chosen path of RMB internationalization differ from that of other major national currencies which have gained international currency status in recent memory? In turn, what do those differences tell us about the motivations behind China's drive toward RMB internationalization? Finally, based on our understanding of the motivations for RMB internationalization, what can we infer about the key dynamics that will determine the pace and success/failure of China's RMB internationalization strategy?

The relevance of these interrelated questions is highlighted as we observe the fits and starts that RMB internationalization has experienced since its origin in 1993, when Premier Zhu Rongji committed the government to achieving full currency convertibility by the end of the century. In 1994, it began removing capital account restrictions gradually and established current account convertibility by November 1996. However, when the Asian financial crisis erupted the following year, China dropped its full-convertibility target.

Since then, the pace of RMB internationalization can be best characterized as modest and at times staggering. China waded back into the water of RMB internationalization in the first half of the 2000s. In 2004, China started off experimenting with offshore

[1] Stiglitz (2011)

RMB transactions in an arrangement with Hong Kong to develop an offshore RMB deposit market in the city, followed in 2005 by a shift from a fixed exchange rate anchored against USD to a managed floating regime against a basket of currencies. As RMB appreciated steadily against USD in the next several years (over 30% appreciation by 2014), along with China's growing weight in the global economy, China use Hong Kong as the first offshore RMB center to kick off the new march. From then on, programs such as Dim Sum Bond, RMB Bilateral Swap Deal and Cross-border Trade Settlement were created and gradually rolled out. In 2013, China signed RMB clearing center funding agreements with Singapore, UK and the EU, which opened more possibility for RMB's global development. Indeed, we can observe a general acceleration of RMB internationalization since.

Is RMB internationalization a response to external events and perceived external opportunities? For example, realists may argue that China is incentivized to internationalize RMB to achieve greater political influence regionally in the short term and globally in the long term. Notably, RMB internationalization will increase China's soft power. In addition, the wider use of RMB internationally, no matter as reserve or transaction currency, is a symbol that indicates international investors' confidence in China's economic prospect and in Chinese government's continuing ability to successfully manage the economy. This recognition in turn enhances the governing legitimacy of the Chinese Communist Party as the strategic planner and leader responsible for China's economic development. This logic of power maximization (both at home and abroad) would be particularly tempting for Chinese decision makers in a time of crisis when the weakness of the incumbent power, i.e. the U.S. and U.S. dollar, was exposed like never before. However, this theory is not sufficient to explain why China chose RMB internationalization to increase influence when there are many other ways to seek the same goals. Nor can this theory explain the fact that the pace of RMB internationalization had been quite slow before 2013 and been accelerating since 2013.

The internationalization of RMB is a process of both policy-driven efforts and market-driven forces. While there are fundamental economic rationales that underlie RMB internationalization, political factors, domestic in particular, play critical roles in China's decision (and its timing) to internationalize RMB. Noticeably, China's cautious journey to open up its financial system and to integrate further with the international financial system intertwine with the nation's plan to reform its domestic financial sector. Indeed, the push to internationalize RMB could arguably be best understood in light of China's pursuit of the next round of structural transformation that will reinvent and reenergize its economic growth model.

This paper argues that the political entrepreneurs at the PBOC, China's central bank, led by Governor Zhou Xiaochuan, used RMB internationalization as the key lever to tip the balance of power among domestic political groups in favor of full-fledged financial reform. In their efforts, Zhou Xiaochuan and his allies had taken advantage of favorable changes in international economic environment, leadership commitment and domestic decision making mechanisms. Most important among these changes is the opening up of significant political space with the creation of the Central Leading Team for Comprehensively Deepening Reform (Zhongyang shenhuagaige lingdao xiaozu, the "CDR Leading Group") led by President Xi Jinping. The availability of such political space is critical for the actions of political entrepreneurs.

RMB internationalization is a goal that China is keen to realize in the long term. In the near term, several external structural factors will conspire to hinder RMB from becoming a global currency that could challenge the US dollar. Yet as this paper argues, beneath the surface, the internationalization process in fact triggered the progress of a broader set of structural reforms in the domestic market, which in turn largely determines pace and the long term success/failure of this process. Moreover, the successes and failures of internationalization policy will correspond closely with the rise and fall of domestic political coalitions behind the policy.

2. Why Does China Pursue RMB Internationalization – An Overview of Alternative Explanations

Why does China pursue RMB internationalization? Literature's approaches have mostly fall under three categories. The first is what we will call a deterministic approach, the second a cost-benefit approach, and the third a crisis response approach.

The deterministic approach looks at the historical precedents and analyzes the common determinants underlying the success or failure of those precedents. [2] Generally, three fundamental factors stand out. The first is the size of the home economy, as measured by GDP or trade. The currency of a country that has a large share in international output, trade, and finance has a big natural advantage. The second is the rate of return of the currency, as measured by the long-term trend in its exchange rate, the variability of the exchange rate, the country's long-term inflation rate, and its position as an international net creditor. Expected high rate of returns translate to market confidence that the value of the currency will be stable, and that it will not be inflated away in the future, which is critical in the decision to use a currency in trade or financial transactions. The third is the development of its financial markets, particularly their depth, liquidity, dependability, and openness. To attain international currency status, capital and money markets in the home country must be not only open and free of controls, but also deep and well-developed.

The determinants thus derived are of course necessary conditions of currency internationalization. But for proponents of this approach, these predominantly economic factors also seem to imply sufficient conditions. In the same way that

[2] Among the relevant references are Aliber (1966); Alogoskoufis and Portes (1992); Bergsten (1975); Black (1989); Eichengreen and Frankel (1996); Eichengreen and Mathieson (2001); Frankel (1992, 1995); Kenen (1983); Krugman (1984); Kindleberger (1981); Matsuyama, Kiyotaki, and Matsui (1993); McKinnon (1969; 1979); Portes and Rey (1998); Rey (2001); Swoboda (1969); Tavlas (1993); Tavlas and Ozeki (1992).

rational state actors postulated by realist theorist react to perceived threats and opportunities to maximize national interests, the underlying economic logic implied by these determinants will compel the select countries that meet these criteria to drive for international currency status.

Measured against the lens of these determinants, RMB scores unevenly. In terms of the size of the economy, Chinese economy passed Japan in 2010, to attain the 2nd largest in the world. Some projections claim it will pass the US soon, based on the calculation that at current rates of growth, the Chinese economy may overtake the U.S. economy within a decade, even by the GDP criterion for size, let alone by trade criterion.[3] But it's worth pointing out that what matters here is GDP (& trade) compared at market exchange rates, not PPP-adjusted. And Euroland's GDP is still substantially bigger than China. What's more, Chinese growth will slow down, well before it reaches per capita equality with the West, as recent economic statistics made painfully clear. The second determinant, the rate of return of the currency, seems to tell a similarly supporting story. Although market fluctuation has recently been intensifying, most market participants still expect the RMB to appreciate against the dollar in the long run. China is a creditor and is still running large surpluses while the U.S. is a debtor and is still running large deficits. Despite fears of a financial crisis lurking somewhere down the road for China, it is likely that the rate of return to holding RMB over the next decade will be high. Indeed that is the reason since 2004 for the strong portfolio capital inflows.[4]

But the third determinant for international currency status is conspicuously missing: deep, liquid, open capital markets. By various measure, China's financial markets still rank far behind others.[5] Domestic system is still highly regulated and "financially

[3] Subramanian (2013)
[4] Prasad & Wei (2007)
[5] E.g. Chinn-Ito (2008)

repressed". Even though China has opened tightly controlled access for foreign investors to its domestic capital market, cross-border capital flows still subject to heavy controls and few foreign companies can borrow in China. Compared with international counterparts in developed countries, liquidity, breadth and openness in China's capital markets still have a long way to go.

Similar to the deterministic approach, the cost-benefit approach to why China pursues RMB internationalization also looks at the economic drivers by tabulating the benefits and costs of currency internationalization. Various studies have discussed the costs and benefits linked to the status of international currencies.[6] The benefits of a world reserve currency generally include the following:

- Reduced transaction costs as well as foreign exchange risks, which could also deliver significant profit boost to the banking and other financial sectors by facilitating their funding and expansion abroad. This is particularly relevant for China as the world's largest trading country with growing aspirations of becoming the world's financial center.
- Seigniorage, referring not only to the interest-free foreign holdings of the currency, but to the home country's ability to run up huge debts denominated in its own currency at low interest rates.
- Enhanced macroeconomic flexibility which comes with the loosened constraint of the balance of payments on domestic monetary and fiscal policy. This is also important for China as it will be able to avoid the currency mismatch that has been a problem in many emerging-market crises in the past.
- Political leverage as foreigners' dependence on the issuing country's currency grows. For example, friendly countries may be granted loans or privileged access to the currency in a monetary crisis; conversely, adversaries may be deprived of access to essential clearing networks when political tensions are running high.

[6] E.g. Cohen (2011)

- Reputation and prestige conferred by the currency's broad circulation among nations. "Great powers have great currencies," as Mundell (1993) recognized. As a potent symbol of international primacy, an international currency can become a form of what political scientists call "soft" power.[7]

On the cost side, the main costs linked to the status of international currencies mainly include:

- Over appreciation that could result from increased average foreign demand for a currency. An inflow of capital chasing assets denominated in the issuing country's currency would cause the currency to appreciate and hamper exporters' competitiveness on world markets. In the US case, it has played a role in the over-expansionary stance of the Fed's monetary policy, which can be interpreted as a compensatory reaction of the central bank amid structural over-appreciation of the currency.

- Increased external constraint imposed on domestic monetary autonomy, which could come in two manifestations. One is the risk of undue volatility in the aggregate demand for the currency, which could make it more difficult for policy makers to target interest rates or an appropriate growth rate for money supply. The other is the risk that domestic priorities could be compromised by external factors, especially when investors abroad have to be persuaded to hold onto their accumulated RMB balances.

- Burden of responsibility that comes with international monetary leadership. As an issuing country, China may find itself obliged to assume greater responsibility for managing broader regional or global monetary structures, to accommodate systemic needs or fragilities should conditions warrant, for example, rather than

[7] Soft power refers to the ability to attract and co-opt rather than coerce, use force or give money as a means of persuasion (Joseph Nye 2004)

being free to devote monetary policy solely to domestic objectives.

Proponents of the cost-benefit approach therefore may argue that careful evaluation of the economic benefits and costs informs the rationale of RMB internationalization. Indeed, studies attempting to quantify the cost/benefit linked with the status of international currency have also shown that the RMB's promotion to the status of world reserve currency could have a neutral (with a positive bias) impact on China's growth, similar to the US experience.[8] With its large pool of reserves and the significant global weight of its economy, China has even the potential to avoid the drawbacks of overly long phases of over-appreciation, which medium-size countries, such as Japan, France and the UK, have suffered most from their status as a world reserve currency.

Both the deterministic and the cost-benefit approaches discussed above assume a long-term oriented rational state actor that weighs the options and sees RMB internationalization as interest maximizing. The third approach in literature, however, postulates that RMB internationalization as a discreet series of ad hoc, short term responses to external crises and pressures, rather than a coherent long term national strategy.[9] The timing of China's decisions at various critical junctures of the RMB internationalization process, proponents of this approach notes, seemed to coincide with and be influenced by dramatic external events. In particular, this approach emphasizes the centrality of the global financial crises of 2008 and characterizes the policy steps taken toward RMB internationalization as short term solutions to problems with which the global financial crises had confronted China.

The proponents of this approach argue that the thrust of RMB internationalization measures in the aftermath of the global financial crises falls into two categories, each reflecting a key Chinese concerns over the impact of the crises. The first is to help China's exporters and importers (mainly exporters) stabilize their international trade

[8] Hu (2015)
[9] Bowles and Wang (2013); Gao and Yu (2009)

volume by supplying liquidity to trade partner countries to support trade settlement. The need was made urgently and painfully felt when global trade financing collapsed in the immediate aftermath of the 2008 financial crisis, which contributed to a 20 percent drop in China's exports. The twenty or so bilateral swap agreements that China has signed with countries from Indonesia to UK are clear examples of the RMB internationalization policy tools that address this concern. The second is to avoid losses to China's large foreign exchange reserve (mainly in USD) from a depreciating dollar, while at the same to manage the inflow of hot money speculating on RMB appreciation. The varied internationalization policy programmes such as QDII, QFII, RQFII, and the more recently announced Hugangtong initiative (Shanghai-Hong Kong stock market direct mutual access) fall into this category.

This analysis could also find echoes in other scholars' proposals for a new system based on U.S. dollar, Euro, and RMB in order to ease the ever increasing tension between the limited supply of reserve currencies and the rapidly growing demand for them.[10] They consider RMB internationalization as a solution to China's "excessive" accumulation of foreign reserves, which had not only exacerbated China's own exposure to foreign exchange rate volatility, but also contributed to shortage of liquidity within the international financial and monetary system.

Underlying both concerns, proponents of the crisis management approach admit, was a deeper qualm about (1) what was perceived as irresponsible US regulatory and monetary policies that puts US interest over and above the responsibility of US Dollar as an international currency, and (2) the intrinsic instability of an existing monetary regime based on one national currency that performs the role of global reserve currency. The qualm was most prominently pronounced in Zhou Xiaochuan's call for SDR as a replacement international reserve currency. However, they argue that even Zhou's SDR proposal mostly "served the purpose of countering, and diverting attention away

[10] Emmanuel, Gourinchas, and Rey (2011)

from, the argument that it was China's 'imbalances' which were to blame for the crisis."[11]

The short term and contextual nature of the RMB internationalization measures adapted in the wake of the global financial crises, according to the third approach, was also evidenced by the often contradictory effect that these measures produced. For example, while the adoption of a wider range for RMB exchange rate fluctuation was successful in reducing speculative market expectations for one-way RMB appreciation, it also had the unintended effect of substantially slowing down the development of offshore markets in Dim Sum bonds. It was further argued that because the measures were created as crisis management tools, they are often accompanied by or mixed with measures that were intended to tighten rather than reduce capital controls, and thus keeping RMB further away from the achieving convertibility and internationalization.

[11] Bowles and Wang (2013)

3. Why Does China Pursue RMB Internationalization - A Theory of Structural Reforms in China

While acknowledging that fundamental economic factors have and will continue to underpin RMB internationalization, it is the contention of this paper that an examination of the dynamics of Chinese domestic politics and the structure of its decision making is key in understanding the motivation behind China's pursuit of RMB internationalization, especially in light of its sudden acceleration after 2012. Particularly relevant to our analysis is an understanding of the PBOC's role in the making of financial sector reform policies which illustrates the importance of individual leadership backed by a bureaucracy with resources and capabilities superior to competing coalition of interest groups.

Popular theories on financial policy making in China have postulated the existence of factional conflicts within the party leadership. For example, Shih has described conflicts between a 'generalist' faction, whose members have broad political responsibilities and pro-growth agendas, and a 'technocratic' faction (including the PBOC), focused more on specific policy areas.[12] For theorists of factional politics, the factions' competition for control of the party and their divergent economic views and priorities provide the underlying dynamics explaining financial policy outcomes. Particularly relevant for our analysis, factional politics lead to emphasis on short term factional gains over long term objectives, consequently frustrating any significant reforms of the financial system. Factional politics theories therefore fall short of explaining why China is nevertheless capable of pushing forward initiatives like RMB internationalization that require systemic changes.

While it remains an authoritarian state with the communist elite as the central pillar of

[12] Shih (2008)

the governing system, this paper argues China has seen its decision making framework evolved into what literature has termed "fragmented authoritarianism" in the governing of economic, international and environmental affairs.[13] Under a fragmented authoritarian model, power, erstwhile concentrated in the hands of an extremely select group of communist party elite members, is increasingly divided and fragmented, mainly as a result of over 30 years of reform first ushered in by Deng Xiaoping in the late 1970s. More specifically, decision making power is fragmented on a horizontal axis by ministries and numerous administrative agencies, and on a vertical axis by regional and local units at various levels.

According to Yves Tiberghien, three key developments since the start of the reform have contributed to this fragmentation.[14] First, the growing institutionalization of the decision making process has stripped even the most senior party leaders of the ability to exercise power outside web of rules and processes of the institutions. Second, the decision making processes, along with the party and government institutions in which they are embedded, have been progressively open to the increasingly diverse interests and demands of a more modern and complex Chinese society. Lastly, the intra-governmental competition for influence among various ministries, agencies and localities has also intensified.

While policy decisions are still made at the center, the fragmented authoritarian model allows political actors at the ministry, agency or regional levels, particularly those involved in implementing the policies, to influence and even shape policy outcome. They achieve this influence in part by forging alliance with each other, and with previously peripheral actors including management of state owned enterprises, opinion leaders such as researcher and scholars, and even those previously excluded from the decision making process such as non-governmental organizations and activists, and the

[13] Tiberghien (2012); Lieberthal (2004); Lieberthal and Oksenberg (1988)
[14] Tiberghien (2012)

media. The forming of alliance and the existence of multiple alliances on any particular policy issues thus transform the policy making process, previously driven by party ideology and top party elite members, into one of bureaucratic bargaining driven by the sometimes parochial interests and political goals of the ministries, agencies or localities, and their allies . The actors who have achieved the most influence in the bargaining succeed partly because they have understood and accepted the general rules of the game of policy making, and perhaps more importantly because they have exploited the cleavages of power that exist between the competing groups and alliances. These territorial, jurisdictional and other political cleavages come into being where institutions and agencies are unable to adapt sufficiently to rapid socioeconomic change, aggressive lobbying groups boosted by new technology and communication tools, or the changing expectations of the citizenry.

Needlessly to say, not all policy issues are created equal. As Yves Tiberghien points out[15], three key variables may impact the ultimate outcome of a policy: First, the balance of power among the major interest groups and agencies involved in any given policy issue; Second, the degree to which a policy is open to public input, as well as the degree of influence public input so expressed through media (old and new) and scholarly leaders can expect to attain; Last but not the least, the degree of politicization and hence involvement by the Standing Committee of the Politburo on the policy issue. While the Politburo Standing Committee may provide the ultimate safety net to ensure a holistic view of national interest is reflected in certain policy outcomes, the decision making on most policy issues increasingly incorporates interests represented by an ever-widening range of competing political actors.

Under the fragmented authoritarian model, the most important actor is what political scientists call “political entrepreneur”. John Kingdon defines a political entrepreneur as “advocates for proposals or for the prominence of an idea”, willing to invest their

[15] Tiberghien (2012)

resources – time, energy, reputation, and sometimes money – in the hope of a future return …in the form of policies of which they approve."[16] "They are individuals with both short-term capital and long-term goals. They have the ability to influence others and to shift the positions of voters or of societal groups, when uncertainty creates doubt over multiple pathways."[17] They are key in the fragmented authoritarian system, as they identify issues and articulate solutions, seek out allies and form coalition around issues, and most importantly exploit the cleavages of power to the advantage of their political goals. The cleavages provided by a fragmented authoritarian system allows political entrepreneurs the sufficient space they need to push forward their political or institutional agenda, and to forging compromises that best incorporate their interests.

Building on this theory of policy decision making in China, this paper argues that China's motivation for pursuing RMB internationalization, and hence the direction and timing of RMB internationalization, could be best explained and understood against the goal of achieving structural reforms in a fragmented authoritarian framework.

China's rise as the world's second largest economy has been extraordinary thanks to the economic reform policy initiated by Deng Xiaoping. While China achieved rapid trade integration with the rest of the world post its WTO ascension, it does not have a financial sector nor a currency that reflects its size and economic significance in the world. In fact, China's financial sectors has produced financial repression that only serves to preserve China's hitherto effective strategy of export-led growth that is increasingly reaching its limits of utility. To transition China to a more sustainable phase of growth therefore requires a new round of structural reform that involves financial sector reform as the key component.

This paper maintains that in China's fragmented authoritarian system, advancing structural reform depends on the balance of power between opposing coalitions of

[16] Kingdon (1995)
[17] Tiberghien (2007)

interest groups that are either in favor of status quo or reform. In general, the prospect of a new round of structural reform creates both impetus of new opportunities and uncertainty. On the one hand, there is cognitive uncertainty arising from realizing the unsustainability of existing political and economic arrangements. On the other hand, there is uncertainty as to the impact of the reforms. Impetus of new opportunities changes the behavior of some political-economic actors and fragments the interest group structure. However, as Tiberghien pointed out, neither is sufficient to induce institutional change or shifts in the balance of power among opposing coalitions of interest groups.[18] If the balance of power is initially aligned in favor of preserving the status quo, as is the case here in China, it will remain so without the insertion of a powerful catalyst.

Political entrepreneurs, embodied in PBOC Governor Zhou Xiaochun as this paper argues, plays that essential role in breaking the stalemate and tipping the balance of power in reform's favor. Tiberghien points out that in trying to tipping the hand toward reform political entrepreneurs resort to a number of main tools and instruments. Significant among these tools and instruments are: (1) Tying the targeted reforms "to other types of reforms in an effort to divide the coalitional majority lined up against" reforms; and (2) reframe a component of reforms in new ways with the objective of dividing up the pro-status quo coalition and recruiting potential supporters.[19] It is precisely in this context that RMB internationalization emerges as a key new instruments in the hands of the political entrepreneurs at the PBOC by which they can reframe and refocus the structural reforms of the financial sector and enlarge the pro-reform coalition.

But why was the political entrepreneurs at the PBOC able to be effective in wielding their instruments, in the form of RMB internationalization, and shift the balance of power away from status quo? Tiberghien observed that the structural source of

[18] Tiberghien (2007)
[19] Tiberghien (2007)

political entrepreneur's effectiveness are determined by "the degree of political autonomy" and "the degree of bureaucratic capacity available to them".[20] Indeed, both factors found their potent manifestation in Chinese fragmented authoritarian system, as the system's core institutions, of which the PBOC itself is a key part, have been transformed by entering a global era.

First, PBOC political entrepreneurs' political autonomy is greatly strengthened by the centralization of key economic and monetary decision making in the bodies of the Central Leading Group for Financial and Economic Affairs (Zhongyang caijing lingdao xiaozu, the "FEA Leading Group"), and the Central Leading Team for Comprehensively Deepening Reform (Zhongyang shenhuagaige lingdao xiaozu, the "CDR Leading Group"). Such top-level institutional changes created significant political space which is critical for the actions of political entrepreneurs at the PBOC. Unlike the Federal Reserve of United States, which is an independent government agency structured not to be subject to political pressures from other government bodies, the PBOC is directly led by China's State Council. While the State Council is charged with a front-stage role of overseeing the implementation of China's economic and monetary policies, the behind-scene power for ultimate economic and monetary decision making, however, increasingly rests with the FEA Leading Group, of which Zhou Xiaochuan is a member. The FEA Leading Group, previously headed by the Premier of the State Council, is now headed by President Xi Jinping, and comprised of members of the Politburo responsible for economic affairs, top members of the State Council and heads of the key ministries in charge of running the economy. More recently in December 2013, the CDR Leading Group, also chaired by President Xi Jinping and of which Zhou Xiaochuan is also a member, was established and put in charge of supervising the devising and implementation of reform plans as a whole. The CDR Leading Group provides the ultimate court for the deliberation and

[20] Tiberghien (2007)

arbitration on matters concerning the grand design of key economic mechanisms such as interest rate reforms and exchange rate reforms.

The proliferation of Leading Groups at the top of the Chinese decision hierarchy, of which the FEA Leading Group and the CDR Leading Group are two of the most important, is mostly a reform era phenomenon. While it is an attempt to address the increasingly complex and cross-sectoral nature of governing issues facing China in the reform era, it also reflects the fact that many of the ministries and agencies have not adapted well to the rapidly changing landscape of issues and challenges. On the one hand, the construct of Leading Groups provides the formalized entry point for various interest groups into the decision process, and the interface for them to do competitive biddings. On the other hand, the centralization of decision making within such a body allows political entrepreneurs such as the PBOC's Zhou Xiaochuan sufficient opportunity and political space for exercising effective leadership. In fact, with President Xi now at the helm of the CDR Leading Group and the FEA Leading Group, in a clear break with political traditions of the previous administrations, the two Leading Groups arguably serves two important functions. First, they provide a critical venue in which President Xi could table through his reform agenda with the aid and benefit of the actions of reformist political entrepreneurs. Equally important, they provide a critical channel through which the PBOC political entrepreneurs could more directly and effectively enlist the support of President Xi in their bidding against the competing alliance of interest groups.

Secondly, Zhou Xiaochuan's effectiveness as political entrepreneur is also buttressed by the steady rise of the PBOC as the preeminent technocratic center within the steep hierarchy of the communist governing elite. As Stephen Bell and Hui Feng remarked, the PBOC has "increasingly developed specialised resources and capacities – information, monetary expertise and innovative policy instruments – that have substantially boosted its role".[21] Those resources and capacities have repeatedly prove superior in relation to other powerful competing ministries and agencies, including the Ministry of Finance ("MOF"), and the National Development and Reform Commission ("NDRC"). The successful recapitalization and restructuring of the four largest state owned banks stand out as a prime example of the strategic use of such superiority. Whereas the PBOC served as a passive conduit for MOF in previous bailouts of the technically bankrupt state owned banks, in 2003 Zhou Xiaochuan and his deputies at the central bank took advantage of the PBOC's position as the manager of China's growing chest of foreign reserves and seized the leadership of banking sector reform from the MOF. The PBOC set up Central Huijin Corporation with injection of large amount of foreign reserve and used this special purpose vehicle to restructure the Big 4 banks by carrying out a series of market-oriented reform measures. In line with best international practices, these measures introduced foreign strategic investors in the banks, enhanced corporate governance standards and management accountability, and culminated in the public listing of the Big 4 and the transformation of the technically bankrupt institutions to one of the most profitable in the world, all in the short span of a decade.

The PBOC's growing preeminence as a technocratic center under Zhou Xiaochuan's leadership stands in contrast with the overall absence of financial markets experiences among China's top decision making circles. As Tiberghien documented, many had privately complained about the lack of conversance in fiscal and economic affairs among the State Council members. [22] The situation certainly doesn't improve when it moves up to the Politburo, especially its Standing Committee, where no members with the exception of Wang Qishan had much exposure to dealings in financial markets. Lacking specialized expertise themselves, party elite thus have tended to allow PBOC to exert more influence in its own policy spheres.

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[21] Bell and Feng (2013)
[22] Tiberghien (2012)

Conversely, the PBOC's technocratic eminence is further accentuated by its interaction with and recognition by the international central bank community, the IMF, and the Bank for International Settlements (BIS). Influence at these powerful external institutions, buttressed by its domestic policy track record, in turn lends credibility to PBOC's institutional resources and capacities.

Last but not the least, the PBOC's technocratic strength is hardened by the unity and vision it had developed as a result of Zhou Xiaochuan's steady stewardship during his unprecedented and much heralded 14-year tenure (and still running) as Governor of the PBOC. The PBOC's singular strength therefore allows its leaders to develop what Bell and Feng called a "symbiotic" relationship with the top party elite,[23] which reinforces their effectiveness as political entrepreneurs, in this case pushing forward RMB internationalization as the key lever for financial sector structural reform.

[23] Bell and Feng (2013)

4. RMB Internationalization: An Uneven Journey

RMB internationalization is generally considered as the process by which RMB realizes its monetary functions outside China. In classical theory, these functions typically include a unit of account (for example corporate invoices), a medium of exchange (to settle cross-border trade), and a store of value (deposits, reserve currency)[24], which can be neatly summarized by means of Table 1 below.

Table 4.1: Different Functions of Currencies

Function	Use by Governments	Use by Private Agents
Store of value (allows transactions to be conducted over long periods and geographical distances)	International reserves	Currency substitution (private dollarization)
Medium of exchange (avoids inefficiencies of barter)	Vehicle for foreign exchange intervention	Settling trade and financial transactions
Unit of account (facilitates valuation and calculation)	Anchor for pegging local currency	Denominating/invoicing trade and financial transactions

Source: Multiple authors

Aubion (2012) emphasizes the role international trade plays in conferring the international currency when he defines an international currency as essentially a currency used for trade purposes - fulfilling the roles of medium of exchanges (of payment), a currency that reduces transactions costs and inefficiencies of barter trade, and of a unit of account.

RMB had been underrepresented in international trade when compared to the size of China's economy. In June 2011, 98% of payments in and out of China were not in RMB but mainly in USD (nearly 80%). This was in sharp contrast to the US, where more than

[24] SWIFT

90% of payments in and out were in USD and Japan, where more than 70% were in JPY.[25] However, RMB has been rapidly gaining ground in international trade, aided by the PBOC policy initiatives. According to SWIFT's report, by the end of 2014, RMB ranked 5th as the most traded currency, at 2.2% of SWIFT payment behind JPY (2.7%), GBP (7.9%), EUR (28.3%) and USD (44.6%). The average monthly RMB trade settlement went up from CN￥320 billion in 2013 to ￥480bn in 2014.

In contrast, RMB has made slower progress in serving as a store of value for both foreign governments and private sectors. Foreign reserves by currency composition are not usually disclosed by central banks, but the IMF's COFER database tracks voluntary reports by IMF member countries. Those reports indicate that the role of the U.S. dollar in the international reserve system has not changed much in recent decades, while RMB's share remained buried in an insignificant "Other Reserve Currencies" category. China's heavy capital controls and a lack of safe and liquid RMB-denominated assets have discouraged central banks from accumulating RMB in any significant scale. Though the interest has been steadily growing though, as evidenced by, e.g. Malaysia's central bank's ground-breaking decision in August 2010 to buy RMB-denominated bonds for its reserves.[26] Similarly, Nigeria in September 2011 announced plans to invest 5 percent to 10 percent of its foreign exchange reserves in RMB as a part of its foreign reserves after an agreement with the PBOC.

Overall, however, China has been slowly introducing policy measures and tools on RMB internationalization for the most part since embarking upon the journey.

[25] SWIFT
[26] Financial Times

Table 4.2: RMB Internationalization Key Milestones

Year (Since)	Programs	Amount	Participators
2007	Dim Sum Bond	131 billion yuan (2011)	
2008			
2009	Cross-border Trade Settlement		
2010	Bilateral Currency Swap Agreements		
2011	R-QFII, CNH FDI,	Combining QFII (since 2002), the total permitted amount has reached around 40 billion USD	
2012			
2013	Offshore RMB Clearing centers		Singapore, ICBC(Industrial and Commercial Bank of China)
2014	Offshore RMB Clearing centers		London, Construction Bank of China Frankfurt, Deutsche Bundesbank
	Hugangtong		Shanghai, Hong Kong Stock Exchanges

Dim Sum Bond

Dim Sum Bonds are offshore RMB denominated bonds, deriving its name from a popular style of snack cuisine in Hong Kong. China Development Bank issue the first Dim Sum bonds in 2007 but the market remained limited until 2010 when foreign companies were allowed to open RMB bank accounts in Hong Kong and exchange currency for any purpose. Although the major market for Dim Sum Bonds is Hong Kong, China Construction Bank became the first Chinese Bank to issue a RMB denominated bond in

London in November 2012, followed by similar issues by non-Chinese banks like ANZ, HSBC and Banco do Brasil earlier in 2013.[27]

Cross-border Trade Settlement

In mid-2009, the pilot scheme of RMB trade settlement was initiated. It covers cross-border trades between Shanghai and four cities in Guangdong on the one hand, and Hong Kong, Macau and ASESN on the other. In June 2010, the scheme was enlarged with a coverage of 20 provinces and cities onshore, which in total accounts for 95 percent of China's total exports. Expanded again in August 2011, the scheme covers the entire mainland.

At the beginning of the scheme, onshore enterprises need to be included on the Mainland Designated Enterprise (MDE) list to be eligible to participate in RMB trade settlement. In March 2012, according to modification to this cross-border trade settlement, as long as the money flowing in and out China is accompanied by genuine trade documents, geographical and enterprise eligibility restrictions are completely removed. Since October 2010, offshore entities were permitted to open nonresident RMB bank settlement accounts (NRAs) with onshore banks and use these accounts (NRAs) for lawful cross-border RMB business. By the end of 2013, the value of China's cross-border trade conducted in RMB reached RMB 4.6 trillion, up 58 percent from RMB 2.9 trillion in 2012.[28]

R-QFII

Announced in December 2011, R-QFII (the Qualified Foreign Institutional Investor Scheme denominated in RMB) is considered a replicate of the QFII scheme which allows foreign investors to bring U.S. dollars onshore and exchange them into RMB). Under the R-QFII scheme, offshore RMB is allowed to be re-invested in the onshore securities

[27] Multiple Media
[28] PBOC

market. The initial quota was RMB 20 billion, less than 5% of the total offshore deposits. Expanded in 2013, total R-QFII quota had exceeded eleven times the original as of the end of first half 2014. In May 2013, in the first extension to RMB trading centers beyond Hong Kong, China in one stroke granted RMB 50 billion quota for financial institutions in Singapore to invest in China's domestic securities under the *R-QFII.*[29] Notably, in 2013, the QFII program too saw its largest-ever increases in investment approvals.

CNH[30] *FDI*

Foreign direct investment (FDI) into China settled in RMB was launched in October 2011 under two sets of guidance published by the Ministry of Commerce (MOFCOM) and the PBoC. This scheme provides an official channel for foreign investors to transfer RMB to mainland China for long term investment purpose. This provides a key outlet for RMB capital raised in Hong Kong markets, which is essential to continued development of Dim Sum Bond market.

Shanghai - Hong Kong Stock Exchange Connect ("Hugangtong")

Announced in April 2014, the Hugangtong initiative opens direct capital flow channel inward and outward for RMB. The pilot program will enable investors in Hong Kong and mainland China to trade eligible shares listed on each other's markets through local securities firms and brokers. A bold attempt at further liberalizing capital accounts, Hugangtong further opens up China's capital markets to foreign investors. As usual, the initial quota was limited with Hong Kong investors allowed an aggregate of RMB 300 billion CNY and a daily trading cap of RMB 13 billion, and Mainland investors an aggregate quota of RMB 250 billion and a daily quota of RMB 10.5 billion.

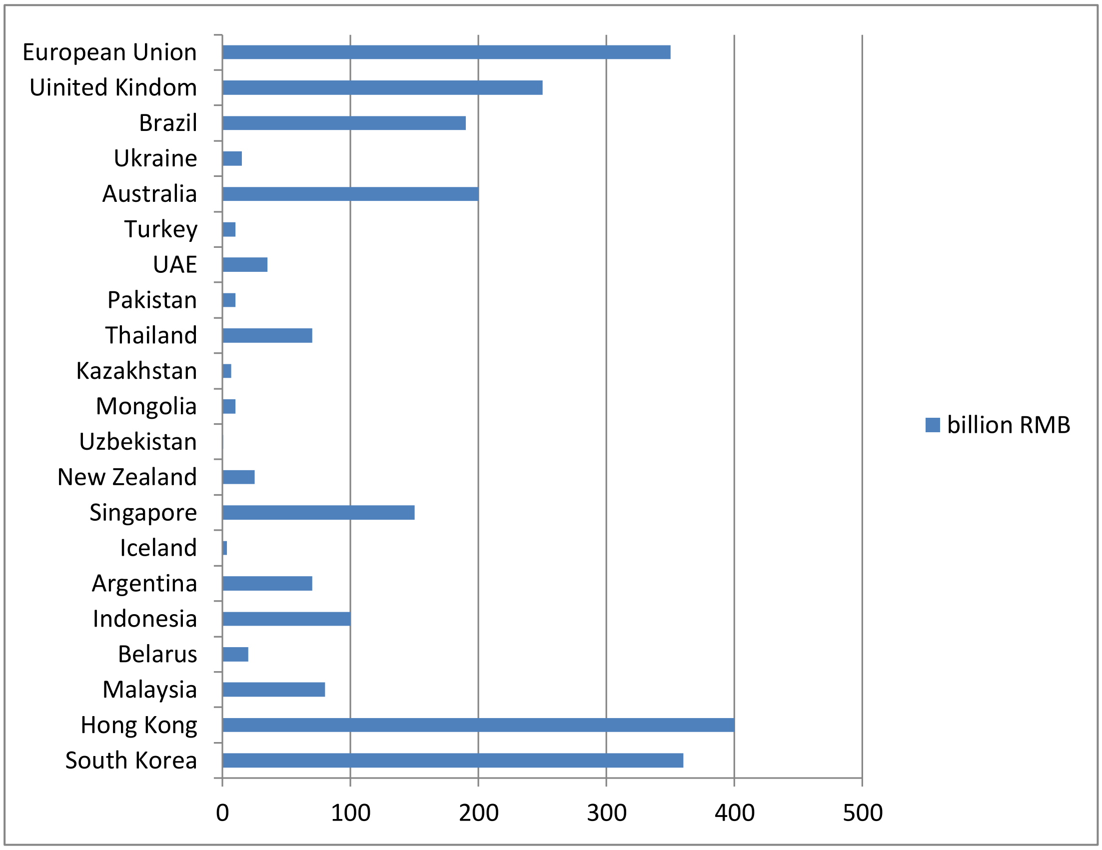
China's Bilateral Currency Swap Agreements with Other Countries

[29] Bloomberg
[30] Haiwai (Oversees) RMB

The origin of China's participation in Bilateral Currency Swap Agreements (BCSA) harkens back to the Chiang Mai Initiative (CMI) in the wake of the Asian Financial Crisis. CMI is a multilateral currency swap arrangement among the ten members of the Association of Southeast Asian Nations (ASEAN), the People's Republic of China (including Hong Kong), Japan, and South Korea. The member countries started the initiative to manage regional short-term liquidity problems and to facilitate the work of other international financial arrangements and organizations like International Monetary Fund. BCSAs provide the main mechanism for the PBOC to facilitate trade with the target countries especially in times of crises or liquidity crunch, as well as for RMB to be used as an official foreign exchange intervention currency. Since 2008, China has signed BCSAs with 25 countries and region, with a total surpassing RMB 2700 billion.

While the BCSAs initially dealt mainly with China's emerging economy trade partners with natural resources, China started to enter into BCSA partnerships with major economic powers like the US or the European Union countries in 2013 when China signed two significant BCSAs with major developed trade partners. In June 2013, the PBOC established a currency swap line with the Bank of England with a three-year duration and a maximum value of RMB 200 billion. Then, in October 2013, China agreed to a Euro/RMB swap line with the European Central Bank. With a duration of three years and a maximum size of RMB 350 billion, it became the second largest swap deal (after the agreement with Hong Kong).

Figure 4.1: China's RMB BSAs with other countries



Source: PBoC, Multiple media

Exchange Rate Formation

In May 2007, the band within which the RMB could fluctuate in day was widened from 0.3 percent to 0.5 percent. Then only in April 2012 did the PBOC allow the currency to fluctuate within 1 percent. Also in a noteworthy move, the PBOC rolled out a raft of changes in late 2011, enabling businesses to use complex currency derivative trades to protect themselves against the ups and downs of the RMB, which suggested that the Chinese government may be laying the foundation for more sophisticated currency risk management in anticipation of greater currency fluctuations.

As is clear from the analysis above, after experimenting with incremental and gradual policy changes for almost a decade, the Chinese government seemed to press the full acceleration pedal on policy moves on RMB internationalization around 2012/2013. But what had prompted that? What can the timing tell us about the drivers behind China's pursuit of RMB internationalization?

5. Unfolding the Story of Structural Reform in China

Rather than viewing decision making through the lens of factional politics which emphasize a client-patron relationship in the formation of political coalitions, this paper maintains that decision making in China be analyzed under the fragmented authoritarian framework, which emphasized the competitive bidding by a criss-cross web of diverse interest groups in an institutionalized process. Like most contentious economic issues today, this paper argues, there have been two competing coalitions of interest groups in China on the issue of structural reforms in the financial sector. Those who promote reforms are led by the PBOC and its more reformist-minded allies inside the communist party. On the other side, those who are more doubtful or outright opposed to it, argue that full-fledged financial sector reform would lead to the ascendance of the financial interest over the real economy where China's real international edge lies, and negatively impact the competitiveness of Chinese manufacturing and export industries, leading to potentially massive job losses and domestic unrest. The opposing camp draw support mainly from officials of State-Owned Enterprises (SOEs), the Ministry of Finance (MOF), the National Development and Reform Commissions (NDRC), and the State Asset Supervision and Administration Commission (SASAC), each representing various domestic groups with parochial commercial or political interests.

Two fundamental issues are at stake in this divide. First of all, the divide is a reflection of China's long standing relationship between financial and industrial sectors. Traditional economic thinking in China has given the development of industry /real economy precedence over that of the financial sector. As a result, the interest of the financial sector has been subordinate to the needs of the industry and the real economy. Therefore, despite the market-oriented reforms advocated and advanced by PBOC and its allies over the past two decades, officials of large SOEs, the MOF, the NDRC, and the SASAC have also enjoyed varied degrees of success in either partially holding onto their turf or even pushing back the advances. Consequently, they continue to exert significant clout in allocating financial resources in the Chinese economy. For example, amid the leadership transition in 2005 the MOF wrested control of the Big 4 state-owned banks away from the PBOC by assimilating Central Huijing Corporation into China Investment Corporation (CIC), MOF's newly mandated sovereign investment vehicle. Most importantly, responsible for the formulation and implementation of national social economic development as well as macroeconomic management of China, the NDRC, together with the MOF, has advocated and mostly succeeded in keeping national bank credit operations at below market interest rates. At times, they have also urged, with only occasional success, the PBOC to halt the appreciation of the RMB in order to boost export-led economic growth. The practice had played an important role in beefing up the public financing of local governments, allowing the SOEs mostly unhindered access to cheap capital and government subsidies, and creating and maintaining employment in the public sector. While this systematic policy of financial repression, supported by the MOF, the NDRC and their key constituents of SOEs, had been successful in spurring rapid national economic growth since the start of the reform era, it had benefited the SOEs disproportionately.

Secondly, at the heart of this debate, as Subramanian points out, there is a tension between the export-led growth strategy, pillared among other things on a policy of internal financial repression, accumulating current-account surpluses and international reserves, and a deep and open financial market built on free-floating interest rates and exchange rates.[31] In essence, the domestic political debate on financial sector reforms turns on the all-important question of whether China's growth can be sustained by continuing the export-led development strategy that it has been following up to now. Further, at the root of that question lies the perennial dilemma, confronting the Chinese government since the beginning of the Reform and Opening Up era, between the role of

[31] Subramanian (2011)

polities and that of the market in managing the domestic economy.

While U.S. deficits continued to provide “risk-free” collateral to developing countries such as China that were hungry for rapid capital formation, the collateral amounted to a free pass for those countries from having to confront the impediments of inefficient domestic financial markets.[32] However, the global imbalances built on large US deficits had become increasingly unsustainable, as the global financial crisis made abundantly clear. As Aizenman and Sun (2010) argued, with China growing at triple the rate of the US, the US current-account deficits needed to absorb China’s surpluses in coming years would very soon run up to unrealistic highs.[33] In other words, as China approaches the US in the size of their respective economies, its ability to sustain export-led growth would be diminishing, and the speed of that decline would be exacerbated by the much slower growth of the deficit countries, the US in particular. And the global financial crisis had served to be the first wake-up call, promoting China to embark on internal rebalancing. Among other things, internal rebalancing will mean slower growth, smaller current-account surpluses and more moderate reserve accumulation may become a longer-term norm and, most importantly, that China may have to rely more on domestic demand and domestic financial markets to channel savings domestic consumption and to expand its economy.

It is therefore the contention of this paper that in promoting financial sector reforms, top Chinese decision makers are in fact acknowledging the limits of China’s hitherto effective strategy of export-led growth. Financial sector reforms therefore become not only an important step towards greater integration between China and the rest of the world, but a key part of a broader set of structural reforms that aims to shift the economy from exports to the domestic oriented, and from one that is industry dominated to one where the financial sector and the market play an equally powerful

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[32] Dooley, Folkerts-Landau, and Garber (2005)

[33] Aizenman and Sun (2010)

role. A deep and efficient capital market is critical to support China's new economic development model and to rebalance the relationship between the banking sector and capital markets. As stated in the Fourth National Financial Work Conference in 2012 January, key financial sector reforms in China's 12th five-year plan include, among others: Further developing the corporate bond and securitization markets, and encouraging private capital into financial services. One of the primary obstacles to these structural reforms is the absence of an effective price-signaling mechanism, i.e. interest rate and exchange rate. Hence the revision of China's interest rate and exchange rate regimes becomes up and front in the efforts to push forward the financial reform.

The politics behind the revision, however, is complex. Under China's fragmented authoritarian framework, it involves breaking the deadlock between those interest groups in favor of the status quo and those promoting reforms, and pushing the situation over the tipping point and irreversibly into the territory of reform, as I argued above in Part III of this paper. In a scenario where the SOEs and their patrons at the MOF and the NDRC will stand to bear the brunt of the loss, the vested interest will not budge without a fight. Since the completion of the public listing of the Big 4 state owned banks, financial sector reforms have advanced on few fronts with the notable exception of the development of the corporate bond market as part of the interbank market. In fact, financial sector reforms have arguably even saw significant setbacks, burdened by the massive stimulus credit expansion between 2008 and 2010, the deteriorating debt load of local governments and the proliferation of shadow banking operations.

For the political entrepreneurs at the PBOC, RMB internationalization emerges as the ideal lever to break that dilemma and push forward the financial sector reforms. On the one hand, the success of RMB internationalization is predicated on full-fledged financial reform, particularly interest and exchange rate liberalization. One the other hand, successful RMB internationalization promises to make Chinese financial institutions, especially the large commercial banks, one of the biggest winners of reforms by enhancing their competitiveness and greatly boosting their expansion abroad. Indeed, it is not beyond the realm of imagination that RMB internationalization could replicate for Chinese financial institutions what China's accession into the World Trade Organization (the "WTO") has done for the ascendance of China's manufacturing and trade industries. Moreover, RMB internationalization will further expose Chinese financial institutions to global practices and standards, thereby introducing external pressure on them to push forward reforms. In sum, in disavowing the old ways of oligopolistic rent seeking and embracing financial sector reforms, Chinese financial institutions, the Big 4 among the most important of them, could find a genuine opportunity to develop into the same powerful institutions as their Western counterparts. In a way almost characteristic of Chinese politics, RMB internationalization could be turned into a rallying cry that could shift domestic political alliances in favor of further reform and liberalization.

Who else then is better equipped to pull that lever than Zhou Xiaochuan, the much acclaimed Mr. RMB and winner of Euromoney's Central Bank Governor of the year 2011? An engineer by training, Zhou Xiaochuan started his career in economics and finance at a reformist think tank under the State Council and has remained a firm advocator of market-oriented reformist agenda since. After serving as vice-governor of the PBOC and governor of the China Construction Bank (taking over from no other than Wang Qishan), he began his 14-year tenure as the PBOC governor in December 2002. Perhaps equally as important as his unparalleled experience as China's top central banker, he had close ties to the highest echelon of the communist party in successive administrations. Zhou's father was a mentor to Jiang Zemin, and Zhou himself was highly regarded and promoted by Zhu Rongji, the reformist Premier who almost single-handedly accomplished China accession into the WTO. Zhou had been an ally of Wang Qishan since their days as the youth champion of market reform initiatives at their respective State Council affiliated think tanks, then each working their way up as senior commercial bankers at the Big 4. As Bell and Feng observed, in China's relationship based society, Zhou Xiaochuan's personal relationship with top party leaders can serve to endow himself and the central bank he heads with significant informal authority.[34]

Bell and Feng had documented the leading role the PBOC had played under Zhou Xiaochuan's governorship in pushing through financial reforms. With responsibilities designated by the 1995 Central Bank Law for the stability of the overall financial system, since 2003 the PBOC had provided the decisive leadership on the restructuring of the banking and securities sectors, the development of a hitherto non-existent corporate bond market, and not the least important of all, the revamping of China's payment and settlement infrastructure including the fostering of one of the world's largest bank card schemes by transaction volume in the short span of fifteen years.[35] Particularly noteworthy is the fact that these reforms were advanced against a background of almost universally expected (and feared) shocks brought forth by China's accession to the WTO, which had produced heightened commitment by the top CCP elite to opening and reform in the financial sector. The PBOC deftly capitalized on this new found commitment from party leaders to instill innovative ideas and establish itself in the driver's seat of the reform, with the growing foreign currency reserve it manages as its main arsenal. Even though PBOC had suffered setbacks in advancing its overall reform agenda, especially after the milestone of completing the Big 4's IPO, it had nonetheless remarkable success in sowing the seeds of further reform by introducing to large financial institutions diversified public ownership, international practices in corporate governance and risk management, and some degree of respect for market discipline and scrutiny.

[34] Bell and Feng (2013)
[35] Bell and Feng (2013)

It is no coincidence therefore that RMB internationalization came back into focus in 2008. The global financial crisis forced China to first recognize the inherent unsustainability of its export-led growth model and embark on a gradual process of rebalancing, as the PBOC again used anticipated shocks from external events to generate new commitment from party leadership. Nevertheless, the acceleration of RMB internationalization has been mirroring the reenergizing of overall reforms since the party leadership transition, when the articulation of and commitment to new growth models, and favorable structural changes in top decision making had provided the ideal context for the effective exercising of political entrepreneurship. The PBOC leaders saw the shifting political priority, and leveraged full-fledged RMB internationalization as the key lever to tip the balance of power and break the stalemate on financial reform in their favor.

In February and April 2012, the Investigation and Statistics Department of the PBOC authored and published two important position papers, "The Conditions for Accelerating the Opening up of Capital Account are Mostly in Place", and "Coordinating the Advancing of Interest Rate and Exchange Rate Reforms and Capital Account Opening". These were considered the most authoritative and systematic statements by the PBOC on the relevant reforms, offering "credible, concrete and operationalized policy recommendations".[36] Also, they were highly indicative of the PBOC's cautious approach and the great lengths it would go to in making the required technical and institutional preparations, a key source of its superior institutional capacity.

The papers enunciated that even though interest rate reforms and capital accounts opening are yet to be achieved, neither is an absolute precondition for the other. Instead, they serve to advance each other in a dynamic process. The papers also maintained that the timing for gradual capital accounts opening is ripe. But in a process where the opening up of capital accounts and market pricing of interest rates

[36] Bell and Feng (2013)

push forward by turns, the paper stated, the exchange rate and foreign currency management reforms will need to take a one-step lead.

In the papers, PBOC also outlined the roadmap for liberalizing capital accounts in three phases. The near term (1-3 years) objective is to encourage Chinese corporates to go global by liberalizing control of direct investment with genuine trade context. In the medium term (3-5 years), PBOC aims to promote RMB internationalization by liberalizing control of commercial credit with real trade context. Finally, over the long term (5-10 years) with building up of financial markets, it is proposed that the order of prudential liberalization will be from inflow to outflow, from real estate to stock and bond trading, replacing quantitative control with management by price in the process.

Despite their focus on RMB internationalization, the PBOC papers emphasized the importance of coordination and cooperation among the reform areas to provide mutual support, thus putting RMB internationalization squarely back in the context of integrated overall financial sector reform, an approach consistently preached by Zhou Xiaochuan and his deputies at the PBOC.

The timing of these PBOC papers was noteworthy as the CCP prepared for leadership transition and various interest groups jostled for influence. Six months later in November 2012, a new leadership led by President Xi took over in the 18th CCP Congress which had initiated three important changes that facilitated the acceleration of RMB internationalization. First, in November 2013, together with the adoption of the "Decision on Major Issues Concerning Comprehensively Deepening Reforms" by the 18th Central Committee of the CCP, President Xi Jinping announced an overarching reform plan, which delineated an ambitious financial sector reform plan to drive internationalization of the RMB: "We will open the financial industry wider… We will push ahead with reform of policy financial institutions. We will improve the multi-layer capital market system, promote reform toward a registration-based stock-issuing system, promote equity financing through diverse channels, develop and regulate the bond market, and increase the proportion of direct financing. . . . We will encourage financial innovations, and enrich the financial market with more levels and more products. . . . We will improve the mechanism for market-based Renminbi exchange rate formation, accelerate interest-rate liberalization, and improve the national debt yield curve that reflects the relationship between market supply and demand. We will promote the opening of the capital market in both directions, raise the convertibility of cross-border capital and financial transactions in an orderly way, establish and improve a management system of foreign debt and capital flow within the framework of macro-management, and accelerate the realization of Renminbi capital account convertibility." As a top-level institutional guarantee of advancing the reform agenda, in December 2013 the CDR Leading Group was established.

Second, but equally important, in a drastic departure from Reform era party traditions, President Xi took over as the Chairmen of four Leading Groups, including the CDR Leading Group and the FEA Leading Group. Also in a departure from old practice, Xi's chairmanship on these Leading Groups was publicly announced. These were powerful steps toward centralizing decision making that had been fragmented by a widening diversity of interests but increasingly tilted towards those favoring the status quo. Furthermore, this new centralization provides an institutionalized venue that facilitated fertile grounds for political entrepreneurs like Zhou Xiaochuan who has personal relationship with top party leaders and backed by a cohesive bureaucracy with superior resources. In the CDR Leading Group and the FEA Leading Group especially, Zhou Xiaochuan also found the support of key allies who are personally close to President Xi and Premier Li Keqiang. Those key allies include Liu He, the Chief of Staff of the FEA Leading Group and the Deputy Head of NDRC, a confidant of President Xi, and Ma Kai, Deputy Premier.

Last but not least, in the most authoritative recognition of the limits of the old export-led growth, President Xi articulated in May 2014 that China’s economy was now in a state of “New Normal” as it took a step down in GDP growth rate from the previous decades. As a result, China will have to develop a new growth model by transitioning from relying on investment and input to innovation as drivers, and by continually upgrading its economic structure from relying on traditional manufacturing to high-tech and modern service industries such as finance.

Therefore, the push to internationalize RMB reflects both policy-driven efforts and market-driven forces. Its motivating forces could be best understood in light of China’s pursuit of the next round of structural transformation that will reinvent and reenergize its economic growth model.

6. Conclusion

The rise of China's economy post its WTO ascension has been one of the most significant events reshaping the international political and economic landscape since the beginning of the twenty-first century. Along with that rise China's RMB has also been making quiet march onto the world stage, first into focus in the aftermath of the 2008 financial crisis, and notably gathering pace after 2012. By examining the seeming puzzle of why RMB internationalization, after a long albeit methodical trudge, accelerated after 2012, this paper seeks to offer a theory that could explain the motivations behind China's pursuit of RMB internationalization. We argue that the existing approaches to this question which primarily looks to the traditional economic factors such as relative national economic fundamentals, cost/benefit of currency internationalization, and impact of external shocks fall short of explaining the timing, pace and trajectory of the RMB internationalization process. We maintain instead that the source of the dynamics driving RMB internationalization should be located in the structure of political decision making and political imperatives of the key players in the decision making process. This paper contends that RMB internationalization should above all be viewed in the broad context of China's next round of reforms that centers on liberalizing the financial sector and developing the capital markets. Putting Chinese political decision making in the perspective of fragmented authoritarianism, this paper argues that with the balance of power of interest group coalitions favoring status quo and change in a deadlock, a lever is needed to break the stalemate and tip the balance toward reforms. Recognizing the need for financial reforms as China increasingly reaches the limit of its export-led growth model, political entrepreneurs at PBOC, under the personal leadership of Governor Zhou Xiaochuan and buttressed by the superior institutional resources and capacity, promoted RMB internationalization as the key lever to redistribute incentives and realign underlying coalitions. Capitalizing on favorable changes at the party's top taking place post the power transition, which brought about a degree of centralization of the financial policy decision making that wasn't available previously, Zhou Xiaochuan and his fellow political entrepreneurs were able to push forward RMB internationalization more effectively that both exposed the need for further financial sector reforms and generated broader support to tip the balance of power toward reforms. Most important among these changes is the creation of the CDR Leading Group led by President Xi Jinping, which provides the critical space for the actions of political entrepreneurs and, in an important way, put the direct support of President Xi behind RMB internationalization and financial sector reform.

That RMB internationalization is a key lever to implementing a broader set of reforms has important implications for how observers may predict the future paths and timing of RMB internationalization. First, it meant that China policy makers will continue to take a cautious and gradualist approach to RMB internationalization, dictated by the political imperative that the advocates of reforms can only grow their influence and power with a track record of sustained albeit small success. This will even imply that policy makers will not even afraid to take some steps back if necessary in order to preserve their influence for pushing further reforms at the right time, as witnessed by the string of capital account control measures the PBOC has taken recently in the wake of downward pressures on RMB exchange rate. Second, RMB internationalization will continue to move forward without being conditional upon first achieving the full convertibility of the currency, let along on the full or partial liberalization of the financial sector. Instead, financial sector reform and RMB internationalization will likely be advanced in a more or less independent fashion, for example in the August 2015 reformulation of exchange rate setting mechanism and the more recent inclusion of RMB in the SDR basket portfolio.

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