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Understanding Currency Policy and Central Banking in China

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CHINA's trade and financial surpluses, exchange rate, and currency reserves make headlines, daily, around the world. As such, it is more imperative than ever to understand the inner workings of currency policy in China. Yet the exercise of power and decision making in these areas has received surprisingly little attention in Chinese politics, political economy, and, arguably, economics.

Books such as *Asian States, Asian Bankers* (Hamilton-Hart 2002), *Financial Policy and Central Banking in Japan* (Cargill, Hutchison, and Ito 2000), and *From Asian to Global Financial Crisis* (Sheng 2009) provide a better understanding of the evolution of currency policy and central banking in Southeast Asia and Japan over the past two decades. Achieving similar knowledge for China, especially regarding the role of the People's Bank of China (PBOC), is daunting given the opaque Chinese policy process. Recently, however, a group of English-language books was published on China's monetary challenges, exchange rate regime, and ongoing currency and financial reforms.[1] These studies use varying approaches, ranging between economics and political science. They are distinguishable as scholarly works versus more applied and think tank-oriented studies, and exhibit different strengths and limitations.

The recent books offer insight on two dimensions of Chinese currency policy. First, they show how and why the effects of China's exchange rate regime on China, the world economy, and the valuation of the RMB exchange rate remain as controversial subjects. There is no consensus among experts or policymakers, on either side of the trade imbalances, about whether the RMB exchange rate is misaligned or whether China ought to move rapidly to a flexible exchange rate regime. Related, the definition of success or failure in policy outcomes remains controversial. Second, and arguably more important, the analyses show that politics plays a significant role in shaping currency policy in China—including the politics of inter-bureaucratic competition between the central bank and other government organs, the influence of Party institutions, and intra-Party factional politics.

The recently published works advance our understanding of potential outcomes of Chinese currency policy and give us a sense that politics matters in determining currency

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[1]This survey of new trends focuses on the English-language literature. Appendix A provides a list of some of the relevant Chinese-language books that were published on money and central banking during the past decade, and some include analysis of central banking in China. It is noteworthy that these Chinese books are not referenced in the recently published English-language materials.

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policy and central bank operations. Despite the progress, questions remain about whether our understanding of the evolution of central banking and the governance of money in China over the past two decades has been strengthened or has progressed adequately alongside the changes that have occurred in governing capacity—even given the lag effect in academic knowledge creation.

We see glimpses in the recent literature that the PBOC is no longer a weak central bank, in terms of its overall effectiveness and influence over currency policy, as well as on the day-to-day administration of the money supply, the exchange rate, and the nation's foreign exchange reserves. The recent analysis also shows that China has absorbed some international norms, with regard to the organizational structure of central banks, and has partially accepted the norm of de jure independence, though its "Chinese Communist" politics do not allow for *absolute* autonomy. However, considerable knowledge gaps remain regarding the changing role and governing capacities of China's central bank; the internal Chinese debates inside and around the PBOC on the role and nature of the central bank in relation to China's unique development context; the degree to which, and conditions under which, local actors take seriously, or conversely ignore, the edicts of the central bank; as well as precisely how central banking in the PRC compares to other national contexts. Finally, some key areas of currency policy remain under-researched, especially regarding China's approach to reserve and sovereign wealth management. We will return to the gaps in the last two sections of the essay.

Rethinking Policy

It is useful to think of the PBOC's main areas of responsibility as currently including monetary policy, foreign exchange reserves management, financial stability, and the oversight of financial services.[2] Traditionally, foreign exchange management has not been a central focus of central bankers, but the situation of China's massive reserves (over US $3 trillion by the end of 2012) makes this a unique case. The custom, for China's central bank, was to treat exchange rate management as part of monetary policy. China is currently redrawing roles in financial supervision, with the PBOC appearing to take on more of a "coordination" role, after the creation of the respective Banking, Insurance, and Securities Regulatory Commissions (discussed below) from 1998 onwards. For financial services, the PBOC backstops settlement payment. Not to be forgotten, the central bank is the famous "lender of last resort," ensuring financial stability.

Monetary and exchange rate policies are closely related in all countries, and China is no exception. Traditionally, central bankers think of exchange rate policy as part of monetary policy. Whereas foreign exchange rate policy primarily determines the value of domestic money for imported foreign goods, and the cost of its exports, monetary policy mainly has a direct bearing on the value of domestic money for domestic goods, assuming the absence of major fluctuations in the exchange rate (Cottarelli 1994, 331). If the exporter's national currency is used by the importer to settle the trade, as is the case often with the dollar, then the exchange rate of the exporter's currency determines

[2] I thank Chinese central bank officials for this depiction of the PBOC's main responsibilities. Interview with PBOC officials, March 2013.

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the value of exported goods in the foreign market. In some countries, the foreign exchange rate regime usually dominates or constrains monetary policy. In other cases, the opposite is true.

Similar to the experience of Japan in the 1970s and 1980s, as China's trade surpluses with the United States and the European Union rose dramatically from 2004 onwards, and following China's move from a pegged exchange rate to a quasi-floating regime in July 2005, the debate (especially in the United States and Europe) has shifted to the question of whether the Chinese currency's rate of appreciation has been sufficiently rapid. Growing interest in the exchange rate of the RMB and China's massive buildup of currency reserves has resulted in three new books on China's foreign exchange regime. The works that focus on policy outcomes and impacts, delve into the purported misalignment of the dollar-RMB exchange rate, and draw links to global imbalances have received the most attention.

In a book that is aimed primarily at a policy audience, *Debating China's Exchange Rate Policy* (Goldstein and Lardy 2008), we see that the exact impact of China's current exchange rate regime remains a controversial theme. The editors of the volume, Goldstein and Lardy, come down on the side of those who argue that China's exchange rate regime is "unsustainable," that is, the existing exchange rate regime cannot, and should not, be maintained. Holding the view that the equilibrium exchange rate for the RMB should be defined as the real effective exchange rate that produces "balance" in China's global current account position, Goldstein and Lardy argue that the RMB is significantly undervalued, and by an increasing margin over time. The chapters and "comments" by other high–profile, US-based economists, such as Eswar Prasad, Kenneth Rogoff, William Cline, John Williamson, Edwin Truman, Michael Mussa, Lawrence Summers, and C. Fred Bergsten, also argue that an increasingly undervalued RMB exchange rate and China's excess buildup of foreign exchange reserves pose interrelated challenges for China, and for the global economy. They suggest that the only way to address the lack of effectiveness and independence of Chinese monetary policy, and to rebalance economic growth, reform the banking system, and adjust China's external imbalances (and correct global payments imbalances), is for China to adopt a flexible exchange rate. These contributions represent the predominant narrative outside of the PRC: that China's ("quasi-pegged") exchange rate is not sustainable for China, or for its trading partners.

However, not all analysts agree with the above assessments. In *Debating China's Exchange Rate Policy* (Goldstein and Lardy 2008), Jin Zhongxia and Shang-Jin Wei both distinguish between the "nominal" and "actual" exchange rate, and they challenge the notion that a flexible exchange rate is required for effective monetary policy and further capital account liberalization. This view is in line with senior Chinese insiders, including deputy central bank governor Yi Gang. Writing in an academic capacity (as professor of economics at Peking University[3]), Yi suggests in the recent edited book *China in the Wake of the Asian Financial Crisis* (M. Wang 2009) that it is essential to dissect through the politically charged debate on China's exchange rate to understand the relevant institutional factors of change in the RMB exchange rate, including the sources

[3]Yi Gang did his doctoral studies in the United States.

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of China's trade competitiveness and the multiple factors that have driven the trade imbalances.

Yi Gang suggests that the increasing trade competitiveness of Chinese goods is the result of improved labor productivity and total factor productivity; progress in building legal systems, including protecting intellectual property rights; the improved perception of Chinese products in the world (which has created huge demand); together with a swift rise in the value of China's assets (non-tradable items). According to Yi, it is this combination of factors, and their accompanying institutional changes, which have led, on the one hand, to China's positive development and, on the other hand, to the financial and trade imbalances.

Harvard political economist Jeffrey Frankel adds to the debate over the RMB's valuation in *Debating China's Exchange Rate Policy* (Goldstein and Lardy 2008) by warning those who are quick to accept that the RMB is vastly undervalued. He revisits the accuracy of the main methodologies for measuring exchange rate equilibrium, and he argues that although the RMB may be somewhat undervalued, it may be undervalued less than previously assumed. Similarly, in *China's Monetary Challenges*, Burdekin (2008) reminds us that there are different approaches to measuring the value of a currency, and that each produces a different answer and leaves the overall degree of undervaluation "far from clear-cut." Using quantitative modeling, Burdekin assesses why RMB appreciation would only have a limited effect on correcting the US trade deficit. More surprising, he offers policy advice to Beijing, warning of the potential risks of bowing to US pressure on currency appreciation, noting the lessons of the (negative) consequences of currency appreciation on Japanese and Taiwanese growth in the 1970s and 1980s.

Jin, Wei, and Burdekin argue that the PBOC has intervened successfully to contain the extra liquidity caused by the massive capital inflows from 2003 to 2007. Burdekin (co-authoring with Pierre Siklos) details how the People's Bank used open market operations, intervention via foreign exchange markets, to "sterilize" the excess inflows of capital, including the sale of central bank bills, and raised capital adequacy requirements for China's domestic banks. Burdekin and Siklos argue that the central bank has maintained the quasi-fixed exchange rate regime for longer than experts have predicted (Burdekin 2008, 77–82), and provide econometric modeling to forecast how long China's central bank can continue with sterilization (82–92).

Yi Gang proposes that rectifying the macro-imbalances and the disequilibria requires adjustments to the "factual" or "effective" exchange rate. Changes in nominal exchange rates, liquidity provision, and commodity price adjustments are all merely part of adjusting effective exchange rates (Yi 2009, 65–66). He argues that creating more mature foreign exchange markets and China's development of a "fully-fledged, multi-tiered foreign exchange market system since 2005, which includes the over-the-counter spot, forward, swap and other derivative markets" are crucial to such adjustment (66). Yi notes that the development of the foreign exchange markets enables financial institutions, businesses, and households to adapt to exchange rate fluctuations and hedge exchange rate risks (67). He notes that these changes are critical to achieving other related goals of the Party and government leadership: protecting economic security and maintaining social stability.

Not surprisingly, Yi Gang suggests that the best way to facilitate China's realignment to the "equilibrium level" is to support its reforms through "constructive dialogue," for

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others to accept that it takes time to establish an efficient market system, and to work with China on internationally coordinated policy measures needed for structural adjustment (2009, 66–67). Holding firm to the Chinese monetary elite position, he argues that China's external imbalances ought to be resolved by promoting domestic demand, increasing imports, investing abroad, and accelerating urbanization—in addition to currency appreciation. He notes that other measures (besides currency appreciation) can generate the desired impacts, such as imposing environmental protection requirements, enhancing labor standards, strengthening labor protection, and upgrading the judiciary system. All these measures cut into trade competitiveness, given the higher costs entailed. Yi preaches patience—such measures will take time, if they are to be implemented in a stable and sustained manner.

Yi Gang states plainly that a "large country like China cannot give up its independent monetary policy" (2009, 62). He does acknowledge, however, that China must continue to push ahead with currency reforms: "China has to choose between a fixed exchange rate and the free flow of capital, in a sense, choosing between stability and efficiency. In the long term, China is bound to have a free flow of capital and a floating exchange rate regime" 62). Some influential Chinese economists, including Yu Yongding of the Chinese Academy of Social Sciences, also suggest that the current exchange rate arrangements are "transitional"; that ultimately China will have to choose between the two main options of free-floating or pegging.[4]

What the above shows is that while much of the "foreign" research has focused on China's exchange rate and its foreign exchange reserves, in contrast, around and inside the PBOC, the more important issue is the role of central banks in transitional economies, or emerging economies—and differences and similarities in their roles in advanced economies. The debate inside the PBOC is about the effects of differing mandates for central banks in different national contexts, and the optimal and changing mix for China.[5] Equally important, while the aforementioned studies update our knowledge with regard to current policy debates about differing exchange rate options, they do not adequately address the *source* of the exchange rate policy decisions that have been taken, nor delve into the *rationale* behind the decisions. In this light, the academic book by Liew and Wu, *The Making of China's Exchange Rate Policy* (2007), makes an important contribution. Liew and Wu suggest that the international criticism of China's "mercantilist" exchange rate regime, especially from the United States, largely reflects the fact that "Chinese authorities have largely gone their own way in transforming the national economy from a planned to a market economy, adopting a 'Beijing Consensus' instead of a 'Washington Consensus'," and this means that Chinese exchange rate policy is a "potent mix of politics as well as economics" (vi). They note that "political analysis barely surfaces in the voluminous amount of scholarly research conducted on the renminbi"; that the "role of Chinese domestic politics in exchange rate policymaking seldom appear on the radar screen" (vii).

Liew and Wu (2007) suggest that the decisions not to devalue in 1998 during the Asian financial crisis and to replace the RMB-dollar peg in 2005 with a managed floating

[4]Yu Yongding's comments are cited in Global Times (2010).
[5]Interview with PBOC officials, March 2013.

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exchange rate regime were based foremost on domestic circumstances, on national priorities and domestic interests, and not in response to external (US) pressure. The overriding objectives were maintaining social stability and preserving party rule. Politics in both senses are thus key in the choices. Under the leadership of Jiang Zemin and Zhu Rongji, the primary motivation behind maintaining a fixed exchange rate was to support export-oriented growth amid China's integration into the global economy and WTO accession. The goal then was to achieve 8 percent growth in GDP, which was seen as necessary for soaking up retrenched workers from the state enterprises (Liew and Wu 2007, 212).

Under the Fourth Generation leadership of Hu Jintao and Wen Jiabao (regarded to have begun in 2003 and lasted until 2012), the main governing objective evolved, at least initially, to ensuring "balanced development" and tackling social welfare needs, rural poverty, and growing inequalities between regions. But the Fifth Generation leadership also had to grapple with the inflationary pressures stemming from the continuation of the peg (Liew and Wu 2007, 208). They decided to end the RMB-dollar peg in 2005, and the RMB was allowed to appreciate, though not to a level that would impact adversely the livelihood of farmers and rural inhabitants. For the central bank, the goal of day-to-day exchange rate administration was to "maintain the RMB exchange rate basically stable at an adaptive and equilibrium level, so as to promote the basic equilibrium of the balance of payments and safeguard macroeconomic and financial stability" (People's Bank of China 2005).

The central insight of *The Making of China's Exchange Rate Policy* is that it offers a plausible interpretation of the source of the pivotal policy decisions on the exchange rate regime: it is not the central bank but rather the Party's Central Leading Group on Financial and Economic Affairs (*Zhongyang caijing lingdao xiaozu* or CLGFEA), working in conjunction with senior Party and government leaders. In brief, the decisions of the top leaders are directly shaped or determined by their involvement in the CLGFEA, or by its recommendations. The Leading Group's recommendations are, however, informed by research and analysis carried out by other key policymaking organs, specifically researchers in the Office of the Leading Group on Financial and Economic Affairs; the State Council Research Office; the former State Council Office for Reform of the Economic Structure; select university-based policy research centers; and core economic ministries, especially the People's Bank of China, its Monetary Policy Committee, and the Monetary Policy Department. Liew and Wu further suggest that under the Hu-Wen leadership, the National Development and Reform Commission (the former State Planning Commission), the Ministry of Finance, and the Ministry of Commerce were added to the core policy network (2007, 142–80). The "critical role" of this network of institutional actors is not in deciding exchange rate policy, but rather in "policy development"—that is, identifying the main issues and generating recommendations for "policy preparation."

From the above, we learn that the PBOC usually manages the money supply on a day-to-day basis, but that its monetary interventions are strongly influenced by its politically determined duty to ensure exchange rate and macroeconomic stability. Liew and Wu's synthesis of the pluralization and institutionalization models of Chinese politics (see Bachman 2001; Shambaugh 2001) and identification of the CLGFEA as the source of exchange rate policy have provided the foundation for other scholars to build on. For example, Yi Jingtao (2011) fuses the bureaucratic politics and "visionary

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leader" models to provide an even more specific group of actors and institutional processes for the 2005 decision to de-peg the RMB from the dollar.

However, a well-researched and empirically rich book,[6] *Factions and Finance* (Shih 2008), tells us that although China's central bank may want to properly manage the money supply and control inflation, it can only do so when there is senior-level support in the Party leadership to do so. Often, the "generalist faction" is more interested in buying the political allegiance of local cadres, and it uses China's banks as automatic teller machines to dispense political lending—to maintain its networks of political backers at the central and sub-national levels. Periodically, the "technocratic faction" steps in to tighten up the money supply and financial lending to curb inflationary pressure. However, Shih's (2008) main insight is that each time the inflationary pressures are brought under control by strong intervention from the PBOC, another cycle of excess political lending begins anew, given that the "technocratic faction" ultimately buckles in order to protect itself. The conclusion that Shih (2008) draws is that the inability of all factions in the Party leadership to avoid such temptation means that the current governing regime can never fully push through sustained banking reforms, toward market-determined lending and private-sector efficiencies.

The cyclical logic, rooted in factional politics, is convincing for patterns in the 1980s and 1990s, and for a less globalized China. However, it is questionable whether it remains the defining dynamic into the Hu-Wen period (2003–12), and especially moving forward, as the autonomy of the central bank has increased gradually over the past three decades (even with periodic reversions), and as factional politics itself becomes more diffuse at the top of the Party leadership. For example, the aggressive credit and monetary policies that China undertook in late 2008 were responses to an exogenous crisis (of Anglo-American finance). The domestic stimulus measures were backed by a consensus of the collective leadership and were not about factional contestation in the Party leadership. These half-trillion-dollar stimulus measures were similar to those taken by central banks of other leading economies. In this regard, the fusion of the pluralization and institutionalization models, and the elite politics and "policy entrepreneur" models, is likely to offer more explanatory power on Chinese policymaking and the governance of currency for an increasingly globalized China.

The Evolution of Central Banking

In retrospect, the early 1990s were a high watermark for the study of central banking and the governance of money in China. Three books, written after the first decade of post-Mao reform by Holz (1992), Bowles and White (1993), and Yi Gang (1994), gave a sense of how the operations and responsibilities of the central bank evolved during the first decade of economic reform. Holz (1992) and Bowles and White (1993, 75, 110) outlined the organizational restructuring that gave rise to a stand-alone PBOC from 1984 onwards and described its role in national financial planning; interest rate

[6] Shih's book is based on an impressive amount of fine-grained data collection, review of key documents, and difficult-to-access field interviews.

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policy; reserve management instruments; and relations with fiscal authorities, the four "specialized banks," and non-bank financial institutions (including the international trust and investment companies).

Holz (1992) analyzed how the central bank tried to use monetary policy to achieve macroeconomic stabilization from 1984 to 1990, but argued that the traditional theory of monetary management of centrally planned systems, based on credit, cash, and foreign exchange planning, continued to inform, and hinder, monetary policy in China into the early 1990s. In contrast, Yi Gang, future deputy governor of the central bank, analyzed the institutional changes during the 1980s and the early 1990s and found an increasingly monetized economy and transformation in the role of money from a "passive accounting tool" within a centrally planned system into an "active and intrinsic factor" in an increasingly market-oriented Chinese economy. He focused on the evolving functions of the central bank in its relations with specialized banks and other financial institutions; its growing role in managing money supply and demand, monetization, price reforms, inflation, and oversight of non-bank financial institutions; and new developments in the financial securities markets.

Two decades have passed since the publication of those seminal books of the early 1990s. Given the recent trove of new books on Chinese money and finance, what is the state of our collective knowledge about China's central bank and the governing of money? The conventional image remains that China's central bank is weak or subservient. Liew and Wu (2007) acknowledge that the influence of the PBOC over monetary policy, especially the exchange rate, has "grown substantially" over the reform period (162), and that the PBOC is becoming a more influential "source of input" on monetary and financial policy and a key "assessor" of exchange rate inputs from other sources (164). They emphasize, however, that the PBOC is "not an independent central bank as is commonly understood, but is instead guided by decisions of the State Council" (163) and the Party's CLGFEA (143–57, 164), and that ultimately, the "real power over the macro-economy rests with the Politburo Standing Committee" (163). The recently published *China's Superbank* (Sanderson and Forsythe 2013) suggests that: "The central bank was a weak government body and was dominated by the provincial offices controlled by local party officials. China's interest rate policy always has been decided by the ruling State Council, China's cabinet, with the *central bank even now playing a more advisory role*" (50–51, emphasis added).

Lardy's portrayal of the PBOC in *China's Unfinished Economic Revolution* (1998) has left a lasting impression. There is consensus in the scholarship that the "Law of the People's Republic of China on the People's Bank of China" (*Zhongguo renmin yinhang fa*, henceforth "Law of the PBOC"), passed on March 18, 1995, was meant to legally confirm the People's Bank's central bank status. Lardy wrote, however, that although the Law of the PBOC states that the PBOC "shall independently implement monetary policies and be free from any intervention from sub-national governments, levels of all government ministries, social groups or individuals," under Article 7, the PBOC still had to work "under the leadership of the State Council" (172). Similarly, Liew and Wu (2007) note that Article 5 gives the PBOC the authority to recommend and implement exchange rate policy, but that exchange rate policy had to be approved by the State Council (163). The Law of the PBOC is written such that de jure and de facto, final authority on many significant matters relating to the central bank, including

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changes in interest rates, reserve requirements, and major exchange rate decisions, "must all be referred to the State Council for approval" (Lardy 1998, 172).

Lardy suggested that the People's Bank was a "weak institution" (1998, 173) when it was initially separated from the Ministry of Finance in 1976; it was subordinate to other central agencies, for example, the State Planning Commission, which formulated the annual credit plan. Lardy (1998) and Yang (2004) further note that until the early 1990s, the provincial branches of the central bank responded primarily to provincial-level political leaders rather than central bank headquarters in Beijing, and as such, the PBOC continued to be pushed into policy lending until the mid-1990s (Lardy 1998, 90–91). Shih (2008) adds that, even after reforms in the late 1990s, such as banking centralization, the implementation of asset-liability management, and the formation of the Monetary Policy Committee, which aimed to strengthen credit control, local governments still found numerous loopholes in the credit control mechanism to finance local growth (37). The reformed credit plan merely served as a "half-opened cage" for the money supply; when elite political signals called for high-speed growth, the state banks routinely exceeded the credit quotas (33).

Shih (2008) adds to the impression of central bank weakness by suggesting that, "despite the establishment of institutions that resemble those seen in a Western banking system, administrative decrees rather than monetary instruments such as reserve requirements, interest rate adjustments, and open market operations still played the dominant role in controlling the money supply" (32). He further argues that the effort, in 1997, of the government to minimize political intervention in monetary policy by furnishing policy authorities to a group of financial experts, the Monetary Policy Committee (MPC), also "failed to filter political signals out of monetary policy" (37). First, in the charter of the MPC, it was designated as a "consultative discussion organ" with no final decision-making power. Second, the MPC consisted of a mix of central bankers, senior technocrats from other economic agencies, and financial experts; soon the MPC devolved into an arena for bureaucratic bargaining over policy favors (37). Chung and Tongzon (2004) add that the role of the twelve-person MPC (per Article 11) was undermined by the formation of a powerful "CCP body," the Central Financial Work Commission (CFWC, *Zhongyang jinrong gongzuo weiyanhui*), around the same time, the main instrument to exert more centralized control over the financial system that operated from 1998 to 2003.

The perception of Chinese central bank weakness is tied up with neoclassical economic assumptions about the importance of central bank "independence" for price stability, and macroeconomic performance more broadly (Alesina and Summers 1993). Such a perspective is useful for highlighting that Party politics and government influence have a constraining effect on the PBOC's autonomy. However, the focus on the "lack of independence" in the existing narratives is problematic in two senses. First, it rests on shaky comparative empirical foundations, in that the US Federal Reserve is usually held up as the model of central bank independence, against which the PBOC is judged. Lardy, for example, predicted: "For the foreseeable future, China is unlikely to develop a central bank with the *degree of independence* of the Federal Reserve in the United States" (1998, 172, emphasis added). A detailed review of the actual policy-making process of the Federal Reserve suggests far more political sensitivity than the conventional view admits, with the independence of the Paul Volker era from the late

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1970s to the mid-1980s as the exception rather than the norm (Kirshner 2013). Meltzer's history of the Federal Reserve (2003, 2009) shows the sensitivity of the Federal Reserve to political institutions despite its de jure independent status, while the Bank of Japan, one of the most de jure dependent central banks until 1998, generated an impressive record of price stability. Bowles and White point out that Germany's Bundesbank should actually be the model of full autonomy, in its areas of decision making and regulation (1994 240).

Second, central bank "independence" is, at best, an imprecise concept. Confusion arises over whether "independence" is an absolute or a relative concept (Bowles and White 1994, 238–40). Rather than treat the issue as one of degree, the tendency is to handle the matter in dichotomous terms, that is, the Federal Reserve is independent, and the PBOC is not. But all governments place some, though different, pressures on central banks. In OECD countries, such pressures are often seen as the self-serving desire of governments to generate a short-term feel-good factor for electoral gains. In developing countries, such pressures are often caused by developmental needs, usually to fill a fiscal hole. However, the situations of the United States and various European countries since the 2007–09 global financial crisis show that it no longer makes sense to think of fiscal and public debt challenges as only developing countries' concerns. In these advanced economies, central banks are also coming under political pressure to print money. At the same time, most central banks undertake foreign exchange operations on their own account to influence the domestic currency's value in the foreign exchange markets (Fry, Goodhardt, and Almeida 1996, 47).

Furthermore, a fixation on absolute independence diverts attention from changes in the degree of autonomy of the central bank and changes in governing capacity. It deflects attention from studying actual and changing determinants, the evolving logic behind the PRC's currency policies, and institutional and organizational redesign that are correlated to changes in governing capacity. As Bowles and White (1993) explained, the goal of central banking reform in China during the first phase of post-Mao reform was to give the PBOC a greater degree of *autonomy* to regulate the monetary system, and power over local authorities to counter local influence over the state commercial banks, but not outright *independence* (83), since Chinese authorities believe that sufficient political control over the central bank must be retained to ensure a financial system that is capable of implementing key developmental objectives such as regional and sectoral redistribution, rapid growth, industrial modernization, and employment creation (168–69). Has the situation changed and, if so, to what degree, how, when, and why? Inside and above China's central bank, the actual debate is about "whether it would be a good scenario for the PBOC to be fully independent; what would be the impact of such independence in terms of the PBOC serving the needs of the country as a whole, especially helping to support its array of institutional reform needs, or conversely, would it become too preoccupied only with a narrow set of responsibilities?"[7]

We also know that the PBOC under governor Dai Xianglong tried to cling onto the sole regulatory authority it exercised over the banking sector during the period of rethinking from the late 1990s to the early 2000s, but that it eventually lost this battle, with the

[7]Interview with PBOC officials, March 2013.

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creation of the Banking Regulatory Supervision Commission, and the PBOC's attention was redirected to focusing on monetary policy and short-term macroeconomic management. This outcome, and the correlation between the rising influence of the PBOC under Zhu Rongji previously and under Zhou Xiaochuan during the current decade, suggests that the clout of the person heading the central bank, as governor, is another key variable affecting the degree of operational autonomy of China's central bank. What we see, then, is that a cascade of factors—legislative, organizational, performance outcomes, and personal power—has had a determining effect on the PBOC's autonomy in the governance of money.

In brief, the field awaits a detailed and coherent analysis of the evolution of Chinese central banking over the last two decades that ties together how, in the early 1990s, the PBOC rode the political clout of Zhu Rongji, and the perception of its unique professional competencies, to position itself to steer China toward a more market-oriented and globally integrated economy. Minus such a study, the conventional wisdom is that central banking in China has remained largely unchanged, despite its evolving capacities over the last two decades.

An outline of some of the changed capacities of the central bank, and changes in currency governance, has begun to take shape in the less orthodox literature. Recently, Hui Feng, a researcher in Australia, depicted the emergence of an increasingly capable, professional, and influential central bank in China. Feng's articles (2007, 2010, 2011, 2012) in the professional journal *Central Banking* trace the central bank's ascent within Beijing policy circles; an increasingly influential PBOC that has already pushed through interest rate liberalization and small but concrete steps to "normalize" the environment for monetary policy (2010, 2012); looking to accelerate the pace of reforms to further liberalize capital controls and the exchange rate regime, as this will free up the central bank's hands regarding monetary policy (2011; 2012, 44); and an increasingly authoritative PBOC that has emerged from a Leninist Party-state that guarded its control over banking, macroeconomic policy, and monetary policy. Just the fact that the RMB exchange rate has risen 23 percent over the past three years suggests that the PBOC is winning some battles inside the policy circles and has achieved some success in convincing decision makers that greater exchange rate flexibility is needed to relieve inflationary pressure.

Liew and Wu (2007) do suggest that the PBOC is becoming more influential in short-term macroeconomic policy (164). Even Shih, who generally sees "pervasive influence of the Chinese Communist Party" (2008, 31) over money supply and credit provision, also presents the view of a uniquely effective PBOC, with the unique capacity to intervene to curtail excessive liquidity when it has political backing to do so; a central bank that can mobilize "its impressive organization and monitoring capacity to enforce the loan ceiling, quelling inflationary expectation" (30–31). Shih describes the PBOC as having control over the performance evaluation of bank managers, and monitoring China's state banks for compliance with the mandated band for deposits and lending interest rates, its review of mandatory monthly reports by each bank's headquarters, and "on the spot" auditing of banks' books (41–42). But if one accepts that the PBOC was a weak central bank when it was first created, how did it develop this range of institutional capacities by the second decade?

The missing link is how do we explain these changes in governing capabilities, and how did the new formal authorities accrued to the central bank become

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institutionalized? How did the PBOC seemingly transform from a fractured, weak, and subservient existence to a central bank that possesses growing governing capacity, policy influence, and even some measures of autonomy by the third decade of post-Mao reform? An undercurrent of research has emerged slowly over the past decade that examines the evolution of central banking in China and the growing capacity of the PBOC. It suggests that a combination of the kick-off that the central bank received in the early 1990s from Zhu Rongji's appointment to head the PBOC, its growing reputation for possessing the technocratic expertise to macro-manage the increasingly complicated Chinese market, and legislative reforms and organizational changes associated with the central bank that ran from the mid to the late 1990s gradually took effect over the past decade. The PBOC gained more autonomy in controlling inflation, relaxing China's exchange rate regime, managing reserves, and supervising financial markets—despite the periodic reversions to political intervention, such as the domestic stimulus package in response to the 2007–09 global financial crisis.

Lardy acknowledged that the powers of the PBOC increased after it assumed the formal legal authorities of a central bank on January 1, 1984, and again in the 1990s, first with the appointment of Zhu Rongji as head of the central bank in July 1993 (1998, 174). Zhu initiated a period of macroeconomic austerity, a new macroeconomic policy regime that delivered slower growth of money and prices, and less cheap credit to the state enterprises. Zhu's appointment gave the PBOC the clout to appoint and remove the heads of the People's Bank branches in each province and major municipality. The PBOC took the unprecedented decision in 1994 to refuse to lend money to the Ministry of Finance to cover the state budget deficit. The head office of the central bank rolled back the 30 percent of central bank lending to the financial system that was previously under the discretionary control of provincial and lower-level branch offices of the PBOC. Zhu, first as vice premier, and then as premier, presided over a process of administrative reorganization of the PBOC.

In the textbook *The Chinese Economy: Transitions and Growth*, Naughton (2007) argues that the Law of the PBOC was a milestone in building a modern central banking system in China, as it gave the People's Bank a "workable" branch network (103) when it closed down 148 duplicate branches across the country and its thirty-one provincial-level branches were consolidated into nine regional branches and two operations offices (including branches in Tianjin, Shenyang, Shanghai, Nanjing, Jinan, Wuhan, Guangzhou, and Chengdu, and operations offices in Beijing and Chongqing). The structure of the US Federal Reserve Board was reportedly the inspiration for the PBOC's reorganization (Yang 2004, 85). These changes are said to have strengthened the institutional integrity of the PBOC and provided the organizational support to the decision to grant the central PBOC the power to appoint (and rotate) the heads of the regional branches.

In April 1997, the State Council promulgated the "Rules on the Monetary Policy Committee of the People's Bank of China," which led to the formation of the Monetary Policy Committee to advise the central bank. In late 1997, the National Conference on Financial Work mapped out the guiding principles for deepening financial system reform, and again urged for the People's Bank to function as a real central bank by fulfilling the fundamental tasks of monetary policy, financial supervision, and financial

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services and by improving its capacities for forecasting, monitoring, and controlling financial risks. Yang suggests that principles of the Glass-Steagall Act are "embodied" in the 1995 Law of the PBOC (2004, 89, 302). Moreover, in 1998, the supervisory functions of the central bank were streamlined, and its supervisory responsibilities for securities institutions were transferred to the China Securities Regulatory Commission (CSRC), and for insurance companies to the China Insurance Regulatory Commission (CIRC). At the same time, the staff of the People's Bank was trimmed by 47 percent, and this had the effect of forcing PBOC senior management to streamline roles and responsibilities for the remaining staff.

This literature suggests that, armed with a renewed focus on monetary policy, backed by a new Monetary Policy Committee, and with streamlined functions, the central bank began to play a more decisive and regularized role in determining and implementing monetary policy (Naughton 2007). In 1998, the national credit plan, by which the government directly controlled lending, was reclassified from a command to an indicative plan, and reserve requirements for the commercial banks were reduced. At the same time, central bank lending to the state commercial banks was curtailed. These changes were meant to give the banks greater autonomy, but they also enabled central bank lending to the commercial banks to be cut back. State commercial banks found themselves facing harder budget constraints.

Perhaps most important, Heilmann (2005), in a penetrating article in *The China Quarterly*, noted that the Party's reassertion of centralized control was relaxed after the new Wen Jiabao government decided to end the CFWC-led approach to financial sector reform and established a new financial supervision framework (15). The Party leadership agreed to establish a China Banking Regulatory Commission (CBRC) in the autumn of 2002, dissolved the CFWC in March 2003, and, importantly, redelegated the oversight functions in the financial system from the CFWC to the four-headed structure of the PBOC, CBRC, CSRC, and CIRC. China's accession to the WTO in late 2001 also induced a loosening effect on Party control of the financial sector, as WTO entry meant gradual opening of the domestic financial sector to foreign financial institutions and normalization of the regulatory structure. These bureaucratic adjustments also reduced the PBOC's role in banking supervision, and have encouraged the central bank to shift more of its focus to monetary and exchange rate policy. In *Remaking the Chinese Leviathan*, Yang (2004, 85) thus writes optimistically that "the PBOC has behaved increasingly like a central bank in a market economy" as a result of the three-year comprehensive restructuring of China's financial system, and especially of the central bank, which was launched after the National Financial Work Conference in November 1997.

Future Research Directions

The aforementioned work on currency policy and central banking in China points to three ways in which the literature can be advanced. First, the research on emerging central bank governing capacities and influence captures an important trend. However, the author's discussions with senior officials of the PBOC suggest that "local interests" and political pressure from "the Center" on behalf of localities continue to be a

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"headache" for the central bank.[8] After the PBOC leadership successfully advocated for a shift in the policy direction toward curtailing local spending and speculative investment, which they recently did in attempting to curb speculation in commercial real estate, central PBOC officials faced significant resistance or foot-dragging from local authorities in implementing the policy shift. The process whereby the formal authorities of the central bank are institutionalized—or *partially* institutionalized—remains opaque. Difficult process-tracking research still needs to be done on when local authorities obey the central edicts of the PBOC and when they ignore them, and why some orders are ignored, while others are followed. The legislative and reorganization answers are insufficient for explaining the degree of institutionalizing the PBOC's money governance authorities that has taken place heretofore, or the limits of implementation.[9]

Second, we still need a better comparative understanding of what exactly the PBOC has in common with central banks in other countries, how it is different from them, and why. China could, in fact, look like many other developing countries where a situation of strong government capacity to influence money supply has served as a disincentive to banking reform (Fry, Goodhart, and Almeida 1996, 28). Moreover, the use of bank reserves and the financial system as a source of government revenue is not unusual, compared to other developing countries. The exact relationship between central banks and their respective governments differs in nature, scope, and direction, from country to country. Some central banks have more leeway to decline their government's requests for credit, and others do not (Cottarelli 1993). Some central banks perform a range of quasi-fiscal activities on behalf of their governments, while others are prevented, in theory, from doing so by statute.

Fry, Goodhart, and Almeida (1996) have argued that governments generally expect to benefit financially from the monopoly privilege over fiat money they grant to their central banks. Central banks, in turn, engage in revenue-raising activities, including the collection of seigniorage revenue; seigniorage becomes government nontax revenue when the central bank's profits are transferred to the government, or the government can take interest-free loans from the central bank, or the government can require its central bank to undertake various fiscal activities on its behalf.[10] Monetary and fiscal objectives are often in conflict, and incompatibilities are almost always resolved in favor of fiscal exigencies—at least in the short run. Thereafter, fiscal reforms are often implemented as part of a stabilization program to contain or address the conflict. The inflationary cycle that Shih (2008) describes is arguably not specific to "Communist China." But where Shih seems to have captured a comparative insight is that China's authoritarian state control explains how China's growth has exhibited a "unique combination of rapid financial deepening, accompanied by relative price stability, in comparison with many developing and postcommunist countries" (3).

[8]Interview with a deputy governor and senior officials of the PBOC, Beijing, June 2011.
[9]I thank Margaret Pearson for emphasizing this point.
[10]Issuing currency and providing non-interest-earning bank reserves in the form of deposits held at the central bank are essential monetary activities of all central banks. On the range of ways in which governments can collect seigniorage through their central banks, see Fry, Goodhart, and Almeida (1996, 33–35).

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Governments in many developing countries have required their central banks to undertake quasi-fiscal activities, including allocating subsidized credit to agriculture, exports, and development finance institutions through selective credit policies; providing below-cost deposit insurance; bailing out insolvent financial institutions; and providing exchange rate subsidies or guarantees for debt service and essential imports. There has often been a blurring of monetary and quasi-fiscal activities.

Where exactly does the People's Bank sit on the spectrum of relationships between central banks and their respective governments? Despite its growing monetary policy influence and operational autonomy, the PBOC definitely remains a central bank that is obliged, at times, to carry out a range of revenue-raising, quasi-fiscal, and market-creating activities, such as providing new market signals and playing a market facilitation role. This means going beyond merely managing the inflationary index, implementing price controls, and setting interest rates. As such, the staunch criticism in *Factions and Finance* of Zhu Rongji's decision to increase the money supply in 1998 and 1999, that his instruction to the PBOC to increase allowable loan-to-deposit ratios, lower reserve requirements, and lower interest rates (Shih 2008, 161, 166–67, 177) prevented China's move toward a more privatized financial sector, misses the mark. For the study of the PBOC's governing capacity, this outcome is less important than the observation that China's central bank achieved reputational gains by demonstrating its ability to help steer the Chinese market economy away from the worst effects of the 1997–98 Asian financial crisis. In contrast to Shih, the individual chapters by Liu He,[11] Jia Kang, and Li Daokuai in *China in the Wake of the Asian Financial Crisis* (M. Wang 2009) argue convincingly that the stimulus measures from 1999 to 2003 were key to generating growth after deflation had set in for China after the 1997–98 Asian financial crisis, and in so doing, kept China on the path of stable and sustained economic reform and international integration.

Finally, the most neglected area of study for the governance of money and central banking in China is reserves and sovereign wealth management. Just over a decade ago, China's reserve managers had to deal with shortages of foreign exchange. But in the past decade, China has accumulated a massive store of investable assets in central bank reserves, savings funds, and pension reserve and social security funds. China surpassed Japan in February 2006 to become the largest holder of reserves in the world. The foreign exchange reserves surpassed the US$3 trillion mark by March 2011. In this period, the PBOC has rolled out a number of initiatives and policies for managing the world's largest official reserves, and we see the rise of a more ambitious monetary authority in China, led by reformers in the PBOC and the State Administration of Foreign Exchange (SAFE), who are looking to "inject rationality, flexibility and practicality into China's approach, not just in the reserve arena, but more broadly in macroeconomic management" (Feng 2007).

China's growing pile of reserves has generated intense debate inside the country, and outside, over reserve adequacy and excess reserve accumulation, and has led to the establishment of official reserves investment corporations and other reserves management vehicles. The China Investment Corporation (CIC) was created to manage a small

[11]Liu He is deputy director of the office of the aforementioned CLGFEA.

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portion of the reserves (US$200 billion). The rest of the official reserve is managed by the SAFE, a subsidiary of the central bank, and has led to the creation of SAFE Inc. The CIC and SAFE now exist in a context that also includes other Chinese sovereign investors, China Development Bank, and the National Social Security Fund. Eaton and Zhang (2010) detail the growing competition between the CIC and SAFE, especially how the PBOC has allowed SAFE to "drift towards" high-risk, high–yield sovereign wealth fund-type investment (489–99), investing in overseas equities for the first time in its history. Feng (2007) suggests that China's cautious leaders have kept safety and liquidity over profitability as the top priority for reserves management. PRC leaders are willing to pay a "premium"—the costs of holding large excess reserves—for asset safety, financial security, and stability. However, at the same time, the PBOC and SAFE are pushing to explore "more efficient means" to use China's reserve assets and are looking to optimize the currency and asset structure of the reserves and expand its investment channels.

Beyond the aforementioned studies, a yawning knowledge gap exists on how exactly China has split its reserves portfolio into different tranches, from the traditional investment universe of central bank reserve managers, such as government instruments, agencies, and instruments issued by supranational institutions, to the broader set of asset classes that entail more exposure to credit risk, such as agency bonds and mortgage-backed securities, or idiosyncratic risk such as corporate bonds and equities. We still know little about the specifics of what Chinese authorities actually want from their reserves, or from their reserve managers, or how the central bank or whatever mix of actors go about defining these goals.

China's massive reserve holdings also carry inherent risks. Wang Xin (2007) noted perceptively that there are two risks in China's investment in dollar-denominated assets: first, Treasury bills generate relatively low returns, meaning that China pays out more on its liabilities than it earns on its foreign assets; second, the large holdings of dollar assets have left China exposed to exchange rate risk, with one credible estimate that each 10 percent decline in the dollar generates a loss equivalent to approximately 3 percent of China's GDP (Cohen 2008, 462). One way for China to reduce or mitigate the reserve risk is to take steps that enable it to reduce its foreign exchange holdings. One way to do this is to increase the international use of the Chinese currency.

Some Chinese economists, and some previously skeptical "foreign" experts, now see internationalization of the RMB as an inevitable step in China's economic evolution. In *Currency Internationalization: Global Experiences and Implications for the Renminbi* (Peng and Chang 2010), the chapters by Wen Hai and Yao Hongxin, Li Daokui and Liu Linlin, Ba Shusong et al., and Gao Haihong suggest that the internationalization of the RMB is the necessary next step for China. Such views have gained legitimacy inside Chinese policy circles after the PBOC issued Governor Zhou Xiaochuan's speech entitled "Reforming the International Monetary System" in March 2009, which called implicitly for reserve currency diversification beyond the dollar (Chin and Wang 2010). Chinese officials and leading Chinese researchers caution that it will be a gradual process, that China can "do some things" to promote the use of the RMB as a settlement currency, though the process must ultimately be market driven.[12] More

[12]Yu Yongding cited in Global Times (2010).

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in-depth international and comparative political economy analysis is needed on the regulatory and institutional innovation that is accompanying RMB internationalization, and the domestic interests and other obstacles that stand in its way, and that must be overcome if the RMB is to be used more internationally.

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