

Chapter 2

Financial Power and the Developmental State

This chapter develops the theoretical framework that will guide the empirical analysis. To this end, it first characterizes the political economy of the developmental state. In a second step, it examines if China falls into the category of the developmental state. It then introduces the concept of the instrumental developmental state to account for the crucial differences between China's political economy and the political economy of the classic developmental states of Japan, South Korea and Taiwan. In a third step, it develops a typology of financial power and provides an overview of the implications of the political economy of the developmental state for its financial power potential.

2.1 Conceptualizing the Developmental State

The classic conceptualization of the developmental state was put forward in Chalmers Johnson's (1982) seminal analysis of the foundations of Japan's economic success in the postwar era, *MITI and the Japanese Miracle*.¹ Johnson (1982: 19) famously distinguished between regulatory or market-rational and developmental or plan-rational states, arguing that the regulatory state "concerns itself with the forms and procedures [...] of economic competition," while the developmental state "will give greatest precedence to industrial policy, that is, to a concern with the structure of domestic industry and with promoting the structure that enhances the nation's international competitiveness." Depicting the pursuit of industrial policy as the defining feature of the developmental state, Johnson (1982: 24–25) argued that the developmental state's industrialization efforts were driven by a nationalistic desire to catch up with the advanced industrialized nations. On the basis of Johnson's work, the model of the developmental state came to play a key role in

¹ Two decades earlier Alexander Gerschenkron (1962) had developed similar ideas.

academic attempts to explain the highly successful industrialization process of East Asian nations after the Second World War.

Even though Johnson's model seemed in danger to slide into obscurity in the 2000s, a number of authors have in recent years invoked the idea of the developmental state in studies of China's political economy, thus aiming to put China's development experience in a comparative perspective (Kroeber 2011; Beeson 2009; Nee et al. 2007; Baek 2005; Tsai and Cook 2005). In his comparison of China's political economy since the beginning of economic reforms in the late 1970s with the political economies of the classic East Asian developmental states of Japan, South Korea and Taiwan, Arthur Kroeber (2011) has provided a lucid and comprehensive overview of the most important features of the political economy of the developmental state. Partly drawing on the work of Gordon White and Robert Wade (1988), Kroeber (2011: 45–46) argues that the classic developmental states were characterized by a set of features concerning the conditions, goals, mechanisms and outcomes of development.

According to Kroeber, the crucial conditions upon which developmental states rely are a high national saving rate, a high level of education, equitable land distribution, an effective bureaucracy and ethnic homogeneity. He argues that the developmental states' goals of "rapid economic growth through comprehensive industrial development" (Kroeber 2011: 45) and technological autonomy are pursued on the basis of the state's control over financial resources, market prices for goods that have no strategic importance, private ownership of industrial companies, promotion of exports and discouragement of foreign direct investment and imports of consumption goods. Last but not least, he claims that the catch-up strategies of developmental states usually result in high economic growth, comprehensive industrialization, trade surpluses, underdeveloped service industries and inefficient financial systems (Kroeber 2011: 45–46).

While this comprehensive list of characteristics certainly provides an illuminating picture of the classic developmental states, not all the features mentioned by Kroeber should be considered equally important. According to Johnson's model, the defining feature of the developmental state is the pursuit of industrial policy aimed at enhancing the nation's international competitiveness. On the other hand, the state's ability to engage in industrial policy making crucially relies on its control of a domestic financial system characterized by a high national saving rate that allows it to determine the allocation of financial resources in line with its policy objectives. Even though the other features that Kroeber considers defining of the developmental state certainly did play a role in the industrialization of Japan, South Korea and Taiwan, we should be careful to avoid the model's conceptual overstretch if we want to ensure its applicability to the analysis of the development experiences of other countries. In this book, we therefore subscribe to a minimalist definition of the developmental state according to which the developmental state pursues comprehensive industrial strategies to enhance the nation's international competitiveness by controlling the allocation of financial resources in a financial system characterized by a high national saving rate.

The centrality of the structure of the financial system to the characteristics of a state's political economy in general and the political economy of the developmental state in particular has been widely acknowledged. As Theda Skocpol (quoted after Woo-Cumings 1999: 11) has pointed out,

[t]he answers to [questions about financial resources] provide the best possible general insight into the direct or indirect leverage a state is likely to have for realizing any sort of goal it may pursue. For a state's means of raising and deploying financial resources tell us more than could any other single factor about its existing (and its immediately potential) capacities to create or strengthen state organizations, to employ personnel, to co-opt political support, to subsidize economic enterprises, and to fund social programs.

With regard to the developmental state, Meredith Woo-Cumings (1999: 10) has pointedly argued that “[f]inance is the tie that binds the state to the industrialists.” Johnson (1987: 147) has also highlighted the importance of “government reliance on financial and monetary means to guide and control private activities” in the classic developmental states of Japan, South Korea and Taiwan. However, the most comprehensive analysis of the relationship between a state's financial system and its ability to pursue comprehensive industrial strategies has been put forward by Zysman (1983) in his seminal analysis of *Financial Systems and the Politics of Industrial Change*.²

In his examination of the links between financial structures and the ability to pursue industrial policies, Zysman distinguishes between three types of financial systems: The first type is a system based on capital markets in which the long-term funding of companies relies on the issuance of securities. In such a system, the main function of banks is to provide short-term lending. Prices are set by the market, and the central bank is almost exclusively concerned with the control of monetary aggregates. In the words of Zysman (1983: 70), “[t]his model places banks, firms, and governments in distinct spheres from which they venture forth to meet as autonomous bargaining partners.” This type is exemplified by the financial systems of the US and the UK.

The second type is a credit-based system dominated by government-administered prices. In such a system, capital markets only play a very limited role in the acquisition of corporate funds, yet they allow the government to issue securities for its own funding. The provision of bank credit thus lies at the heart of the system of corporate finance. The government does not only facilitate bank lending and money creation, but also determines important prices to influence economic development. Due to the administrative setting of prices, markets in such a system tend to be in disequilibrium. Administrative interference is thus necessary to establish a balance between borrowers and lenders. According to

² Instead of adopting Johnson's (1982) distinction between regulatory and developmental state, Zysman (1983: 75) distinguishes between the government as an economic regulator, an economic administrator and an economic player. According to Zysman (1983: 326, footnote 14), the difference between a player state and a developmental state is that the former may intervene without pursuing a developmental objective. Zysman thus considers the developmental state a subcategory of the player state.

Zysman (1983: 71), “[t]he issue in this system is [thus] not whether government intervenes to affect the allocation of financial resources; the question is who controls the process and how.” Hence “the state’s entanglement with industry becomes part and parcel of the financial system” and “[t]he borderline between public and private blurs, not simply because of political arrangements, but because of the very structure of the financial markets” (1983: 72). This type is exemplified by the French and the Japanese financial systems.

The third type is also a credit-based system, yet it is dominated by a limited number of financial institutions that are independent of state support and thus characterized by a lesser degree of government interference. In this system, “[g]overnment does not have the apparatus to dictate allocative choices to the financial institutions and consequently it has no independent instruments in the financial system with which to influence companies” (Zysman 1983: 72).³ Nevertheless, banks “can serve as policy allies for government, on terms negotiated between the government and finance” (Zysman 1983: 22). This type is exemplified by the German financial system.

Having developed this typology of financial systems, Zysman (1983: 76) argues that state control over the allocation of credit “is the single discretion necessary to all state-led industrial strategies” since it allows the state “to enter continuously into the industrial life of private companies and to influence their strategies in the way that a rival or partner would.” To avoid misunderstandings, it needs to be emphasized that Zysman does not deny the possibility of industrial policy making relying on mechanisms other than the control over financial resources. A state may resort to a whole range of measures in its conduct of industrial policy making, including the imposition of sectoral trade barriers, the introduction of local-content requirements or the promotion of specific industries through tax incentives. However, such measures require a time-consuming regulation on a case-by-case basis and thus only permit the state to concern itself with a very limited range of issues. On the other hand, the universal applicability characteristic of selective credit allocation allows the state “to exert influence across a range of issues without having to develop regulatory or administrative apparatus for each specific case” (Zysman 1983: 77). In other words, a regulatory state may occasionally engage in industrial policymaking on the basis of mechanisms other than selective credit allocation, while “a state in which the developmental orientation predominates” (Johnson 1982: 17) can only pursue its comprehensive industrial strategy if it is in a position to exercise control over the allocation of financial resources.

Zysman (1983: 76) does not only draw attention to the importance of selective credit allocation in the state’s control over private companies, but also points out that “[e]ven with public companies, the financial instruments for selectively

³ As Zysman (1983: 72) has pointed out, both the second and the third type are associated with late and rapid development, while the first type has usually emerged within the context of earlier industrial growth. According to Zysman (1983: 63), the reason for the association of credit-based systems with rapid and late economic growth is the fact that companies operating in such an environment need to secure large amounts of funds to be able to achieve high growth rates.

allocating credit provide government a refined set of tools to supplement the appointment of management or the imposition of broadly defined government policy directives.” Due to the significance of selective credit allocation to the pursuit of industrial policies, he then argues that only a credit-based financial system that is dominated by government-administered prices allows the state to pursue a comprehensive industrial strategy. However, it needs to be pointed out that a state may in principle also be able to pursue industrial policy objectives within the framework of a credit-based system dominated by financial institutions if the ownership structure of these institutions allows the government to influence their lending decisions. On the other hand, it appears highly unlikely that a state that actively influenced the lending decisions of state-owned financial institutions to achieve industrial policy objectives would refrain from administratively controlling interest rates to ensure low costs of funding. It is therefore more important to draw attention to the fact that the features of a credit-based system dominated by government-administered prices can be combined with state-ownership of the dominant financial institutions to establish a fourth type of financial systems that allows for the highest possible degree of state control over the allocation of financial resources. As the following chapters will show, this type is exemplified by the Chinese financial system.

Against the backdrop of this analysis, it becomes evident that the financial systems of developmental states either belong to the second or the fourth type of the financial systems characterized above. In other words, developmental states either rely on a credit-based system dominated by government-administered prices or a credit-based system that combines government-administered prices with state-ownership of the dominant financial institutions to control the allocation of financial resources in their pursuit of industrial policy objectives. In any case, the financial systems of developmental states are characterized by the prevalence of bank loans over securities, state control of interest rates guaranteeing low costs of funding and the maintenance of capital controls that ensure the availability of national savings for domestic investment. Developmental states thus rely on a policy of financial repression to facilitate rapid economic growth and strengthen the nation’s international competitiveness.

The concept of financial repression was originally introduced into the economic literature by Ronald McKinnon (1973) and Edward Shaw (1973) to characterize the shallow financial systems of developing countries. Both authors argued that financial repression was a severe obstacle to economic growth. McKinnon (1973: 69) pointed out that financial repression reduces the amount of funds available for investment since the introduction of interest rate ceilings and the resulting low real returns prompt savers to reduce “their holdings of money and near-monies far below what might be considered socially optimal.” At the same time, he argued that financial repression limits the number of potential recipients of funds since interest rate ceilings guarantee that funding is only available for completely safe borrowers or is contingent on political connections while the majority of the population “remain financially ‘repressed’, although they own a significant proportion of the deposits on which the expansion of bank credit to the favored enclaves is

based” (McKinnon 1973: 70–71). In the case of the developmental state, the channeling of funds into sectors and companies that are considered strategically important also has the effect of preventing a large number of potential investors from acquiring funds. However, in contrast to the shallow financial systems that are the focus of McKinnon and Shaw’s analyses, the financial systems of developmental states are characterized by high saving rates that allow the authorities to provide industry with an ample amount of funds for investment at the expense of consumers who remain financially repressed.

2.2 China as a Developmental State?

The question if China should be considered a developmental state has been given divergent answers in the literature. It is generally agreed that China’s political economy has shared some important features with the classic developmental states of Japan, South Korea and Taiwan since the beginning of the reform policies in the late 1970s. Considering administrative resource management a variety of industrial policy, some authors have even argued that the People’s Republic of China has been a developmental state ever since its inception in 1949 (Beeson 2009; White 1988). In contrast with this view, Johnson (1982) explicitly excluded communist political economies from the category of developmental states. He characterized communist states as “plan ideological” as opposed to “plan rational” developmental states, arguing that in the former, “state ownership of the means of production, state planning, and bureaucratic goal-setting are not rational means to a developmental goal [but] fundamental values in themselves, not to be challenged by evidence of either inefficiency or ineffectiveness” (Johnson 1982: 18).

However, with the introduction of economic reforms, the Chinese party-state has discarded at least some of its ideological convictions and has instead adopted a more pragmatic approach to development. On the other hand, the Chinese authorities have continued to engage in state planning and to pursue comprehensive industrial strategies in order to enhance the nation’s international competitiveness. China has thus displayed crucial features of the developmental state. Chinese policymakers already formulated the developmental goals of achieving rapid economic growth, comprehensive industrialization and technological autonomy in the Four Modernizations program whose official launch in 1978 marked the beginning of the reform period (Kroeber 2011: 46). Fourteen years later, during his famous southern tour, China’s then paramount leader Deng Xiaoping underlined the regime’s developmental orientation when he argued that “[o]ur country must develop; if we do not develop then we will be bullied. Development is the only hard truth” (quoted after Kroeber 2011: 204, footnote 4).

With regard to state planning and the formulation of comprehensive industrial strategies, Sebastian Heilmann (2011b: 33) has drawn attention to the fact that instead of gradually abandoning strategic planning, China has “reinvigorated its ambitions in long-term, cross-sectoral coordination of economic, social,

technological, and environmental development from the mid-1990s through the 2000s.” As Heilmann (2011b: 33) has pointed out, Chinese policymakers have designed “multi-year programs with binding and indicative targets in virtually every sector, from space programs and infrastructural construction through human resources and education to health care, cultural life, and tourism.” However, Chinese development planning has undergone substantial changes in the last two decades. While planning was originally considered a “substitute for markets”, a reform of the planning system in the early 1990s required planners to take domestic and global market developments into consideration and to “plan with and for markets” (Heilmann 2011b: 34). Planning was thus redefined as a key element of economic macro-management along with fiscal and monetary policy aimed at facilitating comprehensive economic coordination.

In its pursuit of comprehensive industrial strategies, the Chinese party-state has crucially relied on its high degree of control over the domestic financial system that combines government-administered prices with state-ownership of the dominant financial institutions. Characterized by extensive financial repression, this system has allowed the authorities to control the allocation of the country’s financial resources and to channel them into sectors and companies that are considered strategically important. Also with regard to the role of the financial sector, post-socialist China has thus displayed a crucial feature of the classic developmental states.⁴

However, attention has also been drawn to the features of China’s political economy that distinguish the country from the classic developmental states of Japan, Korea and Taiwan. For one, it has been argued that China’s economic reforms have not exclusively been promoted to achieve rapid economic growth in order to turn China into a ‘rich and powerful country’ (*fuqiang guo*), but have also been considered a means to ensure the Chinese Communist Party’s (CCP) continued grip on power and maintain political stability (Breslin 1996).⁵ Besides, it has been pointed out that diverging political demands from different factions of the party, the decentralization of economic decision making and the high degree of intra-bureaucratic contestation in China’s system of fragmented authoritarianism have “obstructed the formulation of a coherent and effective national economic development strategy” (Breslin 1996: 691) and resulted in a tendency to favor incremental changes over comprehensive reforms.⁶

Even more importantly, it has been highlighted that China differs from the classic East Asian developmental states insofar as its economy is characterized

⁴ The centrality of the state’s control over the financial system to the classification of China as a developmental state has also been emphasized by Baek (2005).

⁵ For a detailed analysis of the political priorities of China’s reform process see Susan Shirk (1993).

⁶ For a similar argumentation see Kroeber (2011: 47), Beeson (2009: 23–24), Tsai and Cook (2005: 50). The term ‘fragmented authoritarianism’ was coined by Lieberthal and Oksenberg (1988).

by a high degree of state ownership as a legacy of its communist past.⁷ As Kroeber (2011: 50) has pointed out, China avoided the path of privatization in contrast to most other postcommunist economies, instead focusing on the deregulation of prices and the creation of competitive markets. In the 1990s, China began to privatize small enterprises without strategic significance. However, the party-state refrained from forsaking its ownership of major state-owned enterprises (SOEs) in strategically important sectors such as finance, infrastructure and resources. Even though there are also numerous private companies that play a crucial role with respect to the creation of employment opportunities, they are of very limited size and are thus in no position to exercise political influence (Kroeber 2011: 50–51).⁸

Do we have to qualify our classification of China as a developmental state in the light of these differences between the Chinese political economy and the political economy of the classic developmental states? Even though the decentralization and fragmentation of China's political system have at times hampered the formulation and implementation of a coherent development strategy, China has taken the art of planning to a new level since the overhaul of its planning system in the early 1990s and should thus be considered a 'plan rational' developmental state. However, an important difference between China and the classic developmental states is the fact that China's development planning has been heavily influenced by the political priority of securing the CCP's grip on power. Not least in order to protect the political interests of the ruling elites, the state-owned sector continues to play a crucial role in China's political economy. The Chinese party-state thus wields a degree of influence over the country's political economy that is much higher than in the classic developmental states since its control of SOE management through the nomenklatura system provides it with additional leverage over their business strategies.⁹ Due to the importance of the state-owned sector to the preservation of the CCP's control over the country's political economy, comprehensive privatization is not deemed an option to be considered in the country's development planning. In contrast to the classic developmental states that pursue the goals of securing rapid economic growth, technical autonomy and international competitiveness as ends in themselves, we should thus consider China an *instrumental developmental state* that only embraces these objectives with the ultimate goal of securing the ruling elites' grip on power.

⁷ A related difference between China's political economy and the political economy of the classic developmental states is the fact that China's development strategy has crucially relied on the promotion of foreign direct investment for the creation of a competitive export sector, whereas the classic developmental states strongly discouraged FDI. While export-oriented business groups in Japan and South Korea greatly benefited from the state's control over the allocation of credit, China's financial system has been geared to support state-owned enterprises that focus on the domestic market (Kroeber 2011: 48, Beeson 2009: 27–28, Baek 2005: 494).

⁸ For a similar argumentation see Tsai and Cook (2005: 50–53). For an analysis of the ownership structure of the Chinese economy see OECD (2005). On the process of SOE reform see Heilmann (2011a).

⁹ On the Chinese nomenklatura system see Heilmann and Kirchberger (2000).

2.3 A Typology of Financial Power

Against the backdrop of the preceding examination of the most crucial features of the political economy of the developmental state, the following sections analyze the different types, sources and mechanisms of financial power in the context of interstate relations.

2.3.1 *Conceptualizing Financial Power*

For an inquiry into the implications of the political economy of the developmental state for its ability to acquire financial power, a clear definition of the concept of financial power is needed. However, as Benjamin Cohen (2001: 433) has noted, the “meaning of power [. . .] is no better understood in monetary scholarship than it is in the broader IR literature.” Even though the concept of financial power is widely used in the international political economy literature, a comprehensive typology of financial power is still lacking. The following sections therefore draw on the insights of the leading scholars of the subject to establish a typology of financial power that will guide the empirical analysis provided in the following chapters.¹⁰

In line with Cohen (2001: 430), this book holds that the realm of international finance “encompass[es] all the main features of monetary relations between states – the processes and institutions of financial intermediation [. . .] as well as the creation and management of money itself.”¹¹ In other words, it contends that the realm of international finance comprises the processes and institutions of the international allocation of credit as well as the distribution and the value of the currencies in which international transactions are denominated.

With regard to the definition of financial power, Cohen (2001) has pointed out that we need to distinguish between an internal and an external dimension of power. While the internal dimension of power “corresponds to the dictionary definition of power as a capacity for action,” the external dimension of power “corresponds to the dictionary definition of power as a capacity to control the behavior of others” (Cohen 2001: 433). In this book, the concept of financial power solely refers to the external dimension of financial power.

According to David Andrews (2006b: 8), external financial power “is manifest when one state’s behavior changes because of its monetary relationship with

¹⁰ To be more specific, the aim of this section is to provide a comprehensive typology of the external dimension of financial power in the context of interstate relations.

¹¹ In his definition of the realm of international finance, Cohen (2001: 430) draws on Strange (1988: 88) who argued that a “financial structure can be defined as the sum of all the arrangements governing the availability of credit plus all the factors determining the terms on which currencies are exchanged for one another.”

another state.”¹² In line with this understanding, this book subscribes to a definition of financial power as a state’s ability to influence the behavior of other states through its financial relations with them.¹³ Power is thus specified as financial if the means through which it is exercised and the sources from which it derives are located in the realm of finance, not if the outcomes that it achieves belong to the realm of finance. Put differently, financial power is defined as power *deriving from the realm of finance* as opposed to power *applied to the realm of finance*.

2.3.2 *Relational, Structural and Institutional Financial Power*

For the development of a typology of international financial power, it is useful to recall Susan Strange’s distinction between relational and structural power in the areas of finance, production, security and knowledge that she developed in her writings on the global political economy.¹⁴ Convinced that structural power was becoming increasingly important in the international system, she argued against the widespread belief in American hegemonic decline.¹⁵ In line with conventional definitions of the concept of power, Strange (1988: 24) thought of relational power as “the power of A to get [...] B to do something they would not otherwise do.” In contrast with relational power, she defined structural power as

the power to shape and determine the structures of the global political economy within which other states, their political institutions, their economic enterprises and (not least) their scientists and other professional people have to operate [...] Structural power, in short, confers the power to decide how things shall be done, the power to shape frameworks within which states relate to each other, relate to people, or relate to corporate enterprises. (1988: 24–25)

Whereas she thought of relational power as being exercised by the application of direct pressure, she considered structural power a more indirect form of power. According to Strange (1988: 31), the possessor of structural power

is able to change the range of choices open to others, without apparently putting pressure directly on them to take one decision or to make one choice rather than others. Such power is less ‘visible’. The range of options open to the others will be extended by giving them opportunities they would not otherwise have had. And it may be restricted by imposing

¹² The concepts of financial power and monetary power are used synonymously in the literature.

¹³ We prefer the use of the concept of influence rather than change since the exercise of a state’s financial power may also prevent another state from changing its behavior.

¹⁴ For Strange’s distinction between structural and relational financial power see for example Strange (1982, 1986, 1988, 1990). The following sections have been influenced by Eric Helleiner (2006) who also discusses the relationship between the concepts of structural power proposed by Strange (1988), Guzzini (1993), Cohen (1977) and Kirshner (1995) but arrives at different conclusions.

¹⁵ For the classic definition of hegemonic stability theory see Keohane (1980).

costs or risks upon them larger than they would otherwise have faced, thus making it less easy to make some choices while making it more easy to make others.

Even though Strange's concept of structural power has greatly influenced international relations theory, it cannot be denied that it is highly ambiguous. As Guzzini (1993: 456–457) has pointed out, Strange in fact refers to two different concepts of structural power without explicitly drawing a distinction between them. According to Guzzini's (1993: 457) interpretation, Strange uses the concept of structural power in the sense of a power to shape structures as well as in the sense of a power deriving from "international structures set up in a way that decisions in some countries are systematically tied to and affect actors in the same and other countries." In Guzzini's understanding, the main difference between these forms of structural power is that the first one – indirect institutional power – is exercised with intent, whereas the second one is by definition non-intentional. While the concept of indirect institutional power refers to an actor's ability to manipulate the formal rules and informal customs that govern the global political economy, the concept of non-intentional power refers to an actor's ability to exercise influence deriving from its position within a certain politico-economic structure.¹⁶ However, Guzzini's implicit claim that power deriving from structures can only be exercised in an unintentional way is not convincing. A structurally powerful state's domestic decisions may have repercussions for other states that are not intended. Yet a structurally powerful state may also exploit its position to deliberately influence outcomes in other states in line with its policy preferences.

While Strange used the term 'structural power' to refer to both power deriving from structures and power applied to structures, this book narrows its conceptual scope down in order to avoid ambiguity and solely uses it to refer to power deriving from structures. It can be briefly illustrated how this narrower conception of structural power affects the distinction between structural and relational power in the realm of finance. According to Strange (1982: 81), the ability of the United States to extract wealth from other states is one of the most important aspects of American structural financial power. Since this power derives from the dollar's role as the global core currency in the structure of the international financial system, the ability to extract wealth qualifies as structural financial power according to our definition. Strange (1986: 55) also pointed out that due to the dominant position of American financial markets in the international financial architecture, US financial regulation had important implications for financial regulation in other states. This book considers this ability to shape financial structures as structural financial power not because it is a power applied to financial structures, but because it is a power that derives from the structure of the international financial system. However, the ability to shape international financial regulation might also stem from a state's position as a creditor that allowed it to exercise direct pressure on other states to

¹⁶ As Helleiner (2006: 76) has emphasized, Strange aimed at providing a definition of power that was not limited to the power of one state over another, but also included a state's power to influence nonstate actors and market forces.

change their financial regulation. In this case, this book would consider it as relational financial power. Alternatively, the ability to shape global financial structures might stem from sources that are not located in the realm of finance, but, for example, in the military realm, in which case this book would not consider it as financial power but as military power.

Notions of structural power have also been discussed in the writings of Cohen (1977) and Kirshner (1995). In *Organizing the World's Money*, Cohen (1977: 56) defines “structure power” as “the ability to extract advantage by favorably modifying the interaction situation” and distinguishes it from “process power” understood as “the ability to extract advantage within the existing interaction situation.” In other words, Cohen (1977: 56) considers process power “the ability to gain under the prevailing rules of the game, while structure power is the ability to gain by rewriting the rules of the game.” Cohen hence understands structural power as power *applied to structures*. On the other hand, Kirshner in *Currency and Coercion* distinguishes between “overt power” (1995: 116) and the power that a state “derives from the rules of the system, or from the ‘structural’ forms of dependence” (1995: 117). Kirshner thus defines structural power as power *deriving from structures*.

On the basis of the preceding discussion, this book distinguishes between relational financial power as a state’s ability to influence the behavior of other states directly by applying financial pressure and structural financial power as a state’s ability to influence the behavior of other states indirectly via the structure of the international financial system. In addition to these two types of power, a third type of financial power that can be characterized as a state’s ability to influence the behavior of other states indirectly through the policy decisions of international financial institutions will be incorporated into the following analysis.¹⁷

2.3.3 *Manipulative and Non-manipulative Financial Power*

As has already been pointed out, structural financial power can either be exercised in a manipulative (or intentional) way or in a non-manipulative (or non-intentional) way. Structural financial power is exercised in a non-manipulative way when financial policy decisions in one state that do not primarily aim at influencing other states have repercussions for these states due to the structure of the international financial system. On the other hand, structural financial power is exercised in a manipulative way when a state exploits its position in the global financial system to deliberately influence outcomes in other states in line with its policy preferences.

¹⁷ This concept of institutional power should not be confused with Guzzini’s (1993) concept of indirect institutional power that is defined as power applied to structures. To avoid misunderstandings, it also needs to be pointed out that due to her broader understanding of the concept of structural financial power, Strange (1982) considered a state’s ability to influence the behavior of other states indirectly through the policy decisions of international financial institutions as an aspect of structural financial power.

Just as structural financial power, institutional financial power can be exercised in a manipulative as well as a non-manipulative way. Institutional financial power is exercised in a non-manipulative way when a state influences the policy decisions of international financial institutions without aiming to achieve specific policy outcomes in other states. On the other hand, institutional financial power is exercised in a manipulative way when a state influences the policy decisions of international financial institutions for the sake of ensuring specific policy outcomes in other states. In contrast to structural and institutional financial power, relational financial power is by definition exercised in a manipulative way.

Both Cohen (2006) and Andrews (2006b) have discussed distinctions similar to the one between manipulative and non-manipulative financial power. As we have already noted, Cohen distinguishes between an internal dimension of power that corresponds to a state's autonomy and an external dimension of power that corresponds to a state's authority or influence. According to Cohen, autonomy in the realm of finance implies a certain degree of influence since financial relations are inherently reciprocal. However, the influence that is implied by a state's autonomy is nothing but a "contingent aspect of power" whose impacts are "diffuse and undirected" (Cohen 2006: 34). Cohen (2006: 34) thus argues that this passive mode of influence needs to be distinguished from influence in the conventional sense – the active mode of influence that is "targeted at specific countries and applied with self-conscious purpose."

In a similar vein, Andrews (2006b) distinguishes between monetary power and monetary statecraft. While Andrews (2006b: 16) understands monetary power as a state's ability to change the behavior of other states through its financial relations with them, he argues that the concept of monetary statecraft has a more restricted meaning and refers to "the conscious manipulation of monetary relations in order to affect the policies of other states." Whereas Andrews' concept of monetary statecraft corresponds to Cohen's concept of the active mode of monetary influence and the concept of manipulative financial power, his notion of monetary power is a broader term that contains Cohen's concept of monetary autonomy and his concept of monetary influence as well as manipulative financial power and non-manipulative financial power.

2.3.4 Objectives of Financial Power

Having defined financial power as power deriving from the realm of finance as opposed to power applied to the realm of finance, this book distinguishes between a manipulative exercise of financial power that is targeted at financial objectives and a manipulative exercise of financial power that is targeted at non-financial objectives. All types of financial power mentioned above can be either targeted at financial or non-financial objectives. One of the most prominent examples of an exercise of (institutional) financial power targeted at non-financial objectives was the US decision to block the UK's access to the IMF's reserves in order to make

London withdraw its forces from Egypt during the Suez Crisis in 1956 (Andrews 2006b: 7).¹⁸

2.3.5 Summary: Types of Financial Power

This book understands financial power as a state's ability to influence other states through its financial relations with them. It distinguishes between relational, structural and institutional financial power. Relational financial power is a state's ability to influence other states directly by applying financial pressure. Structural financial power is a state's ability to influence other states indirectly through the structure of the international financial system. Institutional financial power is a state's ability to influence other states indirectly through the policy decisions of international financial institutions. Whereas relational financial power is by definition manipulative, structural financial power as well as institutional financial power can be exercised in a manipulative as well as a non-manipulative way. The manipulative exercise of power, be it relational, structural or institutional, can be targeted at financial as well as non-financial objectives. The following graphic gives an overview of the different types and subtypes of financial power (see Fig. 2.1).

2.3.6 Relational Financial Power

What are the mechanisms through which these types of power are exercised, and what are the sources from which they derive? As has already been explained, relational financial power is a state's ability to influence other states' behavior directly by applying financial pressure. However, the exercise of relational financial power may also rely on the provision of financial incentives. The main mechanisms for the exercise of relational financial power are the provision of credit as far as incentives are concerned and the withdrawal of credit or the refusal to provide credit as well as the dumping of a debtor state's currency in order to manipulate its exchange rate as far as pressure is concerned. A state's creditor status can hence be considered its main source of relational financial power (Helleiner 1989, 1992; Strange 1990). As Helleiner (1989: 345) has pointed out, the variables that determine the degree of a creditor state's relational financial power are the size and the duration of its capital outflows, the degree of state control over these outflows and the creditor state's vulnerability to its major debtors. Besides, it has to be taken into account that the degree of a creditor state's relational financial power is also influenced by the debtor's vulnerability to the creditor that depends on the

¹⁸ Numerous examples of the exercise of financial power targeted at non-financial objectives can be found in Kirshner (1995, 2006).

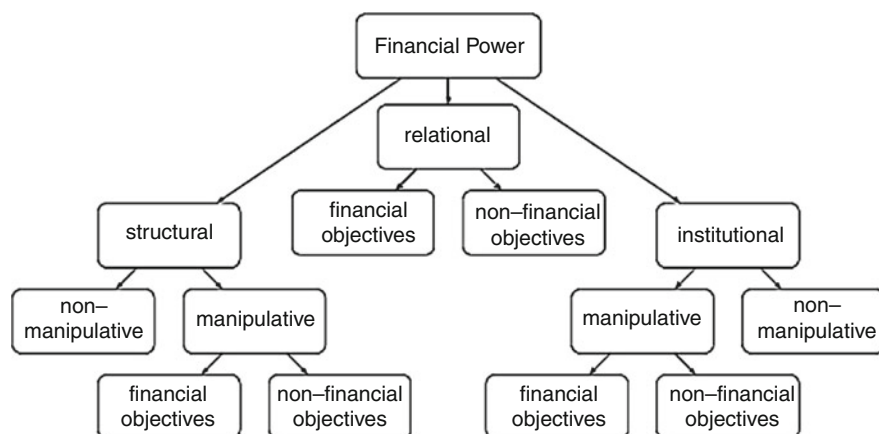


Fig. 2.1 Types of financial power

alternative sources of credit at the debtor's disposal and the nature of the debtor's exchange rate regime (Drezner 2009: 18–20).¹⁹ In order to have relational financial power at its disposal, a state does not necessarily have to be a net creditor. A net debtor that is in the position to provide international credit can also exercise relational financial power. Through the exercise of relational financial power, a state may try to achieve any policy objective it considers important.

2.3.7 *Institutional Financial Power*

While relational financial power is exercised directly, institutional financial power is exercised indirectly through the policy decisions of international financial institutions. Since the International Monetary Fund and the World Bank are the most important financial institutions in the present international financial architecture, a state's voting share, its contribution of funds and its representation among the staff and management of these institutions are the main sources of its institutional financial power (Woods 2003b). The main mechanism for the exercise of institutional financial power is a state's influence on the provision of credit via these institutions and the conditions on which this provision of credit relies. If a state exercises its institutional financial power in a manipulative way, the objectives of its power exercise usually lie in the realm of economic interests. However, in principle any policy objective may be achieved through the exercise of institutional financial power.

¹⁹ These points will be further explained in Chap. 5.

2.3.8 *Structural Financial Power*

The concept of structural financial power can only be understood on the basis of an examination of its different aspects. This section begins with the analysis of one of the most important aspects of structural financial power that concerns the cost of adjustment to balance of payments disequilibria.

2.3.8.1 Power to Delay Adjustment to Deficits

According to Cohen (2006: 36), who has most prominently discussed this aspect of structural financial power, the continuing cost of adjustment to balance of payments disequilibria “may be defined as the cost of the new payments equilibrium prevailing after all change has occurred.”²⁰ These costs are borne by the deficit state, since for the deficit state the restoration of payments equilibrium requires “a reduction of imports relative to exports” that implies that it will “receive a smaller proportion of the combined output of the two economies” (Cohen 2006: 38). For this reason, deficit states have every incentive to try and postpone the process of adjustment. The longer one deficit country can delay the process of adjustment, “the greater will be the pressure on other deficit countries to bear the burden instead” (Cohen 2006: 42).

According to Cohen (2006: 42–43), the power to delay derives from a state’s international liquidity position that allows it to cover deficits in the balance of payments. The main components of a state’s international liquidity are its foreign exchange reserves and its external borrowing capacity. The bigger a state’s stockpile of reserves, the greater its power to delay. However, since the acquisition of reserves always comes at a price, states usually do not seek a maximum level of reserves, but an optimal level. As reserves are in most cases accumulated as a result of a current account surplus, the costs that are associated with them are a reduction of imports relative to exports.²¹

However, Cohen does not pay attention to the fact that the accumulation of reserves is also associated with sterilization costs that arise because the inflationary impact of reserve accumulation has to be neutralized by the issuance of domestic debt. Since sterilization costs can be a serious hindrance to the accumulation of reserves, a state’s ability to acquire foreign exchange reserves is crucially influenced by its ability to control the costs of sterilization. Most important in this

²⁰ Cohen (2006: 46) distinguishes between the power to delay the continuing cost of adjustment and the power to deflect the transitional cost of adjustment, arguing that the power to deflect “derives not from financial variables but [...] from more fundamental structural variables that distinguish one national economy from another”, namely “the degree of openness and the degree of adaptability of each individual economy.” Since the power to deflect does not derive from the realm of finance, its analysis is not included in this book.

²¹ Reserves can also be acquired by external borrowing that leads to costs in the form of interest payment.

regard is the authorities' ability to keep interest rates low and mandate domestic financial institutions to purchase sterilization bonds. A state's ability to acquire foreign exchange reserves is thus significantly bolstered by the maintenance of a system of financial repression.

As Cohen (2006: 43–46) has pointed out, a state's external borrowing capacity depends on the international attractiveness of its financial markets and the assessment of its creditworthiness by foreign investors. Like the accumulation of foreign exchange reserves, external borrowing usually comes at a price. In addition to the interest that has to be paid, there is also the risk of a depreciation of the domestic currency against the borrowed currency that would increase the costs of borrowing. However, a different situation arises if the borrower state issues a global currency and is therefore in a position to borrow in its own money. In this case, the borrower state does not only deflect the risk of exchange rate fluctuations to the creditor state. Its interest burden is also decreased by foreigners who hold its money without investing it in financial assets. The issuance of a global currency thus provides the issuing state with the power to extract wealth from other states that enhances its power to delay adjustment to deficits. Moreover, due to the international demand for its domestic money, a state that issues the international core currency will find it easier than any other state to borrow from abroad. Its power to delay is by far greater than the power to delay of a state that has accumulated reserves by running a balance of payments surplus that would allow it to delay the adjustment to external imbalances if its surplus turned into a deficit. Whereas the borrowing capacity of the state that issues the global currency is almost unlimited, reserves will be spent rather quickly and can therefore only function as an insurance against balance of payments shocks, but do not allow a state to run a permanent current account deficit.

2.3.8.2 Power to Delay Adjustment to Surpluses

Cohen's (2006) analysis of the power to delay explicitly refers to the power of deficit states to delay the process of adjustment. He mentions that surplus states may also want to delay the process of adjustment if they fear the transitional costs associated with that process. Yet he emphasizes that the motivation of surplus states to delay the process of adjustment is not as intense as the motivation of deficit countries since the former do not have to worry about the continuing costs of adjustment (Cohen 2006: 42). However, surplus states may have strong incentives to delay the process of adjustment if they want to sustain their surpluses because they rely on an export-led growth strategy. For this reason, the power to delay adjustment to surpluses that may hinder deficit countries from restoring balance of payments equilibrium should be considered an important aspect of structural financial power. The source of this power is a state's ability to maintain a fixed exchange rate regime that allows the authorities to prevent the domestic currency from appreciating, which in turns depends on a state's ability to maintain capital controls and neutralize the inflationary impact of a trade surplus under a fixed

exchange rate regime.²² In other words, the source of the power to delay adjustment to surpluses is the maintenance of a system of financial repression within the context of an international financial architecture dominated by floating exchange rate regimes.

2.3.8.3 Power to Project Macroeconomic Preferences

As Strange (1986) and Helleiner (2006) have argued, structural financial power also includes a state's ability to project its macroeconomic preferences onto other states. The main mechanism of this aspect of structural financial power is a state's ability to attract international capital, which stems not only from the depth and openness of its financial markets, but also from the international status of its currency. With regard to this aspect, Strange (1986: 22) has drawn attention to the fact that "when US domestic monetary policy changed direction, and when interest rates in the United States responded to changes of policy, other states had no choice but to adjust their own interest rates and their domestic policies to such changes, whereas it never happened the other way around." One of Strange's (1986: 55) examples was the US decision to hike interest rates in its fight against inflation in the late 1970s and "the consequent imposition on other countries and on the world economy of interest rates that were both high and volatile." Besides, macroeconomic preferences can also be projected via a currency's function as a monetary anchor, since a state that chooses to adopt a currency peg without being able to effectively enforce capital controls will inevitably import the latter's monetary policy.

2.3.8.4 Power to Shape International Financial Regulation

According to Strange (1986) and Helleiner (2006), the power to shape international financial regulation is another important aspect of structural financial power. The sources of this power are the dominant international position of a state's currency and its financial markets that allow it to influence international regulatory trends via the regulation or deregulation of its domestic financial system. Since the 1970s, the US has exercised this aspect of structural financial power via domestic liberalization measures that prompted other states "to follow the U.S. regulatory lead because of their fear of losing financial business and capital to liberal and deregulated U.S. dollar markets" (Helleiner 2006: 80).

²² According to the Mundell-Fleming Model, a state cannot simultaneously maintain a fixed exchange rate, an independent monetary policy and free movement of capital. See Mundell (1963) and Fleming (1962).

2.3.8.5 Entrapment

Last but not least, Kirshner (1995) has discussed two important aspects of structural financial power in his analysis of monetary entrapment. Kirshner draws attention to the fact that most states' "primary motivation for leading monetary systems [. . .] is to reap the benefits of entrapment" (Kirshner 1995: 117) which he defines as the "transformation of interests that results from participation in a currency system" (Kirshner 1995: 118). Membership in a currency system fosters trade and investment links with the dominant state by altering transaction costs via the elimination of costs resulting from exchange rate fluctuations. Besides, participation in a currency system creates a common interest in the value and stability of the dominant state's currency since member states usually come to hold significant amounts of that currency. According to Helleiner (2006: 80–82) we can thus distinguish between two different aspects of the mechanism of entrapment that establish two different aspects of structural financial power: Whereas the issuer of an international currency gains the power to reshape economic geography via the alteration of transaction costs, it gains the power to reconstruct economic interests via the creation of dependencies on the value and stability of its currency. The following table gives an overview of the different types of financial power, their mechanisms and their sources (see Table 2.1).

2.4 Preview of the Argument

On the basis of the preceding conceptualization of the developmental state and the development of a typology of financial power, a preliminary explanation of the implications of the political economy of the developmental state for its ability to acquire financial power can now be provided. Since the developmental state's system of financial repression is not compatible with the development of financial markets capable of attracting international investors on a significant scale, it largely prevents the acquisition of structural financial power deriving from the international pulling power of financial markets. For the same reason, the developmental state is not in a position to develop structural financial power by establishing its domestic currency as an international store of value since this aspect of currency internationalization requires the very development of financial markets that is not compatible with a system of financial repression. However, since the developmental state's system of financial repression allows it to withstand currency appreciation pressures, it provides it with the power to delay the costs of adjustment to balance of payments surpluses. Moreover, since their systems of financial repression are geared to facilitate rapid economic growth through comprehensive industrial development at the expense of consumption, developmental states frequently embark on export-led growth strategies resulting in significant current account surpluses that turn them into net creditors with significant relational financial power. Due to their strong creditor positions, developmental states are thus not as dependent on the

Table 2.1 Aspects, mechanisms and sources of financial power

Aspect/Objective	Mechanisms	Sources
Structural financial power		
Power to delay adjustment to deficits	External borrowing	International currency (store of value) International pulling power of financial markets
Power to delay adjustment to surpluses	Maintenance of fixed exchange rate regime	Maintenance of capital controls Ability to contain sterilization costs
Power to project macroeconomic preferences	Attraction of portfolio investment	International currency (store of value) International pulling power of financial markets
	Provision of monetary anchor	International currency (unit of account)
Power to shape international financial regulation	Regulation of financial markets using core currency	International currency (store of value) International pulling power of financial markets
Power to shape economic geography	Alteration of transaction costs	International currency (medium of exchange, unit of account, store of value)
Power to reconstruct economic interests	Creation of a common interest in value and stability of core currency	International currency (store of value)
Relational financial power		
Any policy objective possible	Provision of credit	Creditor status:
	Refusal to provide credit/withdrawal of credit	Size and duration of capital outflows
	Dumping of debtor's currency	State control over capital outflows Creditor's vulnerability to debtor Debtor's vulnerability to creditor
Institutional financial power		
Any policy objective possible	Influence on provision of credit and its conditionality	Influence in IMF and World Bank: Voting share Contribution of funds Representation among staff and management

Adapted from Helleiner (2006: 84)

Additional Sources: Drezner (2009), Woods (2003b), Helleiner (1989)

acquisition of institutional financial power as neoliberal states whose relational financial power tends to be much more limited. In the following chapters, a detailed account of the political economy of the financial systems of both the Japanese and the Chinese developmental state will be provided that will allow for a more profound explanation of the relationship between the political economy of the developmental state and its financial power potential.

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