China's Financial System: Past Reforms, Future Ambitions and Current State

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Abstract Commensurate with its economic strength, China aims for a financial sector and currency of global importance. To assess the likelihood of this ambition in the light of the not fully convertible renminbi and sheltered financial system, this essay reviews past reform efforts and the current state of the Chinese form of capitalism. It finds that after a decade of bold financial reforms under Jiang Zemin and Zhu Rongji, the momentum began to wane from 2005 onwards. The new leadership under Xi Jinping and Li Keqiang needs to complete important reforms before China's financial sector and currency can rise to international standards and importance. The new leaders seem to be aware of the historic nature of this task and are willing to close the gaps. In particular this includes introducing market pricing of capital and risk, increasing the breadth, deepness and liquidity of financial markets and improving the institutional framework for financial stability. If successful, these reforms are likely to sustain economic growth in the long term, boost currency cooperation in East Asia and speed up the emergence of a regional RMB bloc.

Abbreviations

(Chinese equivalents are given for existing institutions)

AMC	Asset Management Company
CBRC	China Banking Regulatory Commission 中国银行业监督管理委员会
CCP	Chinese Communist Party 中国共产党
CIC	China Investment Corporation 中国投资有限责任公司
CIRC	China Insurance Regulatory Commission 中国保险监督管理委员会
CSRC	China Securities Regulatory Commission 中国证券监督管理委员会
DRC	Development Research Center of the State Council 国务院发展研究中心

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GITIC	Guangdong International Trust & Investment Corporation
LGFV	Local Government Financing Vehicle
LSG	(Central) Leading Small Group 中央领导小组
MoF	Ministry of Finance of the PRC 中华人民共和国财政部
NDRC	National Development and Reform Commission 国家发展和改革委员会
NPC	The National People's Congress 全国人民代表大会
PBoC	The People's Bank of China 中国人民银行
PRC	The People's Republic of China 中华人民共和国
PSC	Politburo Standing Committee 政治局常务委员会
RC	Regulatory Commission
RMB	Renminbi
SAFE	State Administration of Foreign Exchange 国家外汇管理局
SDR	Special Drawing Rights
SME	Small and medium enterprise
SOE	State-owned enterprise

1 Introduction

In December 1978, at the Third Plenum of the 11th Party Congress of the Chinese Communist Party (CCP), Deng Xiaoping condemned the Cultural Revolution and requested the CCP to pursue economic development, rather than class struggle, as its primary task. This event is generally seen as the starting point of China's reform era and undisputed economic miracle, as a result of which the country became the world's second largest and most dynamic economy. Even if times of double-digit growth are over, with rates of 7–8 % p.a. China is still the world's fastest growing economy.

Although China's financial system has underwritten this remarkable rise and itself undergone major reforms since 1978, the success of the financial reforms appears mixed and is lagging behind that of the economic reforms. Western and Chinese observers have called China's financial sector "fragile", "messy" and "potentially unstable".[1] Whether or not one shares these views, it does not seem up to international standards and clearly is not on a par with the global importance of China's economy.

China has long been aware of this discrepancy and aims to develop a financial market "commensurate with its economic strength" (*yu woguo jingji shili xiang sheying de* 与我国经济实力相适应的), according to a State Council document

[1] See the sub-title of Walter and Howie (2012) for the first, Yu (2012) for the second ("the PRC's financial markets are in a messy state", p. 23), and World Bank and DRC (2013, pp. 115–117) for the third label.

from April 2009.[2] This ambition had been reinforced by the global financial crisis, which made China's dependence on USD liquidity and the USD-centrism of the international monetary system all the more apparent.[3] Commenting on the widening deficit of the United States, the economist Andy Xie wrote in May 2009 in the Financial Times:

> America's policy [of printing money] is pushing China towards developing an alternative financial system. […] China is aware that it must become independent from the dollar at some point. Its recent decision to turn Shanghai into a financial centre by 2020 reflects China's anxiety over relying on the dollar system.[4]

Can China's financial sector and currency live up to their global ambitions? Are they able to meet international standards and what is missing to rise to regional or global importance? Is the new leadership under Xi Jinping willing and able to close the gaps? What does this mean for the future growth of the Chinese economy? And what implications, if any, does this have for currency cooperation in East Asia?

To be able to answer these questions, this article reviews the focus and legacy of financial reforms in the People's Republic of China (PRC) since 1978 (Sect. 1) and assesses the current state of the Chinese financial system by looking at its main features and actors (Sect. 2). On the basis of the findings and using Eichengreen's measure for international currencies, it then tries to answer the above guiding questions and concludes (Sects. 4 and 5).

2 The History of "Capitalism with Chinese Characteristics"

Before reviewing financial policy-making in the last three and a half decades, it is worthwhile to recall Deng Xiaoping's words at the Third Plenum as they have defined the driver and direction of reform until today. It is not the state or government, which should make economic development its primary task, but the CCP. In China it is the Party, which rules the economy and guarantees wealth and prosperity (see Fig. 1).

For Deng and his successors at the helm of the CCP, the ultimate goal of a strong economy was and is to maintain the political power of the Party. This has been the *leitmotiv* of all reform efforts so far, with political reforms being out of the question,

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[2] Discussed in Hess (2010, p. 23). See http://www.gov.cn/gono/gbacontent/2009/content_1303637.htm.

[3] In his famous speech of March 2009, Governor Zhou Xiaochuan did not mention the USD a single time. But it is obvious that more than establishing the SDR (mentioned 25 times) as a serious alternative, Zhou's aim was to criticize the dominance of the USD and to reduce the appreciation pressure on the RMB. See http://www.pbc.gov.cn/publish/english/956/2009/20091229104425550619706/20091229104425550619706_.html. Accessed 3 November 2013.

[4] See http://www.ft.com/intl/cms/s/0/2f842dec-38d8-11de-8cfe-00144feabdc0.html#axzz2bMbuVsvQ.

Fig. 1 Chinese New Year poster, 2003. Mao Zedong (one of the founders of the CCP in 1921 and the founder of the PRC in 1949), Deng Xiaoping and Jiang Zemin are shown from *top* to *bottom*. The *vertical* Chinese characters read: "Don't believe in gods to get rich (*facai bu xin shen*), fully rely on the Party to gain wealth (*zhifu quan kao dang*)." *Source* DACHS Heidelberg, 2003

in particular after the 1989 protests.[5] And this is also why until today, China's financial sector remains embedded in its political economy, resulting in a specific form of capitalism, which Walter and Howie (2012) refer to as "red capitalism" and I as "capitalism with Chinese characteristics", in line with the official Party goal of "building a socialist country with Chinese characteristics".

Deng understood the importance of economic development for the survival of the Party.[6] This is truer than ever: Today the legitimacy of the CCP is essentially performance-based (output legitimacy), rather than ideology-based as it used to be, and a failure to deliver growth would severely undermine Party authority.

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[5] As witnessed by Deng's statement during his Southern Tour in 1992 that "development is of overriding importance" (*fazhan shi ying daoli*). The poster carries this phrase on the ribbon underneath Deng.

[6] This is in contrast with theories that economic development leads to Western-style democracy and the collapse of one-party systems (see for example Fukuyama 1989). So far, Chinese history proves those theses wrong, and Deng right.

For the time being this authority is relatively stable. China's rising middle class still believes in the CCP's continued ability to promote China's development and to ensure growth and rising living standards. But this confidence cannot be taken for granted forever. From Chinese history, Party leaders know all too well that the ruler can lose the "Mandate of Heaven" and be overthrown.[7] A sharper drop in economic growth could trigger such a loss, hence the need to "keep the eight" (*baoba* 保八) percent growth after the post-Lehman downturn, via the 4 trillion RMB stimulus program, and hence the CCP's preoccupation with **growth as a source of legitimacy** until today.

The development of Chinese financial sector reforms since 1978 can be divided into **three stages**: An **early stage** until 1990, the **Jiang-Zhu era** with bold reforms until 2005, and the current **stage of fading reforms**. Time will tell whether 2013 will go into history as the start of a new bold reform effort.

2.1 The Beginning of the Reforms (1978–1990)

The first decade of financial reforms was marked by a proliferation of financial institutions. Between January 1978 and September 1988, the central bank and many major banks of today were established, as well as countless financial institutions at central, provincial and municipal level, including 745 trust and investment companies and several thousand credit cooperatives.

An important year was 1983, when the People's Bank of China (PBoC) assumed the role of a central bank[8] and its commercial banking functions were split off into four independent, state-owned banks, which became known as the "Big Four": the Bank of China, the Agricultural Bank of China and the People's Construction Bank of China (later renamed into China Construction Bank), as well as the newly founded Industrial and Commercial Bank of China (1984).

A major shortcoming of the institution-building became apparent in the late 1980s. The banks were organised alongside the Party and government administration, with branch managers being appointed by local Party committees. The preference of local governments for growth and easy access to money led to a rapid credit and inflation growth (see Fig. 2). This institutional flaw has not been remedied until today as the incentive structure of local officials remains essentially focused on quantitative rather than qualitative growth. Inflation is now less a problem (see Sect. 4.2), but social inclusion and environmental sustainability of growth are, as a result of skewed incentives.

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[7] The Mandate of Heaven (*Tianming* 天命) is an old Chinese philosophical concept concerning the legitimacy of the Emperor. It postulates that heaven would bless the authority of a just ruler, but would be displeased with a despotic or incompetent ruler and withdraw its mandate, leading to the overthrow of that ruler.

[8] Its status as a central bank was legally confirmed in 1995 with the promulgation of the central bank law.

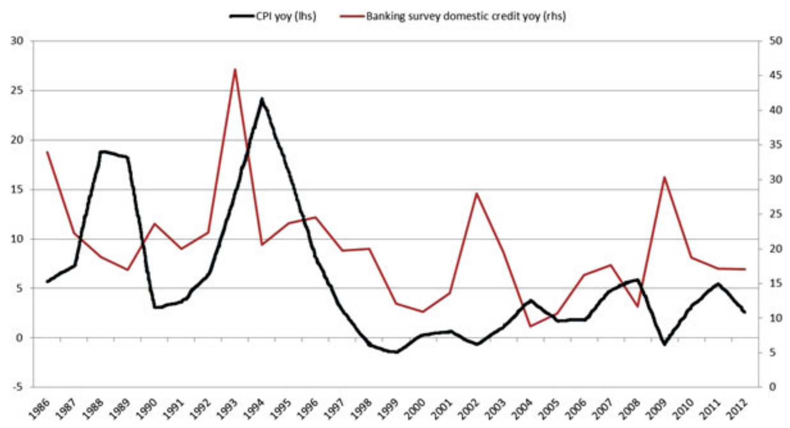

Fig. 2 Chinese CPI and domestic credit since 1986 (annual change in %). *Source* National Bureau of Statistics of China and IMF, *International Financial Statistics*

The rampant inflation of the years 1987–1988, coupled with corruption and a lack of leadership experience, were in fact the main triggers of the dramatic Tian'anmen events of June 1989. The deep-rooted inflation *angst* of Chinese leaders extending til the present day can only be understood against the backdrop of this period, which nearly ended in the downfall of the CCP.

One year later, at the height of a share fever in June 1990, the decision to establish formal stock exchanges was made, partly in order to control sources of social unrest but also to improve the performance of state-owned enterprises (SOEs). As a result, the Shanghai and Shenzhen stock exchanges started operations in December 1990 and July 1991 respectively.

2.2 The Jiang-Zhu Era (1991–2005)

The second stage of financial reforms was marked by Jiang Zemin (General Secretary of the CCP since 1991) and his later Premier Zhu Rongji, and lasted until 2005. Strictly speaking Jiang and Zhu were already succeeded by Hu Jintao and Wen Jiabao in 2003, but as the reform momentum built up by the former continued until 2005, it is appropriate to add these two years to the "Jiang-Zhu era". By education an engineer like Jiang, Zhu Rongji served as Vice-Premier since 1991 and in addition as Governor of the PBoC between July 1993 and June 1995. In the latter role, he managed a soft landing of the Chinese economy, which after Deng's

Southern Tour of December 1992 started to overheat again.[9] In March 1998, Zhu became Premier and embarked with Jiang on a bold reform strategy.

In terms of financial reforms, Zhu's main architect was Zhou Xiaochuan who served as President of China Construction Bank (1998–2000), Chairman of the Chinese securities regulator (2000–2002)[10] and Governor of the PBoC since December 2002. Together Zhu and Zhou designed and implemented a comprehensive reform program, which began in 1998 with a central bank reform aimed at strengthening its regulatory function and reducing the interference by provincial Party chiefs in lending decisions by replacing the provincial PBoC branches with 9 regional branches.

A key event was the collapse of the Guangdong International Trust & Investment Corporation (GITIC) in January 1999, still China's only formal bankruptcy of a major financial firm. It shook the global financial industry and threatened the confidence in China. Rumors that Chinese banks were technically bankrupt spread quickly, and in March 1999 Zhu Rongji had to react to these worries in an unmistaken and unusually direct way:

> I think that those creditor banks and certain financial institutions are too pessimistic in their view on this, i.e. that a financial crisis has broken out in China, that it cannot meet its payment obligations and acts in bad faith. The Chinese economy continues to grow rapidly; we have 145 billion USD in foreign exchange reserves now; our balance of payments is balanced. We are completely able to repay our debt, but the question is whether this kind of debt should be repaid by the government or not?[11]

Zhu Rongji took the issue of moral hazard (the common belief that Beijing would bear the costs) very seriously and ordered the closure of hundreds of trust companies and thousands of urban credit cooperatives across China. But the most important result of the GITIC debacle was that Zhu ordered a rapid recapitalization of the Big Four and demanded their restructuring. Modeled after the Resolution Trust Corporation in the United States, Asset Management Companies (AMCs) were established for each of the banks, which took over their non-performing loans (see Sect. 3.2).[12]

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[9] The former German chancellor Helmut Schmidt is full of praise for Zhu, for this and his other achievement of keeping the Asian Financial Crisis out of China. Of all top-ranking politicians, who Schmidt met, he attests Zhu the deepest insight into the economy of his country, and puts him with Lee Kuan Yew and Alan Greenspan in the highest category of economic policy-makers. See Schmidt and Sieren (2006, pp. 94–107).

[10] At the head of the China Securities Regulatory Commission (see Sect. 3.2), Zhou earned the reputation of being a resolute, market-oriented reformer.

[11] Zhu answered this to a Japanese reporter at the press conference after the National People's Congress (NPC) in March 1999. See Zhu (2009, p. 17, translation by the author). When this book with transcripts of Zhu's annual NPC press conferences and interviews given to media from around the world appeared in 2009, it soon became a bestseller in China.

[12] *Ibid*, p. 59. A detailed assessment of the restructuring of the Big Four can be found in García-Herrero and Santabárbara (2013, pp. 151–155).

Bank restructuring culminated in the international listing of the Big Four (2005/2006). Other important reform measures included the creation of a national social security fund (1997) and the development and opening up of the Chinese bond and stock markets on the financial side, as well as China's accession to the WTO (2001) and a SOE reform on the real economy side. Helmut Schmidt has stressed how urgently Zhu needed the WTO accession in order to keep the pressure high for his domestic reforms (Schmidt and Sieren, 2006, p. 99). Prasad and Ye (2013) see a similar logic at work today when they suggest that the goal of making the RMB a global currency might be used as catalyst for a "broad agenda of domestic policy reforms" (see their quote at the end of Sect. 4.2).

2.3 The Fading of Financial Reforms (2005–2013?)

2005 marks the turning point, after which the reforms began to fade. While in June the PBoC was still allowed to move from the USD peg to a managed float of the RMB, which was another important reform measure, from October 2005 onwards the State Council started to put a brake on the integrated reform program. Under the "New Leftist" Hu-Wen leadership, conservatives in the Party gained the upper hand and started to attack the Zhu-Zhou reforms for having increased income disparities to an intolerable level. Another accusation was that permitting Bank of America and the Singaporean sovereign wealth fund Temasek to buy stakes in China Construction Bank (of 9 and 5.1 % respectively) in mid-2005 meant selling out valuable state assets to foreigners.

Walter and Howie (2012) have argued that Zhou Xiaochuan "violated every norm of traditional bureaucratic behavior" by invading the territories of other institutions like the Ministry of Finance (MoF) and the National Development and Reform Commission (NDRC). They also explain the "PBoC's defeat" with the loss of its "key ally" Huang Ju, the Vice-Premier in charge of finance (Walter and Howie 2012, pp. 15–22). But the main reason is probably simpler: Jiang Zemin stepped down as Chairman of the powerful Central Military Commission in late 2004, and without his protecting hand and support, in less than a year the reform momentum built up since 1998 started to wane.[13]

Western observers have praised the swiftness and effectiveness of the Chinese policy response to the global economic downturn after the Lehman collapse. But the stimulus program, which Barry Naughton called in 2009 a "large, activist intervention in the Chinese economy that will shape the trajectory of Chinese development for a decade or more" (Naughton 2009, p. 1), proved detrimental to the reform momentum.

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[13] As shown by Lieberthal and Oksenberg (1988) in general (see pp. 35–41) and in Hess (2010) for Chinese market infrastructure policy (see pp. 21–27), leadership consensus and the support by the "preeminent leader" (such as Jiang, Hu and today Xi) are crucial pre-requisites for the success of policy-making in China.

Although the stimulus package also comprised elements of structural adjustment, overall it meant a fall-back into old, planned economy patterns, increased the role of the state and counteracted the earlier successes of financial liberalisation. Most importantly the program exacerbated China's economic, fiscal and financial imbalances, the reduction of which will require even more reform efforts in the future. In that sense, Naughton's prophecy turned out to be very true. Walter and Howie (2012) came to a similar conclusion on the long-term effects of the Chinese stimulus:

> If the Asian Financial Crisis in 1997 caused one set of Chinese leaders to see the need for true transformational reform of the financial system, the global crisis of 2008 has had the opposite effect on the current generation of leadership. Their call for a massive stimulus package reliant on bank loans may have washed away for good the fruits of the previous 10 years of reform (Walter and Howie 2012, p. 93).

This was written in 2011, so "current generation of leadership" refers to Hu Jintao and Wen Jiabao. It is still unclear to what conclusion the new leaders Xi Jinping and Li Keqiang will come and what future course financial reforms will take on the spectrum between further stagnation and bold liberalisation (see Sect. 4). What can be taken away though and was still valid in late 2013 is the role of the global financial crisis in stymying financial reform in China and reinforcing the loss of momentum that had started in 2005. Whether the Third Plenum of the 18th Party Congress (see Sect. 4.3) has opened the chapter of a revival of bold financial reforms remains to be seen.

3 The Current State of China's Financial System

3.1 The Main Features

As a result of the unfinished reforms of the Jiang-Zhu era, China's current financial system is characterized by a number of **key features**, which are described and analysed here.[14]

- It is a **bank-based system** with the majority of household and corporate savings placed with the large banks and nearly all financial risk concentrated on their balance sheets. Compared to other emerging markets and advanced economies, the high share of bank lending in China stands out (see Fig. 3 from World Bank-DRC report *China 2030*), even if the share of financing via capital markets and especially the shadow banking sector (see below) has grown over the past years. In the latter, banks play an important role as well.

[14] See Walter and Howie (2012) and Li and Zeng (2007) for detailed discussions of China's financial system.

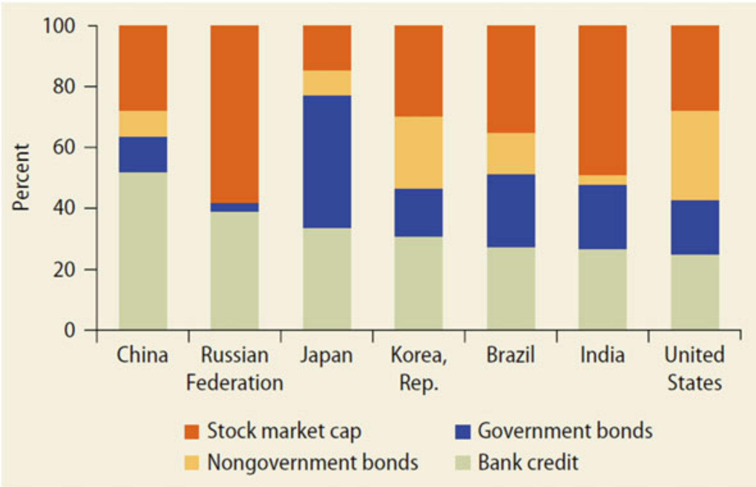

Fig. 3 Financial system structure in comparison, 2009. *Source* BIS, CSRC, IMF, *International Financial Statistics* and World Bank, *World Development Indicators*

- As the state completely owns most banks or holds majority stakes in them, China's financial system is also **pre-dominantly state-owned**.
- Its **capital markets** are **underdeveloped**. Bond markets are dominated by government bonds and central bank bills (issued to sterilise the monetary expansion resulting from China's exchange rate policy), which the state-owned banks are mandated to buy.[15] As a result, the large majority of bonds are held long-term by banks, and trading is very low. Equity markets are policy-driven[16] and dominated by SOEs to ensure their access to finance.
- Like the whole economy it is a system **controlled by the CCP** or more precisely special interest groups within the Party leadership, the interests of which need to be balanced in a constant bargaining process. Party control over the financial system is *inter alia* ensured via the CCP's Central Organisation Department, which appoints its leaders (see Fig. 5) and those of the major SOEs.[17]
- The system has a strong **bias towards** financing the **state sector** to keep the SOEs alive, to the detriment of small and medium enterprises (SMEs). There is anecdotal evidence that large amounts of the low-rate loans by state-owned banks to large SOEs are illegally relent at much higher rates to private sector SMEs,

[15] For this reason, Walter and Howie (2012) call Chinese bonds "little more than disguised loans" (p. 158).

[16] Chinese stock markets are also called "policy markets" as they move on the expectation of government policy changes rather than on news of company performance.

[17] Walter and Howie (2012) call this group of SOEs in key industries the "National Team", see pp. 182–213.

which are in need of money but face difficulties in accessing bank financing (one of the reasons for the growth in shadow banking).

- **Interest rates** in the formal sector are **set administratively** to ensure the profitability of the banking industry and control the allocation of financial resources. The tight control of interest rates, which are set in favour of borrowers barely above the inflation rate, results in a significant redistribution of income from depositors to the rest of the economy, which is commonly referred to as *financial repression*.[18]
- There is a growing **shadow banking sector**, which includes micro loans, bank acceptance bills, entrusted loans, trust products, leasing activities and underground lending and is estimated to amount to nearly 30 trillion RMB (about 57 % of GDP) at end-2012.[19] In particular the trust sector and its "wealth management products" pose risks for financial stability, such as credit and liquidity risks, intransparency, increases in off-balance sheet exposures and moral hazards. Authorities are aware of these risks and started in late 2012 to take measures (see footnote 26) to bring the shadow financial system under control.
- With the exception of the shadow banking sector, the **system is not market-based** and does not allow for a market pricing of capital and risk. In addition to controlling the interest rates (see Fig. 4), authorities set quarterly quota on the total value of loans for the state-owned banks and provide "window guidance", which amounts they should lend to which sectors.

  A statement by Frank Newman in 2007, then CEO of the Shenzhen Development Bank and the first foreigner ever at the top of a mainland bank, may serve as an illustration of this point:

> There's also a complication right now because macroeconomic policy is to not have lending grow too fast. If we wanted to grow at 30 % a year in our lending, I don't think the People's Bank of China would let us at the moment no matter how much capital we had because it is trying to control the rate of growth in the country.[20]

The **lack of the market mechanism** stemming from the far-reaching Party control of banks and SOEs and the capital allocation by administrative fiat rather

[18] On 19 July 2013, the PBoC announced the elimination of controls on lending rates. However, the most important source of financial repression remains the ceiling on deposit rates, which is a key driver behind the rapid growth in shadow banking and the real estate boom as households search for higher real yields. Porter and Xu (2013) have shown empirically that the regulation of key retail interest rates influences the behavior of market-determined interbank rates, which may have limited their independence as price signals. They recommend further deposit rate liberalisation, which should allow short-term interbank rates to play a more effective role as the primary indirect monetary policy tool.

[19] ECB estimate based on data by the PBoC, China Trustee Association, Deutsche Bank and JP Morgan Chase.

[20] See Kevin Hamlin, "The New Man in Chinese Banking", *Institutional Investor—International Edition*, Vol. 32, Issue 2, pp. 32–40, March 2007.

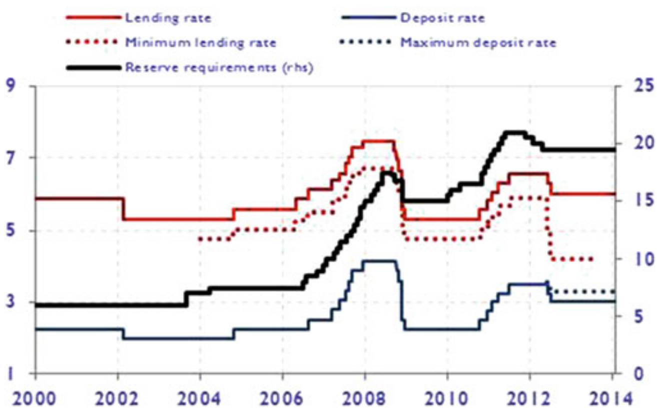

Fig. 4 Interest rates and reserve ratios since 2000 (%). *Source* PBoC, daily 1-year lending and deposit rate and monthly reserve ratio, January 2000–January 2014

than by market forces is probably the most important gap in China's financial system in comparison with international standards.

- Last but not least, China's **currency** is **not fully convertible** and capital controls remain in place as past financial crises (e.g. the Mexican of 1994, the Asian of 1997/1998 and the global of 2008) reinforced the leaders' determination to keep the system closed off from international financial markets.

An exception to the last point was Zhu Rongji who seems to have intended to induce change in China's financial system via international scrutiny and foreign competition. The second to last point, the absence of the market principle, was flagged by Zhu already 15 years ago when answering in March 1998 a question by a Chinese journalist on the "most pressing and challenging issues in the five years ahead":

> Because the current financial system is mainly a system of administrative approval, the market cannot perform its basic function of resource allocation. This has created a lot of redundant infrastructure. We must carry out thorough reforms to let the financial system meet the requirements of a market-based economy (Zhou 2009, p. 5).

Zhu saw the problem but he could not deliver the solution. This is linked to the function of China's **system of financial repression**: As noted by Sandra Heep, it allows the party-state to engage in comprehensive industrial policy-making and to support the **state-owned sector of the economy**, which is a **crucial pillar of the CCP's grip on power** (Heep 2014). Zhu carried out a major SOE reform, but neither broke the SOE monopolies nor disbanded the nexus between SOEs and the banking sector. Cutting this nexus would result in huge consequences for China's political system as it would undermine the power of the CCP. This is the reason why it was never—and might never be—successfully attempted to break up the SOE-banking complex.

3.2 The Main Actors

Many illustrations of China's financial sector fail to show a key feature: the Party control. Hence Fig. 5 depicts not only its **main actors** but also the **main lines of authority** as of late 2013.

In the center, Fig. 5 shows the 7-member Politburo Standing Committee (PSC, abbreviated *Changwei* 常委 in Chinese) led by Xi Jinping. It is China's highest leadership body and also its ultimate economic and financial decision-maker. **Party authority** over the financial system is exercised not only via the Central Organisation Department, which appoints the heads of all major institutions, but also via the Central Finance and Economy Leading Small Group (*Zhongyang caijing lingdao xiaozu* 中央财经领导小组). Information about this group is scarce but it consists of members from the highest Party and state echelons, including Li Keqiang as Chairman and other PSC members, and is China's top financial and economic decision-making body.

Premier Li is also at the top of China's executive, the State Council (*Guowuyuan* 国务院), which has direct **administrative authority** over the main governing agencies of the financial system. These are the NDRC, the MoF, the PBoC and its sister agency, the State Administration of Foreign Exchange (SAFE), the sovereign wealth fund China Investment Corporation (CIC), as well as the three Regulatory Commissions (RCs) China Banking Regulatory Commission (CBRC), China Securities Regulatory Commission (CSRC), and China Insurance Regulatory Commission (CIRC).

The three RCs, the MoF (as major shareholder on behalf of the state) and the PBoC (as lender of last resort and macro-prudential supervisor[21]) have **supervisory authority** over the banks and, together with the NDRC and partly also the Ministry of Commerce (not shown), the other sectors and market participants. To reflect the banks' dominance, Fig. 5 shows only the banking sector in detail. Apart from the Big Four and their AMCs—Orient AMC for Bank of China, Great Wall AMC for Agricultural Bank of China, Cinda AMC for China Construction Bank and Huarong AMC for Industrial and Commercial Bank of China—the banking sector comprises the so-called "Policy Banks" China Development Bank, Agricultural Development Bank of China and Export–Import Bank of China (China Exim Bank), as well as other banks such as the China Postal Savings Bank, the second tier banks (including the Bank of Communications), and the city commercial banks.

There is a **substantial degree of institutional overlap, rivalry and infighting** between the different supervisory authorities, which makes an efficient regulation of

[21] Micro-prudential banking supervision is exercised by the CBRC.

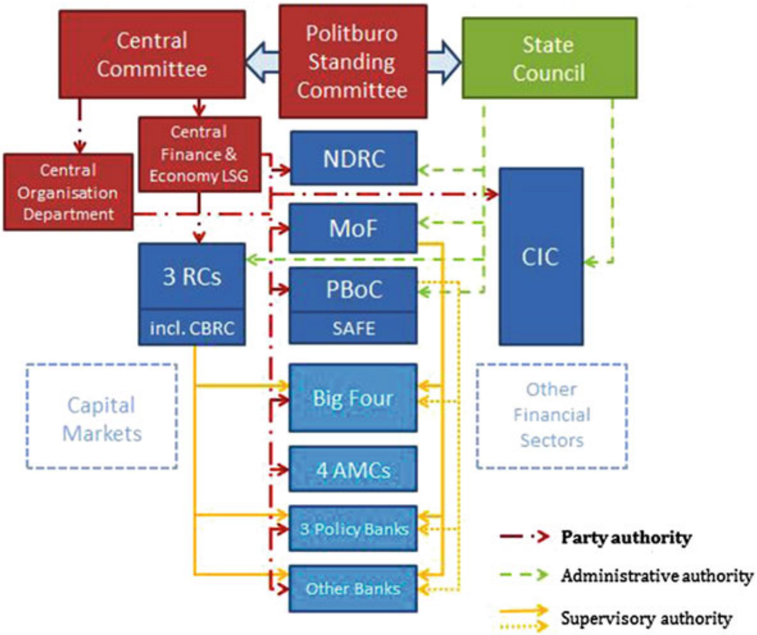

Fig. 5 Main actors and lines of authority of China's financial system, late 2013

the financial system difficult and can even block reforms, as illustrated by the crucial year 2005 when the NDRC and MoF "won" over the PBoC (see 2.3). Another example is the fragile relation between the PBoC and the CBRC. This institutional inefficiency is the background of Christine Lagarde's statement in a recent IMF publication on financial stability in China:

> China needs to develop a clear and accountable institutional framework for financial stability in which the roles and responsibilities of the relevant government institutions are clearly specified (Lagarde 2013, p. ix).

A major step in this direction would be the creation of a super agency for financial regulation under the lead of the PBoC, which the State Council announced on 20 August 2013. The new group is intended to consist of the heads of the PBoC, CBRC, CSRC, CIRC and SAFE and to be able to also invite the NDRC and the MoF if needed to its regular quarterly meetings and extraordinary meetings. The super agency is planned to coordinate monetary and financial supervisory policies and information sharing between these regulators and to supervise legislation, without changing the roles of the incumbent institutions.[22] The idea to form such a

[22] Cf. Chiang and Qing (2013).

"super regulator" was first brought up in 2005, and if the plans are to be really implemented, this would be an important reform measure.

4 China's Ambition for a Currency Commensurate with its Economic Status

4.1 Determinants of an International Currency

According to Barry Eichengreen, an *international currency* is "widely used in private commercial and financial transactions and held by central banks and governments as reserves" and "has three essential attributes: scale, stability, and liquidity".[23]

- In more detail, *scale* refers to the existence of **extensive transactional networks**, which are based on trade and investment relations between the issuing country and the global economy.
- *Stability* means the **confidence of foreign investors** (for an international currency its use by non-residents is crucial!) **in the currency's stable value**, which is based on the central bank's independence and reputation to keep inflation low.
- *Liquidity* is particularly important and refers to the ability to buy and sell large amounts of assets in that currency without moving its price. In other words, an international currency requires **sufficiently broad, deep and liquid financial markets with international pulling power**.

In the following sub-section, the RMB will be assessed against these three determinants of an international currency.[24]

4.2 Potential of the Renminbi to Become an International Currency

With the first factor, the existence of large transactional networks of the issuing country, China scores relatively high. Due to its growing weight in global output and trade, the use of the RMB has grown rapidly in the past few years, primarily as a

[23] Eichengreen (2013, p. 149). Yu (2012) reviews and refines other definitions of an international currency.

[24] Eichengreen (2013) and Taylor (2013) have also noted that historically reserve currencies came from democracies with "checks and balances on the executive" or "economically and politically liberal societies with strong rule of law and property rights". See Eichengreen (2013, p. 158) and Taylor (2013, p. 11). While this observation might be true *ex post*, it can not be postulated *ex ante* and does not seem to have any predictive power for the likelihood of the RMB to become an international currency.

trade currency (to a share of around 10 %), but also as an investment and financing currency.[25] This development was fostered by a series of policy initiatives undertaken by mainland authorities since July 2009 on current account settlement and financial investments. It is supported by the "going-global" (*zou chu qu* 走出去) of Chinese banks, which are following the overseas expansion of Chinese companies and are becoming increasingly important players in global investment, merger and acquisition services and trade finance and settlement. Judged on the first determinant alone, the RMB would thus indeed have the potential of becoming a prominent international currency over the medium term. However, this condition is not sufficient, as Eichengreen points out (Eichengreen 2013, p. 153).

The score on the second factor is more mixed. Due to the social unrest that high inflation can cause—as happened in 1989—China's highest leaders and the PBoC have shown a strong determination to fight inflation. This commitment and the long track record of keeping inflation low—since 1997 CPI inflation stood on average at 1.92 % and never significantly surpassed 5 % (see Fig. 2)—have clearly strengthened foreigners' confidence in the stable value of the RMB, even if the central bank is not independent. But investor confidence may also be threatened by excessive financial stability risks, which, if they materialise, can affect the economic performance of a country, and thereby its reserve currency status. Here doubts have recently grown, especially in relation to risks stemming from shadow banking and local government financing, which are taken increasingly seriously by the authorities (see also Sect. 3.1).[26]

As discussed above, the last criterion is the area with the largest room for improvement. As a result of continued capital restrictions, China's financial sector remains largely closed and cannot exert international pulling power. It lacks breadth in the sense of access to a wide range of financial instruments including derivatives to hedge against exchange rate volatility. Despite quantitative growth over recent years, capital markets are still underdeveloped and clearly not broad, deep and liquid enough to fulfill the financial market requirement for reserve currency status. Eswar Prasad and Ye Lei reach the same conclusion:

> Although China's rapidly growing size and dynamism are enormous advantages that will help promote the international use of its currency, its low level of financial market development is a major constraint on the likelihood of the renminbi attaining reserve currency status. […] The big question now is whether China's government will use the goal of making the renminbi a global currency to catalyze momentum on a broad agenda of

[25] See ECB (2013) for a detailed description of this development and its drivers, as well as challenges ahead.

[26] Authorities have taken several measures and are particularly concerned about the link between shadow banking and regular banking activities and the inherent risks for financial stability. A joint notice by the MoF, NDRC, PBoC and CBRC of 24 December 2012 states that "local […] governments must fully recognise the importance and urgency of stopping illegal and irregular financial behaviour". See MoF Notice No. 463 (in Chinese only): http://yss.mof.gov.cn/zhengwuxinxi/zhengceguizhang/201212/t20121231_723354.html.

> domestic policy reforms that are required to support this goal. Ultimately, the path of China's growth and its role in the global economy will depend on those policy choices.[27]

The argument that a global RMB requires financial liberalisation works both ways: The internationalisation of the RMB is also serving as a catalyst for financial liberalisation and opening,[28] in a similar way as the prestige of accessing the WTO in 2001 helped Zhu Rongji a great deal to put through his comprehensive domestic reform agenda (see 2.2).

4.3 The Reform Agenda of the New Leadership (2012–2022)

On 17 September 2012, the *12th 5-year Guidance for the Development and Reform of the Financial Industry* was released. The joint document by the PBoC, the SAFE and the three RCs emphasised greater exchange rate flexibility, capital account liberalisation and increased diversification of foreign reserves as the main directions of financial reforms in the period 2011–2015.[29] Since the leadership transition to Xi and Li started at the 18th Party Congress in November 2012 and was formally completed at the NPC in March 2013, more detailed financial reform priorities and some concrete measures such as the removal of lending rate controls (see footnote 18) have been announced.

Taken together this forms an ambitious reform agenda consisting of exchange and interest rate liberalisation, strengthened regulation and supervision, and gradual capital market opening with the aim to reduce regulatory arbitrage, improve allocation of resources through market-based pricing of capital and risks, and remove the moral hazard stemming from an implicit asset guarantee by the state. The agenda addresses the crucial issues that plague China's financial system today and would by and large complete the unfinished reforms of the Jiang-Zhu era. Zhou Xiaochuan, a key actor at the time and still at the top of the central bank, alluded to the historic nature of the upcoming reform task in his afterword to the abovementioned IMF publication:

> China's financial industry today stands at a new historic starting point. […] Further deepening of reform, and opening up and development of China's financial industry, are critically important to promoting stable and sustainable development in China and even in the global economy. In accordance with the requirements of the Twelfth Five-Year Plan, […] we will continue to implement sound monetary policy, strengthen the flexibility of

[27] Prasad and Ye (2013, p. 215). See also Prasad and Ye (2012), a detailed study of the prospects of the RMB.

[28] Ma and Miao (2013) refer to the consensus in China to internationalise its currency, which in their view is driven by a mix of national pride, perceived economic benefits and external demand, as "a commitment device for pushing forward other financial reforms" (p. 191).

[29] Cf. Zhongguo Renmin Yinhang (2012), published on the Chinese website of the PBoC and available under http://www.pbc.gov.cn/publish/goutongjiaoliu/524/2012/20120917155836347504341/20120917155836347504341.html. Accessed 19 August 2013.

> monetary operations, steadily promote interest rate and foreign exchange rate liberalization, and gradually achieve renminbi capital account convertibility (Zhou 2013, p. 219).

But the key question will be to what extent the new leadership under Xi and Li will be able to implement this bold reform agenda. The tensions in the Chinese money market in June 2013 allow an interesting insight in this respect. A spike in money market rates had occurred before, but what was quite unusual this time was the initial inaction of the PBoC and the fact that, after finally injecting liquidity, it published two statements with explanations of the reasons for the cash crunch and a warning to the banks to carefully manage their liquidity.[30]

This episode may be seen as being emblematic of indecision or even a struggle in the top leadership over whether or not to go for extensive market reforms. On the one hand, there are reformers like the Finance Minister Lou Jiwei and PBoC Governor Zhou, and on the other conservatives, who are worried about an erosion of the political power and control of the CCP. The initial failure to intervene in the cash crunch seems to have been motivated by the PBoC's aim to force the banks to cut down their lending to SOEs, Local Government Financing Vehicles (LGFVs) and the riskier parts of shadow banking. The fact that the central bank finally *did* intervene may mean that vested interests, such as those of the big banks and SOEs, which would feel the "pain" of the reforms, got the upper hand (there are powerful SOE representatives among the top leaders).

It is not clear where Xi Jinping and Li Keqiang stand. So far Xi has given mixed signals: On the one hand he is a strong, visionary leader who wants to start a similarly big move like Deng did at the Third Plenum in December 1978, and on the other, he left no doubt about the primacy of the CCP and its indisputable leadership. It is possible that Li Keqiang will gather a group of reformers around him and assume a similar role as Zhu Rongji during his time, but also that is not clear yet. More signs of the internal struggle over the scope of reforms might surface before and after the Third Plenum—which is traditionally when the economic direction and reform plans of a new leadership are revealed—in mid-November 2013. Thereafter it will probably become clearer whether China will go for bold economic and financial liberalisation or further stagnation.

5 Conclusion

For the time being, China's financial sector and currency cannot live up to their global ambitions. The former does not seem up to global standards mainly because the Party, and not the market, runs the process of capital allocation, but also in terms of legal, regulatory and accounting standards. As a result of these shortcomings, the latter seems to lack what currencies need to attain reserve currency status, namely in the first place broad, deep and liquid financial markets with international pulling

[30] The People's Bank of China (2013).

power. A currency "commensurate with China's economic status" might fit nicely into nationalistic dreams among Chinese Party members and netizens, but for now a truly global RMB remains rather wishful thinking.

To meet international standards and rise to regional or even global importance, Chinese financial markets must first and foremost become market-based and allow for market pricing as the basic mechanism for capital and risk allocation. This would at the same time mitigate the risks and imbalances, which have built up in the system, and alleviate concerns over financial instability. Together with the development of broad, deep and liquid bond and stock markets characterised by maximising returns on investment rather than by the primary aim of financing the state sector, this would also increase the potential of the RMB to become an international currency. For China's currency to do so, the full opening of its capital account would be another key condition.

Looking at its financial reform agenda, the current leadership under Xi Jinping and Li Keqiang seems to be aware of this historic task and willing to close the gaps. What remains open though is how strong the conservative reaction to bold reform efforts will be. Breaking up the SOE-banking complex and SOE monopolies will be the hardest part of the reforms because they are full of vested interests.

If market-oriented reformers gain (or keep) the upper hand and the Third Plenum blesses bold financial reforms, which indeed get implemented, the world is likely to see lower Chinese economic growth in the short term, and more balanced and sustainable growth in the long term. If not, the result could instead be a higher short-term growth with considerable financial stability and growth risks building up in the medium to long term. A materialization of those risks could lead to a sharp drop in growth and even a major financial crisis emanating from China, both with considerable impact on the East Asian region and the rest of the world.

The willingness and ability of the new leaders to accomplish the huge financial reform task has also implications for currency cooperation in East Asia. If Xi and Li are not successful in their liberalisation efforts, the achievements of regional currency cooperation already reached are likely to remain symbolic and further negotiations could end in stalemate. If they do succeed, this is likely to boost regional currency cooperation and speed up the emergence of an RMB bloc with other East and Southeast Asian economies pegging their currencies to the RMB and increasing its share in their reserve portfolios—provided that the determination of those countries to reduce dependence on the USD outweighs their fears of China's dominance.

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