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A UNIQUE JOURNEY TO A MAJOR GLOBAL CURRENCY

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ACRONYMS

CPC	Communist Party of China
GFC	global financial crisis
IMF	International Monetary Fund
NDRC	National Development and Reform Commission
OCLGFEA	Office of the Central Leading Group for Financial and Economic Affairs
PBoC	People's Bank of China
QE	quantitative easing
RMB	renminbi
SOE	state-owned enterprise
WTO	World Trade Organization

EXECUTIVE SUMMARY

Based on literature reviews on the concept of an international currency and its economic and political determinants, as well as China's motivation for renminbi (RMB) internationalization by both Chinese and foreign scholars, this paper provides a broader perspective of political economy on how the idea of RMB internationalization originated. It was triggered by Chinese leaders' concerns over excessive dependence on the US dollar with the 2008 global financial crisis (GFC) unfolding. China's envy toward and doubt surrounding the US dollar hegemony, and China's determination to establish its own modern financial system and rise financially, bring insight to underlying causes of RMB internationalization.

The paper concentrates on the political economy explanation of the road map of RMB internationalization the Chinese government currently pursues. Beginning in 2009, the People's Bank of China (PBoC) pushed RMB internationalization in a low-profile way through cross-border trade settlement, establishment of offshore RMB markets and swap agreements with other central banks, in spite of unfinished market-oriented reform on the exchange and interest rate, and a still strictly regulated capital account. The indirect and manageable approach toward RMB internationalization, in practice, leads to a de facto capital account liberalization.

The PBoC insists that its efforts for the liberalization of the capital account are coordinating with measures to promote two other important policy goals, market-based interest rate and exchange rate reform. It is implementing a coordinated and controllable way for China's financial reform, which is well supported by theoretical and practical reasons. Theoretically, there is an intermediate

state of neither being fully regulated nor fully liberated between the fixed and fully liberated exchange rate system. Practically, the great difficulties facing the market-oriented reforms on the exchange and interest rate make it an unrealistic option for the PBoC to act in accordance with the ideal sequence for China's financial reform and RMB internationalization: reform of the market-based interest rate and exchange rate formation mechanism, convertibility of RMB under the capital account and then completion of the RMB internationalization.

Following the PBoC's coordinated way of promoting market-oriented exchange and interest rate reform, as well as liberalization of the capital account simultaneously, RMB internationalization, while an important collateral goal in and of itself, evolved into a propeller for further financial reform in China. The fundamental reason for the indirect and manageable way of RMB internationalization and China's financial reform lies in the difficulties of the market-oriented reforms on the exchange and interest rate. Reform of the regulated interest rate — the deposit rate, precisely — is supposed to change the financial repression policy that constitutes the most important foundation of China's current economic growth model, characterized by investment and exports.

The greatest difficulty comes from the opposition of the powerful vested interest groups that benefit from the current financial repression and growth model. They tend to oppose policy changes such as exchange and interest rate liberalization, which are logically linked to RMB internationalization, without being directly against RMB internationalization per se. These de facto restrictive forces include China's large state-owned commercial banks, state-owned industrial enterprises, export industrials, National Development and Reform Commission (NDRC), the local governments, and real estate and construction industries. The supporting forces for RMB internationalization consist of the PBoC, top Chinese leaders and their aides, and favourable public opinion. In general, the prospect of RMB internationalization and the underlying goal of promoting domestic financial reform depend on the following: determination of top leaders to deepen reforms of China's growth model; the PBoC's expertise and ability to use it wisely; the political wisdom of supporting leaders and scholars; and how much strength and efforts the reformers exert against the powerful and extremely adamant opposition.

INTRODUCTION

RMB internationalization, while a goal in and of itself, is, in practice, developing into a propeller for the PBoC to achieve the ultimate goal of domestic financial reform — liberalizing the capital account, exchange rate and interest rate. The unique route of RMB internationalization taken under the concurrently controlled capital account and exchange rate is why this process has evolved into a booster for domestic financial reform. Since launching the cross-border RMB trade settlement scheme in July 2009, many RMB offshore markets and currency swap arrangements have been created, a process that is likely to continue. Accompanying theoretical and empirical studies, Chinese and otherwise, have highlighted the concurrent economic and political forces propelling the internationalization process. These combined forces raise several questions: How can we assess the separate roles played by economic factors and political considerations? How do the two determinants interact in shaping policy outcomes? Is the leading role played by the market or a government strategy? If it is a government strategy, what sequencing or reform road map has been, or is being, pursued? Is it one based on classic political economy theory[1] or a reversed coercing path?[2]

This paper answers these questions by performing a political economy-oriented analysis of the motivation behind the internationalization process, and the road map being used to achieve it. It discusses how RMB internationalization originated from the idea of China's rise within the international monetary system. Further, Chinese leaders were worried following the 2008 GFC about China's excessive dependence on the US dollar. In practice, this worry evolved into a process to push domestic financial reform aimed at liberalizing the capital account, market-based interest rate and exchange rates.

This paper first reviews the literature on the concept of an international currency and its economic and political determinants, and then examines motivations for RMB internationalization. Second, it explores the connection between RMB internationalization and China's rise in international financial markets. Third, it focuses on the political economy considerations embodied in the actual internationalization process, including the role of domestic financial reform in transforming China's economic development model from export- and investment-driven to consumption-driven, as well as the opponents and supporters for the reforms.

1 Classical political economy theory is the initial liberalization of interest rate and market-based exchange rates, allowing for the openness of the capital account and RMB internationalization to take its course naturally.

2 A reversed coercing path begins with RMB internationalization in the form of cross-border trade settlements and the establishment of offshore RMB markets and swap agreements before the resulting internationalization-related pressures push for the liberation of exchange rates, interest rates and the capital account.

INTERNATIONAL CURRENCIES: MOTIVATION FOR INTERNATIONALIZATION

Concepts of International Currencies

An international currency is one that is commonly used outside of a domestic country's currency. All or part of its function — the classic three functions of money (unit of account, medium of exchange and store of value) — can be transferred to the international level. This concept based on monetary function was defined by Benjamin J. Cohen (1971) and refined by Peter Kenen (1983) into six combinations comprised of three functions of international currency in private and public transactions (see Table 1). Among these three, the function as a store of value represents the highest level of internationalization of a currency (the reserve currency).

Table 1: Roles of an International Currency

Function of Currency	Governments	Private actors
Unit of account	Anchor for pegging local currency	Denominating trade and financial transactions
Medium of exchange	Vehicle currency for foreign exchange intervention	Invoicing trade and financial transactions
Store of value	Foreign exchange reserves	Investment on financial assets

Data source: Kenen (1983) and Frankel (2011).

Susan Strange (1971) studies the political considerations in the evolution of international currencies, classifying them into four categories in her study of sterling: master, top, negotiated and neutral. This political economy typology of international currencies was updated by Eric Helleiner (2008) to include the influence political economy has on currencies. His research focuses more on the top currency and negotiated currency concepts.

Master currencies — of a hegemonic or imperial state that coerce their use by other states, such as the pound in the sterling area and the French franc in the previous franc zone — and neutral currencies — no desire for international use, such as the Swiss franc and the German deutschmark — both have their limitations and do not possess universal significance, as they apply only within a certain historical context (Strange 1971). By contrast, the top currency — one most favoured by the world market for various monetary purposes due to its economic superiority, such as the US dollar in the 1950s — as well as negotiated currencies — occur when the issuing state bargains or negotiates politically with other states for their use of its currency, offering inducements such as military and diplomatic support or economic benefits, such as the pound in the postwar period and the US dollar in the 1960s — both have examples in the modern world. To some degree, today's dollar can still be considered a top currency, and today's RMB, as judged by the path and ways by which the Chinese government promotes it, can be a proper example of a negotiated currency. Helleiner (2008) points out that a negotiated currency can also be a currency on the rise, and is not necessarily one that has lost or is losing political dominance as a master currency or economic dominance as a top currency. Such is the case of the RMB.

Economic and Political Determinants of Currency Internationalization

Economic and political determinants together define the concept of an international currency. Accordingly, studies on international currency issues should focus on both indispensable aspects. The political factors have attracted less recognition than the vast attention economists have awarded this topic, but are equally deserving. Scholarly research in the political economy arena has provided some analytical frameworks for further study on the subject, but more is warranted. Scholars conclude that the fundamental determinants of international currency status are economic size, confidence in the currency and depth of financial markets (see Frankel 1992; 2011; Eichengreen and Frankel 1996; Chinn and Frankel 2008). Helleiner (2008) categorizes various economic factors of major determinants of currency internationalization into three broader attributes — confidence, liquidity and transactional networks — which are all heavily influenced by the political economy.

Recent studies argue that the effects of economic size and transactional networks (network externalities) on international currency choice are in fact not very strong. Paul Krugman (1984) and Menzie Chinn and Jeffrey Frankel (2007) point out that the international use of a currency is non-linearly related to the issuing country's economic size. Barry Eichengreen (2005; 2011) and Eichengreen and Marc Flandreau (2010) argue that network externalities have a weak connection with currency use as a store of value, although a potentially strong connection may exist with its use as a medium of exchange. They also point out that advances in information technology have substantially lowered the transaction costs of using multiple international currencies.

Two other determinants, liquidity (also referred to as depth of financial markets) and confidence, receive less doubt as to the influence of their attributes on currency internationalization. Economically, confidence in a currency can be affected by diverse factors, including monetary and fiscal policies, as well as the issuing country's current account and net-debtor position (Tavlas and Ozeki 1992). Or as Helleiner (2008) puts it, foreigners' confidence in a currency — in particular as a

store of value and unit of account — is inspired through consistent stability, an attribute that is usually linked to sound macroeconomic fundamentals in the issuing country. Confidence in a currency, however, can be derived not only from economic fundamentals but also from the broader international security power of the issuing country (Strange 1971). It can also be influenced profoundly by domestic politics and institutions. Andrew Walter (2006) notes that the stable value of pound, which inspired such confidence abroad, was linked to Britain's limited government, narrow electoral franchise and a conservative financial sector control exhibited by the Bank of England. Following the same logic, a contrary example is that the broader uncertainties surrounding the strength of European political cooperation and the inability of Europe to project its power in a unified manner at the international level — not just in monetary affairs, but also in political and security affairs —undermines confidence in the euro (Cohen 2004; 2007; Henning 1997; 2000; McNamara 2008).

Economists believe that the existence of well-developed and open financial markets in the issuing country, which lower the currency's transaction costs, is another salient economic attribute of an international currency (Lim 2006). Frankel (2011) generalizes the economic factor as the development of its financial markets, in particular their depth, liquidity, dependability and openness. For example, full development of the US financial markets after the creation of the Federal Reserve in 1913, as well as London's financial markets in the nineteenth century, laid the foundation for the rise of the dollar and pound, respectively, as international currencies. In contrast, the tightly regulated financial markets in Japan and Germany were frequently referred to as the principal obstacles of the internationalization of the yen and the Deutschmark (Aliber 1964; Tavlas 1991). Political scientists explain two structural factors that promote the international standing of a currency: the political context characterized by limited, constitutional government and pro-creditor legal frameworks (Stasavage 2003; Walter 2006); and the political legitimacy of a domestic financial order in the eyes of low-income groups (Seabrooke 2006). Helleiner (2008) reiterates that political agencies can play a role in the construction of financial systems that support international currency leadership. He highlights the creation of the Federal Reserve System in the cultivation of the dollar's international role. The creation of this system by US policy makers helped boost liquidity in dollar-based New York financial markets through activities such as rediscounting and open market purchases.

Why China Pushes for RMB Internationalization: A Literature Review

Based on the conditions discussed above, one can argue that the RMB certainly has the potential to evolve into a major international reserve currency. Its capacity to do so is underscored by the size of China's economy — second-largest in the world — current account surplus and accompanying expectations for RMB appreciation. However, the full development of financial markets (characterized in particular by depth, liquidity, dependability and openness), which China lacks, constitutes an indispensable precursor for an international currency. Furthermore, by the criteria of liquidity, breadth and openness, Chinese financial markets still have a long way to go before they catch up to those of other major currencies (Frankel 2011). Internationalization of the RMB was started and pushed on the perception of China not yet needing to liberalize its capital account, as well as China not having finished its market-based exchange rate formation regime reform and not having finalized its market-oriented reform of interest rates. This is an unusual pattern, as it defies the logic of classic economics, which states that a currency's internationalization comes with the requirements of a liberalized capital account, a fully market-based exchange rate formation regime and an unregulated interest rate being met.

A unique path based on political economy considerations has been taken to push RMB internationalization, a path that cannot be fully explained by economic or monetary determinants alone. Frankel (2011) raises three hypotheses regarding China's consideration in pushing RMB internationalization. The first is that China seeks the advantages of international currency status: seigniorage, convenience for its firms and international prestige. The second hypothesis claims that China does not fully realize the tensions between its simultaneously pursued goals of internationalization and maintaining a competitively valued currency. The third is that an elite few in China (both government officials and academic scholars) push to promote shifting the economy from being export-driven to domestic sector-driven, and they believe that financial opening, the easing of financial repression and RMB appreciation would contribute to that strategy. Ulrich Volz (2013) argues that RMB internationalization has been triggered mostly by China's domestic need for financial reform, along with the country's defensive reaction to its excessive dependence on the US dollar. All these considerations are based on a political economy analysis.

Studies from a political economy approach by Chinese scholars have produced significant results. Based on their research, reasons for China's surging interest in promoting the RMB internationalization since 2009 could be summarized as follows.

First, one reason is to avoid the exchange rate risk facing Chinese firms and to promote trade by reducing transaction costs (He 2009; Zhang Ming 2013; Gao and Yu 2011; Huang and Lynch 2013; Yu 2014). RMB internationalization would lead to more foreign trade and financial transactions being invoiced and settled in RMB, resulting in enterprises not needing to hedge the exchange rate risk. Specifically, the

considerable exchange rate fluctuation of the dollar — the main international trade settlement currency — in the GFC underscored the massive risks facing China and most of its neighbouring countries and regions. It is the GFC that initially pushed the Chinese government to promote cross-border RMB trade settlements (to reduce transaction costs for China and its regional trading partners), thus insulating China from the exchange rate risks of multiple cross-border capital flows denominated principally in US dollars. In this way, smooth development of trade relations between China and its regional partners could also be secured and maintained.

A second motivation may be to ease the negative effects on China's economy brought about by developed economies' quantitative easing (QE) policies since the GFC. While the Fed's QE plus the US Treasury's intervention succeeded in stabilizing US financial markets, they brought rapid expansion of the Fed's balance sheet (Yu 2014). The potential for a devaluation of the US dollar, resulting in significant capital losses on China's foreign exchange reserves, became the biggest concern for Chinese leaders in the years following the GFC. The QE policy and consequent devaluation of the US dollar exerted great pressure on the RMB and other emerging economies' currencies. Affected currencies appreciated, causing global excess liquidity, which resulted in short-term capital inflow, inflation and asset price increases in emerging countries, including China. Currency appreciation to a certain level would negatively affect the export and economic growth in China and other emerging countries. Some analysts (Mao and Qin 2013) thus conclude that RMB internationalization reflects China's strategy to deal with international currency competition during the negative environment caused by loose monetary policies carried out by developed economies since the GFC. In the long run, more widely used RMB in trade settlements, and perhaps as a reserve currency, should help prevent the negative spillovers caused by the Fed's "irresponsible" policies, such as the three-round QE policy seen over recent years.

Third, RMB internationalization would increase China's international economic and political prestige. Additionally, RMB internationalization would allow the Chinese monetary authority to collect seigniorage from the rest of world. As international standing of RMB expands, international loans and investments would be executed increasingly more often through Chinese financial institutions, effectively boosting Shanghai as a financial centre (Gao and Yu 2011). In short, a successful RMB internationalization would be seen by China's leaders and elites as a symbol of China's rise in the international financial sphere.

Fourth, RMB internationalization is a new booster for China's financial reform (Huang 2009; Wang 2011; He and Ma 2011). Under international currency status, the market-based exchange rate and interest rate reform of the RMB will be required. This unavoidable prerequisite implies that liberalization of the exchange and interest rates could generate as profound a change to China's financial market openness as China's entry into the World Trade Organization (WTO) did (Zhang Ming 2013). Development of offshore RMB markets would build up more pressure on exchange rate and interest rate reforms (He and Ma 2011; Wang 2011; Wu 2011). It is the powerful vested interest groups that obstructed the advancement of liberalization of exchange and interest rates that constitute the most difficult part of China's financial system reform. That difficulty forced the PBoC to first promote RMB internationalization in the form of trade settlements, in order for channels to be created that would allow these RMB to flow back, which would build up great pressure on the need to realize RMB convertibility under the capital account. This is called the "reversed coercing mechanism" in China's financial reform.

Some scholars have different perspectives on whether using RMB internationalization as a force to push domestic financial reform will work. Zhang Bin (2011) argues that until 2011, development of Hong Kong's offshore markets only forced the Chinese monetary authority to buy more foreign reserves and suffer the financial loss caused by the RMB appreciation against the dollar. Future development of Hong Kong's offshore market is expected to make a greater impact on China's regulated exchange and interest rates (deposit rate). Policy for maintaining current exchange rates within the fixed band and regulated deposit rate would be under further pressure. However, it is not yet clear whether the pressure could produce more regulation or market-oriented reform. Yu Yongding (2011; 2012) also observes that the growth of RMB offshore markets brought opportunities for arbitrage, which exerted new pressures on China's macroeconomic management. Whether these pressures could translate into impetus to push domestic financial reform is uncertain.

The studies above provide some insight into RMB internationalization from a political economy perspective. Among them, two motivations are agreed upon by both Chinese and foreign scholars: to increase China's international prestige economically and politically, and to use it to push China's domestic financial reform. Chinese scholars specifically emphasize two additional direct incentives: RMB in cross-border trade settlement to promote trade by eschewing exchange rate risk and lowering transaction costs, and to deal with the pressure on RMB appreciation and actual losses on China's foreign exchange reserves[3] brought by the QE policies and consequent dollar devaluation since the GFC.

3 In practice, however, it did not work. On the contrary, more use of the RMB in cross-border trade settlement only increased the accumulation of China's foreign exchange rate reserves. This is explained more fully in the following sections.

These perspectives show a variety of motives for RMB internationalization, both political and economic. However, current research fails to use a broader political economy background to explore the connection between RMB internationalization and China's views on the US dollar dominance, as well as Chinese top leaders' vision on financial power. It also fails to provide an integrated analysis on political incentives influencing the road map of RMB internationalization, as well as why interest groups and other domestic factors matter in the policy-making process. This paper explores the answers to these two questions and by doing so, a clearer and more comprehensive understanding of the political economy-related logic for RMB internationalization emerges.

HOW THE IDEA OF RMB INTERNATIONALIZATION ORIGINATED: A BROADER PERSPECTIVE OF POLITICAL ECONOMY

China's Concerns over Its Excessive Dependence on the US Dollar

In stark contrast to the popular image of China as the United States' biggest creditor ("America's banker," among the American public), Chinese elites are highly concerned with their excessive dependence on the US dollar (in the form of dollar-denominated assets, including bonds and bills) and the possible severe consequences it could have on China's economic and political stability. China has fallen into a dollar trap[4] and the GFC showcased the real danger facing its extensive foreign reserves of US Treasury bonds and bills. During the GFC, China was put on the brink of massive capital losses on its foreign exchange reserves, especially on its US government-sponsored enterprise bonds (Yu 2014). After the GFC, the perils of holding enormous amounts of dollars became evident: facing a serious deterioration of the US economy, the Fed's QE, while aiming to stabilize the US financial market, led to a sharp decline in the value of the dollar that would severely reduce the value of China's foreign exchange reserves.

A solution to this was to diversify its foreign reserves; however, China's options were limited. China accumulates foreign reserves at a rate of about US$400 billion a year — there is simply no combination of markets in the world capable of absorbing such large amounts as the US Treasury market (Kroeber 2011). Furthermore, China prioritizes safety and liquidity above return (the three objectives for foreign reserve management). In China's eyes, US Treasury securities remain the best choice in terms of safety and return among all investment products in the international financial market (Yu and Liu 2011). Further, China would expose itself to more risk should it stop buying US Treasury securities (Yi 2010). As Lawrence Summers (2004) said, "it is true and can be argued forcefully that the incentive for Japan or China to dump treasury bills at a rapid rate is not very strong, given the consequences that it would have for their own economies." This is what Summers calls a "balance of financial terror," wherein China simply cannot stop financing the United States. Or as Krugman (2009) points out, "China now owns so many dollars that it can't sell them off without driving the dollar down and triggering the very capital loss its leaders fear."

The reality is that China never strategically reduced its US Treasury reserves, but instead continues to increase holdings, reaching a record high US$1.3 trillion by May 2013, and as of September 2014 still remains the number one foreign holder of US Treasury securities (Department of the Treasury 2014). Even in the two years following the GFC, when newspapers were filled with stories about China "dumping dollars," China actually increased its holdings of US Treasury securities: from US$618 billion in September 2008 (when China became the foreign country holding the most US Treasury securities for the first time) to US$1.15 trillion in September 2010 (ibid.). According to Nouriel Roubini, an economist at New York University, if the dollar fell by a third against the RMB, China could suffer a capital loss equivalent to 10 percent of its GDP (cited in Ferguson 2005). For that reason alone, the PBoC has every incentive to continue printing RMB in order to buy dollars. Niall Ferguson (2005) believes that China will continue financing America's twin deficits for a longer period than the dollar pessimists expect. Due to lack of adequate domestic support, the solution of liberalizing the exchange rate to avoid the dollar trap has not been an option for China's policy makers. In short, it can be argued that China is at the mercy of the United States, and not the other way around.

One feasible way to eliminate the dependence and the dollar trap is to promote the RMB to an international status. Some economists in China argue that as a long-term strategy, RMB internationalization should be the correct way to eliminate its dollar dependency (He 2009; Xiang 2011; 2013; Cao Yuanzheng 2014). Although the process will take years or even decades, and will bring large economic costs, such as reducing export competitiveness and compromising monetary policy independence, it is still the right solution for stepping out of the dollar trap. In the long run, it can bring vast political and economic advantages.

Other economists in China, however, demonstrate that the current path of RMB internationalization has not reduced China's dependence on the dollar, but instead has led China to accumulate more dollar-denominated assets and increase its exposure to exchange rate risk.

4 In April 2009, Paul Krugman, New York Times op-ed columnist and Nobel Prize Laureate, called this "China's dollar trap." See www.nytimes.com/2009/04/03/opinion/03krugman.html.

On one hand, under the one-way expectation of RMB appreciation in the market, foreign and Chinese exporters are inclined to use RMB as an invoice currency. On the other hand, importers in foreign countries and China are reluctant to use the RMB as an invoice currency, as they may lose possible gains from appreciation. In reality, due to different bargaining powers possessed by foreign and Chinese enterprises, the amount of RMB being used to pay for imports is much higher than the amount received by China's exporters. Overseas investors have incentives to continuously increase holdings of RMB assets under the RMB's unilateral passage for appreciation. Further, to maintain the current fixed exchange rate floating band, China's monetary authorities must continue buying into the increased foreign reserves (Zhang Ming 2011; Zhang and Xu 2012; Yu 2014). Assuming that the latter opinion is correct, what then explains the PBoC continuing to push RMB internationalization along the current route? Are there incentives beyond simply eliminating dollar dependence? To answer this, more considerations need to be explored. The pursuit of RMB internationalization must have greater goals than simply eliminating excessive dollar dependence.

China's Envy Toward, and Doubt Surrounding, the US Dollar Hegemony

China's apprehension of its excessive dependence on the US dollar can be traced under a broader political economic background, involving how China perceives the US dollar hegemony. A popular interpretation of the dollar hegemony among China's public and elite can be summarized as follows: it is an international order in which the United States easily gains and even "plunders" (as some scholars term it) the material and financial wealth from the rest of the world.

Following the conclusion of the gold standard in 1971, the dollar standard system formed, and endowed the United States with the financial monopoly that is supported by its national strength. The dollar's unique status as the international currency in this system enables the United States to plunder wealth from the rest of the world, most notably the developing countries, in two related ways. First, the United States maintains a twin deficit — current account and fiscal — implying that it seizes material wealth from other countries through US dollar exports in exchange for foreign-made goods. Second, through the issuing of Treasury bonds and the development of financial derivatives, the outflow of the dollar through the current account deficit flows back to the United States. In this way, the United States effectively imports production value and further supports its financial system. This circulation mechanism causes an inner impulse for the United States to print money. Should the mechanism be in danger of breaking, the United States can pay the debts or dilute its debts by printing money. In doing so, it avoids the obligation to pay debts or reduce the amount of debt through devaluating the dollar. The QE policy, in essence, is debt monetization, and the depreciation of the dollar accompanying the QE policy leads to foreign reserves denominated in dollars held by foreign countries to fall substantially. This, thus, leads foreign countries to suffer while the United States plunders wealth (Li and Li 2014; Wang and Cheng 2011; Zhang 2010).

Chinese scholars' opinions on the dollar monetary hegemony echo the idea expressed by some Western economists, such as Niall Ferguson. Instead of calling it "wealth plundering," Ferguson (2005) terms it "tribute." He believes today's Sino-American economic relationship has an imperial attribute: empires traditionally collect tributes from their people. Rather than the "blood and treasure" paid to a traditional empire, today's tribute is effectively paid to the American empire by China and other East Asian economies in the form of underpriced exports and low-interest, high-risk loans. Just as the US Treasury Secretary in the Richard Nixon administration, John Connally, told his European counterparts that "the dollar is our currency, but your problem," Ferguson believes today's United States can say the same to China and other Asian countries. As such, the well-known saying is quoted frequently by Chinese scholars to describe the dollar hegemony and to illustrate their analysis on how the United States plunders wealth from China and other countries.

Some Chinese scholars who hold more radical opinions go further on the dollar hegemony (see Ding and Niu 2014; Qiao 2007; 2014). In their conspiracy-based views, the United States had used the dollar to hammer the Japanese economy into a decade-long recession, effectively destroying the possibility of Japan catching up with the United States economically in the 1980s.[5] These scholars argue that China must remain highly vigilant to the American conspiracy, which is embodied in the measures the United States took to exert pressure on China, including further opening of the financial market, liberalization of the exchange rate and opening of the capital account. Similarly, economists and even officials who advocate for market-based reforms in the fields above are usually criticized as being agents for US multinationals. They further explain a cyclical process in which the dollar hegemony provides the United States with cheap capital from the rest of the world, which is used to finance its military power, and which, in turn, allows it to maintain the dollar's hegemony.

Some of China's more highly regarded economists, however, interpret the dollar hegemony in a neutral way (He 2004; Zhang 2009; Yi 2011; Xiang and Wang 2014). Zhang Yuyan's explanation provides an example: US monetary hegemony allows it to collect seigniorage from

5 The Plaza Accord in 1985 was widely used in China as "proof" of the US conspiracy and the trigger of Japan's subsequent recession.

the rest of the world because most countries use and reserve the dollar. The dollars circulates beyond the United States and the dollar reserves held by all other economies are only sustainable through a continuous and large US current account deficit, from which the United States enjoys global resources and services provided by exporting the dollar and dollar-denominated assets. To maintain the stable dollar circulation, the United States must continue to export the dollar and provide enough financial products to meet the demand for trade and overseas reserves.

In these Chinese scholars' opinions, the fundamental problem of the international monetary system lies in the fact that the US monetary authorities only make monetary policies and macroeconomic policies based on their judgments on the US domestic economic situation (ibid.). In other words, the United States fails to consider negative spillover effects of its monetary policy on other economies. This explains why China proposes to establish a super-sovereign reserve currency and reform the current international monetary system. However, the reform of the international monetary system and the promotion of the International Monetary Fund's (IMF's) Special Drawing Rights are difficult without the support of the United States. Another option left to China then is to push RMB internationalization to fulfill the functions of an international currency (unit of account, means of exchange and store of value), while insisting on pursuing the goals of reforming the international monetary system.

This neutral opinion on the US monetary hegemony is also echoed by some mainstream US economists. Eichengreen (2011) states in his book *Exorbitant Privilege* that one of the big benefits of the dollar's international currency status is that other countries need to provide real resources in order to obtain it. About US$500 billion circulates outside the United States, for which foreigners have had to provide the United States with US$500 billion of actual goods and services. Because of the convenience of dollar securities, foreign banks hold large amounts of US bonds and bills, and are willing to pay more to obtain them. This allows the United States to run an external deficit in the amount of the interest rate differences between what it pays on foreign investment liabilities and the return on its foreign investment, thus allowing it to import more than it exports and consume more than it produces year after year without becoming more indebted to the rest of the world.

Either based on conspiracy or neutral economic analysis, China believes that the secret of the United States as a superpower lies in the dollar hegemony. The dollar's status as the world's currency allows for the use of foreign assistance to support American living standards and subsidize American multinationals. Further, there is no evidence showing that the left-wing, conspiracy-based opinion — epitomized in the bestselling book series, *Currency Wars*[6] — has influenced Chinese leaders' views on the monetary hegemony. It is fair to say, however, that this viewpoint, in addition to neutral opinions from economists, illustrates the importance of monetary power for a sovereign country's economic and political prestige in the modern world. RMB internationalization is China's first necessary step in pursuing its goal of becoming a financial power in the global monetary system.

China Rises Financially: Establishment of the Modern Financial System

Chinese leaders have been developing their own understanding of the importance of finance in the modern economy since the beginning of China's new round of economic reform after the 1989 Tiananmen event. Deng Xiaoping's unexpected foresight in 1991 that "finance is the core of modern economy" (Deng 1994) indicated that China's leaders realized the importance of finance in modernizing China's economy. Following in the spirit of the highest direction from Deng, China launched the market-based financial reform in the mid-1990s, and started to "[be] in line with international norms" (or, *yu guoji Jiegui*, as translated in Mandarin). The RMB was devalued and a managed floating system was introduced in 1994. China opened its current account by accepting the IMF's Article VIII in 1996 and a road map for capital account liberalization was set (Yu 2014). The initially smooth financial reform, however, took a sudden turn at the outbreak of Asian financial crisis in 1997. During the crisis, the RMB was repegged to the US dollar, capital account liberalization was stopped and capital control was tightened.

Although financial sector reform has been pushed since the 1990s, China's confidence in its strictly regulated financial system increased after it successfully withstood, to a great extent, the Asian financial crisis, which in turn impeded further financial reform. However, integration with the global financial market remained the ultimate goal for Chinese policy makers. The GFC triggered a new round of reform out of China's concern that the dollar trap would lead to large capital losses. The report released at the 18th National Congress of the Communist Party of China (CPC) in 2012 set the goal of financial reform: to "deepen reform of the financial system and improve the modern financial system so that it will better contribute to macroeconomic

6 *Currency Wars* (Houbi Zhanzheng), compiled by Song Hongbing in 2007 and a bestseller in China, is a conspiracy theory-based book series that claims Western countries are ultimately controlled by a group of private banks. It has drawn criticism and praise, and is seen as a prominent exponent of economic nationalism. Its sequel and third installment were published in 2009 and 2011, respectively. The sequel, *Currency Wars 2: World of Gold Privilege* was reported as being one of the most popular books in China by late 2009.

stability and support development of the real economy."[7] In other words, the modernization of China's financial sector and the building of strong institutions to manage the financial system were priorities. The report also called for reforms to "accelerate development of a multilevel capital market, take steady steps to make interest rates and the RMB exchange rate more market-based, and promote the RMB's convertibility under capital accounts in due course."[8]

The reform platform released from the 3rd Plenary Session of 18th CPC Central Committee in 2013 highlights three points of financial reform: lowering the entry threshold to boost financial market competition; promoting the marketization of interest rates and exchange rate formation, and the opening of capital markets; and managing potential financial risks by administrations and institutions, as well as improving financial infrastructures. Generally speaking, the key point of the reform was to let the market play a decisive role. In August 2013, before the plenum, Premier of the State Council of the People's Republic of China Li Keqiang stated the same financial agenda to the international community at the Summer Davos Forum in Dalian, China.[9] Premier Li said China's financial reform was "a key move of a chess piece to revitalize the whole game of the Chinese economy."[10]

Scholars began to recognize the importance of a fully developed financial market in China's economic growth in the coming years. Compared to the leaders, scholars have become more focused on the integration of China's financial sector into the global financial market and use more direct words to advocate the importance of finance in the global economy. They emphasize finance's function of leverage in the global economic division of labour and believe the competitiveness of a country's financial sector determines, to a great extent, its status in the global economy (Zhang Yugui 2013). Domestically, they believe that market-oriented financial reform is regarded as the core of the next transformation of economic structure. The market-based financial reform would support the rebalancing of growth toward greater domestic demand.

The success of the financial reform will determine the future of China's economic transformation (Huang 2014; Zhang Yugui 2013; World Bank and Development Research Center of the State Council, P. R. China 2013). RMB internationalization — because of China's concerns regarding the market-oriented reform on exchange rate formation and the interest rate, liberalization of the capital account and modernization of the financial system — has become the crucial point that will play the pivotal role in China's comprehensive market-based financial reform. Or, as some scholars put it, economic and financial transformations in China constitute the precondition for RMB internationalization. When the structural transformations are finished, the conditions for RMB internationalization should be ripe. The success of the internationalization could be expected, implying that China will have finally fulfilled its strategy in becoming a financial power (Xia 2011; Pan and Wu 2012).

It can be argued that China, as the second-largest economy in the world, deserves its own international currency. The miraculous economic growth in China since the reform and "opening-up" policy (the Chinese economic reform) at the end of the 1970s is built on desired integration into the global economy and the adoption of market-oriented policy. China's entry into the WTO pushed its manufacturers into the international division of labour and contributed greatly to economic growth. Full participation and integration into the global financial market, which would irreversibly connect China's domestic financial market to the global market, is regarded as another key dimension for China's economic progress in the even more intertwined world economy since the dawning of the twenty-first century. Following this logic, in the current credit-based global monetary system, an international currency implies power. RMB internationalization itself is the core of the "Chinese dream"[11] in the financial field and can provide the financial support needed to realize the dream in its entirety.

Eliminating dollar dependence, trying to achieve an equal status to the dollar in the global monetary system and establishing a modern financial system constitute the long-term goals of the broader, political economy-related background of RMB internationalization. The current internationalization road map is indirect, gradual and intends to achieve these long-term objectives of RMB internationalization through domestic financial reform, despite having increased China's dollar dependence in the initial years — a necessary cost in China's eyes.

7 To access the full text of Hu Jintao's report, see http://news.xinhuanet.com/english/special/18cpcnc/2012-11/17/c_131981259.htm.

8 Ibid.

9 See http://topic.chinadaily.com.cn/index/special/sid/505.

10 See http://usa.chinadaily.com.cn/epaper/2013-11/12/content_17097692.htm.

11 "Chinese dream" is a new term originally used by Chinese President Xi Jinping to describe the nation's rejuvenation, improvement of people's livelihoods, prosperity, construction of a better society and military strengthening. Accordingly, each government department and every walk of life in Chinese society have their roles to play in contributing to the realization of the dream.

ROAD MAP OF RMB INTERNATIONALIZATION: A POLITICAL ECONOMY EXPLANATION

An Indirect and Manageable Approach for RMB Internationalization

Despite the academic chorus of appeal for RMB internationalization and the consensus on market-based exchange and interest rate reform (and liberalizing the capital account), the Chinese government has yet to claim a strategy or even publicly address the internationalization process. However, an indirect and manageable approach for RMB internationalization is underway.

Following the GFC, RMB internationalization was promoted as a necessary measure to avoid the risk of China's excessive dependence on the dollar. The Chinese government was not prepared for the increased demand from academic circles to accelerate RMB internationalization, which became more strident in the aftermath of the GFC. China's market-oriented financial reform was far from finished, as the exchange rate and interest rate reform and opening of the capital account were slowly progressing.

The central government recognizes the virtues of China's managed financial system and has confidence in a gradual and manageable approach to financial reform. Chinese scholars and leaders realize the risks of transitioning to a more financially integrated economy, especially the possible impact that capital account liberalization could have on China's economy. The indirect, controllable approach to financial reform is seen as the right choice for China. Facing the great appeal for RMB internationalization, economists and PBoC officials have been studying the gradual manner or middle way to promote RMB internationalization on the condition of a regulated capital account and limited convertibility. The consensus was reached that it could be started from promotion of cross-border trade settlement.

The RMB has been widely used in China's neighbouring countries and regions to settle border trade years before the GFC, and a series of studies have since been done by Chinese scholars (Xu 2014). In July 2009, the State Council's Administrative Measures on Pilot Projects for RMB Cross-Border Trade Settlement (PBoC 2009) was issued,[12] officially initiating the cross-border trade settlement and symbolizing an acceleration of RMB internationalization.

Despite the rapid progress of RMB internationalization in trade settlement over recent years, deposits of overseas residences, RMB bonds, RMB cross-border loans, RMB overseas direct investment, the introduction of RMB qualified foreign institutional investors and RMB swap agreements with other central banks,[13] Chinese authorities continue to keep a low public profile regarding the RMB internationalization process. It was not until the beginning of 2011, one and half years after the acceleration of RMB internationalization, that the Chinese authority first officially mentioned the wording, albeit in a consistently overlooked document (Xu 2014). Chinese officials describe the process of RMB internationalization as a "let market-take-its-course"[14] situation, and internationalization will be realized when conditions are ripe. In reality, however, Chinese authorities actively push RMB internationalization by the means mentioned above. It appears the Chinese government took a subtle "do-without-saying" approach to RMB internationalization.

This gradual and manageable approach to RMB internationalization follows the same model as the reform of exchange rate formation since 2005 — the first serious step of China's market-based financial reform. China did not fully liberalize at once, but instead followed a gradual means of regulation through a managed floating exchange rate regime based on market supply and demand in reference to a basket of currencies. In the following years, it proved to be a way of avoiding risk, as the government thought the negative impact on the whole economic situation was being controlled. Similarly, the current Chinese government believes that it is still not in a position to fully push market-based exchange rate and interest rate reform, two prerequisites for the internationalizing of its currency (according to the classical theory on sequencing a currency's internationalization). The path chosen for RMB internationalization was thus still gradual and even circuitous. The best option left to reformers is to promote the cross-border trade settlement and establishment of offshore RMB markets. In doing so, the two prerequesites for RMB internationalization can be achieved.

China's worry about the control of foreign capital over its financial market, and consequent encroachment on its financial sovereignty caused by market-based reform, also contributes to its gradual and manageable means of achieving RMB internationalization. Combined with Chinese leaders' emphasis on the importance of finance, China's tight grip on the financial power and worry over foreign control of its financial markets is understandable.

12 This was jointly issued by the PBoC, the Ministry of Finance, the Ministry of Commerce, the General Administration of Customs, the State Administration Taxation and the China Bank Regulatory Commission — the six ministries of the State Council (China's cabinet).

13 For detailed progress on RMB internationalization, please refer to the paper by Yu (2014).

14 Yi Gang, deputy governor of the PBoC, expressed this opinion when interviewed by journalists from the official Xinhua news agency on March 1, 2013. See http://rmb.xinhua08.com/a/20130301/1130481.shtml. Jia Kan, director of the Research Institute for Fiscal Science at the Ministry of Finance, published an article to explain this perspective in 2012. See http://paper.people.com.cn/rmlt/html/2012-02/22/content_1006917.htm?div=-1.

China will likely never relinquish control of its financial market and would be very reluctant to let foreigners play a significant role in its domestic financial markets, which, according to a US scholar (Kroeber 2011), is crucial if China wants to let the RMB become a substantial reserve currency.

All things considered, the current approach taken in internationalizing the RMB is quite unique. What is seen as a more "normal" approach would be to push market-based reform on exchange and interest rates and liberalize the capital account, as this will naturally lead to internationalization of the RMB. The reality, however, is that in spite of unfinished market-oriented reform on exchange and interest rates and a still strictly regulated capital account, the Chinese government, albeit in a low-profile way, pushes RMB internationalization by ways of cross-border trade settlement, establishment of offshore RMB markets and swap agreements with other central banks.[15]

Behind the indirect and manageable approach taken for RMB internationalization, there are deeper reasons that need to be explored, such as the so-called reverse coercing mechanism — the most plausible explanation.

Capital Account Liberalization in the Name of RMB Internationalization

The fundamental problem with the current road map for RMB internationalization, according to Yu (2014), is that China cannot provide liquidity to the rest of the world without increasing its foreign liabilities correspondingly, due to China running a current account surplus. Ultimately, China's current means of RMB internationalization — i.e., relying on RMB trade settlement to provide offshore markets RMB liquidity — will lead China to hold increasingly more dollar-denominated assets, which is exactly what it is trying to avoid by promoting RMB internationalization. As a result, the goal of RMB internationalization would never be realized. To make it worse, one of the most serious consequences of the current approach is the rampant exchange and interest rate arbitrage. Profits from arbitrage are the major driving force of current RMB internationalization, causing China to suffer great welfare loss.

The regulated exchange rate mechanism is to blame for the failure. Based on the expectation of RMB appreciation, certain progress has been made on the current path of internationalization under dual control of the exchange rate and capital account; however, this progress is unsustainable. Since September 2011, the reversal of expected RMB appreciation has set back the process. Additionally, turmoil in global financial markets would also lead to a huge amount of capital denominated in RMB assets being converted to US dollars. Regardless, the consequences of reduced holdings of RMB assets and of trading volume of RMB cross-border trade settlements prove that the government-led initiatives of currency internationalization under controlled exchange rate and capital account are unstable.

The performance of the RMB internationalization process in 2014 further proved this instability. 2014 marked the first net depreciation (over the course of a year) of the yuan relative to the US dollar in five years. As the strong dollar emerges and the Chinese economy slows down, market expectations for RMB appreciation have declined substantially. Consequently, the process of RMB internationalization has slowed down, even though the Chinese government has bolstered it by establishing offshore RMB centres in Canada and Australia, two developed economies, as well as introduced other measures for further opening of its capital account, such as the enlargement of RMB Qualified Foreign Institutional Investors quotas and the kick-off of the Shanghai-Hong Kong Stock Connect. The increase of offshore RMB deposits in Hong Kong in 2014 was the smallest in 21 months, and once even declined mid-year. The share of China's goods trade settled in RMB dipped to 13.2 percent in July 2014, the lowest since October 2013 (Global Research of Standard Chartered 2014).

Given all these constraints and setbacks to the RMB internationalization, two important questions still remain: What is the reasoning behind opting for the current road map? And why does the PBoC continue using the current means of RMB internationalization despite the apparent lack of stability and sustainability?

The answers lie in the liberalization of the capital account. Following the current approach, the PBoC is actually pushing the capital account liberalization under the guise of RMB internationalization. First, opening RMB trade settlements and developing offshore RMB markets are ways of relaxing the capital account control (Yu 2011). Currency swap agreements signed between the PBoC and other central banks are another way to break through the capital account control, ostensibly in the name of RMB internationalization, by providing an anticipation of adequate liquidity to encourage more use of RMB in overseas markets (Zhang and Xu 2012). This explains why RMB trade settlements, development of offshore RMB markets and currency swap agreements were still pushed forcefully after 2011, although scholars had pointed out the inherent defects of RMB internationalization under the current path and had called for a halt (Yu 2011; Zhang and Xu 2012). In November 2014, the beginning of the Hong Kong-Shanghai Stock Connect "through train" — which

15 The amount of RMB that has been activated only accounted for a tiny part of the total size of RMB in the swap agreements. For example, only 4.169 billion yuan had been activated out of 296 billion yuan in the third quarter of 2013 (1.4 percent), according to China Monetary Policy Report, Quarter Three, 2013 (PBoC 2013).

allows Chinese mainland investors to buy Hong Kong shares, and for international investors to gain access to one of China's two stock markets via Hong Kong-based brokerages — provided another nudge to further open the door of the capital account without having to directly lift China's capital control. As Charles Li, chief executive of Hong Kong Exchanges and Clearing said, the scheme marked a breakthrough point for the two-way opening of mainland China's capital account (Li 2014).

The liberalization of the capital account is a policy goal supported by authoritative official documents, which justifies the current approach the PBoC is using to promote RMB internationalization. It is worth noting that while neither the PBoC nor any other departments ever mention RMB internationalization or the relationship between RMB internationalization and capital account liberalization in their official documents and statements, liberalization of the capital account — a desired, if not the primary, consequence of RMB internationalization — is specified as a priority in such authoritative documents as the "12th Five-Year Plan," the report of the 3rd Plenary Session of the 18th CPC Central Committee.

Therefore, the PBoC insisted on its policy and proposed a period of "strategic opportunity" for capital account liberalization in 2012 (Research Team of Statistics and Analysis Department of PBoC 2012b) and has continued to push to liberalize the capital account since, despite many economists warning of the great danger it could bring to China's economy. In practice, the PBoC did not intend to push the capital account liberalization in one swing. The proposed strategic opportunity was more of an announcement as to the importance and urgency for the capital account to be liberalized. The current approaches of RMB internationalization have actually indirectly broken through the capital account control. In this way, capital account liberalization does not have to directly confront the powerful interest groups, but instead provides a logical and feasible path for domestic financial reform under the current political and economic background in China.

Coordinated and Controllable Way for China's Financial Reform

An important supplementary explanation for the PBoC's efforts for the liberalization of the capital account is that the PBoC does not seek to promote the policy in a rigid way. According to what Deputy Governor Yi Gang said in a recent debate with Yu Yongding, the PBoC is concurrently promoting the liberalization of the interest rate, the exchange rate and the capital account "in a coordinated way" (Sina Finance 2014). This is also what the PBoC February 2012 policy research report indicates (Research Team of Statistics and Analysis Department of PBoC 2012b). It claims that the classic economic theory, "the impossible trinity" (or "trilemma"), has its limitations and does not apply to China's current situation. One of the key limitations of the theory is that it does not take the "intermediate states" of each component of the triangle into account. For example, between the fixed and fully liberated exchange rate system, there is an intermediate state of neither being fully regulated nor fully liberated. This constitutes the theoretical foundation for the coordinated means of promoting China's financial reform.

Some other influential economists in China, such as Xia Bin,[16] endorse the PBoC's opinion on the gradual model of China's coordinated reforms of the three important policy goals (Xia 2014). Xia believes the sequencing is no longer the key for China's financial market reform, as both exchange rate reform and liberalization of the capital account have already made some progress. Further complicating the situation is the ongoing effort to internationalize the RMB, effectively adding a new heavyweight variable to China's financial market reform. RMB internationalization, in its current state, is pushed under a regulated exchange rate and unfinished capital account liberalization, and should not follow an abstract theory. This is not a case that has ever occurred in Western classical economic textbooks, and there is no experience China can learn from.

The PBoC is emphasizing that at present, the conditions for accelerating the capital account liberalization are ripe, and are promoting the market-oriented exchange and interest rate reform, as well as liberalization of the capital account in a coordinated way. China's choice is to promote the exchange rate, interest rate and capital account liberalizations simultaneously in an alternative way, launching whichever reform once the conditions for it are ripe. In this way, some combination of measures would be taken and the risks reduced.

Based on its own calculation and confidence in the current gradual approach, the PBoC did not follow the ideal sequencing. Judging from some comments of PBoC officials, such as Deputy Governor Yi Gang and former Deputy Governor Wu Xiaoling, the PBoC is promoting the use of the RMB as a settlement and investment currency, which will bring great external pressure to liberalize the capital account. Only after the liberalization of the capital account is achieved, can interest and exchange rate reform be realized. This is what Yu (2014) calls the PBoC's "functional approach" to RMB internationalization, or as other scholars refer to it, the "reversed coercing approach."

16 Xia Bin is the director-general of the Financial Research Institute at the Development Research Center of the State Council and a former member of the monetary policy committee of the PBoC.

Meanwhile, at the request of other countries,[17] signing currency swap agreements with foreign central banks is a supplement to the basic PBoC approach to promote RMB internationalization.[18]

At present, the PBoC is under much more criticism regarding the slow pace of interest and exchange rate reforms. Some analysts (Yu, Zhang and Zhang 2013) believe the current policy combination of slow exchange rate reform and promotion of capital account and RMB internationalization is not ideal, based on the rampant exchange rate and interest rate arbitrage caused by the policy. The PBoC should recognize that a more flexible exchange rate could offset negative impacts brought by further liberalizing the capital account. The PBoC's slow-moving exchange rate reform in recent years lies in the greatest difficulties facing them. Some progress was made when certain favourable conditions were prepared, such as the devaluation of the RMB in 2014. In March 2014, the PBoC widened the RMB exchange rate trading band to two percent and began to gradually reduce its regular intervention on the foreign exchange markets. Yi Gang believes that by the end of 2014, RMB exchange rate flexibility had increased and a two-way fluctuation for the RMB exchange rate was forged (Yi 2014).

RMB INTERNATIONALIZATION AS A DE FACTO PROPELLER AND IMPORTANT COLLATERAL GOAL FOR FURTHER FINANCIAL REFORM IN CHINA

It is evident that PBoC officials understand the sequencing for RMB internationalization is important and should adhere to the following order: reform of market-based interest rate and exchange rate formation mechanism, convertibility of RMB under capital account and then complete the RMB internationalization. However, exchange and interest rate reforms are facing too many difficulties and it is very hard to break the powerful vested interest groups in state-owned enterprises (SOEs), the "big four" — four state-owned commercial banks — and local governments, which are supported and protected by the current financial repression-based economic development model. As Wu Xiaoling (2011), vice chairwoman of the Financial and Economic Affairs Committee of the National People's Congress, said in 2001, "it is too difficult to reach consensus among all the parties concerned with how to reform the exchange rate regime." The PBoC has to shift to another means of exchange rate reform — first by promoting RMB internationalization, then taking advantage of the pressures brought by RMB internationalization to promote the convertibility of the RMB under capital accounts and, lastly, fulfilling the exchange rate reform.

It works in this way: under the current approach for RMB internationalization, cross-border trade settlement and establishment of offshore RMB markets would lead to large amounts of offshore RMB. The offshore RMB trading hubs themselves also function as the mechanisms to provide channels for overseas RMB to flow back to China, which ensure that RMB internationalization could proceed. The amount of capital flow, in turn, will exert great pressure on the still-controlled capital account and exchange rate.

In reality, the mechanism may not necessarily bring success, but may bring China losses in the form of exchange rate and interest rate arbitrage, as argued by some scholars (see Zhang Bin 2011; Yu 2011; 2012). This, however, is viewed as a necessary cost of RMB internationalization and realization of the greater goal of China's financial reform. RMB internationalization under current routes is the second-best choice for China. The best choice — the liberalization of exchange and interest rates first — however, is not feasible under present circumstances. Furthermore, with the market expectation for the RMB turned into depreciation from appreciation, and the PBoC further relaxing control of the exchange rate in 2014, the arbitrage activities became less profitable and the cost was reduced. The dilemma is that with the reduction of the cost, the process of RMB internationalization also slowed down accordingly.

Therefore, it would be fair to say that RMB internationalization is being used as a booster for domestic financial reform, and it is a collateral goal of the latter. For China's difficult financial reform, it seems the reversed coercing mechanism is in fact a practical option for the PBoC and its supporters.

RMB internationalization is a crucial tool that would bring two key goals of China's economic development: globally, it will enhance the competitiveness of China's international finance, and progressively shake off the constraints brought about by current global monetary system regulations dominated by developed countries; and domestically, it will boost the financial reform, efficiently advancing China's economic development. In China's view, the US dollar's hegemony and policy consequences arising therefrom, such as its actual veto power at the IMF, the negative externalities of the US monetary policy, and constant and huge current account and fiscal deficits, could bring an unfavourable impact on China's economic development. China will be more competitive financially and more capable of seizing the initiative in international monetary policy coordination and its international status

17 The PBoC's swap agreements with South Korea in December 2008 and other countries' central banks in the first months of 2009 were all signed at these countries' requests (Ba 2009). In recent years, many swap agreements were also at the request of other countries' central banks for different reasons — for example, Argentina, Malaysia and Indonesia for trade settlement currency, and Russia, the Philippines, Cambodia and Belarus for reserve currency (Yang 2014).

18 The PBoC did not zealously promote the swap agreements with other countries. Personal interview with Xu Qiyuan.

would be promoted upon the RMB becoming a major reserve currency. Domestically, it will push a series of market-oriented financial reforms involving the exchange rate, interest rate, bank sector and capital market.

Chinese top leaders have a clear understanding of RMB internationalization's position in China's financial reform (Cheng 2014).[19] It is clear that the ultimate goal of China's financial reform is in fact not RMB internationalization itself, but is instead the building of a moderately prosperous society by 2020. Wu Xiaoling emphasizes that the PBoC is paying more attention to how to promote market-based domestic financial reform, rather than how to push the RMB toward becoming an internationalized currency, and, thus, the era of the RMB is yet to come (Wu 2014). Governor Zhou Xiaochuan also stresses that for RMB internationalization, the PBoC primarily focus on finishing its "homework," including lifting unnecessary restrictions for the use of the RMB, such as legal and business regulations, gradually pushing to realize the RMB capital account convertibility. The PBoC is creating conditions for more wide use of the RMB, and will not set a pre-arranged speed, rhythm and point for it (Zhou 2014).

At the same time, RMB internationalization itself as a collateral goal is also of importance in view of the political and economic benefits it could bring to China. It would be ready to be realized if the set goals of financial reform are finished. This provides another explanation as to why the PBoC is still promoting RMB internationalization in its unique way, even though no country has ever taken initiative to push internationalization of its currency — primarily because of the potentially extreme cost and responsibilities.

Logic behind the Indirect and Manageable Way of RMB Internationalization: The Key to China's Economic Structure Transformation

The fundamental reason for the reversed coercing method of financial reform lies in the difficulties of the market-oriented exchange rate and interest rate reform — normally, the prerequisites for the full internationalization of a currency. Among them, the market-based interest rate system takes up the core of China's current financial reform and is a fundamental constraint for real market-oriented exchange rate reform and liberalization of the capital account.

According to interest rate parity theory, while domestic interest rate is regulated, liberalization of the exchange rate will lead to large exchange rate fluctuations, widened interest rate spread and great amount of cross-border capital flows, all of which impact domestic monetary policy. In China today, regulated interest rates will lead to a distorted exchange rate and an impossible-to-set reasonable fluctuation interval under the current, regulated exchange rate system. Additionally, the long-term ceiling on the deposit interest rate and maintenance of low nominal interest rates will put an upward pressure on China's exchange rate. In short, a market-based interest rate constitutes the precondition of the liberalization of exchange rate.

Eighteen years after the market-based interest rate reform began in 1996, the most important deposit rate still remains untouched, and is now the only regulated interest rate. Scholars, both domestic and foreign, agree that the financial repression, with its centrepiece in regulated interest rates, comprises the core of the financial system in China (Huang 2014; Cao Tong 2014; Sender 2012; Lardy 2012; Ito and Volz 2013). The financial repression, which had been implemented since the reform and opening-up policy began more than 30 years ago, guaranteed that household wealth was transferred to governments and SOEs. It constitutes the most important foundation of China's current economic growth model, characterized by investment and exports. It also constitutes a key element to the CPC's influence over the Chinese economy.

Market-oriented interest rate reform is thought to be the most difficult part of financial reform in China. It intends to change the financial repression policy, and is essential for moving China from the current economic growth model — investment- and export-driven — to a consumption-driven growth path. This constitutes a departure from the most successful economic growth model over the past 30 years, and cannot be realized without grand determination from the top policy makers in China.

The greatest difficulty comes from the opposition of the powerful vested interest groups that benefit from the current financial repression and growth model. They tend to oppose policy changes such as exchange and interest rate liberalization, which are logically linked to RMB internationalization, without being directly against RMB internationalization per se. Premier Li Keqiang expressed his opinion on these powerful interests and the difficulty to push the reform at his inaugural press conference in March 2013 by saying "sometimes stirring vested interests may be more difficult than to stir the soul"(Zhang 2013).

Main de Facto Restrictive and Supportive Forces of RMB Internationalization

Main Restrictive Forces

Large State-owned Commercial Banks

Although competing and benefitting from a role in offshore RMB clearing banks, large commercial banks constitute a significant de facto restrictive force for RMB

19 Cheng Siwei is a famous economist and vice chairperson of the 9th and 10th Standing Committee of the National People's Congress.

internationalization by vigorously maintaining the regulated deposit rate.

Large commercial banks in China enjoy substantial subsidies brought by negative real deposit rates. In 2011, average interest income accounted for 80 percent of total bank income (China Banking Regulatory Committee 2012, 8). Former Deputy Governor of the PBoC Wu Xiaoling called the banks' profits "unreasonable." Current Mayor of Chongqing Huang Qifan said that banks' net interest spread in China is two percent higher than those in other countries (Su and Lou 2012). Zhang Weiying (2011), a well-known economist from Peking University, describes the state-owned banks' method of profiting "easy money" through its monopoly status as being based on the logic of a gangster — a deposit rate of 1.2 percent and a lending rate of 5.6 percent provide a spread that even a fool could make money from. A study by US scholar Nicholas Borst echoes Zhang's criticism. He describes how since the PBoC completely removed controls on financial institutions and the floor for lending rates of financial institutions, banks in China have lived with a comfortable margin of around three percent (Borst 2012).

At present, deposit rate control is the only one remaining in China's interest rate reform, which, according to official sources, has been viewed as the most crucial and risky step, and therefore remains untouched. As an important prerequisite to RMB internationalization, interest rate reform was opposed fiercely by large commercial banks because it would result in the deposit-loan spread narrowing significantly, which would have serious repercussions on bank profitability. The four biggest state-owned banks, which dominate the banking system, had an average return on equity of about 25 percent in 2011 (Orlik and Reilly 2012). Facing the questions from the public on their excessive profits in 2012, some leaders of China's biggest banks were quick to deny the profits (Su and Lou 2012). This is a sign of the potential difficulties the deposit rate reform may face, as the leaders will not succumb easily.

State-owned Industrial Enterprises

Some state-owned industrial enterprises might benefit from RMB settlements of trade and outward direct investment — two channels of RMB internationalization — however, as the major borrowers of China's current financial system and receivers of cheap funding from the state-owned banking system, state-owned industrial enterprises strongly opposed financial market reform, most notably the untouched deposit rates. This puts them on the list of de facto restrictive forces of RMB internationalization. Even the lending rates have been marketized since 2013, unregulated deposit rates will accordingly, lead to the rise of lending rates, and will, erode the relatively high profitability of SOEs. After an investigation trip to Zhejiang Province in 2012, Chairman of All-China Federation of Industry and Commerce Huang Mengfu noted that a percentage of SOEs' profitability comes from transfer payments of interest rates, as they can get the loan from the bank at a fairly low rate. The interest rate on petty loans averages at 20 percent, much higher than the 10 percent rate that large-size private enterprises would be happy with. The SOEs, however, can get loans from a bank with a 5.3 percent lending rate (Liu 2013). A competition with the private sector on lending from banks would benefit overall welfare at the expense of SOEs. According to *The Nature, Performance and Reform of the State-owned Enterprises*, a book published by the Unirule Institute of Economics (2012), absolute majority of a ¥10 trillion loan went to the SOEs in 2010.

Export Industries

Exchange rate liberalization would result in significant appreciation against the US dollar.[20] China's export industries, with support from the powerful NDRC and the Ministry of Commerce — as well as the coastal provinces in which export industries account for a large percentage of GDP and job opportunity — formed a powerful interest group that opposed the fully market-based exchange rate reform. Since the beginning of the exchange rate reform in 2005, reformers have consistently witnessed the influence of the loose coalition of interest groups. Although some export enterprises have benefitted from RMB trade settlement since it was officially initiated in 2009, limiting factors such as current foreign trade structure[21] and Chinese exporting enterprises' lack of bargaining power, determine that 90 percent of Chinese foreign trade enterprises still choose to settle in US dollars (Wang 2014), and still greatly oppose the risk of a fully liberalized exchange rate.

The NDRC

With its nickname "miniature State Council," the NDRC — the macroeconomic management agency under State Council — is the major policy maker and implementer of China's financial repression policy that guarantees the low-cost huge investment to sustain China's economic development in the past decade. The policy, centred on low interest rates, depresses household income and

20 Under the current regulated capital account, more capital will still find ways to flow in China and push RMB to appreciate. The RMB has been appreciated for eight years since the beginning of exchange rate reform in 2005. Recently, the expectation for one-way RMB appreciation has gone down with the decline of China's current account surplus and unstable fluctuation of cross-border capital flow. Furthermore, with the Fed formally ending the QE policy in 2014, the RMB could enter into the passage for depreciation against the US dollar. It would reduce the pressure from China's export sector and thus lead to a window of opportunity for exchange rate reform.

21 For example, companies from China's main trade partners (i.e., developed economies like the United States and European countries) favour not using the RMB in trade settlements; commodities are settled in the US dollar.

contributes to the buildup of the country's property bubble by causing a much larger allocation of investment into real estate. The prevailing interest rate system also contributes to serious distortions in capital allocation and exacerbates macroeconomic imbalance in the Chinese economy (Lardy 2012).

Local Governments

According to a Chinese Academy of Social Sciences researcher, the massive debt held by local governments in China amounting to ¥20 trillion — or, according to data released by the China Bank Regulatory Commission in 2013, ¥9.7 trillion (Lee 2013) — has become one of the major obstacles faced in the liberalization of interest rates. Interest rate liberalization, which would drive up deposit and lending rates, will significantly increase the government's borrowing costs and debt levels (Zhang Bin 2011). The massive amounts of debt held by local governments would be a source of systemic risk to China's financial market if it seeks to liberate its deposit rate before solving the problem. This concern turns local governments into major forces of opposition to the interest rate reform (ibid.), specifically to the loss of control over the deposit rate.

Real Estate and Construction Industries

China's real estate and related construction industry have developed into a large pillar of economic growth since the country's market-oriented housing system reform in 1998. The thriving of industries can be attributed to the great amount of cheap loans from state-owned banks (as they profit from the negative real deposit rates). With the introduction of a ¥4 trillion stimulus package after the GFC in 2008, the real estate industry re-boomed and became closely bound to the highly invested banks. The negative real deposit rates and lack of alternative investment opportunity pushed a large amount of money into the real estate market, which boosted the development of the property market en route to a property bubble. The sustainable development of the real estate market, with its huge size and supporting role in economic growth (plus its being bound together for better or worse with financing from banks and local governments), makes it a powerful interest group that prefers to keep the current regulated interest rate system.

These groups have not openly opposed RMB internationalization because it is widely interpreted and accepted as part of the goal of full economic nationalism. This goal symbolizes the elevation — perhaps to the same level as the United States — of China in the global economy upon the intended rise of the RMB as an international currency. The groups are not in a convenient position to oppose a policy for promoting China's rise as a financial power. However, the desired internationalization of the RMB will necessitate market-oriented exchange rate and interest rate reform, which endangers these groups' fundamental interests. Their opposition is the primary reason for the uniqueness of the internationalization process and its irregularity compared to the classic means of currency internationalization.

Main Supporting Forces

The current route of RMB internationalization under the dual control of the capital account and the exchange rate highlights the PBoC's dominance in governing the process. It nails down the support from top leaders, which guarantees the cooperation of other relevant government agencies such as the Ministry of Finance and the China Banking Regulatory Committee, which are essentially in an auxiliary position and are capable of offering technological support to the process. The economic nationalism implications of RMB internationalization, from another point of view, create a favourable public opinion regarding the process.

The PBoC

One of the few agencies countering the many interest groups for RMB internationalization is the PBoC. The capacity the PBoC has for advancing the internationalization of the RMB and related financial market reform largely depends either on its independence relative to central banks in Western countries, or — given the lack of central bank independence in China — on the amount of support it can get from the top leaders.

The PBoC is granted power over monetary policy, however, it is not as independent as central banks such as the Fed or Bank of England in Western countries. Significant policies, such as the market-based reform of exchange and interest rates, as well as RMB internationalization, must be decided by the top leaders after consulting relevant agencies and experts. This means that the PBoC has to compete with other government departments (and the powerful interest groups behind them) for influential power.

The biggest advantage the PBoC has lies in its financial sector expertise. It seems as though the initiative of RMB internationalization was shrouded as an economic nationalism policy that is supposed to raise China's status in the international financial market. In this way, it is put in a favourable position to be realized. In practice, it is fair to say that RMB internationalization in part depends on the relative advantage the PBoC has though its expertise of the financial sector, whereas other departments and interest groups lack sufficient knowledge and experience.

The PBoC has at minimum, two strong points for bidding for support from top leaders:

First, the cross-border trade settlement with neighbouring countries and regions turned into a "two birds with one stone" policy. It is the centrepiece of current RMB internationalization, and will help enhance economic and political relations with these countries. As such, the fact that Hong Kong's economic development benefitted from the establishment of an offshore RMB market would result in an increasingly stable political situation, which is a big concern for Chinese leaders. It is also an important step for RMB internationalization because of Hong Kong's status as an international financial centre. The Chinese government's continued effort in the fall of 2014 to initiate the Hong Kong-Shanghai Stock Connect through-train as arranged amid the months-long street protests in Hong Kong — albeit a number of days delayed — demonstrated this point.

And second, the PBoC's policy priority is to liberalize the capital account. This policy goal conforms to the financial reform goal made in the reform agenda at the 3rd Plenary Session of 18th CPC Central Committee. Wu Xiaolin (2011) expressed that within five years, China should be able to realize the convertibility of the RMB under the capital account. The report released by the PBoC in February 2012 claimed that China was in a period of "strategic opportunity" for capital account liberalization, and it should be accelerated (Research Team of Statistics and Analysis Department of PBoC 2012a). It also reassured the skeptical academics that there would be no large risks resulting from China opening its capital account. As Yu Yongding (2014) observes, the PBoC's intention to use RMB internationalization to promote capital account liberalization has become increasingly clear over time.

Top Leaders and Their Aides

There are more important dynamics involved in the liberalization of the capital account: it was endorsed by President Xi's top economic adviser and the prime architect of China's new economic reform, Liu He. Liu was elevated to the director of the Office of the Central Leading Group for Financial and Economic Affairs (OCLGFEA), a White House National Economic Council-like agency, which advises President Xi and the other six members of the Politburo Standing Committee, China's final arbiters of power. Reform-minded Liu, with long experiences as an adviser for top leaders and close connection with President Xi, is believed to have significant power over China's economic and financial policy making (Wang 2013; Lian 2013).

Historically, external forces were frequently used to realize the reform agenda in China's modern and contemporary era. The risk is that reformers who seek foreign pressures were always criticized as "looking to enhance their status by relying on foreign powers" (in Chinese, *xie yang zi zhong*), or in some cases were even called traitors by conservatives. The power and influence commanded by reformers could effectively protect them from attacks by conservatives and promote the reforms, just as former Premier Zhu Rongji promoted China's economic reform with China's entry into the WTO in 2001. The current market-oriented financial reforms seemingly gained support from top leaders, although the opposing forces still remain powerful. Liu He's connection with President Xi, Governor Zhou's unusual remaining in office and Premier Li Keqiang's pro-reform financial measures all demonstrate the support from the top leaders.

Liu's philosophy of taking advantage of external forces to push domestic reforms matches the current means of RMB internationalization promoted by the PBoC. In 2010, Liu said that "from the perspective of China's long history, a unified domestic drive and external pressures have been keys to success" and that "domestic drive often needs to be activated by external pressure" (Yu 2013; Davis and Wei 2013). Similarly, RMB internationalization was used to press the domestic financial reform, in particular the liberalization of the capital account. In the financial sector, Zhou is an important ally that Liu worked with for years. The PBoC's financial liberalization reform has support from Liu in addition to two important personnel changes. First, Vice Governor of the PBoC, Yi Gang was quietly named the deputy director of the OCLGFEA in April 2014. For years, Yi and Zhou have been pushing to make it easier for money to flow in and out of the country and to give the market a greater role in setting both exchange rates and interest rates (Davis and Wei 2013). Second, Fang Xinhai, who was invited back to work at China's financial sector by Zhou, joined the OCLGFEA in 2013 and is responsible for crafting a financial liberalization plan.

Favourable Public Opinion

Historically, the PBoC has frequently lost battles for exchange and interest rate reform-related policy influence with the more powerful NDRC and the Ministry of Commerce. Now, in the case of RMB internationalization, there is certainly a role reversal in the PBoC's favour. The sentiment of economic nationalism and the accompanying idea of a much larger international role for the RMB gaining momentum are very much helping the internationalization process by forging a consensus that would see, should the RMB become a major international reserve currency, China approach the status the United States has in the global monetary system and proclaim its successful rise in global financial field. As Bob Davis from *The Wall Street Journal* believes, the PBoC indeed could take advantage of its financial expertise to push market-based financial reform under the favourable atmosphere (Wei and Davis 2014). With these advantages, the PBoC began its plan for the internationalization in the aftermath of the GFC. As some foreign observers argue (Goodfriend and Prasad 2006), China's financial reform would help give the PBoC unconditional control of the monetary base. It now sets the

tone for the macroeconomic policy and reform agendas (Wei and Davis 2014).

CONCLUSION

The process of RMB internationalization will proceed with China trying to push it through setting up more RMB offshore markets in European cities such as London, Frankfurt, Paris and Luxembourg, as well as North American cities such as Toronto. China continues to sign currency swap agreements with developing and emerging economies. The basic logic behind the moves above are the same as previously mentioned: to promote a gradual enlarging of the international use of the RMB — geographically it follows the specific road map of first targeting the neighbouring regions before spreading use in BRICS countries (Brazil, Russia, India, China and South Africa) and other emerging countries via currency swap agreements — and the final goal of full internationalization. Functionally, the goal is to become a settlement currency first, then an investment currency and lastly a reserve currency.[22]

Behind these measures and trends for the goal of RMB internationalization lies the PBoC's real goal of pushing for domestic financial reform in the coming years: liberalization of the capital account and market-oriented exchange and interest rate reforms. Ultimately, intensifying the reform should be the true goal of China's full modernization by 2020. By then, China may hold greater chances to realize the long-term objectives of RMB internationalization — eliminating dollar dependence and trying to achieve an equal status with the dollar in the global monetary system, as well as establishing a modern financial system.

In general, the prospect of RMB internationalization and the underlying goal of promoting domestic financial reform depend on the following: determination of top leaders to deepen reforms of China's growth model; the PBoC's expertise and ability to use it wisely; the political wisdom of supporting leaders and scholars; and how much strength and efforts the reformers exert against the powerful and extremely adamant opposition. Specifically, the current means of internationalization relies highly on the expectation for RMB appreciation, which implies unsustainability. The process of RMB internationalization beginning to lose its momentum with the devaluation of the RMB against the dollar in 2014 proved this risk.

2014 witnessed the decrease of expectations for RMB appreciation, as well as the strengthening of the dollar. This worries Chinese policy makers with the great possibility of large-scale capital flight. Consequently, it would trigger a more prudent policy toward the liberalization of capital account, and the development of offshore RMB markets would be shadowed, thus resulting in a downward progress of the RMB internationalization.

On the other hand, the two-way exchange rate fluctuation that occurred during 2014, in addition to implying a more flexible exchange rate formation mechanism, effectively eliminated the almost exclusive expectation for the RMB to continuously appreciate. Furthermore, the Chinese economy is expected to continue to develop in a sustainable way in coming years and the sheer size of its economy and trade volume indicate the great demand for yuan. The RMB should continue to appreciate in the long run, although it is expected to experience a two-way fluctuation in the coming years with the expected continued strengthening of the dollar. For the PBoC, a natural two-way floating exchange rate is an important policy goal, and achieving it would further benefit the RMB internationalization process by improving confidence in the RMB, rather than potential arbitrage opportunities, as well as further benefit the financial market reform in China.

Both officials and scholars are well aware of the possible negative impact that may arise as a result of liberalizing the capital account. Although it appeared the PBoC had already made its decision and declared China as being in a period of "strategic opportunity" for capital account liberalization in 2012, the process is still very complicated and at some point may stop or even reverse. These potential occurrences can be observed from the PBoC's recently changing tone regarding capital account liberalization, as it has reverted to a more cautious attitude and adjusted its policy accordingly in 2014.

As far as time is concerned, both PBoC officials and economists in China agree that RMB internationalization is a long-term process that will take years, or perhaps even decades. The PBoC's gradual manner and cautious attitude toward promoting the interest and exchange rates in combination with top policy makers' hesitance regarding capital account liberalization increases the potential for the reform to turn into a decades-long process. Reformers in China will be required to use any means necessary to wear down the opposition. Such is the nature of gradual reforms of this magnitude.

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22 Of course, in practice, this is not a rigid process that RMB internationalization followed. Some countries already chose RMB as one of their options for foreign exchange reserve with China's efforts (Chatterjee and Armstrong 2014).

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