The Elusive Price of Stability: Ideas and Interests in the Reform of China's Exchange Rate Regime

By

Logan Houston Wright

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M.A. May 2001, Georgetown University

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Dissertation directed by
Susan K. Sell
Professor of Political Science and International Affairs

The Columbian College of Arts and Sciences of The George Washington University certifies that Logan Houston Wright has passed the Final Examination for the degree of Doctor of Philosophy as of January 30, 2009. This is the final and approved form of the dissertation.

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Logan Houston Wright

Dissertation Research Committee:

Susan K. Sell, Professor of Political Science and International Affairs, Dissertation Director

Bruce J. Dickson, Professor of Political Science and International Affairs, Committee Member

Erik Voeten, Peter F. Krogh Assistant Professor of Geopolitics and Global Justice, Georgetown University, Committee Member

To my parents, Sharon and Perry Wright

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Abstract of Dissertation

The Elusive Price of Stability: Ideas and Interests in the Reform of China's Exchange Rate Regime

What factors explain China's decision to abandon its longstanding peg to the U.S. dollar in July 2005 and replace it with an exchange rate regime permitting additional market influence, despite considerable domestic political opposition to reform? This dissertation argues that China's exchange rate reforms were driven by the confluence of China's changing self-perceptions as a responsible actor in the international system and the ideas within international financial institutions concerning exchange rate policy that emerged in the aftermath of the Asian financial crisis. These ideational factors influenced the Chinese leadership's consideration of its own interests in the long term. China's exchange rate reforms were not inevitable, and the form of China's new exchange rate regime depended heavily upon the dominant ideas concerning exchange rate policy within international financial institutions and the strategic use of those ideas within domestic political debates by the reformist leadership of China's central bank.

Traditionally, explanations of the political logic of economic reform in China have focused on China's economic self-interest, elite politics, bureaucratic or institutional factors, political economy approaches focusing on the influence of interest groups, or pressure from other powerful states. Instead, the dissertation argues that "best practices" of exchange rate policy, infused with the legitimacy of recommendations from international financial institutions, including the informal consensus surrounding flexible exchange rate regimes, provided Chinese policymakers in the central bank intent on reforming China's financial system with opportunities to present financial reforms as

congruent with China's emergence as a powerful and "normal" state in the international system.

For observers of Chinese politics, the argument that exchange rate reform was a contingent phenomenon, and was not inevitable, casts doubt on the conventional narrative of China's economic reform and opening to the global economy. While the conventional image assumes that China is becoming incrementally more open to the rest of the world, permitting greater influence for markets each year in accordance with a long-term "grand strategy" for economic reform, this analysis of China's exchange rate reforms suggests that economic reform and liberalization in China are distinctly non-linear processes, with political factors driving the pace and direction of reforms.

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Chapter 1- Introduction

Starting in 2003, China's exchange rate regime emerged from relative obscurity to become one of the hottest topics in international finance. Following the Asian financial crisis, China had reiterated its commitment to a fixed exchange rate between its currency, the yuan, and the U.S. dollar. By resisting a one-off depreciation to boost the export sector during the crisis, China's maintenance of a fixed exchange rate was praised throughout Asia. However, as China's export growth began to accelerate in 2003, at the same time as the U.S. trade deficit surged, media attention to the rapid growth of the Chinese economy and the "jobless recovery" in the United States began to focus on China's rigid control of the exchange rate as a primary cause of growing global economic imbalances. As China pegged the yuan to the dollar, China's Asian competitors also managed their currencies to avoid losing competitiveness to China, exacerbating these global imbalances. The results were rapidly growing Chinese trade surpluses, rapidly rising U.S. trade deficits, a surge of capital inflows into China, and a rapidly escalating political issue between China and the United States.

However, independent of the pressure from the United States and the growing international focus on China's exchange rate policies, a debate over the efficacy of the dollar peg was already beginning within China, led by reformers within the People's

Bank of China, China's central bank. The argument advanced by these reformers within the rest of the bureaucracy was that flexibility in the exchange rate regime would permit more autonomy in monetary policy, so that China could use interest rates to contain the impact of inflationary pressure resulting from capital inflows and rising trade surpluses. Without a market-determined exchange rate, interest rate hikes would be ineffective in managing the impact of capital inflows, as the higher rate of return on yuan-denominated assets would provide additional incentives to move funds into China. However, other Chinese institutions representing exporters and state-owned enterprises were reluctant to introduce fluctuations in the yuan's value to banks and companies inexperienced in managing exchange rate risks, and were unwilling to penalize exporters by appreciating the yuan relative to the dollar, making Chinese exports more expensive in foreign markets. Within this domestic political debate that also began around 2003, reformers at the People's Bank of China confronted significant opposition to exchange rate reforms from almost every other economic institution within the bureaucracy. At the same time, a relatively consistent message emerged from all Chinese officials emphasizing the ineffectiveness of international pressure, as exchange rate policy was presented as an issue of Chinese sovereignty.

The end of China's peg to the dollar came roughly two years after the policy debate over the exchange rate regime began in earnest. On the evening of July 21, 2005, China's central bank announced that the value of China's currency, the yuan, would appreciate 2.1 percent against the U.S. dollar. In addition, the central bank introduced a new system permitting more market influence over the exchange rate, replacing the peg to the dollar, which had been in place at the same price for over ten years. While many

analysts expected a change in China's exchange rate, the timing of the move, the modest size of the move and the nature of the new exchange rate regime created significant questions for scholars of China's economic reform and China's domestic politics.

Continuity and Change in China's Exchange Rate Regime

The dependent variable of this study is the reform of China's exchange rate regime, including its effects on the reform of China's overall financial system. The dependent variable should be assessed on the basis of whether reforms result in state-directed or market-directed forms of adjustment.[1] Studying the course of reform of China's exchange rate regime is critical because market-based adjustment in the exchange rate regime enables market-based adjustment in other financial sectors, but maintenance of state control also enables state-directed adjustment strategies in the banking sector and financial markets. The reform of China's exchange rate regime is both an enabler and an indicator of broader reforms in China's financial system. Because the exchange rate affects the prices of foreign goods in China and the prices of Chinese goods abroad, the decision to fix the exchange rate at a certain level reflects a bias in industrial policy toward export-oriented enterprises, as a marginal yuan of new

[1] This approach has been used elsewhere in studies of the impact of international institutions and economic interdependence on Chinese economic policy. See, for example, Thomas G. Moore and Dixia Yang, "Empowered and Restrained: Chinese Foreign Policy in the Age of Economic Interdependence," in David Lampton, ed., *The Making of Chinese Foreign and Security Policy in the Era of Reform* (Stanford: Stanford University Press, 2001), p. 191-229. "Since the legitimacy of the Chinese regime is now heavily dependent upon economic performance, and given the additional fact that the open policy could be reversed only at great political as well as economic cost, EI [economic interdependence] can be expected to have a substantial, albeit not easily predicted, long-term impact on China's foreign policy-making process and behavior. The process of reform and opening has, over the course of two decades, already led to reduced economic sovereignty vis-a-vis the outside world and a weakening of central control over certain aspects of economic decision-making." Moore and Yang, p. 228.

investment is likely to be channeled into the export sector rather than industries focused on the domestic market. In essence, the fixed exchange rate regime perpetuates a form of economic planning.[2] A decision to allow the market to adjust the exchange rate reflects a different set of priorities, and less control of the state over the mechanics of reform in the rest of China's financial system.

Before 1994, there were two exchange rates operative in China. The first was an official fixed exchange rate, priced at a rate of 5.8 yuan per dollar in 1994. There were frequent adjustments to this exchange rate after 1978, but the exchange rate regime always featured a peg to the U.S. dollar. The second exchange rate was determined in a secondary market where exporting companies could sell a portion of their profits in foreign exchange at a different price. In 1994, the central bank unified these exchange rates at a price of 8.7 yuan to the dollar, which was the prevailing rate in the secondary market at the time.[3] After a slight appreciation of that rate to 8.28 yuan per dollar in 1995, the central bank began to tighten the fluctuation bands of the yuan, leaving its nominal value essentially unchanged for ten years.

Until the People's Bank of China (PBOC) announcement of a change to China's exchange rate regime in July 2005, the country had adopted a fixed-but-adjustable regime. The value of the yuan was allowed to fluctuate, but only within an extremely narrow range, making the regime effectively fixed. A commonly accepted international standard for fixed rates are exchange rate regimes where the floating band is less than 2

[2] David F. DeRosa, "China's Defense of the Peg Perpetuates Central Planning," *Cato Journal* **25**, no. 1 (Winter 2005), p. 49-54.
[3] Nicholas Lardy, "Exchange Rate and Monetary Policy in China," *Cato Journal* **25**, no. 1 (Winter 2005), p. 43.

percent on each side of a central parity.[4] Under this system, the exchange rate was in essence decided by administrative fiat, and was maintained by central bank interventions into the open market, in contrast to an absolutely fixed regime (such as the use of another country's currency, monetary union, or a currency board), which requires that foreign exchange reserves determine the size of the country's monetary base.[5] Despite foreign currency speculation betting that the yuan was undervalued and should appreciate, China's central bankers chose to acquire foreign exchange reserves, by selling yuan to foreign speculators and exporters, rather than change the value of the yuan to remove future opportunities for speculation.

International Norms of Exchange Rate Flexibility and China's Reforms

If almost every institution in the Chinese bureaucracy was opposed to changing China's fixed exchange rate regime, and the July 2005 reforms were inconsistent with China's historical pattern of monetary policy behavior, how did the reforms emerge from China's opaque political process? The question has implications for studies of both Chinese domestic politics and international political economy. Basic models of Chinese domestic politics will have a difficult time explaining the introduction of reforms opposed by a significant majority of the Chinese bureaucracy, particularly when the preferences of those bureaucratic actors have not changed over time. Arguments from an international political economy perspective will focus on the power of international

[4] Maurice Obstfeld and Kenneth Rogoff, "The Mirage of Fixed Exchange Rates," *The Journal of Economic Perspectives* **9**:4 (Autumn 1995), p. 87.
[5] W. Max Corden, *Too Sensational: On the Choice of Exchange Rate Regimes* (Cambridge, Mass.: MIT Press, 2002), 22-23, 41.

factors and the influence of monetary power, but these arguments have difficulty illustrating the mechanisms through which these international variables become relevant in any particular domestic political context. The basic argument of this study is that the process by which a more flexible exchange rate regime became a politically viable solution in China involves the influence of internationally shared norms and ideas regarding the importance of autonomy in monetary policy and the dominance of flexible exchange rate regimes in the global economy. This analysis of China's exchange rate reforms involves the processes by which these ideas became relevant in China's domestic political context, during the period from 2003 to early 2005, rather than before.

Primarily, appeals to international norms of monetary economics came from two groups at different levels within the Chinese bureaucracy. First, a group of reformers among decision-makers within China's central bank, the People's Bank of China (PBOC), gradually introduced concepts related to the "best practices" of international financial institutions, which included flexible exchange rates and a greater degree of autonomy in conducting monetary policy. Working within the central bank, these officials became critical advocates for a more flexible monetary policy, which required flexibility in the exchange rate regime. Their views could not be easily dismissed as resulting from their institution's position in the bureaucracy, as data from interviews indicate that the PBOC was divided on the question of additional exchange rate flexibility and the potential consequences for speculative capital inflows.[6] The second group consisted of higher-level officials interested in China's international reputation as a responsible player in the international system. These leaders came under pressure at a variety of international summits, where the issue of China's inflexible exchange rate

[6] Interview 06-111.

regime arose with increasing frequency. While the central bankers had been advocates of a more flexible monetary policy since the Asian financial crisis exposed the dangers of soft currency pegs, their influence was limited within a Chinese bureaucracy focused on preserving social stability and aware of the potential dangers of releasing the reins of a critical lever of the economy.

However, a combination of factors produced a change in the political calculus in debates within China's State Council, the state's highest decision-making body. First, a debate emerged within China concerning the sustainability of China's pattern of economic growth, which has been led by investment and exports rather than private consumption. Chinese economic growth rates were high, but Chinese growth was inefficient, both in terms of energy use, employment created per unit of capital, and improvements in citizens' basic standards of living. Reformers in the system began to draw attention to a more flexible exchange rate as a mechanism to change the fundamental direction of Chinese growth toward a pattern more consistent with the central government's changing objectives. Secondly, the mounting international pressure on China's top leadership at international conferences and other meetings changed the political calculus regarding the urgency of reform.

International pressure was incapable, however, of placing specific policy choices on the agenda of the State Council; policy options filtered up through China's think tanks and policy research offices. One of the corollary arguments of this study was that international pressure, in the context of exchange rate policy, served an agenda-setting function, but was not determinative of the final choice of policy options. When China's top leaders moved the State Council in the direction of "doing something" about the

rigidity of the exchange rate regime, there were undoubtedly several policy options on the table.[7] However, the one that was chosen—a system permitting more market influence over the exchange rate, expanding the regime's "flexibility"—was the one most broadly consistent with the international "best practices" in monetary economics, which called for the exchange rate as a tool of adjustment. The international consensus behind these practices varied considerably over time, and depended upon the assumption that exchange rates were an effective tool for the adjustment of payments imbalances.[8] When critical decisions were made, the policy options advanced by the reformist group of central bankers calling for exchange rate flexibility appeared the most consonant with international financial norms. The actual 2.1 percent change in the exchange rate in July 2005 was marginal, and this appears to be a compromise that emerged to allow the central bank to acquire more autonomy in monetary policy and a more flexible exchange rate regime in exchange for a commitment to other ministries to move slowly and predictably in appreciating the yuan.[9]

However, the variables determining the course of reform in China's exchange rate regime involved international norms about exchange rate flexibility, not bureaucratic politics. A purely domestic analysis of Chinese bureaucratic politics would have predicted no change at all, as explored in Chapter 3. Instead, the structural power of international financial norms limited the set of policy options available to China's leaders, given their conception of their interests as presenting China as a responsible player in global politics, fulfilling their obligations to remedy growing international

[7] Interview 06-120.
[8] Interview 07-110, and Barry Eichengreen, "The Endogeneity of Exchange Rate Regimes," in Kenen, ed., *Understanding Interdependence: The Macroeconomics of the Open Economy* (Princeton: Princeton University Press, 1995), p. 1-30.
[9] Interview 06-120.

economic imbalances. The power of these international norms, consistent with the views of critical theorists in international political economy, was persuasive and consensual rather than juridical in nature.[10] The idea that China needed to adjust its exchange rate regime for the good of the world was repeated to China's leaders extensively, and the current leadership continues to hear these concerns.

At the same time, these international norms did not determine the course of reform of China's exchange rate regime; they merely limited the potential range of options available to China's leaders that would have been consonant with global norms of financial governance. This set of options, in turn, depended upon the policy recommendations that China's financial institutions made to the State Council. While the central bank is not necessarily a very powerful institution within the State Council (an argument confirmed through numerous interviews within and outside the PBOC), the reformist leadership of the bank found a receptive audience for its argument that China should exit a fixed exchange rate regime under conditions of capital inflows rather than capital flight.[11] The reformist leadership of the central bank, in other words, had the right remedy at the right time, based on the criteria that China's top leaders were examining. At the time the State Council was debating the issue, a more flexible exchange rate regime and more autonomy in monetary policy appeared to be in line with global demands for market determination of exchange rates. China's leaders were interested in both responding to international pressure and in presenting their system as consonant with global standards in exchange rate regimes. This occurred at a time when China's largest financial institutions were being prepared for initial public offerings in Hong

[10] Mark Roden, "US-China Relations in the Contemporary Era: An International Political Economy Perspective," *Politics* **23**: 3 (2003), p. 192-199.
[11] Interview 06-113, Interview 06-120.

Kong, effectively providing the banks with the legitimacy of being treated on international exchanges as fully commercialized banks.[12] China was approaching the end of its five-year "grace period" to implement reforms following its admission to the World Trade Organization. The exchange rate decision was one of many reforms designed to move China's financial system in line with international standards, but as will be discussed in Chapter 2, it was also one of the most important decisions.

The transition from defending China's exchange rate peg on "national sovereignty" grounds in early 2004 to claims that the market was influencing the value of the exchange rate in late 2005 suggests a significant change in the Chinese leadership's attitude toward the issue. This change then filtered down through the multiple levels of the bureaucracy. Chinese leaders who publicly rebuked international pressure for China to revalue the exchange rate began praising the degree of market determination in China's new system. China's leaders were looking to both assuage international concerns about China's responsibility for global economic imbalances while avoiding the appearance of caving to international pressure, for domestic political reasons. The central bank's proposals for more exchange rate flexibility fulfilled both objectives, by tying exchange rate reforms to a more favorable direction of Chinese economic growth and by permitting more market influence over the exchange rate.

It is far too simple to dismiss the solution that China's leaders reached as an obvious, "just so" compromise to satisfy both domestic and international audiences. Exchange rate reform was not inevitable. As Jeffry Frieden has argued, "It is not simply an academic curiosity to insist that conflict between the nominal exchange rate and

[12] The Bank of China, Industrial and Commercial Bank of China, and China Construction Bank all received extensive recapitalization packages from the government totaling $60 billion between 2003 and 2005.

macroeconomic fundamentals does not necessarily end with the exchange rate adapting."[13] The story of how these reforms emerged is contingent, based upon both a committed set of reformers and a receptive leadership focused on presenting China as a responsible player in the global economy. The impact of international norms in Chinese politics depended upon the configuration of bureaucratic interests and the structure of China's domestic institutions, as well as leadership within those institutions. For example, Andrew Mertha's work on the impact of international pressure on intellectual property rights protection in China also highlights the significance of bureaucratic interests in shaping the ultimate degree of compliance with international standards.[14] Peter Gourevitch, for example, has demonstrated that political forces help to shape the institutions that determine different countries' responses to sources of pressure.[15] At the same time, Gourevitch's work demonstrates that pressure does not necessarily produce a convergence among policy outcomes, and the ultimate outcome depends upon both political entrepreneurship and its utility within different institutional forms.[16]

The influence of global financial institutions operated at multiple levels, both by socializing China's central bankers into a worldview privileging monetary policy flexibility in a world of capital mobility and by creating incentives for China's high-level leadership to present China's economy as consistent with standard global economic practices rather than standing outside them. Had either those global norms in monetary

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[13] Jeffry Frieden, "The Politics of Exchange Rates," in Sebastian Edwards and Moises Naim, eds. *Mexico 1994: Anatomy of an Emerging-Market Crash* (Washington, DC: Carnegie Endowment for International Peace, 1997), p. 83.
[14] Andrew C. Mertha, *The Politics of Piracy: Intellectual Property in Contemporary China* (Ithaca, NY: Cornell University Press, 2005).
[15] Peter Gourevitch, "The Macropolitics of Microinstitutional Differences in the Analysis of Comparative Capitalism," in Suzanne Berger and Ronald Dore, eds. *National Diversity and Global Capitalism* (Ithaca, NY: Cornell University Press, 1996), p. 239-259.
[16] Gourevitch, p. 259.

economics or the reformist bent of China's central bank leadership been absent, exchange rate reform would not have occurred, because conservative forces within China would have dominated. The structural power of these international financial norms influenced the range of potential outcomes but was not determinative of the resulting reforms. Global standards and "best practices" in monetary economics operated at different levels within the Chinese state. The result was a modest, piecemeal approach to exchange rate reform consistent with China's gradualist political culture of policy implementation. The political compromise that emerged allowed the market more influence over the exchange rate, the central bank more influence over monetary policy, and was meant to provide other Chinese institutions time to adjust to a gradually changing exchange rate environment.

For observers of Chinese politics, the fact that exchange rate reform was a contingent phenomenon, and was not inevitable, casts doubt on the conventional narrative of China's economic reform and opening to the global economy. While the conventional image assumes that China is becoming incrementally more open to the rest of the world, permitting greater influence for markets each year in accordance with a long-term "grand strategy" for economic reform, the picture that emerges from this analysis of China's exchange rate reforms suggests that economic reform and liberalization in China are distinctly non-linear processes. The analysis of China's exchange rate reforms described here is similar to Pei Minxin's discussion of a "trapped transition" in the process of broader economic reforms, with political factors as the key determinants of the pace of reform.[17] Domestic political forces can speed up and slow

[17] Minxin Pei, *China's Trapped Transition: The Limits of Developmental Autocracy* (Cambridge, Mass.: Harvard University Press, 2006).

down this process, and policy changes often follow what Yves Tiberghian labeled "the path of least political resistance" in the Japanese context.[18] This does not suggest long-term planning by the Chinese leadership to liberalize China's financial system or integrate more deeply with the rest of the global economy.

By exacerbating the scale of capital flows into China, the exchange rate reforms of July 2005 have likely slowed China's path to full capital account liberalization. Following the decision to permit more market influence over the exchange rate, Chinese policy-makers have reimposed non-market measures such as administrative restrictions on investment projects in particular industries and on prices in certain commodities in order to manage inflation. These policy choices are inconsistent with a long-term plan to permit more market influence over China's economy, but were implemented in order to minimize the domestic political effects of rapid credit growth and rising inflationary pressure. In this context, the importance of international norms in influencing China's exchange rate policies emerges more clearly; China's leaders reformed the country's exchange rate regime in order to make its financial system appear in line with international financial standards, and without this influence, exchange rate reform would not have occurred. Domestic political forces were still influential in limiting the effects of these norms within economic policy-making, and the result of China's limited exchange rate reforms in July 2005 has been an ad hoc, reactive decision-making process.

The analysis also suggests that China's political system itself in terms of economic policy-making is more conservative than individual Chinese leaders, even including those at the very top. Many scholars have noted that Chinese policy-making

[18] Yves Tiberghian, "Navigating the Path of Least Resistance: Financial Deregulation and the Origins of the Japanese Crisis," *Journal of East Asian Studies* **5** (2005), p. 427-464.

has become more consensus-driven in the era of Hu Jintao and Wen Jiabao, and neither Hu nor Wen appears to have the political power to force policies unpopular with the rest of the bureaucracy through the State Council, as former Premier Zhu Rongji had done when reforming the Chinese bureaucracy to meet requirements for WTO admission in the late 1990s. However, China's integration with the international financial system, however limited, carries significant risks for the domestic economy, where financial institutions remain relatively fragile and unaccustomed to managing these risks. The fact that this consensus-driven policy-making process, or as one interview subject described it, the "A plus B divided by two" process, extended to the decision to reform China's exchange rate regime, which sets the most important price in China's economy, carries two implications for the future of China's economic reforms.[19] First, there is no necessary intersection between policy solutions that emerge from China's consensus-driven decision-making process and those that satisfy international financial markets. Second, the conservatism and gradualism of China's political system, in attempting to manage and limit the risks of integration with the global financial system, provides little insurance against those risks, and may exacerbate them.[20] Years after the reform of China's exchange rate regime, Chinese policy-making in the economic realm remains ad hoc, reactive, and conforms to no apparent long-term plan, while global markets have made their own judgment of China's exchange rate regime, sending capital flooding into the Chinese economy and exacerbating internal and external imbalances.

Plan of Dissertation

[19] Interview 08-05.
[20] Minxin Pei describes some of the economic costs of gradual reforms in *China's Trapped Transition*, p. 122-131.

This study emerged following over four years and over 120 interviews with Chinese policy-makers, academics, financial analysts, and other secondhand observers of China's economic policy-making, from June 2004 to July 2008. The basic narrative of Chinese exchange rate reform presented within this study was vetted with some of the policy-makers and academics with knowledge of the decision-making process. The interviews are referenced by number and date in order to preserve the anonymity of those involved, many of whom are still serving in Chinese government institutions overseeing the management of the economy and the exchange rate; these individuals spoke with the author only under conditions of anonymity. Many interview subjects were promoted between the starting and finishing dates of the dissertation, moving within and between financial and government institutions, and were willing to share the differences of opinions between these institutions regarding exchange rate policy. The study proceeds as follows.

Chapter 2 attempts to situate the argument within the international political economy literature, which includes several analyses of the influence of ideas upon economic policy choices. The Asian financial crisis was a formative experience for Chinese financial technocrats, and the lessons drawn from the Asian and Argentine financial crises questioned the sustainability of fixed-but-adjustable exchange rate regimes. In turn, the growing political consensus behind flexible exchange rate regimes both informed and structured Chinese policy-makers' perceptions of the available solutions, and provided advocates of exchange rate reform with additional political legitimacy within debates in the State Council. The chapter then explains the political

implications of states' choices of different exchange rate regimes, as well as the political implications of ideas concerning capital mobility. The chapter concludes with a discussion of China's exchange rate reforms as an example of cooperation in a world of flexible exchange rate regimes, even though the existing literature usually discusses monetary cooperation in terms of global fixed exchange rate regimes.

Chapter 3 discusses the potential alternative political explanations for China's exchange rate reforms that are available within existing bodies of literature. These include arguments focused on the power of domestic interest groups, elite or bureaucratic political factors, and the influence of international pressure. The chapter details these arguments and discusses the shortcomings of these approaches in explaining the reform of China's exchange rate regime, while explaining the importance of incorporating ideational variables in order to explain the formation of China's conception of its own interests. The chapter concludes by situating this ideational explanation for China's exchange rate reforms within the literature concerning Chinese foreign policy, including a discussion of whether China is "adapting" or "learning" in response to international norms.

Chapter 4 discusses the role of the reformers within the People's Bank of China in initiating the debate over introducing more flexibility in China's exchange rate regime. These reformers studied the impact of the Asian financial crisis on other states in the region, and based on that experience, pushed for additional exchange rate flexibility on the grounds that China needed monetary policy autonomy to respond to external shocks, and exiting from a fixed exchange rate regime was easier under conditions of capital inflow than capital outflow. In addition, the chapter will discuss the influence of

international financial institutions such as the International Monetary Fund, and the power of the advice of these institutions, particularly in a Chinese policy-making process that has relied heavily upon foreign technical expertise in the era of economic reform.

Chapter 5 discusses the emergence of China's exchange rate regime as an international political issue, and the impact of international pressure on the nascent domestic Chinese exchange rate debate. Starting with criticism from Japan, the U.S. Congress took up the issue in the summer of 2003, and pressure on China's top leaders to end the dollar peg began to emerge in a variety of international summits. As the debate progressed, Chinese rhetoric began to shift significantly in a short period of time, from defending the benefits of state-directed adjustment to accepting the legitimacy and the logic of market-directed adjustment. This shift in the nature of the debate significantly limited the scope of acceptable policy options in reforming China's exchange rate regime, as China's top leadership had accepted the legitimacy of market determination of the exchange rate.

Chapter 6 discusses the final stages of the exchange rate debate, starting from the Central Economic Work Conference of 2004, where it was likely that a general consensus for exchange rate reform was reached. However, within the domestic political debates that took place from late 2004 to mid-2005, the Ministry of Commerce and the National Development and Reform Commission extracted key concessions limiting the scope and influence of exchange rate reform. After some last-minute political wrangling over the threat of tariffs from the Schumer-Graham bill and some last-minute diplomacy from the Treasury Department, China announced the end of the peg to the dollar on July 21, 2005. The chapter discusses the domestic and international reactions to the exchange rate move,

as well as the evidence for the influence of international norms in China's decision to introduce additional flexibility in the exchange rate regime.

Chapter 7 explores some of the economic and political consequences of the exchange rate reforms of July 2005, including the influence on market perceptions of the future direction of the exchange rate, which produced significant speculative capital inflows in the years following reforms. As a result, China continued to struggle with the ancillary consequences of capital inflows, including excess liquidity in the banking system, excessive credit and investment growth, and inflationary pressure. The chapter discusses the ad hoc reactive nature of Chinese economic policy-making since the exchange rate reforms of July 2005, explaining that many of the problems that China's economy has faced in recent years, and the government's limits in reacting to these problems, can be attributable to the limited nature of the initial exchange rate reforms. The concluding chapter discusses the impact of China's exchange rate policies on the global credit crisis that emerged in 2007 and 2008, and explores the implications of this study for analyses of Chinese economic policy-making, Chinese domestic politics, and international political economy.

Chapter 2- Ideas in the Political Economy of Exchange Rates

The Asian financial crisis that began in 1997 was a formative experience for both Chinese policy-makers and Chinese financial technocrats. Policy-makers became alarmed that sovereign governments could be delegitimized and destabilized by factors as esoteric as the movements of exchange rates and decisions made far from their own borders. Financial technocrats saw the similarities between the countries in crisis and China's own financial system at the time: directed lending to state companies and state projects, weak financial infrastructures, opaque accounting practices that disguised risks, and poor risk management at banks, among other problems. In the aftermath of the crisis, financial technocrats embarked upon a wholesale reform of China's financial system, including restructuring the central bank and initiating reform of the state-owned banks so that they would eventually perform more like commercial lenders. On the exchange rate front, however, China committed to the stability of the exchange rate in the face of devaluation pressure, and with the assistance of the country's capital controls, earned plaudits in Asia for failing to respond with a competitive devaluation of the exchange rate designed to protect China's exports.[21]

[21] See, for example, Wang Hongying, "China's Exchange Rate Policy in the Aftermath of the Asian Financial Crisis," in Jonathan Kirshner, ed., *Monetary Orders: Ambiguous Economics, Ubiquitous Politics*

For both Chinese financial technocrats and international financial institutions, the formative lessons drawn from the Asian financial crisis and the later Argentine financial crisis, however, concerned the unsustainable nature of fixed exchange rate regimes. Given the rapid assaults on Asian currencies during the crisis, the critical threat to the stability of these nations' financial systems appeared to come from speculative capital flows, which were facilitated by currency convertibility on the capital account. Fixed exchange rate regimes always appeared vulnerable to attacks from international speculators, forcing massive devaluations after the pegs could no longer be sustained, and therefore, exiting from a fixed exchange rate regime was advisable under conditions of capital inflow, rather than under the pressure of capital outflow. In terms of exchange rate policy, the Asian financial crisis led Chinese technocrats, armed with the advice and technical expertise of international financial institutions, to question the sustainability of China's own fixed-but-adjustable exchange rate regime, even though stability of the exchange rate was required immediately following the crisis, to resist devaluation pressure.

Explaining China's Exchange Rate Reforms: The Argument in Brief

China's exchange rate reforms were the product of ideational factors, consisting of the international consensus regarding the efficacy of flexible, market-determined exchange rate regimes and China's own self-perception as a responsible actor in the international financial system. When China began to see considerable capital inflows

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(Ithaca, NY: Cornell University Press, 2003), p. 153-171, and Samuel S. Kim, "Chinese Foreign Policy Faces Globalization Challenges," in Alastair Iain Johnston and Robert S. Ross, *New Directions in the Study of China's Foreign Policy* (Stanford: Stanford University Press, 2006), p. 276-306.

starting in 2002 and 2003, the nation's financial technocrats began to consider ending the peg to the dollar and permitting more flexibility. As China's fixed-but-adjustable exchange rate regime had been delegitimized by the Asian financial crisis, policy-makers began to search for alternatives, and they drew upon the recommendations of both Chinese technocrats and international financial institutions. In the political debate that ensued within China, the lessons learned from the aftermath of the Asian financial crisis played a critical role in shaping the debate. Capital inflows were a new problem for the Chinese financial system, as they brought more foreign exchange reserves, faster credit and investment growth, and additional inflationary pressure.

The uncertainty surrounding the indeterminate effects of different exchange rate regimes on China's ability to manage the effects of capital inflows produced a policy environment that was conducive to the influence of ideational factors. Under conditions of uncertainty where actors are uncertain how to characterize or act in accordance with their own interests, the ideas that structure the ways that policy-makers characterize the uncertainty and the policies to be enacted in response are far more influential than the interests of the actors involved; interests require explanation as well as ideas (Blyth 2002).[22] In these periods of crisis, the ideas that key economic decision-makers hold provide a framework for understanding the nature of the financial risks involved and the policies to mitigate these threats.[23] These ideas were the shared causal beliefs concerning the power of speculative capital flows and the difficulty of sustaining fixed exchange rate

[22] Mark Blyth, *Great Transformations: Economic Ideas and Institutional Change in the Twentieth Century* (Cambridge: Cambridge University Press, 2002), p. 9. Blyth labels these conditions of uncertainty "Knightian" uncertainty, regarding "unique events where the agents are unsure as to what their interests actually are, let alone how to realize them." The original conception of these types of risks comes from Frank H. Knight, *Risk, Uncertainty and Profit* (Boston and New York: Houghton Mifflin, 1921).
[23] Blyth, p. 11.

regimes, and they largely emerged in global financial circles in the aftermath of the Asian financial crisis. However, in Thomas Risse-Kappen's formulation, "ideas do not float freely," and domestic political institutions provide conditions under which ideas become relevant in domestic political debates; China's consensus-driven political process under the leadership of Hu Jintao and Wen Jiabao was a critical enabler of the influence of international norms concerning the efficacy of flexible exchange rates.[24] Under these conditions of uncertainty regarding the effects of different exchange rate regimes, it is difficult for particular interest groups within domestic political debates to advocate a particular course of action as representing the state's economic interests, because the effects of these choices are so indeterminate. Instead, shared causal beliefs about the effects of particular policies guide policy-makers in the choice of exchange rate regimes under conditions of uncertainty. In addition, when these shared causal beliefs are reinforced by an international consensus of institutions with expertise in financial matters, these ideational factors become even more relevant in domestic policy debates.

The influence of ideational factors on China's conceptions of its material economic interests also varied with time. In this context, China's interests require explanation, rather than providing the explanatory force behind the reform of the exchange rate regime. In the short term, the decision was contrary to China's material economic interests. In the long term, China's interests could not be clearly understood by policy-makers, particularly because of the complex financial interactions involved in

[24] Thomas Risse-Kappen, "Ideas do not float freely: transnational coalitions, domestic structures, and the end of the cold war," *International Organization* **48**:2 (Spring 1994), p. 185-214. "In sum, a domestic structure approach that incorporates political culture can account for the differential foreign policy impact of ideas promoted by transnational communities. The channels by which these ideas enter the policymaking process and become incorporated into national foreign policies seem to be determined by the nature of the political institutions."

exchange rate policy-making. The Chinese leadership's conceptions of the nation's long-term interests were determined by shared causal beliefs and theories about the interaction of economic and political forces. China's decision to reform the exchange rate regime produced significant short-term costs for the Chinese banking system and China's export sector, and was contrary to China's material economic interests. However, in the long term, China's conceptions of its interests were heavily influenced by the formative experiences of the Asian financial crisis and the international consensus behind market-determined and flexible exchange rate regimes. Interests in this context are not an alternative explanation for China's exchange rate reforms in competition with ideational factors; a nation's long-term interests in setting exchange rate policy cannot be determined *a priori* without the influence of ideational factors.[25]

Under conditions of considerable uncertainty regarding the effects of ending the yuan's peg to the dollar, the ideas that emerged from the formative experience of the Asian financial crisis played a critical role in influencing Chinese leaders' perceptions of the state's economic interests in the long term. Fixed exchange rate regimes were viewed as eventually unsustainable, and flexible exchange rate regimes would permit Chinese leaders additional autonomy in monetary policy to manage the domestic effects of the new threat of capital inflows. The international consensus behind the efficacy of flexible exchange rate regimes guided Chinese policy-makers, in a debate marked by considerable uncertainty, toward a decision to end China's peg to the dollar.

However, the formative experiences of the Asian financial crisis were not the only ideational factors that contributed to China's decision to end the peg to the dollar.

[25] See also Ngaire Woods, "Economic Ideas and International Relations: Beyond Rational Neglect," *International Studies Quarterly* **39** (1995), p. 161-180.

Chinese perspectives on the legitimacy of international institutions and China's role within them was already in the process of changing when the issue of exchange rate reform began to emerge among Chinese policy-makers. One of the critical questions arising from the exchange rate reforms of July 2005 is why they did not occur earlier, in response to similar economic shocks (such as the inflation of the mid-1990s or the decline in Chinese export growth at the end of the 1990s, when a devaluation would have provided some support). The timing of the July 2005 exchange rate reforms, after more than a decade of exchange rate stability, can largely be explained by the confluence of China's changing self-perceptions as a responsible actor in the international system and the ideas concerning exchange rate policy that emerged from the aftermath of the Asian financial crisis.

The argument is not that ideas were more important than interests in influencing China's decision-making, but that these ideational factors influenced the Chinese leadership's consideration of its own interests in the long-term. The subsequent chapters will attempt to demonstrate not only the presence of these ideational factors in the Chinese policy-making process, but how these ideas became relevant and influential in the domestic policy debate regarding exchange rate reform.

Exchange rate policy, in particular, provided conditions that were amenable to the influence of international norms, for three reasons. First, sustained capital inflows were a new problem for Chinese economic authorities, which meant that China did not necessarily have a policy "toolkit" ready to handle these inflows, unlike other economic problems such as inflation. Furthermore, Chinese policy-makers had no preconceived notions regarding the policies to manage capital inflows, as these were a new problem.

This provided international financial institutions with opportunities to influence the financial technocrats that were responsible for managing these effects of these inflows on a daily basis. Discussions of the root causes of these inflows ultimately led to discussions of the nature of China's exchange rate regime. Second, the changing nature of China's attitude toward international institutions provided additional domestic salience to multilateral pleas for Chinese exchange rate reform, such as those within G-7 communiques. With an international consensus in favor of additional exchange rate flexibility, Chinese policy-makers saw flexibility as a mechanism to develop China's financial system in line with international standards, and domestic advocates of reform used these international standards strategically to frame the context of the domestic debate over exchange rate policy. Third, as China has moved from a planned to a market economy, the process of Chinese financial reform has often involved technical advice from foreign experts, and the use of particular models from foreign countries for the development of financial institutions. This pattern of Chinese financial reform meant that international financial institutions had more influence in shaping the policy choices available to Chinese decision-makers. In addition, proponents of reform within the Chinese political system could use the international consensus behind exchange rate reform to enhance the legitimacy of their ideas, given the historical pattern of Chinese financial reform.

The subsequent chapters will explain the causal mechanisms through which these ideas influenced China's policy-making process, drawing on a considerable body of literature regarding the influence of ideas in international political economy and the variables influencing the choice of exchange rate regimes. The international consensus

behind flexible exchange rate regimes constrained the eventual choice of exchange rate reforms considered acceptable to Chinese policy-makers. China was not a passive recipient of these international norms, as several institutions within the Chinese bureaucracy resisted the calls for reform from Chinese financial technocrats, limiting the scope of the reforms of July 2005. The absence of policy convergence in exchange rate behavior globally does not mean that international norms behind flexible exchange rate regimes have no influence; domestic institutions will produce different policy outcomes, but the range of those outcomes is still highly constrained by the norms themselves. In China's case, the lessons of the Asian financial crisis and China's own changing self-perceptions influenced the Chinese leadership's conception of China's own long-term interests in the realm of exchange rate policy, and these ideas were the critical enablers of the decision to end China's peg to the dollar in July 2005, despite considerable domestic opposition.

Ideas and China's Interests in the Short and Long Term

Explanations focused on ideational factors are frequently countered with rationalist arguments stressing the primary importance of interests. Rationalist explanations, in turn, depend upon the specification of those interests and the decision rules of the relevant agents.[26] In the case of exchange rate policy, however, the ability of the relevant agents to identify their own interests varies considerably with time. Over the long term, particularly when policy-makers confront conditions of uncertainty, where the

[26] See, for example, Barbara Geddes, "Uses and Limitations of Rational Choice," in Peter H. Smith. Ed., *Latin America In Comparative Perspective: New Approaches to Methods and Analysis* (Boulder, Colorado: Westview Press, 1995), p. 81-108.

previous orthodoxy has been delegitimized by financial crisis, agents' conceptions of their long-term interests are determined by theories concerning exchange rate management, and shared causal beliefs about those theories in particular. Without those theories and the shared causal beliefs of those interpreting the previous financial crisis, policy-makers have difficulty specifying their own interests, given the complexity of the interactions between different exchange rate regimes and international financial markets. The result is that policy-makers often turn to either financial technocrats or international institutions with technical expertise in shaping their views. In the short term, it was obvious to most policy-makers in China that the country would face costs in appreciating the yuan and introducing more flexibility in the exchange rate regime. Over the long term, the ideas concerning flexible exchange rate regimes that emerged from the Asian financial crisis influenced the Chinese leadership's perceptions of their own interests in favoring additional exchange rate flexibility. The actual exchange rate reforms of July 2005 were limited in scope, which reflected some of the leadership's concern about short-term costs, but also reflected the influence of international financial institutions and central bank technocrats' views about the efficacy of flexible exchange rates. Under conditions of uncertainty such as those following financial crisis, the interests of agents require explanation; they are informed by theories and ideational factors, rather than providing alternative explanatory power by themselves.

Over the short-term, however, Chinese policy-makers were aware that appreciating the yuan and introducing additional exchange rate flexibility would entail some pain within the Chinese financial system. Virtually all analysts of China's currency argued that a significant appreciation of the exchange rate would have entailed economic

costs for China in the short term. Because exports comprised over 30 percent of China's GDP, increasing the price of those exports in international markets would likely have slowed Chinese economic growth, particularly in the coastal provinces. An appreciation of the exchange rate entails political costs for the Chinese leadership as well. Unemployment in the export sector is the most significant political consequence of a large exchange rate adjustment, because of the potential for urban unrest. Chinese export industries operate at relatively low profit margins (around 7-10 percent), because most Chinese export manufacturers are final assemblers of intermediate goods imported from elsewhere.[27] Therefore, some analysts argued that an exchange rate adjustment in the range of 10 percent would have effectively eliminated profits, forcing either unemployment or a shift of Chinese export business to other labor-intensive producers in Southeast Asia. However, the key political factor involved in this calculus is the number of concentrated angry people, likely to protest at losing their jobs as a result of central government diktat over which they have no say.

In addition, imports would have become less expensive in China, potentially hampering the competitiveness of some Chinese industries, particularly in the agricultural sector. One argument circulating at the time was that an appreciation of the exchange rate would significantly enhance the competitiveness of foreign agricultural imports, from countries where productivity far exceeds the relatively undeveloped agricultural practices in most of China. Premier Wen Jiabao and President Hu Jintao have placed much of the emphasis during their period of governance upon alleviating rural economic

[27] Estimate of average profit margin taken from Interview 05-12.

stresses, and a significant appreciation of the exchange rate would have precisely the opposite effect.[28]

In addition, exchange rate movements are likely to create significant problems for the reform of China's banking system, which is beset by non-performing loans, denominated in the domestic currency, the renminbi. The central government has injected several billion dollars, funded from foreign reserves, in order to shore up the banks' capital adequacy, and the government has created asset management companies to take those non-performing loans off the balance sheets of the banks. The government's strategy focused on listing Chinese banks on international stock markets, particularly in Hong Kong, in order to attract foreign investment to improve banks' management and to pay off the non-performing loans. The China Construction Bank listed in November 2005, the Bank of China listed in June 2006, and the Industrial and Commercial Bank of China listed in both Hong Kong and Shanghai in October 2006. In return, the banks surrendered equity to foreign investors, without yielding controlling stakes. A sharp appreciation of the renminbi would have dramatically reduced the banks' capital adequacy ratios, probably below Basel standards (8 percent), and would have made the prospects for investment in the banks considerably less attractive for investors in the banks' stocks, because of the higher costs of the non-performing loans.[29] In addition, an appreciation would have created significant liquidity concerns for Chinese banks, due to speculators attempting to convert their speculative renminbi investments back into foreign currency, creating imbalances in currency flows in several Chinese banks that

[28] Li Cheng, "The New Bipartisanship within the Chinese Communist Party," p. 391-395.
[29] One of the publicly promulgated goals of China's banking regulators is to improve state-owned banks' capital adequacy to international standards, embodied in the Basel accord, in advance of offering the banks publicly on international financial markets. People's Bank of China, China Monetary Policy Report, Q4 2004, http://www.pbc.gov.cn/english//detail.asp?col=6612&ID=27.

lack experience in managing currency risk appropriately.[30] These were considerable short-term risks to China's financial system. The exchange rate reforms of July 2005 steered China's financial system clear of many of these risks primarily because of the limited nature of the initial appreciation, at only 2.1 percent on July 21, 2005, and less than 10 percent in the first two years following the exchange rate reforms.

Over the long term, however, in the case of exchange rate policy, it was difficult for Chinese policy-makers to identify their interests *ex ante*; these interests were informed by ideational factors concerning the efficacy of flexible exchange rate regimes. The contestation between those ideational factors, and the way in which international norms concerning exchange rate flexibility became relevant within the Chinese policy-making process is the primary focus of this study. This is not a clash over relative explanatory power involving ideas versus interests, but an explanation of how ideas inform China's views of its own interests. China's interests, in this case, require explanation, rather than providing explanations.

Rationalist explanations typically rely upon a clear specification of actors' preferences, the decision rules of the interaction between those preferences and other actors, the payoffs resulting from those decisions, and the assumption of methodological individualism.[31] In exchange rate policy, these payoffs are often unclear, and political factors inform how states choose to balance the tradeoffs involved in choices of both the type of exchange rate regime and the level of the exchange rate. The existing China-

[30] Interview 05-13, 05-21.
[31] Barbara Geddes, "Uses and Limitations of Rational Choice," in Peter H. Smith. Ed., *Latin America In Comparative Perspective: New Approaches to Methods and Analysis* (Boulder, Colorado: Westview Press, 1995), p. 81-108.

focused literature also faces difficulties in attempting to specify the interests of the Chinese state as a unitary actor, rather than interests of agents below the level of the state itself, over the long term. The traditional China-specific political economy literature typically focuses on the interests of particular elites, elite factions, or institutions within the Chinese bureaucracy, rather than the economic interests of the Chinese state as a whole.[32] In short, analyzing the course of reform of China's exchange rate regime requires other variables that both inform and change China's conception of its long-term economic interests. These include China's image as a modernizing nation, and globally prevalent "best practices" of monetary policy and exchange rate management, which influenced Chinese leaders' views of these interests.

Ultimately, financial technocrats, primarily at the PBOC, made the case for exchange rate reform based on the lessons of the Asian financial crisis and the advice of international financial institutions. In particular, financial technocrats argued that even if there were costs in the short term, additional exchange rate flexibility would allow China to adjust to macroeconomic shocks through a more independent monetary policy, and would play a role in shifting the engines of Chinese growth toward domestic consumption and away from fixed asset investment and exports. Technocrats argued that China's development will depend upon the growth of a strong consumer-based domestic economy, and excessive reliance on exports via an undervalued exchange rate delays this shift. In addition, an undervalued exchange rate distorts Chinese investment patterns by

[32] Leong H. Liew, "Policy Elites in the Political Economy of China's Exchange Rate Policymaking," *Journal of Contemporary China* **13** (February 2004), p. 21-51; Victor Shih, "Dealing with Non-Performing Loans: Political Constraints and Financial Policies in China," *China Quarterly* (2004), p. 922-944; Li Cheng, *China's Leaders: The New Generation* (London: Rowman and Littlefield, 2001), and Li Cheng, "The New Bipartisanship within the Chinese Communist Party," *Orbis* **49**:3 (Summer 2005), p. 387-400, which explains the current state of factional allegiances within the CCP.

directing more fixed asset investment into export-oriented enterprises that may not be economically sustainable once demand adjusts based on the exchange rate.[33] In contrast, domestic demand in China is relatively weak, and consumption (measured using national statistics for China's retail sales) accounts for a relatively small percentage of China's GDP by international standards, with this proportion declining throughout the past decade.[34]

China's exchange rate reforms were consistent with the theoretical arguments behind such a shift toward domestic demand, but the short-term concern about costs to the financial system prevented a larger adjustment of China's exchange rate. The initial adjustment was insufficient to spark this change, as later chapters describe in greater detail. At the same time, the exchange rate reforms did not provide sufficient flexibility to provide the central bank with more autonomy in monetary policy, as the PBOC remained committed to an exchange rate target, in the form of a gradual pace of appreciation. As a result, the central bank was still unable to raise interest rates aggressively to limit investment and credit growth, without concerns about attracting additional capital inflows.

However, the extent of the shift away from past patterns of Chinese monetary policy behavior was still significant, and highlights the influence of ideational factors in shaping the Chinese leadership's conceptions of its own interests in exchange rate policy. The exchange rate reforms of July 2005 were inconsistent with usual Chinese practice in the conduct of monetary and exchange rate policy, and were also inconsistent with the

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[33] See, for example, Laura Tyson, "A Stronger Yuan Helps China," *Business Week* 31 October 2005.
[34] Statistics on consumption cited from China Economic Information Network, China Economic Statistics Database, accessed June 2006. See also Grace Ng, JP Morgan Chase Hong Kong, "China 2005 real GDP rose at impressive 9.9% pace; solid growth outlook for 2006," JP Morgan Chase Asia Newsletter, January 25, 2006. In comparison, consumption accounts for around 70 percent of United States GDP.

historical pattern of changes to exchange rate regimes in other countries as well.[35] In 1994, China depreciated the yuan in order to unify the exchange rates in official and secondary markets, allowed a mild appreciation following this initial depreciation, and then maintained the value of the yuan at around 8.276 yuan per dollar until July 2005. Throughout the course of this decade of exchange rate stability, China's domestic macroeconomic situation and balance of payments changed considerably, but the exchange rate was not the preferred mode of adjustment.

[35] Michael Bleaney and Manuela Francisco, "The Choice of Exchange Rate Regime: How Valid is the Binary Model?" Centre for Research in Economic Development and International Trade, University of Nottingham, CREDIT Research Paper No. 05-02, 2005. Bleaney and Francisco's work is one of the large-n studies considering the likelihood of countries moving to floating regimes from fixed regimes; this literature can help to provide a more balanced assessment of the course of reform of China's exchange rate policies. This study examines the declared exchange rate regimes and the actual exchange rate behavior of 102 developing nations from 1990 to 2000, including both polar exchange rate regimes (hard pegs and free floats) as well as comparisons between polar regimes and intermediate regimes (managed floats and soft pegs). In the analysis of the polar regimes, Bleaney and Francisco find that countries with floating exchange rate regimes tended to be larger in terms of population, with lower average incomes in terms of GDP per capita, are more open to international trade (in terms of exports and imports relative to GDP), and experience higher inflation in general. In addition, Bleaney and Francisco argue that clear distinctions can be made between soft pegs—the state of China's exchange rate regime since 1980—and managed floats, where some people argue China's exchange rate regime is moving since the July 2005 reforms. Managed floating countries tend to be more populous, poorer, and more open to international trade, according to the Bleaney-Francisco results. According to the Bleaney and Francisco study, China is a significant outlier among developing countries in terms of exchange rate behavior. With a large population, a relatively low per capita GDP for most of the period under study, and a relatively high degree of international openness, as exports contributed significantly to GDP growth, the Bleaney-Francisco model would predict that China would have floated its currency far earlier, or moved to a managed float. In a comparison of intermediate regimes, Bleaney and Francisco's model would predict that China would look more like a managed floating country than one with a soft peg; however, China's exchange rate regime still has elements of a soft peg, even if that peg is a reference to a basket of currencies heavily reliant upon the U.S. dollar, rather than exclusively the U.S. dollar.

Figure 2.1- Inflation and China's Export Growth, 1994-2005.
Source: National Bureau of Statistics (China), General Administration of Customs

China's inflation rate spiked in 1994, remained elevated until 1996, and then the country sank into deflation in 1998 and 1999 following the Asian financial crisis, when the currency was facing pressure to depreciate. In the early 21st century, China's economy veered into deflation once again in 2001 and 2002, before inflation picked up rapidly in 2004. At the same time, China's balance of payments position changed dramatically during this period, oscillating between moderate surpluses and deficits (offset at times by some capital outflows during the Asian financial crisis) before China's trade surpluses began to skyrocket in 2003. Throughout this period, the Chinese economic authorities did not view the exchange rate as a necessary tool of economic adjustment, despite the fact that these are the critical economic variables usually compelling exchange rate adjustment.

Despite their limited nature, the exchange rate reforms of July 2005 did represent a sharp deviation from past patterns of Chinese exchange rate behavior, and the factors

that produced this shift in the Chinese leadership's conception of the state's long-term interests will be discussed at length in subsequent chapters. The shift in behavior also highlights the difficulties of specifying the state's long-term interests in exchange rate policy without reference to the causal beliefs and theories that were circulating in policy-making circles at the time; in the past, a variety of economic stresses had produced no changes in exchange rate policy at all. However, under conditions of uncertainty about the costs and benefits of particular exchange rate regimes, particularly following the Asian financial crisis, international norms concerning the market-based determination of exchange rates became influential within Chinese policy-making circles and shaped Chinese leaders' views of their own interests, which produced the exchange rate reforms of July 2005.

Ideas in International Political Economy

These arguments concerning the influence of ideas and norms over policy outcomes in the economic realm have a firm foothold in the international political economy literature. Constructivist scholars have attacked rationalist explanations of states' economic policy choices, by demonstrating the difficulty of specifying actors' interests *ex ante*, while arguing for the importance of ideational factors in shaping actors' perceptions of those interests. The ideas that Chinese policy-makers held regarding the effects of different exchange rate regimes on capital flows and the ability to spare the Chinese economy from financial crises similar to the Asian crisis in 1997 were critical

factors explaining why Chinese policy-makers viewed an end to the peg to the dollar as consistent with China's interests.

The power of international norms and ideational factors over economic policy-making under conditions of uncertainty has been generally characterized in two forms within the literature. The first can be described as a "social learning" process in which policy-makers' views of new economic policy questions are influenced by shared ideas from past experiences. The second process involves more agency among state decision-makers, who use international norms strategically in order to enhance the legitimacy of their own policy proposals. Both of these processes were influential in the political debate over the reform of China's exchange rate regime.

First, ideas can provide a framework for actors to interpret the most salient threats to the national economy and the policies that can best avert those threats; policy-makers use ideas to identify potential crises and to frame certain economic problems as particularly risky to the national economy as a whole. As Mark Blyth has argued, economic ideas can define what a crisis is and the policies that can resolve such a crisis.[36] Out of an economic crisis such as the Asian financial crisis, the ways in which political leaders interpret the experience, and the lessons they draw from it, will frame their decisions in economic policy in the period following the crisis. Scholars such as Peter Hall and Kathleen McNamara have made similar arguments. McNamara argued that European policy failures in the aftermath of the first oil crisis in the 1970s discredited Keynesianism and contributed to the neoliberal policy consensus that was critical to the

[36] Blyth, p. 10. "Since structures do not come with an instruction sheet, economic ideas make such an institutional resolution possible by providing the authoritative diagnosis as to what a crisis actually is and when a given situation actually constitutes a crisis. They diagnose "what has gone wrong" and thus "what is to be done."

creation of the European Monetary Union.[37] Peter Hall uses a similar type of argument to describe the "social learning" that occurred in the process of setting British macroeconomic policy from 1970 to 1989.[38] Hall described how a series of perceived macroeconomic policy failures led British decision-makers to question the policy paradigm of Keynesianism; these judgments were largely political rather than scientific in nature, emerging out of a contest for authority between communities of technical experts.[39] The Asian financial crisis played a similar role for Chinese policy-makers, and Chinese financial technocrats communicated to those policy-makers the lessons of the crisis, which were in turn shaped in consultations and discussions with international financial institutions. In a similar process to that described by McNamara and Hall, the Asian financial crisis created conditions amenable to questioning China's fixed-but-adjustable exchange rate regime.

Peter Haas's discussion of the power of "epistemic communities" illustrates the power that groups of "knowledge-based" experts can have in shaping policy coordination across states, especially under conditions in which states are influenced by other states' policy choices.[40] Exchange rate policy is especially amenable to influence from epistemic communities within international financial institutions, because the management of exchange rate regimes is complex, requiring significant technical expertise, and the implications of exchange rate choices for the entire economy are significant. Haas argues that states' decision-makers are more willing to rely upon advice

[37] Kathleen McNamara, *The Currency of Ideas* (Ithaca, NY: Cornell University Press, 1999), p. 5-6.
[38] Peter Hall, "Policy Paradigms, Social Learning, and the State: The Case of Economic Policymaking in Britain," *Comparative Politics* **25** (April 1993), p. 275-296.
[39] Hall, p. 280.
[40] Peter Haas, "Introduction: Epistemic Communities and International Policy Coordination," *International Organization* **46**:1 (1992), p. 29.

from epistemic communities because the variety of issues that states have to manage, including macroeconomic policy, are becoming increasingly complex, requiring technical expertise.[41]

Michael Barnett and Martha Finnemore further this line of argument in their study of international organizations, including the role of the International Monetary Fund in restructuring the economies of member states.[42] Barnett and Finnemore argue that one of the reasons that member states respond to the IMF's recommendations for fundamental structural reforms of members' economies involves the "widely shared agreement among economists across borders" regarding the Fund's approach to economic policies.[43] The international consensus behind particular assessments of exchange rate policies, such as the notion that fixed exchange rate regimes were eventually unsustainable following the Asian and Argentine financial crises, helps to reinforce policy-makers' support for these assessments within particular domestic policy contexts. In China's case, the financial technocrats at the People's Bank of China were informed by the IMF's policy assessments and recommendations regarding exchange rate policy, and were able to appeal to the legitimacy of those recommendations in domestic political debates over exchange rate policy.

These types of arguments are not confined to constructivists within political science, but can be found within the field of economics itself. Mark Blyth, in his study of the power of economic ideas, highlights an essay from the economists Frank Hahn and Robert Solow, where they argue that, "The way the economy actually does work can

[41] Haas, p. 12-13.
[42] Michael Barnett and Martha Finnemore, *Rules for the World: International Organizations in Global Politics* (Ithaca, NY: Cornell University Press, 2004), p. 45-72.
[43] Barnett and Finnemore, p. 68.

depend upon the way agents believe the economy to work. . . [and] the way the economy responds to a policy move by the government can depend upon the interpretation that other agents place on it, and therefore on the beliefs about the way things work. . .'"[44] Behavioral economists have also focused on the cognitive and psychological bases of economic decision-making, which essentially involves the incorporation of additional variables into calculations of economic interests, in order to explain divergence between observed economic behavior and the predictions of economic theory.[45]

China-focused scholars have also used arguments about the importance of ideas in shaping economic policy choices within the Chinese domestic political context. Harold Jacobson and Michel Oksenberg describe the interactions between Chinese policy-makers and international financial institutions in the realm of development policy, arguing that these interactions were critical to introducing international ideas into Chinese policy debates.[46] Edward Steinfeld argued that the perceptions of Chinese policy-makers toward the linkages between firms and the market, or the "market visions" of policy-makers, influenced the path of institutional change in China's financial system.[47] In Steinfeld's analysis, two different conceptions of the influence of the market held by Chinese policy-makers, as either a "selector" or "savior" of firms, could produce dramatically different policy choices in the area of reform of state-owned enterprises and

[44] Frank Hahn and Robert Solow, *A Critical Essay on Macroeconomic Theory* (Oxford: Blackwell Publishers, 1995), p. 150.
[45] See, for example, Daniel Kahneman and Amos Tversky, "Prospect Theory: An Analysis of Decision under Risk," *Econometrica* **47** (1979), p. 263-291, and Richard H. Thaler, "The End of Behavioral Finance," Financial Analysts Journal (November/December 1999), p. 12-17.
[46] Harold Jacobson and Michel Oksenberg, *China's Participation in the IMF, the World Bank, and GATT: Toward a Global Economic Order* (Ann Arbor: University of Michigan Press, 1990).
[47] Edward Steinfeld, "Market Visions: The Interplay of Ideas and Institutions in Chinese Financial Restructuring," *Political Studies* **52** (2004), p. 643-663.

the banking system.[48] Steinfeld explains how the assumptions of many Chinese policy-makers, which are consistent with the "market as salvation" perspective, could "lead actors consistently to diagnose problems in particular ways and adopt routinized solutions" such as capital injections to state-owned enterprises and state-owned banks, contributing to China's persistent problems with efficient allocation of capital.[49] In the context of Chinese economic policy-making, under conditions of uncertainty, ideas can provide a framework that allows policy-makers to interpret complex economic signals, shaping the eventual policy choices seen as preventing another economic crisis. The Asian financial crisis acted in this way to delegitimize fixed exchange rate regimes in the eyes of Chinese policy-makers and international financial institutions.

Secondly, the constructivist literature in IPE explains how ideas can be used strategically by actors within the policy-making process, when those actors appeal to the legitimacy of international norms and reframe policy-makers' conceptions of states' interests. Keck and Sikkink's work on transnational advocacy networks involves a considerable degree of agency by these networks, who "use the power of their information, ideas, and strategies to alter the information and value contexts in which states make policies."[50] The strategies that Keck and Sikkink described can be applied within a domestic policy context as well. In the debate concerning China's exchange rate regime, the financial technocrats at the People's Bank of China were engaged in a form of what Keck and Sikkink might label "leverage" politics, involving the inclusion of more

[48] Steinfeld, p. 651-652.
[49] Steinfeld, p. 658.
[50] Margaret E. Keck and Kathryn Sikkink, *Activists Beyond Borders: Advocacy Networks in International Politics* (Ithaca, NY: Cornell University Press, 1998), p. 16.

powerful actors into an area in which weaker actors are usually powerless.[51] Financial technocrats at the central bank used the international consensus behind flexible exchange rate regimes strategically, by framing their own ideas about exchange rate reform as a solution to problems of international pressure faced by China's top leadership.

Kathleen McNamara's work concerning central bank independence highlights a distinction between two channels for ideational influence over policy choice, both of which were influential in the debate over how to reform China's exchange rate regime. This is basically similar to the previous distinction between explanations focused on "social learning" and explanations focused on the strategic use of international norms by domestic political actors. McNamara discusses literature within sociological institutionalism to explain the process by which governments' cultural environments influence their rational choice of institutional forms such as independent central banks.[52] McNamara labels one process as "normative isomorphism," in which choices emerge from a process of socialization within networks of technical experts in particular fields.[53] The second is labeled as "coercive isomorphism," or the use of political incentives, sanctions, and other forms of legitimacy to influence states' choices. Both of these processes were evident in the reform of China's exchange rate regime. Chinese leaders were certainly aware of the international consensus behind market-determined exchange rate regimes and the political pressure to reform China's system in line with international

[51] Keck and Sikkink, p. 16.
[52] Kathleen McNamara, "Rational Fictions: Central Bank Independence and the Social Logic of Delegation," *West European Politics* **25**: 1 (January 2002), p. 59, and R.W. Scott, J. Meyer, et al. *Institutional Environments and Organization: Structural Complexity and Individuation* (Thousand Oaks, Calif.: Sage, 1994).
[53] McNamara, "Rational Fictions," p. 64.

standards; advocates of exchange rate reform were able to appeal to that consensus to enhance the domestic legitimacy of additional exchange rate flexibility.

McNamara's scholarship has also explored the legitimizing characteristics of international norms, as states may choose certain institutional forms, such as central bank independence, for symbolic reasons. McNamara argues that "organizational mimicry" can cause states to adopt certain economic reforms that have been successful elsewhere, as the symbolic properties of these reforms and their association with "modernity" or best practices are often more significant than their functional benefits.[54] McNamara argues, "Organizational models are diffused across borders through the perceptions and actions of people seeking to replicate others' success and legitimize their own efforts at reform by borrowing rules from other settings, even if those rules are materially inappropriate to their local needs."[55] At the same time, the technical expertise involved in reforming China's exchange rate regime came from financial technocrats themselves, interacting within networks of experts tied to international financial institutions such as the IMF. The model of "organizational mimicry" that McNamara describes explains the process of China's financial reforms fairly well in a variety of policy contexts, including the reform of the exchange rate regime.

The question of how one can know whether or not norms are politically salient within a particular domestic context is a difficult one for arguments focused on the power of ideas. After all, policy-making behavior that is consistent with a particular set of international norms does not necessarily indicate that those norms influenced the state's policy-makers; while declaring their actions consistent with an international consensus,

[54] McNamara, "Rational Fictions," p. 47-76.
[55] McNamara, "Rational Fictions," p. 48.

states can continue to pursue their own interests. In the context of exchange rate policy, however, this is far more difficult. A state with a previously fixed exchange rate regime, such as China, has few choices besides permitting more market influence and additional exchange rate flexibility, in attempting to act consistently with an international consensus favoring flexible regimes.

Within China's exchange rate debate, appeals to international norms worked through the two channels described above. China's financial technocrats absorbed the lessons of the Asian financial crisis, which were communicated via their own assessments as well as interactions with international financial institutions. In addition, China's leaders viewed those ideas as legitimate largely because of the technical expertise of international financial institutions and the international consensus behind flexible regimes. Financial technocrats at the PBOC were able to appeal to the legitimacy of these ideas within internal policy debates. Even though one may be able to argue that China's leaders were ultimately "insincere" in seeking additional flexibility, the legitimacy of the international consensus behind flexible exchange rate regimes led Chinese policy-makers to frame the exchange rate reforms of July 2005 as moving China's exchange rate regime in a direction consistent with international standards. As Wayne Sandholtz has argued, ". . . social norms constrain even such strategic, insincere actors in their actions and arguments."[56]

These international norms will not necessarily produce policy convergence, and the influence of China's domestic bureaucratic politics was critical in limiting the scope of the eventual flexibility of China's exchange rate regime. The work of Andrew Cortell,

[56] Wayne Sandholtz, *Prohibiting Plunder: How Norms Change* (Oxford: Oxford University Press, 2007), p. 12.

James Davis, and Peter Gourevitch, in particular, highlights the interplay of global norms and domestic political institutions, explaining how global standards can create different economic outcomes in different political and economic systems because of the influence of domestic political institutions.[57] The ideas that were influential in Chinese decision-making regarding exchange rate policy were not necessarily economic ideologies per se, but reflected a particular set of lessons drawn from the Asian financial crisis. While exchange rate choices had far-reaching effects on economic performance, the ideas that emerged from the aftermath of the Asian financial crisis concerned the efficacy of particular exchange rate regimes in a period of capital outflow, rather than a far-ranging set of ideas regarding the proper relationship between the state and the market. The influence of norms in the case of China's exchange rate policy-making may be closer to Eric Helleiner's discussion of economic nationalism, where national identity informs and influences policy choices.[58] In China's case, the influence of China's changing self-perception as a responsible actor in the global financial system also enhanced the legitimacy of the international consensus behind flexible exchange rate regimes, which severely constrained the choices of exchange rate policy available to China, because fewer options would be consistent with these international norms concerning exchange rate flexibility.

Capital Mobility and Exchange Rate Regimes

[57] Andrew Cortell and James Davis, "How Do International Institutions Matter? The Domestic Impact of International Rules and Norms," *International Studies Quarterly* **40** (December 1996), p. 451-478. Peter Gourevitch, "Squaring the Circle: The Domestic Sources of International Cooperation," *International Organization* **50**: 2 (Spring 1996), p. 349-373.

[58] Eric Helleiner, "Conclusion: The Meaning and Contemporary Significance of Economic Nationalism," in Eric Helleiner and Andreas Pickel, eds. *Economic Nationalism in a Globalizing World* (Ithaca: Cornell University Press, 2005), p, 220-234.

The previous section described the processes by which international norms can influence economic policy choices. However, these ideas about exchange rates have critical economic foundations that depend upon the operation of different types of exchange rate regimes. The lessons of the Asian financial crisis were linked to these economic effects, which can explain states' changing views toward fixed and flexible exchange rate regimes following the crisis. However, these economic ideas have independent political effects; the choice of exchange rate regime is a political choice, decided by policy-makers, even though economic variables influence this choice.

The international consensus behind exchange rate flexibility that emerged after the Asian financial crisis was largely underpinned by concerns about the rapid adjustments in exchange rates that could occur under conditions of large capital outflows. Flexible exchange rates could prevent massive exchange rate devaluations that resulted from speculators' bets about the sustainability of states' foreign exchange reserves. While flexible exchange rate regimes can prevent these rapid adjustments, they also sacrifice other economic objectives of states, such as the ability to set an implicit inflation target and to use fiscal policy to stimulate the economy more effectively. Flexible exchange rate regimes permit additional political influence to capital flows and monetary policy, at the expense of fiscal policy. In addition, they increase exchange rate risks to individual firms and investors, particularly in countries trading large volumes of goods, which can reduce the attractiveness of foreign investment. These tradeoffs have political implications, both within domestic political contexts and in relationships between states and the international monetary system.

The idea of an international consensus behind flexible exchange rate regimes was influential in constraining China's choices in the process of ending the peg to the dollar. Yet this international consensus and the international norms that shaped it were not politically neutral, but emerged from a particular narrative of the lessons of the Asian financial crisis among global financial technocrats. International financial institutions favored flexible exchange rate regimes following the Asian and Argentine financial crises largely because of the perceived influence of mobile capital flows on emerging market economies, and the potential destabilizing consequences of capital outflows. These perceptions of the power of mobile capital also exerted influence on the political debate surrounding the reform of China's exchange rate regime. The resulting reforms were highly dependent upon the prevailing conventional wisdom among international financial institutions at the time.

Choices of Exchange Rate Regimes

The choice of exchange rate regime by an individual state reflects a choice between internal and external adjustment to economic imbalances, or state-directed or market-directed forms of adjustment.[59] The reform of China's exchange rate regime is a critical indicator of the political factors driving Chinese financial reforms, because market-based adjustment in the exchange rate regime enables market-based adjustment in other financial sectors, but maintenance of state control also enables state-directed

[59] This approach has been used elsewhere in studies of the impact of international institutions and economic interdependence on Chinese economic policy. See, for example, Thomas G. Moore and Dixia Yang, "Empowered and Restrained: Chinese Foreign Policy in the Age of Economic Interdependence," in David Lampton, ed., *The Making of Chinese Foreign and Security Policy in the Era of Reform* (Stanford: Stanford University Press, 2001), 191-229.

adjustment strategies in the banking sector and other financial markets. A decision to allow the market to adjust the exchange rate reflects a different set of priorities, and less control of the state over the mechanics of reform in the rest of China's financial system.

This interplay between market and state control of China's economy is typically expressed in the economic literature as the Mundell-Fleming "unholy trinity," in which a state can only achieve, at maximum, two of three objectives: liberalized capital flows, autonomy over monetary policy, or a fixed exchange rate.[60] The logic of the "unholy trinity" flows from the condition of interest rate parity in liberalized capital markets, where capital can quickly adjust and arbitrage away any differences in foreign and domestic interest rates. Therefore, the level of capital mobility and policy-makers' visions of the power of capital mobility are highly influential in shaping exchange rate policy choices. Under conditions where capital mobility is high, if a state develops a balance of payments surplus or deficit, this will compel an adjustment in either the country's money supply or the exchange rate. Therefore, if a state's central bank chooses to control the exchange rate, the domestic money supply must adjust to capital inflows or outflows, reflecting internal rather than external adjustment. Through this process, the state loses control over domestic monetary policy under a fixed exchange rate regime.

[60] The Mundell-Fleming "unholy trinity" or "impossible trinity" is a common term in the literature concerning international capital flows and exchange rates. For a recent summary and explanation, see Paul Krugman, "The Return of Depression Economics," *Foreign Affairs* **78**:1 (January/February 1999), p. 56-74.

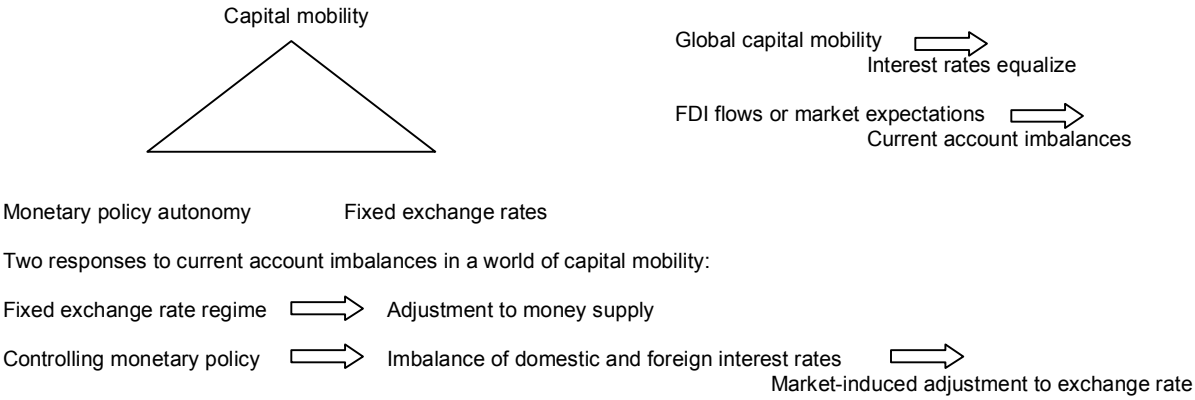

Figure 2.2 The Mundell-Fleming "Unholy Trinity"

If the central bank chooses to limit the growth or contraction of the domestic money supply, this will precipitate a divergence between foreign and domestic interest rates, which will then compel an adjustment of the exchange rate (external adjustment) to compensate for this difference. Therefore, under the pre-July 2005 system, China had chosen relatively free capital mobility (into the country, if not out of the country), and fixed exchange rates, meaning that the central bank lacked the capability to implement an independent monetary policy, and alter the country's interest rate or money supply. Underlying these political choices, however, is the assumption, formed after the Asian financial crisis, that mobile capital flows were sufficiently large that they could influence the domestic money supply and jeopardize the state's management of the economy. Under conditions where capital mobility is relatively limited, states can maintain fixed exchange rates and adjust their own domestic interest rates, because capital flows will not arbitrage away those interest rate differentials. Under conditions in which capital mobility is relatively high, and capital flows are expected to respond to interest rate

moves, states cannot control the domestic money supply. Despite the fact that China's capital controls did maintain some differentials in interest rates across borders, Chinese monetary policy decisions before exchange rate reform were still highly constrained by concerns about capital inflows.

Capital inflows are typically inflationary, as they expand the domestic money supply; if China had raised interest rates to counter this expansion while maintaining a fixed exchange rate, this would have encouraged additional capital inflows, further expanding the money supply and exacerbating inflationary pressure. Therefore, China's interest rate, or the rate of return on yuan-denominated assets, was effectively set by forces outside of China's control. Under these circumstances, international financial market perceptions of the value of the currency can dramatically influence capital flows. If the interest rate plus the expected change in valuation of the currency is viewed as too high, money will flow into the country, and if the interest rate plus the expected change in the currency's value is seen as too low, money will flow out of the country. Under China's dollar-pegged exchange rate regime, China could not adjust the interest rate to compensate for the adverse domestic economic effects of importing American monetary policy.

These choices of exchange rate regimes have political consequences, and therefore, the international consensus behind flexible exchange rate regimes also carries political implications. Despite the stresses on maintaining a fixed exchange rate regime under conditions of capital inflows, markets cannot move currencies directly; as Jeffry Frieden's work has illustrated, the exchange rate remains a policy variable, set by policy-makers. As Frieden argues, "Political conditions determine the range of policy options

available to authorities."[61] In setting an exchange rate regime, there is no clear economic efficiency argument for any particular form of regime; as Frieden and Lawrence Broz have pointed out, the choice of regime is always explicitly political.[62] In addition, macroeconomic fundamentals do not necessarily drive the eventual movement of the exchange rate; policy-makers can delay these adjustments, and markets often react to the perception of policy changes, as well as assessments of the fundamental value of currencies.[63] Speculators were especially active in the Asian financial crisis because they bet against the sustainability of fixed exchange rate regimes due to emerging markets' large levels of foreign debt and dwindling foreign exchange reserves. Those speculative bets required a policy change to be successful, as governments chose to devalue the currencies rather than raise interest rates domestically. However, the political consensus that emerged behind flexible exchange rate regimes after the Asian financial crisis was a contingent phenomenon, reflecting political judgments of international financial technocrats following the crisis. In terms of the choice of exchange rate regimes, political variables influenced policy-makers' perception of states' economic interests.

The Political Implications of Capital Mobility

The idea that capital should, or will, be allowed to move freely across borders was an essential assumption of the arguments against the sustainability of fixed exchange rate

[61] Jeffry Frieden, "The Politics of Exchange Rates," in Sebastian Edwards and Moises Naim, eds. *Mexico, 1994: Anatomy of an Emerging Market Crash* (Washington: Carnegie Endowment for International Peace, 1997), p. 83.
[62] J. Lawrence Broz and Jeffry Frieden, "The Political Economy of International Monetary Relations." *Annual Reviews of Political Science* **4** (2001), p. 317-43.
[63] Frieden, "The Politics of Exchange Rates," p. 83.

regimes following the Asian financial crisis. Speculation against the value of a fixed currency could eventually drain countries' foreign exchange reserves and trigger a massive devaluation in the currency, along with the potential for financial crisis. Flexible exchange rate regimes, in contrast, provide a less attractive target for speculators, as market-based adjustments will ensure that there are buyers and sellers of the currency. At the same time, flexible exchange rate regimes introduce exchange rate risks for economic participants. These ideas about the power of capital mobility are not politically neutral. As Jonathan Kirshner has argued, "…there is something special about the role of ideas in money—the power of ideas does more than just shape the possible. It defines the feasible. Ideas about money can profoundly shape policy in ways divorced from the economic logic or merit of these ideas."[64] The international consensus behind flexible exchange rate regimes following the Asian financial crisis presupposed the power of mobile capital, and influenced policy-makers' perceptions of the feasibility of controlling the exchange rate.

Flexible exchange rates, in turn, facilitated capital mobility. Flexible exchange rate regimes provide central banks with additional autonomy to set domestic monetary policy, which facilitates external and market-based adjustments rather than state-directed forms of adjustment within domestic economies. This, in turn, was consistent with an international consensus in favor of freedom for capital movements. Rawi Abdelal, for example, argues that the international consensus favoring global capital mobility was influential in shaping the activities and recommendations of international financial institutions, but that this consensus largely emerged from European rather than American

[64] Jonathan Kirshner, "Money is Politics," *Review of International Political Economy* **10**:4 (November 2003), p. 655.

policymakers, contrary to most accounts.[65] Abdelal argues, "Freedom for capital movements became the new orthodoxy. Any disputes were generally prejudged against governments and in favor of markets, the bearers of discipline."[66] These ideas were also the foundations of the formation of the international consensus behind market-determined, flexible exchange rate regimes, as the exchange rate was the most critical price in an economy, and controlling the exchange rate effectively represented a state-directed rather than market-directed form of adjustment. The international consensus surrounding flexible exchange rate regimes was linked to ideas presupposing the benefits of global capital mobility, but these ideas were historically contingent and laden with political implications, producing outcomes that further facilitated the political power of mobile capital.

The work of several Gramscian scholars in international political economy has highlighted the influence of ideas about capital mobility in the political context of shaping policy choices and the future path of financial reform. These scholars argue that ideas about globalization and the power of capital mobility can be as influential than capital flows themselves, by influencing policy-makers' perceptions of the reactions of financial markets and mobile capital to particular policy changes. Matthew Watson, for example, argues that measuring capital mobility independently is extremely difficult, but that perceptions of the power of capital mobility can lead to real policy changes.[67] The image of globalization can be used as a justification for policy changes, regardless of the actual impact of global capital flows on states' policy choices. Watson argues, "the idea

[65] Rawi Abdelal, *Capital Rules: The Construction of Global Finance* (Cambridge, Mass: Harvard University Press, 2007), p. 1-4.
[66] Abdelal, p. 1.
[67] Matthew Watson, "International Capital Mobility in an Era of Globalization: Adding a Political Dimension to the 'Feldstein-Horioka Puzzle." *Politics* **21**:2 (2001), p. 81-92.

that financial markets were already integrated into a single global structure seems to have been the cue for setting in motion a self-perpetuating sequence of events that has led ever closer to the creation of just such a structure."[68] Ideas about the power of mobile capital can have an independent causal effect on policy-makers' choices, including over monetary policy.

Watson argues that the trend toward central bank independence is a product of ideas emphasizing the power of mobile capital. "The threat of capital flight consequently conditions the search for a new institutional bargain which militates against the pursuit of more heterodox monetary policies. Typically, that search has ended with governments delegating policy-making responsibilities to independent central banks, and receiving the assent of international financial institutions for doing so."[69] The trend toward central bank independence, in turn, is more likely to encourage governments to adopt flexible exchange rate regimes, as they provide central banks with autonomy in monetary policy, and more influence over the management of the domestic economy. In addition, Watson's work highlights the importance of an assumed political bias toward fighting inflation in the spread of central bank independence. These choices of institutional reforms, based on the prevailing international consensus at the time, in turn, influence the future direction of financial policy for individual states. "The timing of institutional reform therefore has significant long-run consequences since it is usual to base reform on

[68] Watson, p. 88.
[69] Watson, p. 87.

attempts to embed the dominant norm of the day. While the prevailing norm may only be temporary, once institutionally embedded it is likely to continue to influence behavior."[70]

Even though China's central bank is not independent, Watson's work provides insight into the mechanisms for the transmission of the international norm of exchange rate flexibility into Chinese domestic politics. After the Asian financial crisis, international financial institutions began to question the sustainability of fixed exchange rate regimes, which seemed vulnerable to massive capital flight. These assumptions, in turn, influenced Chinese financial technocrats in their advocacy of additional flexibility in China's exchange rate regime, as a method to limit the influence of speculative capital flows. The limited form of flexibility that China adopted, however, influenced the future course of China's monetary policy. Ideas about the importance of capital mobility are not politically neutral, and can have independent causal effects, making states more likely to favor external adjustment, while attempting to maintain control over domestic monetary policy. As Kirshner argues, "While there is no reason to believe that very low inflation or complete capital mobility are the only plausible options available to states, once enough people share that belief, it becomes a self-fulfilling prophecy. Other policies become unsustainable, solely because of the belief that they are unsustainable."[71] The reform of China's exchange rate regime, in turn, was heavily influenced by similar fears of the power of flows of speculative capital, which called into question the sustainability of fixed exchange rate regimes. These ideas influenced Chinese leaders' perceptions of

[70] Matthew Watson, "The institutional paradoxes of monetary orthodoxy: reflections on the political economy of central bank independence." *Review of International Political Economy* **9**:1 (March 2002), p. 189.
[71] Kirshner, p. 654.

the state's interests, but they also had far-reaching economic consequences for China, as the subsequent chapters will show.

Capital Mobility, The "Corners Hypothesis," and China's Exchange Rate Regime

In the choice of exchange rate regimes, economists have noted a global shift in recent decades toward regimes at the "corners" of available choices, meaning either a full float or an explicit currency peg. One factor contributing to this shift has been the assumed power of global capital flows. Intermediate regimes, such as fixed-but-adjustable rates (China's pre-2005 regime), crawling pegs or basket arrangements, appear less credible in response to rapid capital flows that can quickly exhaust states' foreign exchange reserves, because they raise the possibility of state-directed adjustments to the exchange rate for political reasons.[72] Jeffrey Frankel has argued that intermediate regimes are more difficult for market participants to verify in terms of the actual movement of the exchange rate, which provides central banks at the "corners" with additional credibility in foreign exchange markets, making them less susceptible to speculative attacks.[73] Capital mobility is critical to this calculation; states that maintain capital controls or other barriers to international markets can effectively control both the exchange rate and domestic monetary policy, meaning that the choice of exchange rate

[72] George Tavlas, "The Economics of Exchange-Rate Regimes: A Review Essay," *World Economy* **26**:8 (September 2003), p. 1215-1246.
[73] Jeffrey Frankel, Eduardo Fajnzylber, Sergio Schmukler, and Luis Serven, "Verifying Exchange Rate Regimes," World Bank Working Paper, May 2000, http://wbln0018.worldbank.org/Research/workpapers.nsf/12e6920265e1e0d3852567e50050df1f/023fbe4230513c7f8525691c006bcdea/$FILE/wps2397.pdf.

regimes depends heavily upon policy-makers' perceptions of the feasibility of capital controls.

The political economy field includes several explanations for states' choice of exchange rate regimes, operating at the level of domestic or international politics. Political variables are critical in states' choice of exchange rate regimes, including factors within state political institutions, as well as international variables concerning a state's interaction with the prevailing international financial system. Existing studies concerning states' choice of exchange rate regimes has emphasized the importance of democratic political institutions and election systems in state selection of exchange rate regimes. Bernhard and Leblang, for example, argue that domestic political institutions explain states' choices of fixed or floating exchange rate regimes, as states featuring single member districts or exogenous timing of elections will be more likely to float their exchange rates, to maintain a maximum degree of autonomy over domestic monetary policy in advance of critical election periods.[74] Other scholarship, such as Frieden's, highlights the importance of sectoral interests in influencing states' selection of exchange rate regimes.[75]

However, existing scholarship also highlights the importance of international and systemic factors in influencing individual states' choices of exchange rate regimes. Eichengreen's work, in particular, points to the dominance of different exchange rate regimes at different periods of time, and lays out potential variables that could compel these shifts, including an intellectual consensus behind the best practices in monetary

[74] William Bernhard and David Leblang, "Democratic Institutions and Exchange-Rate Commitments," *International Organization* **53**:1 (Winter 1999), p. 71-99.
[75] Jeffry Frieden, "Invested interests: the politics of national economic policies in a world of global finance," *International Organization* **45**:4 (Fall 1991), p. 425-451.

policy and the role of a hegemon in maintaining a cooperative system of exchange rate management.[76] The stabilizing role of a hegemon is often cited as an explanation for international cooperation in the management of exchange rates, but as Eichengreen's work notes, the British experience during the era of the gold standard and the American experience in the creation of Bretton Woods were not necessarily indicative of hegemonic power in creating the dominant exchange rate system of the time; other powers still exhibited significant influence.[77] Francis Gavin's work also highlights the extreme constraints of the Bretton Woods system on American power, arguing that the attention to the balance of payments crisis actually compromised American security objectives during the Cold War, with three American presidents potentially interested in withdrawing military forces from Europe in order to remedy payments imbalances.[78] The character of the international monetary system depends upon strategic interactions among governments, and this, in turn, influences states' choices of exchange rate regimes. The key implication from this line of scholarship for this study is that states' exchange rate choices are often influenced by the international environment as well as domestic political priorities. In China's case, the international norm behind flexible exchange rate regimes, and China's interaction with international financial markets, influenced the Chinese leadership's perceptions of the state's interest in the choice of exchange rate regimes.

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[76] Barry Eichengreen, "The Endogeneity of Exchange Rate Regimes," in Kenen, ed., *Understanding Interdependence: The Macroeconomics of the Open Economy* (Princeton: Princeton University Press, 1995), p. 3-33.
[77] Barry Eichengreen, "Hegemonic Stability Theories of the International Monetary System," in Richard N. Cooper et al., ed., *Can Nations Agree? Issues in International Economic Cooperation.* (Washington: Brookings Institution Press, 1989), p. 255-298.
[78] Francis J. Gavin, *Gold, Dollars, and Power* (Chapel Hill, NC: University of North Carolina Press, 2004).

The political debate surrounding China's exchange rate regime, and the reforms that resulted, involved a conflict between China's gradualist, step-by-step political culture of economic reform and the emerging consensus behind the "corners hypothesis" and the policy constraints of global capital mobility. Minxin Pei has written extensively concerning China's gradualist pattern of economic reform, arguing that regime survival is the key factor preventing more radical economic reform measures, and that all authoritarian regimes have avoided so-called "big bang" economic reform measures.[79] Pei argues that the uncertainty of the outcome of significant reforms (and this is particularly the case in the reform of China's exchange rate regime) prevents governments from creating and maintaining political coalitions favoring reform.[80] In contrast, gradualism allows the Chinese Communist Party to maintain control over critical economic sectors and maintain political support from vital interests in those sectors, while liberalizing other sectors where "rents are relatively low and less concentrated."[81] Whether or not Pei is correct in that this has been the primary political logic behind gradualist reform in China throughout the past thirty years, the case of China's exchange rate policy fits this logic fairly well. There was no political coalition for exchange rate reform outside the central bank, and much of the opposition was driven by fears about the uncertain outcomes of exchange rate reform; this bureaucratic opposition was able to limit the scope of exchange rate reform and drive China's top leaders toward acceptance of a more gradualist reform path.

The resulting reforms highlighted the fact that the set of solutions acceptable to China's gradualist policy-making process and the set of solutions preferred by

[79] Pei, p. 30.
[80] Pei. p. 29.
[81] Pei, p. 31.

international financial markets do not necessarily intersect. China chose a moderate, limited adjustment to the exchange rate, and replaced a fixed-but-adjustable exchange rate regime with an opaque crawling peg to the dollar. In response, speculative capital inflows continued to pour into China, complicating domestic authorities' management of the macroeconomy and nullifying any benefits from additional monetary policy autonomy. At the same time, the reforms illustrated the significance of international norms of exchange rate flexibility in framing China's conception of its own interests, as well as the importance of China's interaction with the existing international system, where flexible exchange rate regimes were more prevalent. China's self-perception as a "responsible" actor in the international system required an exchange rate regime that made China's system appear in line with international best practices.

Monetary Cooperation in a World of Flexible Exchange Rates

Monetary cooperation, particularly in exchange rate management, has long been a focus of scholars in international political economy. Prominent examples include McNamara's work on the process of European monetary cooperation in a world of mobile capital, and Eichengreen's discussion of a hegemonic power in maintaining exchange rate cooperation. In discussions of exchange rates, there is a considerable bias in the literature toward studies of periods of international cooperation on global fixed exchange rate regimes, such as the gold standard and the Bretton Woods system.[82] Beth

[82] Isabelle Grunberg, "Exploring the "myth" of hegemonic stability," *International Organization* **44**:4 (Fall 1990): 431-477; Eichengreen, "Hegemonic Stability Theories of the International Monetary System," in Richard N. Cooper et al., ed., *Can Nations Agree? Issues in International Economic Cooperation* (Washington: Brookings Institution Press, 1989), 255-282.

Simmons's work on states' deviations from the gold exchange standard in the interwar years, for example, highlights the domestic political factors that caused states to "defect" from the cooperative outcome of exchange rate stability, which required making the balance of payments a higher priority than domestic economic conditions.[83]

China's "cooperation" with the dominant international norms of exchange rate behavior, however, involved China's integration into a global financial system dominated by market-determined, flexible exchange rates. International cooperation, in this context, refers not to global fixed exchange rate arrangements such as Bretton Woods but to global standards concerning liberalized capital markets, resulting in states' choices of flexible exchange rate regimes. Literature discussing hegemonic stability theory typically analyzes the global financial system, rather than an individual state's exchange rate regime. In the typical version of hegemonic stability theory, international monetary stability is a public good, and free-riding problems limit its incidence without the willingness of a hegemon to absorb the costs of a stable monetary order.[84] According to Eichengreen, the hegemon plays three critical roles in maintaining international monetary stability: providing a focal point for other states' economic adjustment, providing liquidity when the monetary system needs currency to resolve short-term transactional deficiencies, and acting as a lender of last resort when other states needed to support their fixed exchange rates with additional foreign reserves.[85] However, in the case of the pressure on China to change its exchange rate, the United States did not play any of these

[83] Beth Simmons, *Who Adjusts? Domestic Sources of Foreign Economic Policy During the Interwar Years* (Princeton: Princeton University Press, 1994).
[84] Eichengreen, "Hegemonic Stability Theories of the International Monetary System," p. 255, and David Lake, "International Economic Structures and American Foreign Economic Policy, 1887-1934," *World Politics* **35** (July 1983), p. 517-543; Robert Keohane, "The Theory of Hegemonic Stability and Changes in International Economic Regimes, 1967-1977,"in Robert Keohane, ed., *International Institutions and State Power* (Westview, 1989), p. 74-100.
[85] Eichengreen, "Hegemonic Stability Theories of the International Monetary System," 268-282.

roles, except possibly the first, and the U.S. position was largely concerned with the positions of powerful lobbies blaming China for the U.S. trade deficit. Hegemonic stability theory would predict that the United States would be willing to endure a large trade deficit for the purpose of maintaining the stability of the global financial system. Therefore, the account of the power of global financial institutions in shaping China's interests described in the following chapters differs considerably from the literature concerning hegemonic stability theory.

The position of China and the so-called BRIC countries (Brazil, Russia, India, China) in the early 21st century also questions the nature of monetary power described by hegemonic stability theory and other international political economy literature. As these nations built up considerable foreign exchange reserves and reinvested them primarily in U.S. markets, a larger portion of the U.S. deficit was financed by official rather than private capital. As a result, the sovereign governments of these developing countries were far more influential over the stability of the international monetary order than would be implied by the existing literature concerning Bretton Woods. Francis Gavin's revisionist history of Bretton Woods reinforces this different notion of monetary power as well, as he argues that the United States remained dependent upon the actions of France and Germany to finance the deficit, and that serious consideration was given within the United States to the dissolution of the Bretton Woods system, contrary to the conventional discussion of the benefits to the hegemon from this system. Gavin argues, ". . . the growing European dollar balances, which, under the rules of the system, could be cashed in for gold at any time, were a kind of sword of Damocles hanging over their

heads. The U.S. government felt vulnerable, and it did not like it."[86] Matthias Kaelberer and Wang Hongying also questioned the nature of monetary power, and described its true nature as the absence of a payment constraint, in an argument concerning why the United States was unsuccessful in changing China's exchange rate regime.[87] Kaelberer and Wang focus narrowly on the limited change in China's exchange rate regime, but in reality, the change in the regime was far more significant in its economic consequences, as it permitted further market expectations concerning future yuan appreciation. In addition, Chinese officials publicly embraced the logic behind additional exchange rate flexibility and attempted to portray China's new system as consistent with international standards; they did not defend the pre-2005 regime. However, Kaelberer and Wang raise a valid question about the changing nature of monetary power under a system dominated by flexible exchange rate regimes but growing reserve balances. China's "cooperation" with this system occurred from a position of greater strength than would be implied by traditional accounts of monetary cooperation under fixed exchange rate regimes.

The process of China's exchange rate reforms illustrates that monetary cooperation can exist in a world dominated by flexible exchange rate regimes, as well as fixed exchange rate systems. China's choice to reform its exchange rate regime in line with the international norms supporting flexible exchange rates reflected both the symbolic importance of flexible exchange rates as the preferred system of developed economies and China's self-perception as a responsible actor in the global financial system. Chinese leaders reiterated their commitment to a cooperative effort in resolving

[86] Gavin, p. 10.
[87] Matthias Kaelberer and Hongying Wang, "The US-Chinese Exchange Rate Controversy: A Deviant Case in North-South Monetary Relations?", Paper presented to the annual meeting of the International Studies Association, March 22-26, 2006.

global economic imbalances in acceding to demands for more flexibility in China's exchange rate regime. Chinese domestic politics played a critical role in limiting the scope of the exchange rate reforms of July 2005, but the impetus for additional exchange rate flexibility came from the international consensus questioning the sustainability of fixed-but-adjustable exchange rate regimes that emerged after the Asian financial crisis.

China's exchange rate reforms were contingent upon the dominant form of exchange rate management at the time, and reflected politically significant assumptions about the power of capital mobility. China's reforms reflect a form of monetary cooperation that is different from existing research in international political economy, but this cooperation was similarly encouraged by international financial institutions, communities of financial technocrats, and the prevailing international practices in exchange rate management. The results of those reforms, however, strain the credibility of arguments that China acted in accordance with a narrow conception of economic self-interest; China entailed short-term costs in appreciating the yuan, and its long-term economic interests were difficult to determine without reference to shared causal beliefs surrounding the consequences of exchange rate policies. The next chapter discusses several alternative political explanations for China's exchange rate reforms within current scholarship.

Chapter 3- Political Explanations of Exchange Rate Reform

China's decision to reform its exchange rate regime in July 2005, ending the peg to the dollar, despite considerable domestic opposition, presents a number of questions for political scientists. The relative importance of domestic bureaucratic politics and international pressure in the Chinese leadership's decision-making stand out among these issues. As explained previously, the argument of this study, which draws extensively from literature applying constructivist approaches to international political economy, is that international financial institutions indirectly shaped China's perceptions of its own long-term economic interests. According to this literature, the reform of China's exchange rate regime was designed to bring China's financial system in line with the market-based adjustment mechanisms and "best practices" of global financial governance, for both economic and political reasons.

However, there are a variety of alternative explanations within existing literatures for China's decisions to both appreciate its currency and permit greater market influence over its value. First, there are political economy explanations focusing on the influence of domestic political coalitions created based on exchange rate moves' disparate impact on producers and consumers of tradable and non-tradable goods. Second, bureaucratic

politics explanations emphasize the influence of the preferences and relative power of institutions within the Chinese decision-making apparatus in determining the final content of financial reforms. Third, explanations focused on elite politics, long popular within China studies, emphasize the exchange rate move's potential to empower or marginalize key leaders or factions of critical elites. Fourth, international political explanations emphasize the importance of appreciating the exchange rate in response to international pressure, because of China's political interests in stable and constructive political relations with the rest of the world, even at a marginal cost to China's economic performance.

There are many potential explanations for China's decision to end the yuan's peg to the dollar in July 2005, but individually, these explanations fail to account for critical aspects of the political process that produced China's exchange rate reforms. Political economy explanations do not map particularly well onto China's bureaucratic structure, and there was little evidence that corporate interests drove the political support for additional exchange rate flexibility; at most, these interests limited the scope of exchange rate reform, but cannot explain its genesis. Bureaucratic political explanations fail to account for the near-universal opposition to exchange rate reform within the Chinese bureaucracy, outside the relatively weak People's Bank of China, which is China's central bank. Elite politics also explains little with respect to exchange rate reform; opponents of reform were unified across traditional factional lines, while proponents were linked more firmly by their institutional affiliation than by personal political ties. Finally, the eventual exchange rate reforms fell far short of the demands of China's foreign critics, and the July 2005 adjustments to China's exchange rate regime barely

delayed international political pressure. Rather than demonstrating China's willingness to provide political concessions in the face of pressure, foreign criticism reinforced China's resistance to a more considerable adjustment in the exchange rate, and China delayed the exchange rate reforms because of these political difficulties. While international pressure provided an agenda-setting function, the resulting reforms were the product of the Chinese leadership's consideration of the nation's role as a responsible actor in the international system, driving the reform of China's exchange rate regime in line with international standards, but not necessarily in response to foreign demands.

This chapter will assess these alternative explanations and their shortcomings in demonstrating the critical factors that produced China's exchange rate reforms.

The Political Economy of Exchange Rates

One type of political explanation for China's exchange rate reforms can be found in scholarship concerning the domestic political economy of exchange rate choice. Explanations focusing on China's domestic political economy emphasize the influence of domestic political coalitions on exchange rate policy, based on the potential for exchange rate moves to have a disparate impact on producers and consumers of tradable and non-tradable goods. There are generally two distinct bodies of literature focusing on the intersection between exchange rate regimes and domestic interest groups. The first school holds that the political preferences of interest groups toward a country's exchange rate regime can be determined *ex ante*, based on the group's position in the economy and the different economic impacts of different exchange rate regimes. The second set of

arguments within the political economy literature holds that exchange rate regimes have no fixed political coalitions, because of the complexities of international financial markets and the difficulties of translating the impact of an uncertain financial environment into political support. In sum, the literature concerning the political economy of exchange rate regimes assumes, when applied to China, that the preferences of domestic interest groups, based on their economic position, influence the course of reform of China's exchange rate regime.

Most explanations focused on the interaction of exchange rates and the political influence of domestic interest groups come from the first school. This body of literature assumes that fixed exchange rate regimes have pre-determined political coalitions, and flexible exchange rate regimes are likely to have different advocates in the political process. The literature assumes these coalitions' interests can be determined exogenously, and that interest groups' economic positions are likely to be the most significant determinant of political preferences toward exchange rate regimes. This literature is generally drawn from the broader set of arguments concerning the impact of domestic interest groups on political conflicts over trade policy. However, because exchange rates essentially function as prices in the domestic economy, and as an economy's most important and influential price level, the effects of different regimes and different levels of the exchange rate are complex and variable; therefore, the political conflicts over exchange rate regimes cannot be reduced simply to "protectionist" and "free-trading" camps.

In particular, two domestic political conflicts become prominent within this literature. First, there are debates over whether a country's exchange rate regime should

be fixed or flexible, as the decision to peg the currency to another (usually the U.S. dollar) can create coalitions supporting or opposing the stability of the exchange rate. Secondly, there are debates concerning the level of the exchange rate itself, independent of its degree of stability; this debate typically pits exporters of tradable goods and domestic producers of nontradable goods against each other.

The most relevant work in this first body of political economy literature comes from Ronald Rogowski and Jeffry Frieden. Rogowski uses the Stolper-Samuelson theorem, derived from the Heckscher-Ohlin model, to provide interest-based models of political cleavages created by international trade and integration with the global economy based upon relative factor distributions within individual countries.[88] At the same time, Rogowski uses a simple model of the relationship between economic power and political power that can be useful in examining the distributional effects of exchange rate regimes on domestic interest groups. Rogowski's model of politics requires the following assumptions concerning the interaction of economic power and domestic politics. First, the groups that benefit from policy changes will attempt to promote those policy changes, and opponents will attempt to repeal those policy changes. Second, economic power translates, with few intervening variables, into political influence in some form. Third, Olsonian collective action problems are likely to be less severe under conditions where constituencies in favor of particular policy changes develop in the domestic political sphere; in other words, domestic majorities within relevant institutional constraints

[88] Ronald Rogowski, *Commerce and Coalitions: How Trade Affects Domestic Political Alignments* (Princeton: Princeton University Press, 1990), and Jeffry Frieden, "Invested Interests: The Politics of National Economic Policies in a World of Global Finance," *International Organization* **45**:4 (1991), p. 425-51.

typically can achieve their political objectives.[89] Applying these models to China can provide a "baseline" that predicts the likely political conflicts over the nature of China's exchange rate regime based on the specific factors that are relatively abundant in China.

Jeffry Frieden's work is more specific to exchange rates, emphasizing the political conflicts created over exchange rate regimes in a world where capital mobility has increased dramatically. In addition, Frieden highlights the two key political decisions over the exchange rate regime that contribute to political conflict: the flexibility of the exchange rate regime, and the level of the exchange rate.[90] According to Frieden, groups lobbying for a fixed exchange rate should include export-oriented producers of tradable goods and international traders and investors, while those arguing for more flexibility should include producers of nontradable goods and services and domestically focused producers of import-competing goods.[91] At the same time, these domestically focused producers should unite with exporters in favoring an undervalued exchange rate, while traders and investors should join with producers of nontradable goods to lobby for an appreciated exchange rate.[92] Using these studies to predict a baseline (essentially a null hypothesis) for the political conflicts over any exchange rate policy can help to isolate the ways in which the political conflict over China's exchange rate regime differs from this baseline, which is derivative exclusively of these groups' economic interests. In addition, because the debate on China's exchange rate regime encompasses conflicts over both the relative flexibility of the exchange rate regime and the level of the exchange rate,

[89] Rogowski, 4-5.
[90] Frieden, "Invested Interests," p. 444-445.
[91] Frieden, "Invested Interests," p. 445.
[92] Frieden, "Invested Interests," p. 445.

the positions of some of these groups toward exchange rate reform will be indeterminate by adhering solely to Frieden's framework.

The second body of relevant political economy literature is more consistent with the argument that China's exchange rate reform can be explained via ideational variables as well as the distributional effects on domestic interest groups. This literature essentially argues that particular exchange rate regimes have no fixed domestic political coalitions, because complex interactions between exchange rate regimes and international financial markets do not necessarily provide a predictable set of outcomes that can be easily mobilized for the purposes of harnessing domestic political support. Authors arguing for this perspective include Kathleen McNamara and Alberto Giovannini, who have both primarily discussed the political debate over monetary union in several European countries.[93] In this body of literature, economic and political interests cannot be determined exogenously. Because of this, it is difficult to construct a null hypothesis, along with expectations, concerning the political outcome, in terms of the form of China's exchange rate regime, resulting exclusively from exogenously determined economic interests. In turn, the indeterminacy of economic and political interests highlighted in this literature reinforces the significance of ideational variables in determining the form of states' exchange rate regimes. Policy-makers may be influenced by ideas concerning their own interests, even without a specific model analyzing their own costs and benefits from different exchange rate regimes. This observation, in turn, reinforces the argument that shared causal beliefs compel policy-makers to

[93] Kathleen McNamara, "Consensus and Constraint: Ideas and Capital Mobility in European Monetary Integration," *Journal of Common Market Studies* **37**:3 (September 1999), p. 455-476, and Alberto Giovannini, "Economic and Monetary Union: What Happened? Exploring the Political Dimension of Optimum Currency Areas," in Alberto Giovannini, ed., *The Debate on Money in Europe* (Cambridge: MIT Press, 1995), p. 311-312.

reconceptualize their interests; ideas and interests play different but complementary causal roles in the implementation of exchange rate regimes.

Domestic Political Economy Explanations and the Chinese Exchange Rate Debate

The Chinese exchange rate debate, however, does not map very cleanly onto the expected interest group conflicts implied by the framework described by Jeffry Frieden. According to Frieden's models, the coalition in favor of a more flexible exchange rate regime should include import-competing producers of tradable goods for the domestic market, and producers of nontradable goods and services for the domestic market. Frieden argues that both of these groups should be more interested in the government's monetary policy autonomy, which is only possible in a flexible exchange rate regime, rather than currency stability.[94] This is largely because their businesses are largely domestically focused and do not involve invoices or receipts in foreign exchange.[95] Therefore, the most critical variable for these producers is for the government to be able to control the direction of the national domestic economy, through autonomous monetary policy.

However, there is little evidence in China of this type of political mobilization on behalf of industries producing and consuming nontradable goods. The critical institution initiating the changes that resulted in the July 2005 reforms was the central bank itself, in a process detailed in the subsequent chapters, and one of the critical reasons that it acted

[94] Frieden, "Invested Interests," p. 445-6.
[95] Frieden, "Invested Interests," p. 445.

was to initiate the process of financial market development.[96] The primary activity of the central government has been to promote its overall policies of macroeconomic control, limiting overall lending and investment levels; these types of policies contradict the interests of producers of tradables and nontradables alike, and are not generally concerned with the monetary policies of the central bank.[97] Producers of nontradables would still seek an audience, within China's institutional framework, with the Ministry of Commerce or another business association with ties to the State Council; these institutions have opposed greater flexibility of the exchange rate regime, which suggests that Frieden's model does not effectively capture interest group lobbying in China, or that lobbying from these sectors is minimal and insignificant in terms of influencing State Council decision-making. In addition, in terms of monetary policy, China's central bank, the PBOC, has demonstrated policy preferences at odds with much of the rest of China's business establishment; this casts doubt on Frieden's model of the political interests of producers of nontradable goods. In fact, every indication from the central bank throughout the period of exchange rate reform indicates that they favored higher interest rates and higher reserve requirements than the rest of the Chinese bureaucracy, as well as an overall policy of monetary tightening, which would harm credit availability for producers of import-competing tradables and nontradables alike.[98] In addition, there is little evidence in recent Chinese economic history of overall macroeconomic management from the central bank; it seems odd, in these circumstances, to expect that Chinese producers would lobby the government in any form on the basis of a preference

[96] Interview 06-112.
[97] Wen Jiabao's comments were taken from Financial Express, "Wen pledges 'forceful' tightening," 27 July 2006, http://www.financialexpress.com/fe_full_story.php?content_id=135370.
[98] Interview 06-111.

for monetary policy autonomy. Frieden's model does not appear to capture some of the most critical domestic political forces responsible for both the long period of continuity and the changes that occurred in China's exchange rate regime in July 2005.

Evidence for lobbying from domestic interest groups can be found primarily among the groups resisting change, favoring the fixed exchange rate regime that characterized China's system from 1994 to 2005: export-oriented producers of tradable goods and international traders and investors. For export-oriented producers of tradable goods, the evidence is fairly consistent with Frieden's model. These companies were the foundation of China's export-oriented growth model; they favor not only a fixed exchange rate regime but a relatively undervalued exchange rate as well, so dissociating these two preferences remains difficult. At the same time, there is considerable evidence nested within the structure of export contracts that would reinforce Frieden's argument that these companies should favor a fixed exchange rate regime, regardless of the exchange rate. Because export contracts are often negotiated over multi-year periods, and the domestic costs of export production are likely to remain constant, export-oriented producers would seek stability on the revenue side of their contracts as well as on the cost side. Since their revenues are denominated in foreign exchange, usually in US dollars (surveys indicate that 70-80 percent of China's export invoices are denominated in USD), and their costs are denominated in yuan, these companies have an interest in ensuring the stability of their financial projections over as long a time horizon as possible, hence favoring a fixed exchange rate regime.[99] Survey data of Chinese enterprises do indicate

[99] Interview 05-11.

sensitivity to rapid exchange rate fluctuations, but disaggregating the effects of appreciation versus the effects of fluctuation remains difficult.[100]

For international traders and investors, the evidence regarding Frieden's hypotheses is mixed. For example, while international investors should favor a fixed exchange rate to make the consequences of their long-term investment decisions more predictable, many Chinese investors are heavily influenced by the need to develop China's financial system and protect their investments domestically over the long term; reforming the fixed exchange rate regime is a critical first step in initiating market-driven changes elsewhere in China's financial system over the long term. For this reason, while export-oriented enterprises clearly supported the pre-July 2005 system, some investors and traders may have favored a more flexible exchange rate regime for the purposes of developing China's financial market. Frieden's model finds limited support, but does not effectively model the complexity of the domestic debate over China's exchange rate regime.

Domestic coalitions favoring an overall policy of a depressed exchange rate include the same export-oriented producers of tradable goods, along with producers of import-competing tradable goods, primarily for the domestic market. The evidence in this case is fairly straightforward: surveys of both export-oriented enterprises, particularly in the textile industry, and of tradables for the domestic market, reveal sensitivity to even limited exchange rate appreciations. In May 2006, Bo Xilai, the Chinese Minister of Commerce, had commented that the July 2005 appreciations have already subjected Chinese export-oriented companies to a significant degree of stress, as they lack pricing

[100] Survey data mentioned here include comments from survey participants in the Market News International China Business Sentiment Survey, administered quarterly from 2005-2006 and monthly from 2007 to the present.

power when competing with other companies solely on the basis of the cost of labor.[101] China remains at the lower end of the value chain even in high-technology industries, where the primary value-added originates in the final assembly of products whose components are heavily sourced from elsewhere in Asia. These companies can convey their preferences to the State Council through two primary institutions: the Ministry of Commerce itself, which represents those export-oriented enterprises, and through business associations that typically express their views through research institutions that advise the Economic and Financial Leading Small Group.[102]

In the case of import-competing producers of tradable goods, some evidence exists that the Development Research Council, which advises the Leading Small Group, is concerned about the effect of a higher exchange rate on the competitiveness of agricultural producers in China within their own domestic market, as cheaper agricultural imports could deal an additional blow to rural incomes in certain agricultural products.[103] At the same time, other evidence indicates that some of the State Council's primary concerns about exchange rate appreciation were not economic but political; harming export enterprises becomes relevant not only for their economic effects but because of the potential for protests from angry workers disenfranchised as a result of central government fiat.[104] In this case, this argument points to the demands of the central government within China's one-party system, rather than enterprise associations and other interest groups forcing change from below. In short, while evidence exists that the

[101] Bo Xilai's comments were taken from Forbes, "Chinese commerce minister says US calls for yuan appreciation 'groundless'," 31 May 2006, http://www.forbes.com/markets/feeds/afx/2006/05/30/afx2782241.html.
[102] Leong H. Liew, "Policy Elites in the Political Economy of China's Exchange Rate Policymaking," *Journal of Contemporary China* **13** (February 2004), p. 25-28.
[103] Interview 05-11, 05-16.
[104] Interview 05-12.

State Council and its research institutions were interested in protecting export-oriented enterprises, this evidence does not necessarily support Frieden's model of the political economy of exchange rate regimes, which fails to include the interaction between the political preferences of the central government and the course of reform of the exchange rate regime.

One of the central puzzles of the July 2005 exchange rate reforms is: Without an obvious source of domestic pressure, why did the State Council change the regime at that time? In Frieden's model, the coalition in favor of a higher exchange rate should include these same producers of nontradable goods and services (airlines, for example, whose costs are denominated in dollars and receivables in renminbi), and international traders and investors, who are interested in using retained earnings from domestic enterprises and investments to fund overseas investments and acquisitions. Much attention had been focused on the rising price of oil and the potential for these costs to generate a coalition pressuring the State Council and the central bank to appreciate China's currency; however, there is no obvious institution represented before the State Council that would express these concerns. The Ministry of Commerce has clearly indicated its opposition to a higher exchange rate, given the extent of China's dependence upon demand for its exports. International traders and investors also lack obvious institutional representation, except in the form of the central bank, which has committed to develop the financial markets over time, which serves these traders and investors' interests.

Frieden's model, when applied to the Chinese case, finds few obvious sources of support. While all models are useful to the extent that they clarify the expectations that follow from particular assumptions and help to generate hypotheses, Frieden's

hypotheses find little supporting evidence in the political debate surrounding China's exchange rate regime. The arguments of elites, and the preferences of the institutions themselves, such as the PBOC, the NDRC, and the DRC, rather than their constituencies within the domestic economy, appear to have exerted more influence within China's policy-making apparatus. This suggests that political economy approaches are not necessarily the most useful tools in evaluating the critical factors creating both continuity and change in China's exchange rate regime.

In addition, there are several factors particular to the Chinese political system that make political economy approaches less useful in evaluating the course of reform of China's exchange rate regime. First, interest groups, as understood in pluralist political systems, do not exist in the same form in the Chinese political system. The Chinese Communist Party retains its monopoly on power, and attempts to challenge the legitimacy and the existence of groups that form independently of the state. For that reason, each interest group must be tied to or sponsored by a particular organization within the Party-state structure; while there have been independent groups, their influence has so far been limited. Therefore, when discussing the preferences of interest groups, such as exporters of tradable goods, these groups are not really independent interests, in the Chinese context, but already reflect a degree of state cooptation of their objectives and preferences. Secondly, not only the structure of these interest groups but also the structure in which they operate varies significantly from pluralist political systems to a system such as China's. For groups of business associations, such as exporters,

importers, traders, and investors, there is no distinct lobbying structure within the Chinese government for domestic interest groups to express their preferences.[105]

These models of political economy may not be applicable to China's system, which displays elements of state corporatism. Corporatism, as Schmitter discussed, is a system of interest representation characterized by hierarchical organization of functionally differentiated units representing a monopoly of political power within a certain issue area.[106] Each business association or independent group within China is required to link into the political structure of power, normally through functionally differentiated units roughly in line with the corporatist model. If these groups cannot be coopted by the structure of the Party-state, they are likely to either be directly attacked by the organizations of the Party-state or to have very little legitimacy within its structures. While China's system of interest representation is growing more institutionalized and contains elements of both corporatist and pluralist political systems, the utility of political economy approaches focusing on interest groups lobbying the state for policy changes is still likely to be somewhat limited. For these reasons, modeling and predicting Chinese decision-making based on the preferences of domestic interest groups may not be the most useful approach to explaining the course of reform of China's exchange rate regime, because it is unclear how the influence of these domestic interest groups passes through the filter of China's bureaucratic and elite politics.

In addition to the differences in the form and function of China's interest groups relative to those of pluralist political systems, two characteristics of China's political system during the era of economic reform may cast doubt on the utility of political

[105] For a thorough analysis of lobbying activities in China, see Scott Kennedy, *The Business of Lobbying in China* (Cambridge, Mass.: Harvard University Press, 2005).
[106] Phillipe Schmitter, "Still the Century of Corporatism?" *Review of Politics* **36** (1974), p. 85-131.

economy approaches. First, a model of politics based on central-provincial relations captures much of the utility of political economy approaches, since it is usually provincial governments, particularly those of export-intensive provinces, that are likely to express the same preferences as the enterprises of the province, and are likely to possess more political power in Beijing, after policy recommendations are passed through the Economic and Financial Leading Small Group and to the Politburo, where many key provincial heads hold positions.[107] The provincial leaders' preferences should be commensurate with those of their enterprises because provincial party secretaries are typically promoted to the central leadership in Beijing following their terms in the province, and one of the primary tools that the Organization Department uses to evaluate potential candidates for higher office includes the overall growth rate of the province under management. For that reason, appreciation leading to difficulties among export-oriented enterprises would ensure significant political costs for several provincial party leaders; in other words, the interests of enterprises and other interests may be more effectively represented by provincial party secretaries than by interest groups as we understand them in pluralist political systems.

Secondly, the path of Chinese political history has produced more incentives for economic growth at the top of the Chinese leadership rather than at the bottom. While the leaders of all states, particularly developing countries, face pressure to varying degrees to "deliver the goods" in the form of economic prosperity, China's political history has elevated the importance of economic growth to the Chinese Communist Party in particular. Deng Xiaoping's reforms starting in 1978 shifted the primary source of

[107] Victor Shih, *Factions and Finance in China: Elite Conflict and Inflation* (Cambridge, Cambridge University Press, 2007).

Party legitimacy from Communist ideology to the CCP's ability to improve standards of living for Chinese citizens. For the most part, sustained economic growth has strengthened CCP legitimacy. However, the prospects of an economic reversal, either triggered by an external or internal economic shock, could also create significant problems for CCP legitimacy. The protests of 1989 occurred against the backdrop of stagnating agricultural output in the late 1980s, accelerating inflationary pressure, and a decline in urban employment levels, particularly in state-owned enterprises. Since 1989, China has become a member of the World Trade Organization, has seen foreign investment of hundreds of billions of dollars flow across its borders, and has become more connected to the global economy than isolated from it. While this degree of interconnectedness has bolstered perceptions of the CCP as effective economic managers, it also poses distinct dangers to the rule of the CCP party-state, making China vulnerable to external economic dynamics, actors, and decisions. External economic crises could create internal political crises for the CCP, because the CCP is dependent upon continued economic growth for legitimacy.

In other words, political economy approaches may not reflect the course of reform of China's exchange rate regime because the policy debate is more constrained among the leadership of the State Council than it would be in a system in which domestic interest groups were competing over the direction of economic policy; China's leaders are likely more fearful of the influence of international markets than the interests competing to influence these leaders. Minxin Pei's scholarship has demonstrated that uncertainty about potential outcomes can prevent authoritarian governments from

maintaining a coalition in favor of radical reforms; the result is gradualism.[108] For the Chinese Communist Party, economic growth is a necessity for continued political legitimacy, making it unlikely that any but the most gradual steps will be considered among China's leaders.

Both because of the form and structure of China's system of interest representation, and some peculiar characteristics of the history of China's economic reform, political economy approaches focusing on fixed political coalitions supporting particular exchange rate regimes are unlikely to capture critical political forces explaining both continuity and change in China's exchange rate regime. Where domestic interest groups entered China's exchange rate debate, they largely attempted to limit the extent of exchange rate reform, but the political impetus behind reform resulted from priorities of the top leadership and financial technocrats, rather than domestic interest groups. This evidence is more consistent with McNamara and Giovannini's work, which found that the interests in favor of exchange rate reform are likely to be indeterminate *ex ante* based on the economic position of these interest groups, providing more scope for ideational variables such as Chinese leaders' image of the country as a responsible actor in the international financial system. In elucidating the influence of domestic variables over China's exchange rate reforms, the literature concerning bureaucratic politics provides more explanatory power than the domestic political economy literature.

Bureaucratic Politics

[108] Pei, p. 31.

Incorporating bureaucratic factors into explanations of the reform of China's exchange rate regime is necessary to understand the mechanisms by which global norms of market-based exchange rate adjustment became relevant within China's domestic political context. However, these factors provide little insight into the origin of China's exchange rate reforms; the key advocates of a more flexible exchange rate regime were bureaucratically weak, and far more powerful agencies advocated no change at all. Outside the People's Bank of China, virtually every institution within China's bureaucracy was opposed to exchange rate reform. The fact that the July 2005 reforms could emerge at all in an environment of such significant opposition deserves careful study; as the subsequent chapters will demonstrate, international commitments by Chinese leaders limited the scope of potential exchange rate reforms. However, bureaucratic and elite politics did play a significant role in shaping the final form of China's adjustments to its exchange rate regime. The Ministry of Commerce and the National Development and Reform Commission were influential in preventing the People's Bank of China from appreciating the yuan quickly, or adjusting its value significantly.

Even though elite and bureaucratic political explanations both focus on the preferences of actors within the structure of the state, there are some critical differences between them. Explanations emphasizing elite politics examine the political preferences and attitudes of elites within the Chinese Communist Party (CCP) and factions of those elites, and use those data to explain the course of reform of China's exchange rate regime. An explanation relying solely on political factors among China's elites, for example, would emphasize the influence of Zhou Xiaochuan, the head of the PBOC, over

Wen Jiabao, China's premier, and the economic decision-making body he heads, the Central Leading Group on Finance and Economics. Elite politics has long been a popular approach in analyzing Chinese decision-making, even in the realm of financial and economic policy. For example, in one of the most detailed studies of China's decision-making process regarding exchange rates, Leong H. Liew uses the preferences and interests of key policymakers in China's bureaucracy to explain the devaluation of China's exchange rate in 1989 and the decision not to devalue during the Asian financial crisis in 1997 and 1998.[109] Victor Shih uses the survival instincts of bureaucrats and factional struggles between them to explain the slow pace of reform in China's banking sector, particularly concerning the well-publicized problem of non-performing loans.[110] In the past, when Chinese politics was less institutionalized, elite politics provided more explanatory power over bureaucratic or institutional arguments, because key leaders could bypass or ignore institutional channels in implementing their preferred policies. Since the death of Deng Xiaoping, Chinese politics has become more institutionalized in character, so that authority stems not only from personal relationships but also from a leader's official position.[111] Therefore, contemporary arguments focusing on elite politics typically incorporate bureaucratic or institutional elements as well.

Bureaucratic politics explanations emphasize the influence of the preferences and relative power of institutions within the Chinese decision-making apparatus in determining the final form of financial reform measures. However, bureaucratic politics

[109] Leong H. Liew, "Policy Elites in the Political Economy of China's Exchange Rate Policymaking," *Journal of Contemporary China* **13** (February 2004), p. 21-51.
[110] Victor Shih, "Dealing with Non-Performing Loans: Political Constraints and Financial Policies in China," *China Quarterly* (2004), p. 922-944.
[111] In addition to Liew, p. 50, Li Cheng, "The New Bipartisanship within the Chinese Communist Party," see, for example, Lowell Dittmer and William Hurst, "Contemporary Chinese Politics and the Maturation of Reform," in Lowell Dittmer and Liu Guoli, China's Deep Reform: Domestic Politics in Transition (Rowman and Littlefield, 2006), p. 25-30.

approaches differ from elite politics approaches. In bureaucratic explanations, the position, interests, and preference of the bureaucratic institution influence the policy preferences of the institution's leadership (the "where you stand depends on where you sit" hypothesis), rather than the leader's preferences influencing the policy advocacy of the institution.[112]

In the case of China's exchange rate reforms, however, neither bureaucratic nor elite political explanations provide a significant degree of explanatory power by themselves in assessing the course of reform of China's exchange rate regime. There have been several models of bureaucratic influence within Chinese politics, but virtually all of these models would likely have predicted no change at all in China's exchange rate regime. The PBOC was the only major institution favoring exchange rate reform within the Chinese bureaucracy, and any bureaucratic explanation for China's July 2005 exchange rate reforms would require the central bank to gain in influence through institutional changes before the enactment of reform. While the PBOC has gained in influence as Chinese economic policy-making has become more institutionalized, this has primarily been a product of the exchange rate reforms of July 2005 themselves, as the exchange rate is now more influential as a tool of economic adjustment.[113] However, this institutionalization also increased the importance of the Ministry of Commerce, a noted

[112] Graham Allison, *Essence of Decision: Explaining the Cuban Missile Crisis* (Boston: Little, Brown, 1971). For more discussion of the bureaucratic politics approach to explaining foreign policy decision-making, see Morton Halperin, *Bureaucratic Politics and Foreign Policy* (Washington: Brookings Institute Press, 1974), Graham T. Allison and Morton H. Halperin, "Bureaucratic Politics: A Paradigm and Some Policy Implications," *World Politics* **24** (1972), p. 40-79, Stephen D. Krasner, "Are Bureaucracies Important? (Or Allison Wonderland)," *Foreign Policy* **7** (1974), p. 159-179, Robert J. Art, "Bureaucratic Politics and American Foreign Policy: A Critique," *Policy Sciences* **4** (1973), p. 467-490.
[113] Yi Jingtao, "China's Exchange Rate Policymaking in the Hu-Wen Era," October 2007, University of Nottingham China Policy Institution, Briefing Series- Issue 29.

opponent of exchange rate reform, over exchange rate policy-making within the Chinese bureaucracy.[114]

Bureaucratic explanations of exchange rate policy by Leong H. Liew, Yi Jingtao, and Victor Shih all emphasize the importance of the Central Leading Small Group on Finance and Economics in shaping the eventual policy choices placed before the Chinese leadership. This group, which belongs to neither the Communist Party nor the Chinese state, assesses policy inputs by research institutions and other ministries, and eventually places policy options concerning financial matters before the State Council and the Politburo.[115] However, the final policy decisions, based on the options available, are made by the top leaders themselves, and decision-making has generally become more consensus-driven under the leadership of Hu Jintao and Wen Jiabao.[116] In this environment, the expanding bureaucratic influence of the PBOC cannot really explain the origin of the exchange rate reforms of July 2005; there were multiple opportunities for the PBOC's proposals for exchange rate reform to be rejected by a conservative, consensus-oriented Chinese bureaucracy. However, this opposition to exchange rate reform elsewhere in the bureaucracy does explain the limited form of exchange rate adjustment that the Chinese government eventually announced in 2005.

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[114] Yi Jingtao, p. 6.

[115] Liew, p. 24-34, and Victor Shih, Factions and Finance, *Factions and Finance in China: Elite Conflict and Inflation* (Cambridge, Cambridge University Press, 2007). For more on "leading small groups," see Carol Lee Hamrin, "The Party Leadership System," in Kenneth Lieberthal and David Lampton, ed., *Bureaucracy, Politics, and Decision-Making in Post-Mao China* (Berkeley, University of California Press, 1992), p. 95-124, Kenneth Lieberthal, Governing China (New York: W.W. Norton, 1995), p. 192-194, and footnote no. 42 in David Shambaugh, "Containment or Engagement of China: Calculating Beijing's Responses," *International Security* **21**:2 (Fall 1996), p. 180-209.

[116] See, for example, Barry Naughton, "Strengthening the Center, and Premier Wen Jiabao," China Leadership Monitor, no. 21 (2007), p. 1, and Li Cheng, "The New Bipartisanship within the Chinese Communist Party."

Evidence from interviews scattered throughout the subsequent chapters indicates that most institutions with influence in the State Council and the Economic and Financial Leading Small Group were either opposed to exchange rate reform or were divided internally concerning the possibility of change. The institutions active in the State Council, which would have to approve any decision to change the exchange rate system, include the Development Research Center (DRC), an economic think tank reporting directly to Premier Wen Jiabao, the Ministry of Finance (MOF), the Ministry of Commerce (MofComm), and the People's Bank of China (PBOC). Of these institutions, only the PBOC would potentially be interested in an exchange rate adjustment, because they would be interested in pursuing an independent monetary policy, but this consideration is mitigated by the difficulties that an appreciation would pose for the banks' capital adequacy and disposition of non-performing loans. The MOF, for example, is not interested in an independent monetary policy, so that its own area of jurisdiction, fiscal policy, retains its significance.

Elite Politics

Assessing explanations focused on elite politics, or the preferences of individual elites in shaping policy outcomes, requires separating those elites' preferences from those of their institutions, and demonstrating their relevance within the policy debate over reforming the exchange rate regime. In general, the wide range of bureaucratic opposition to exchange rate reform also argues against the utility of explanations focused on elite or factional allegiances. As Li Cheng has argued, representatives from both of

China's primary factions during the Hu-Wen era, the so-called "populists" and "elitists", are generally present within most critical institutions in Chinese domestic politics.[117] The result is a tendency toward compromise and consensus-oriented policy-making. While Zhou Xiaochuan may have been China's most active central banker in history, and did have influence over opponents of exchange rate reform within the central bank, there is little evidence that Zhou's factional allegiances or personal ties to other policy-makers had a material impact on the political debate surrounding the reform of China's exchange rate regime. Opposition to changing China's exchange rate regime was significant and spanned several institutions; members of typical elite factions described in this literature ("the Shanghai Gang", the "tuanpai") were on both sides of the exchange rate debate.[118]

Bureaucratic explanations of change appear less useful if the majority of China's financial bureaucracies opposed changing the exchange rate regime. Therefore, it appears that following a more thorough institutional analysis, other variables will be necessary to explain why one relatively weak institution was able to carry the day in deliberations despite considerable bureaucratic resistance to change in China's exchange rate regime. In addition, the "true" state of factional politics within the CCP remains opaque, and relying solely on elite preferences to explain changes in China's exchange rate regime overlooks the importance of the international political environment and the pressures of the international economy. Overall, explanations relying upon bureaucratic and elite politics can help to explain the limited and marginal form of the July 2005

[117] Li Cheng, "The New Bipartisanship within the Chinese Communist Party."
[118] For discussions of the typical factional alignments of Chinese leaders in the Hu-Wen era, see Li Cheng and Lynn T. White, "The Sixteenth Central Committee of the Chinese Communist Party: Hu Gets What?" *Asian Survey* **43**:4 (July/August 2003), p. 553-597, as well as more recent analyses such as Shaun Breslin, "Do Leaders Matter? Chinese Politics, Leadership Transition, and the 17th Party Congress," *Contemporary Politics* **14**:2 (June 2008), p. 215-231. For an application of these factional alignments and their importance in financial policy-making, see Victor Shih, *Factions and Finance in China: Elite Conflict and Inflation* (Cambridge, Cambridge University Press, 2007).

exchange rate reforms, but they offer little insight into the origins of those reforms, nor do they explain how the PBOC's ideas about exchange rate flexibility became politically salient from 2003 to 2005.

International Pressure

Many analysts of the change in China's exchange rate regime viewed the move as explicitly political, designed to offset direct pressure from the United States and China's other trading partners that had been mounting during the period from 2003 to 2005. Arguments in the mainstream media focused on the reputational costs China accrued as the largest economy in the world fixing its exchange rate, leading to the accumulation of billions of dollars in foreign exchange reserves. Other arguments focused on the move's timing relative to major international summits, where an appreciation would hypothetically reduce the pressure on China's leadership at these meetings. In particular, the exchange rate issue became considerably more salient in US-China relations in 2004 and 2005, and explanations citing the health of this relationship as a factor in China's decision-making were fairly prevalent.[119] Essentially, these arguments explained the limited form of China's exchange rate reforms as a limited concession to the United States, with a promise of additional appreciation and additional flexibility to come in the near future.

This explanation is more closely identified with realist literature in international politics and international political economy, and relies upon the relative power of the

[119] See, for example, Jingtao Yi, Yongnian Zheng, and Minjia Chen, "Revaluation of the Chinese Currency and its Impacts on China: A Political Economy Approach," *Issues and Studies* **44**: 2 (June 2008), p. 193-218, and Peter S. Goodman, "China Ends Fixed-Rate Currency," *Washington Post* 22 July 2005: A1.

United States and China to explain the Chinese decision to reform its exchange rate regime, in response to U.S. demands. These types of explanations focused on the influence of the United States over China raises a difficult question: How can one tell the difference, observationally, between the influence of international norms and best practices and the influence of international political pressure, when the observed behavior predicted by these two variables appears the same?

The answer in this case is that despite appearances, the behavior predicted by the influence of international norms and the influence of international pressure is not the same. The operative international norms in this case were the international consensus behind the utility of flexible exchange rates, the apparent risks of fixed exchange rate regimes exposed by the Asian financial crisis, and the idea that exiting from a fixed exchange rate regime was easier under conditions of capital inflow than capital outflow. The international pressure in this case, primarily from the U.S. Congress, was focused almost exclusively on the level of the exchange rate itself, as several in Congress argued that the yuan should appreciate significantly against the dollar. Andrew Cortell and James Davis use a tripartite framework to discuss the domestic salience of international norms, and this framework is applied to the Chinese exchange rate debate in Chapter 6, reinforcing the distinctions between the predictions of these two sets of explanations.

The eventual Chinese exchange rate reforms of July 2005 did not occur in a vacuum, but in the context of a process of reform by Chinese financial technocrats who were already more interested in introducing additional forms of market influence and flexibility into China's exchange rate regime. As the narrative in the subsequent chapters reveals, that domestic policy debate emphasized the importance of exchange rate

flexibility for the management of China's economy, using arguments that drew heavily from the consensus and shared experiences of international financial institutions at the time. That debate did not focus extensively on the necessity of a large initial appreciation of the yuan, despite the demands from the U.S. Congress. If China were responding explicitly to U.S. pressure, we would have expected a larger initial revaluation, with less attention to the overall reform of China's financial system using methods that would increase market influence. Instead, the debate focused significantly on the benefits of exchange rate flexibility, despite the fact that China's exchange rate would have to appreciate significantly for the central bank to gain additional autonomy in monetary policy.

Furthermore, the extent of the initial revaluation, at 2.1 percent, fell far short of Congressional hopes. Senators Charles Schumer and Lindsey Graham somewhat arbitrarily had asked for a 27.5 percent appreciation of the exchange rate, and other estimates of the undervaluation of China's currency were in a similar range. As the narrative in the subsequent chapters will explain, Chinese domestic opponents of exchange rate reform, primarily in the Ministry of Commerce and the National Development and Reform Commission, successfully limited the scope of reform, the size of the initial appreciation, and the speed of appreciation following the July 2005 reforms. In the three years following the end of the dollar peg, China's exchange rate rose only 21 percent against the dollar, with most of that appreciation in the third year. On a trade-weighted basis, using the yuan's movement against China's twelve-largest trading partners, the yuan appreciated by only 11.8% in the three years following exchange rate

reform.[120] This slow pace of appreciation did little to stop Congressional pressure. At the second meeting of the US-China Strategic Economic Dialogue in Washington, the visiting Chinese delegation met with legislators in both houses of Congress, and the reluctance of Chinese officials to move faster in allowing the yuan to appreciate left several members of Congress committed to pushing forward with legislative remedies.[121] If this international pressure was such a critical factor driving China's exchange rate reforms, it is difficult to explain why China was unresponsive to this pressure in 2003 and 2004, responsive in 2005, and then unresponsive for the next three years.

In addition, this direct political pressure in some ways delayed the introduction of exchange rate reforms in 2005, which would be inconsistent with explanations focused on the influence of political pressure on China's behavior. As China's domestic political debate over exchange rate reform began to develop in the spring of 2005, with a consensus forming behind an initial limited appreciation and the end of the peg to the U.S. dollar, several Chinese officials began to comment that the threat of U.S. tariffs was delaying the introduction of exchange rate reform. Many governments are reluctant to appear as if they are meekly making concessions to their foreign counterparts, for fear of domestic political resistance, and China is no different. However, in the Chinese political system, the historical influence of China's century and a half of "shame and humilation" at the hands of foreign powers provides additional political obstacles to these types of concessions, and provides additional political capital to opponents of reforms consistent with foreign demands. As the following chapters will relate, Chinese officials sent indirect messages to the U.S. Treasury that exchange rate reform could not proceed while

[120] Data from Stone & McCarthy Research Associates.
[121] John Shaw and Logan Wright, "US House, Chinese Delegation Differ on Pace of FX Reform," Market News International 23 May 2007.

China was being threatened with tariffs; eventually the tariff bill was delayed at the end of June 2005, and exchange rate reform proceeded in the following weeks. Exchange rate reforms may have occurred sooner in the absence of direct political pressure, which is consistent with the influence of international norms, but inconsistent with the influence of direct political pressure on China's decision-making.

This type of direct international political pressure did play an agenda-setting role, however, as it forced China's leadership to address the issue of exchange rate reform, which provided an impetus for Chinese government institutions to research and evaluate a variety of policy options for reforming China's exchange rate. The key institution leading the charge for exchange rate reform was the People's Bank of China, China's central bank, whose officials argued that additional exchange rate flexibility would provide Chinese authorities with additional tools to control excessive monetary growth, investment growth, and inflationary pressure. As China's top leaders began to address the exchange rate issue more frequently in international meetings, the PBOC's proposals for additional flexibility appeared to be consistent with the international consensus that emerged after the Asian financial crisis. Eventually, the scope of exchange rate reform was limited by other Chinese economic institutions.

China ended its peg to the dollar because the domestic proponents of additional exchange rate flexibility found a sympathetic audience among China's top leaders, who found the PBOC's ideas consistent with both an international consensus of best practices in exchange rate policy and a new Chinese role as a "responsible" player in the international financial system. International attention to the exchange rate issue forced China's leaders to put exchange rate reform on the policy agenda, but international norms

shaped the domestic political debate in China by providing proponents of exchange rate flexibility with additional influence to argue that reform would be consistent with international best practices and China's image as a responsible actor. The international consensus behind the benefits of exchange rate flexibility played a much larger role in China's decision to end the peg to the dollar than direct political pressure from the United States for a large yuan appreciation.

A further problem for realist explanations of China's decision to end the peg to the dollar is the murky nature of the power relationship between the United States and China in the context of China's exchange rate reforms. A large appreciation of China's exchange rate, while benefiting certain politically organized constituents in the U.S. manufacturing sector, would significantly increase U.S. interest rates, because China would no longer need to intervene as much in the foreign exchange market to purchase dollars, and then recycle those dollars into U.S. fixed income markets, where Chinese demand for U.S. Treasury bonds kept U.S. interest rates low. During the runup to China's exchange rate reforms, China was one of the largest creditors to the United States, holding billions of dollars in U.S. government bonds. This situation essentially presented Chinese authorities with a significant source of leverage over the United States, as Chinese traders in U.S. markets could plausibly threaten to "take their ball and go home", or sell U.S. Treasury bonds en masse in favor of other assets or other currencies, which would depress the price of these bonds and push up U.S. interest rates. Even though this would undoubtedly also hurt the value of China's own holdings, as they could not sell significant volumes of these bonds without frightening the markets, the fear of this scenario gripped financial markets throughout the period preceding China's exchange

rate reforms. While the U.S. Congress was pressuring China to appreciate its exchange rate, China possessed arguably far more significant tools with which to pressure the United States at the same time, which makes simplistic arguments focused on the influence of international pressure more difficult to sustain.

The influence of international norms, however, provides an additional explanation why China did not choose to use this tool of leverage. China's exchange rate reforms were motivated by shaping China's financial system in line with the best practices in the international financial system, and China's leaders saw these moves as consistent with China's role as a "responsible" player in the international financial system. This self-perception as a responsible actor would have argued against using a drastic threat to the U.S. financial system, such as selling U.S. government bonds en masse. China portrayed its exchange rate reforms as "responsible" in line with the recommendations in multilateral financial summits for actions to correct global economic imbalances via additional exchange rate flexibility in surplus countries, rather than framing this responsibility in terms of China's relationship with the United States. Political pressure and China's concern about its relationship with the United States and with the international community can provide a partial explanation of change in China's exchange rate regime, but not the modest form of change that occurred or the course of the Chinese political debate that produced the July 2005 reforms.

Exchange Rate Reform and Chinese Foreign Policy

The case of China's exchange rate reform also implicates the academic literature concerning the drivers of China's foreign policy, since the issue of exchange rate reform was a high-profile issue within China's most significant bilateral relationship, and Chinese leaders faced external pressure in multilateral summits on the issue as well. Conventional explanations of China's exchange rate reform drawn from the literatures described previously have difficulty explaining both the timing and the modest form of change that occurred in July 2005. While China ended the yuan's peg to the dollar and introduced additional market influence over the exchange rate, the change fell far short of both the demands of China's foreign critics, and the limited nature of the change failed to provide China's central bank with additional autonomy in monetary policy. At the same time, explanations focused on China's domestic politics, drawing from bureaucratic or elite politics literatures, would have predicted virtually no change at all, since there were powerful domestic opponents of exchange rate reform.

China's exchange rate reforms were the product of both international norms arguing for the superior functionality of flexible exchange rate regimes and China's changing self-perceptions, with Chinese leaders eager to present the nation as acting responsibly in maintaining the stability of the global financial system. This notion of responsibility emerges throughout the narrative of exchange rate reform described in the following chapters, and provides some insight into the influence of international norms in shaping China's exchange rate reforms. The eventual modest nature of the reforms allowed China's leaders to argue that their exchange rate regime was developing in line with the international consensus behind exchange rate flexibility, and were consistent with China's responsibilities to play a part in remedying global economic imbalances.

The academic literature concerning Chinese foreign policy has discussed the change in China's pattern of engagement with the rest of the world and changes in China's approach to international institutions over the last two decades. Most of this literature has emphasized security concerns, rather than economic factors, but economic diplomacy has been critical to this changing approach toward the legitimacy of international institutions as well; China has adopted a more aggressive posture in advancing the nation's interests through diplomatic means in recent years.[122] The debate over the importance of these developments generally focuses on the extent to which China is being integrated and socialized into the international community, along with the dominant norms of behavior within the international community. Allen Carlson, for example, described China's changing views on sovereignty, particularly with regard to changes in views of the legitimacy of humanitarian intervention, explaining that ideational factors did provide some degree of influence over China's conception of the national interest, although ideational factors were not the only relevant variables.[123] Margaret Pearson's work on China's activities in the WTO since joining the body in 2001 argues that, amid a wide range of behavior that can sometimes be difficult to categorize, China is basically working within the rules of the institution, is not challenging the legitimacy of those rules, and has a stake in appearing as a cooperative member of the

[122] For example, see Medeiros and Fravel, "China's New Diplomacy," and David Shambaugh, "China Engages Asia," *International Security* **29**: 3 (Winter 2004/5), p. 64-99, and Kokubun Ryosei and Wang Jisi, eds., *The Rise of China and a Changing East Asian Order* (Tokyo: Japan Center for International Exchange, 2004). Robert Sutter also provides a more balanced view of this shift in *China's Rise in Asia: Promises and Perils* (London: Rowman and Littlefield, 2005). See also Robert Sutter, "China's Rise in Asia--Promises, Prospects and Implications for the United States," Asia-Pacific Center for Security Studies, Occasional Paper Series, February 2005.

[123] Allen Carlson, "More Than Just Saying No: China's Evolving Approach to Sovereignty and Intervention After Tiananmen," in Alastair Iain Johnston and Robert S. Ross, eds., *New Directions in the Study of China's Foreign Policy* (Stanford: Stanford University Press, 2006), p. 217-235.

WTO.[124] The question of the extent to which China embraces and can be influenced by international norms is central to the academic debate over the drivers of China's foreign policy behavior and the changes in China's approach to international institutions.

This debate also engages Chinese views of the drivers of China's foreign policy, and is not confined to foreign scholars. In 2003 and 2004, a school of thought discussing China's "peaceful rise" emerged within domestic intellectual circles, led primarily by Zheng Bijian of the China Reform Forum. The idea of China's "peaceful rise" was an attempt to manage China's emergence as a great power while working within the preexisting international order, rather than challenging it. Consistent with this idea is a new attitude toward international institutions, in which China attempts to maximize influence by working within existing international institutions, rather than supplanting them, as rising powers have attempted in the past. This idea circulated throughout China's academic and policy advisory bodies and attracted some powerful advocates, although during this process, the term "peaceful rise" attracted some domestic critics who favored the term "peaceful development."[125]

In the area of exchange rate policy, China has attempted to portray its exchange rate regime as consistent with global and regional economic stability. Following the Asian financial crisis, Chinese officials emphasized the country's reluctance to engage in competitive devaluations as a responsible step. Samuel Kim noted that the primary factor that Chinese leaders considered in response to the crisis was "China's integration into the

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[124] Margaret Pearson, "China in Geneva," in in Alastair Iain Johnston and Robert S. Ross, eds., *New Directions in the Study of China's Foreign Policy* (Stanford: Stanford University Press, 2006), p. 242-275.
[125] For an extensive look at the emergence of the "peaceful rise" theory in Chinese foreign policy, see Bonnie S. Glaser and Evan S. Medeiros, "The Changing Ecology of Foreign Policy-Making in China: The Ascension and Demise of the Theory of 'Peaceful Rise'," *China Quarterly* **190** (June 2007), p. 291-310. See also Robert Suettinger, "The Rise and Descent of 'Peaceful Rise'," *China Leadership Monitor,* no. 12 (Fall 2004).

global community as a responsible great power."[126] Wang Hongying noted that China's exchange rate policy following the crisis entailed reputational benefits, as China wanted to be seen as acting responsibly toward the international economic system before entering the WTO.[127] While a responsible stance toward the international system in exchange rate policy required a fixed exchange rate regime following the Asian financial crisis, the emergence of global imbalances, and the role of China's exchange rate regime in driving those imbalances, redefined responsibility as involving additional exchange rate flexibility. As the following chapters will demonstrate, this notion of responsibility was a significant factor throughout the debate over China's exchange rate reform.

The debate within the Chinese foreign policy literature on China's changing approach toward engagement with international institutions has centered largely around two explanations identified first by Alastair Iain Johnston: adaptation and learning.[128] Johnston's categories were meant to organize multiple explanations for changes in Soviet foreign policy in the Gorbachev era, and he then looked for similar behavior in Chinese arms control policy. According to Johnston, behavior consistent with adaptation to international norms basically implies a short-term accommodation to those standards of behavior for the purpose of political expediency, but without fundamental changes to foreign policy preferences. Learning, in contrast, implies a deeper process of rethinking those basic preferences, which may occur based on the influence of international norms. Therefore, if adaptation strategies dominate, compliance with international norms is

[126] Samuel S. Kim, "Chinese Foreign Policy Faces Globalization Challenges," in Alastair Iain Johnston and Robert S. Ross, *New Directions in the Study of China's Foreign Policy* (Stanford: Stanford University Press, 2006), p. 286.
[127] Wang Hongying, "China's Exchange Rate Policy in the Aftermath of the Asian Financial Crisis," in Jonathan Kirshner, ed., *Monetary Orders: Ambiguous Economics, Ubiquitous Politics* (Ithaca, NY: Cornell University Press, 2003), p. 153-171.
[128] Alastair Iain Johnston, "Learning Versus Adaptation: Explaining Change in Chinese Arms Control Policy in the 1980s and 1990s," *The China Journal* **35** (January 1996), p. 27-61.

likely to be contingent upon the institutional constraints and changes in the costs and benefits of joining those institutions. However, if learning strategies dominate, formal institutional structures are less necessary, because the state has reconsidered its interests in line with international standards of behavior.

Much of the debate concerning the influence of ideas over China's changing approach toward international institutions centers heavily upon these two types of explanations, involving either strategic adaptation or learning, and a change in preferences. Scholars focusing on China's adaptation to the rules of the international system would argue that China's fundamental foreign policy goals have not changed, but China is attempting to improve its diplomatic image in order to enable the fulfillment of those long-term objectives, which usually include reducing U.S. influence in Asia. However, the learning perspective would argue that China is changing its approach toward international institutions because of a more fundamental shift in China's perceptions of its long-term interests, and that these interests are more consistent with those of the rest of the world; hence, China perceives itself as a responsible actor in the international system, rather than simply wanting to be perceived as a responsible actor. The basic argument under the learning approach would conclude that China's changing self-perceptions as a responsible actor in the international system have emerged in the 21st century as a byproduct of the country's rapid economic development and increasing importance in the global economy and the international political system.

In the case of exchange rate policy, there are two different sets of international norms involved in driving China's exchange rate reforms. The first is the international consensus behind the efficacy of flexible exchange rate regimes, which emerged

following the Asian financial crisis. The evidence suggests that reformers in China's central bank were gradually introduced to these ideas through interaction with international financial institutions such as the International Monetary Fund, and they changed their conceptions of the benefits of exchange rate flexibility for China's long-term economic interests. For the reformers in the central bank, their behavior can be consistent with "learning"-related explanations. However, the behavior of the rest of the bureaucracy, including several powerful ministries, did not reflect learning or adaptation, but outright opposition to the international consensus behind exchange rate flexibility.

The second set of ideational factors involved in China's exchange rate reform concerned the notion of China as a responsible player in the international monetary system. Amid this bureaucratic debate, China's top leaders in the State Council had few firm preconceived ideas about exchange rate policy, but accepted the central bank's arguments because of their consistency with an international consensus. For China's top leadership, the content of the international consensus behind exchange rate flexibility was less significant than the procedural nature of the consensus. This type of behavior is difficult to categorize as either adaptation or learning, but the evidence does indicate that the idea of China as a responsible actor was influential in driving forward additional exchange rate flexibility over considerable domestic opposition. This attempt to position China's reforms within an international consensus on exchange rate policy that has changed over time also suggests that there is little evidence of a "grand strategy" involving long-term plans in the area of China's economic reform and opening.[129] This also implies that adaptation-style behavior is unlikely to occur in Chinese economic

[129] Thomas J. Christensen, Alastair Iain Johnston, and Robert S. Ross, "Conclusions and Future Directions," in Alastair Iain Johnston and Robert S. Ross, eds. *New Directions in the Study of China's Foreign Policy* (Stanford: Stanford University Press, 2006), p. 406.

policy, if there is not a without a well-defined long-term grand strategy in economic policy, other than becoming rich and powerful. In making one of the most critical economic policy decisions of the past decade, with considerable implications for the legitimacy of the rule of the Chinese Communist Party, China's self-perception as a responsible global actor influenced the leadership's conceptions of China's interests in the area of exchange rate policy.

The domestic debate over the reform of China's exchange rate regime reveals the changing approach to the legitimacy of international institutions seen elsewhere in Chinese foreign policy, with the concept of "responsibility" in exchange rate policy assuming a prominent role in this debate. The idea of China acting responsibly in the international system assumes that China will avoid mercantilist and protectionist trade behavior, and that China will behave as a force for stability in an economic sense as well as reinforcing other states' security. Zheng Bijian, a key figure in the school of thought associated with China's "peaceful rise," argues that economic protectionism and mercantilism were essential characteristics reinforcing the escalation of conflict resulting from the rise of previous great powers, and he argues China will need to take steps to avoid these misperceptions in the economic realm as well.[130] In addition, many economists analyze the exchange rate regime and the reform of China's financial system in a political vacuum. Many currency analysts based in Hong Kong, New York, or London assume, implicitly or explicitly, that China's economic decision-makers will act

[130] Suettinger, and Zheng Bijian, "China's 'Peaceful Rise' to Great-Power Status," *Foreign Affairs* **84**:5 (September/October 2005): 18-24. In Zheng's own article in *Foreign Affairs*, he claims, "The most significant strategic choice the Chinese have made was to embrace economic globalization rather than detach themselves from it." Zheng, 20.

ultimately in line with a narrow conception of China's economic self-interest.[131] The idea that China is acting "responsibly" in the international arena argues that the political calculations resulting from China's economic engagement with the Asia-Pacific region and the world matter as well in reconstituting China's conceptions of its economic interests, while influencing China's exchange rate policies. Over time, they are also likely to influence market reactions to policy changes.

Once China has committed publicly to a particular conception of their economic engagement with the global economy, they will entail both political and economic costs in reversing course, as the assumptions of observers of China in international financial markets will play an important role in influencing capital flows entering and leaving the Chinese financial system. For this reason, the ideas by which China justifies the reform of its financial system are significant in explaining the course of reform and the consequences of these reforms. In arguing for additional exchange rate flexibility, reformers within China's central bank were able to position China's exchange rate reform as a mechanism for improving China's reputation as a responsible global citizen, playing its part to remedy global economic imbalances. This explains both China's public commitment to additional flexibility, as well as the modest nature of China's exchange rate reforms; China's leaders wanted the benefits of appearing to fulfill their global responsibilities, while some Chinese bureaucratic institutions were strongly opposed to rapid adjustments in China's exchange rate. China's changing self-perceptions as a responsible actor, as well as the international consensus behind flexible exchange rate regimes, effectively changed how China's leaders viewed the nation's interests, providing a more compelling explanation than purely rationalist arguments focused on China's

[131] Interview 05-31.

economic performance or international pressure. The following chapters explain how these international norms became relevant within Chinese domestic politics, and ultimately produced the exchange rate reforms of July 2005.

Chapter 4- Reformers in the Central Bank and the Origin of Exchange Rate Reforms

This chapter will demonstrate how reforms to China's exchange rate regime emerged within China's political system, by describing the processes by which two different sets of intersubjective understandings surrounding flexible exchange rate regimes became relevant in Chinese policy debates. The first set of norms and ideas concerns the operational efficacy of flexible exchange rate regimes in limiting financial crises and preserving domestic monetary policy tools. The second set of norms concerns the broader political consensus behind flexible exchange rate regimes as the dominant system in the global economy; the consensus behind the norm is more influential here than the efficacy of flexible exchange rate regimes themselves. Both are ideational factors, but the first set of norms reflects shared understandings concerning causal relationships, while the second reflects China's image of itself as a responsible actor in the international system. China's central bankers were largely concerned with the first set of norms, and China's top leaders were largely concerned with the second set, which reflected their vision of China's expanding role in the global economy.

This chapter will start by describing the reform-oriented central bank officials who pushed for exchange rate flexibility, and the ways in which the influence of

international financial institutions, including the International Monetary Fund, may have structured the preferences of these central bankers and their views of China's economic interests. Subsequently, the chapter will detail the channels by which Chinese leaders were receptive to these international norms. China's financial reform has depended heavily upon international technical expertise in the restructuring and reorganization of Chinese institutions, and this pattern of financial reform contributed to the top leadership's openness to international norms of flexible exchange rate regimes. In addition, China's top leadership was open to international norms in part because of changes in China's approach to international institutions over roughly the past decade. The chapter will explain the processes through which these ideational factors influenced the positions of the key players in the debate. It will attempt to explain why the reformers at the PBOC pushed for exchange rate reform in internal political debates, and why China's top leaders were interested in the central bank's ideas, which gained legitimacy from the advocacy of international institutions.

The following chapter will detail the bureaucratic debate itself, including the recommendations from foreign governments, which eventually produced the exchange rate reforms of July 21, 2005. In addition, Chapter 6 will attempt to demonstrate the domestic salience of these international financial norms in China using a framework developed by Andrew Cortell and James Davis. In addition, this chapter will discuss whether and how Chinese leaders and institutions are "adapting" or "learning" in response to international financial norms.

Reformers and the Legacy of the Asian Financial Crisis

In attempting to characterize any individual or group's causal beliefs, demonstrating where autonomous preferences end and structural constraints begin is always a challenge. In studies of Chinese politics, it is common for studies to characterize "reformers" and "conservatives" locking horns over a particular policy issue, while those labels may simply obscure the importance of the subjects' positions within Chinese institutions, resulting in mislabeling a conflict about bureaucratic or institutional interests as a conflict over the pace and direction of change. However, for the purposes of this chapter, and the dependent variable of this study, "reformers" will be disaggregated from "conservatives" on exchange rate policy regardless of the institution in which they worked. Based on several interviews within the Chinese bureaucracy and analysis of the secondary literature, advocates for a more flexible exchange rate regime were concentrated almost exclusively within the central bank, the People's Bank of China (PBOC), and advisors to the central bank. The PBOC was not a unified institution on the issue of exchange rate flexibility; although there may have been institutional reasons to favor the independence in monetary policy that exchange rate flexibility would create, these were not shared universally within the central bank.

The emergence of support for flexible exchange rate regimes within the Chinese bureaucracy fits into a larger debate concerning the domestic salience and political relevance of international norms: why do some ideas become important in certain political contexts and why are others cast aside? Throughout the interviews conducted for this study in China, the leadership of the central bank was defined as either "liberal" or "reformist" in orientation, reflecting their policy preferences even in debates within the

central bank itself. Yet where did these liberal views come from, and how were they different from the rest of China's economic policy-making apparatus? Why were the central bankers leading the push for reform, besides their institutional position?

The process by which dominant international norms and best practices become acceptable, logical, and reasonable within a particular domestic context has been the subject of considerable study among both constructivists and Gramscians within international political economy. At issue in most of these works are the mechanisms of hegemonic power in compelling change in peripheral states that is in line with the hegemon's interests and the prevailing international standards of behavior. The story of China's exchange rate reform, however, reflects the influence of two different types of norms, as mentioned previously. At one level, reformist officials within the central bank became advocates of the post-Asian financial crisis international consensus concerning the questionable sustainability of fixed exchange rates, and the benefits to exiting these regimes when times were good, under conditions of capital inflow, rather than allowing speculators to force a devaluation. At another level, Chinese leaders were interested in the larger project of normalizing China within the international system, and presenting China as a more responsible player in international politics, which required a reorientation of China's exchange rate regime.

The process described here involves the legitimation of international financial norms within a group of Chinese officials whose ideas became influential under very limited conditions. Ikenberry and Kupchan describe a similar process when they discuss the distinction between hegemonic power that operates on the basis of material incentives

and power that operates at the level of substantive beliefs.[132] According to Ikenberry and Kupchan, "Elites in secondary states buy into and internalize norms that are articulated by the hegemon and therefore pursue policies consistent with the hegemon's notion of international order. The exercise of power--and hence the mechanism through which compliance is achieved--involves the projection by the hegemon of a set of norms and their embrace by leaders in other nations."[133] In China's case, one argument of this study is that lower-level elites in China's central bank internalized the ideas surrounding the efficacy of flexible exchange rate regimes and then argued successfully to China's State Council that reform of the exchange rate regime would be in China's interest. China's top leadership acquiesced to the change not out of a belief in a flexible exchange rate regime's efficacy, but because it was in line with international financial best practices and demonstrated China acting responsibly on the international stage. In their discussion of these processes through which norms become influential, Ikenberry and Kupchan draw upon crises and wars as catalysts for socialization, as turmoil and reorganization leads to the creation of new conventional wisdom.[134] "At the domestic level, crisis creates an environment in which elites seek alternatives to existing norms that have been discredited by events and in which new norms offer opportunities for political gains and coalitional realignment."[135] In China's context, as discussed previously, the Asian financial crisis played such a role, as it raised the question of fixed exchange rate regimes' sustainability in the eyes of reformers.

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[132] G. John Ikenberry and Charles Kupchan, "Socialization and Hegemonic Power," *International Organization* **44**:3 (1990), p. 283.
[133] *Ibid.*
[134] Ikenberry and Kupchan, p. 284.
[135] Ikenberry and Kupchan, p. 284.

As discussed in Chapter 2, under conditions of capital mobility, flexible exchange rate regimes provide states with autonomy over monetary policy, and fixed exchange rate regimes relinquish control over monetary policy for the purpose of maintaining the exchange rate regime, effectively substituting external for internal adjustment. Following the Argentine financial crisis in particular, doubts about the sustainability of fixed exchange rate regimes began to form throughout global financial circles; the Argentine currency board arrangement had been considered fairly credible, and its collapse, with consequent effects on the real economy, suggested that floating exchange rate regimes could help to mitigate crises by avoiding the abrupt dislocations that losses in credibility of fixed but adjustable pegs entailed.[136]

The supporters of exchange rate reform within China were heavily influenced by the lessons of the 1997 Asian financial crisis, which ironically coincided with pressure on China to maintain their peg to an appreciating U.S. dollar during a period when Chinese export growth was suffering. For many countries in Asia, particularly Thailand, Malaysia, and the Republic of Korea, the combination of pegging to an appreciating currency (the U.S. dollar) and a buildup of external indebtedness contributed to a rise of speculative pressure on the credibility of these countries' currency pegs. In combination with liberalized capital accounts, international currency speculators were effectively able to force these nations' foreign exchange reserves into untenably low positions, forcing the countries to float their currencies, with resulting abrupt depreciations. Because China's currency remains non-convertible on the capital account, the yuan was not

[136] Mark Spiegel, "Argentina's Currency Crisis: Lessons for Asia," FRBSF Economic Letter, 2002-25, August 23, 2002, http://www.frbsf.org/publications/economics/letter/2002/el2002-25.html.

subject to the same pressures; foreign holdings of yuan were limited, and could not be exchanged in international markets. As a result, there was little pressure on China's foreign exchange reserves, even though capital probably flowed out of China unofficially during the late 1990s. In an environment of rapidly declining Asian demand for its exports, China was expected by many to devalue its currency in order to stimulate the economy. However, the Chinese response was to tighten the narrow range in which the currency traded against the dollar, as well as delaying the country's existing plans for liberalizing the capital account, following the trade account's full liberalization in 1996. Leong H. Liew, in a study of the Chinese decision not to devalue the yuan during this time, discusses the fact that China's decision earned the nation plaudits throughout the region for acting responsibly in the face of a shared period of economic difficulty for Asia.[137]

However, the Asian financial crisis challenged Chinese policy-makers in a more indirect fashion as well, and the seeds of exchange rate reform emerged out of the lessons that Chinese officials drew from the crisis. Chinese officials saw many similarities between their own system and the economies of the fast-growing Asian nations affected by the crisis. State-owned or state-directed lending to large state-linked conglomerates was a common phenomenon throughout the region, and this was a critical pillar of China's growth strategy as well. First and foremost, the crisis provided a powerful lesson about the combination of capital account liberalization and fixed exchange rate regimes. Exposed to the whims of international speculators, Thailand, Malaysia, and Korea were unable to maintain the credibility of their pegs while foreign exchange reserves dwindled.

[137] Leong H. Liew, "Policy Elites in the Political Economy of China's Exchange Rate Policymaking," *Journal of Contemporary China* 13 (February 2004): 21-51.

Joseph Stiglitz later attributed the collapse of these financial systems to the liberalization of the capital account, but Chinese policymakers meeting immediately following the crisis drew these conclusions relatively quickly.[138] The Chinese literature concerning the causes of the Asian financial crisis focused heavily on the impact of international speculators, and concern about "hot money" from international speculators continues to plague Chinese discussions of the potential for capital account liberalization.[139] For example, even in late 2007, after China had been battling large capital inflows for nearly five years, a statement in the State Administration of Foreign Exchange's H1 2007 Balance of Payments report warned about the potential for capital outflows in the event of a decline in Chinese equity and property prices.[140] The immediate Chinese policy response in the aftermath of the Asian crisis, of course, was to tighten the trading band of the yuan against the dollar in order to shore up the central bank's credibility, as well as tightening capital inflows, but one of the lessons that emerged from discussions of the crisis was that it was better to exit from fixed exchange rate regimes under conditions of capital inflow rather than capital outflow, in order to avoid the rapid fluctuations that occur when exiting under the threat of speculation, when foreign exchange reserves are exhausted. As discussed in Chapter 2, the sustainability of fixed exchange rates depend

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[138] Joseph Stiglitz, Globalization and its Discontents, 2002, (New York: W.W. Norton, 2002), p. 89-132, Wang Hongying, "The Asian financial crisis and financial reforms in China," *The Pacific Review*, vol. 12, no. 4 (1999), p. 537-556,and Edward Steinfeld, "The Asian Financial Crisis: Beijing's Year of Reckoning," The *Washington Quarterly* **21**:3 (Summer 1998), 38-39.

[139] Interview 07-103, Interview 07-151, as well as Pang Zhongying, "Guoji Jinrong Tixi Yunniang Gaige," [International financial system considers reform, *People's Daily*, 9 April 1998, and Guan Chajia, "Jingji quanqiuhua huhuan jinrong anquan," [Economic globalization calls for financial security] *People's Daily Overseas Edition*, 22 October 1998.

[140] State Administration of Foreign Exchange, H1 2007 Balance of Payments Report, published October 31, 2007. The statement says, "In general, the continuous rise in prices of domestic assets is a reflection of global excess liquidity in domestic financial markets. Asset appreciation has passed the interest rate gap and exchange rate appreciation to become an important factor attracting foreign capital inflows. In future, if the situation reverses, that capital may flow out, enhancing the risks to the international balance of payments."

upon the ability of central banks to provide market participants with a credible commitment to maintain and defend the peg.

The Chinese officials interested in a more flexible exchange rate regime drew heavily from expertise gained through repeated interactions with international financial institutions. Whereas in the past, international monetary cooperation involved commitment to a fixed exchange rate regime and internal rather than external adjustment, the post-Bretton Woods global monetary order has been dominated by flexible exchange rate regimes. As a result, international financial institutions responsible for sustaining the stability of the current global monetary order typically operate under a set of assumptions, stated or unstated, regarding the desirability of flexible exchange rate regimes over fixed regimes.

After the Asian financial crisis demonstrated the dramatic fluctuations that can result from fixed exchange rate regimes, and the Argentine financial crisis of 2001-2002 was arguably more severe on account of the country's dramatic exit from a currency board arrangement, the IMF began to recommend more flexibility in countries' choices of exchange rate regimes.[141] In its 1977 Decision on Surveillance over Exchange Rate Policies, the IMF claimed that it would discuss exchange rate policies with a member state if the Fund found evidence of several phenomena that are common under fixed exchange rate regimes, including intervention into the foreign exchange market and policies aimed to discourage or encourage capital inflows for balance of payments purposes.[142] However, the decision clearly couches its appraisals within the context of

[141] "The IMF's Advice on Exchange Rate Policy," Draft Issues Paper for an Evaluation by the Independent Evaluation Office, April 19, 2006. http://www.oecd.org/dataoecd/48/27/36543649.pdf.
[142] International Monetary Fund, 1977 Decision No. 5392, Decision on Surveillance Over Exchange Rate Policies. "The Fund's appraisal of a member's exchange rate policies shall be based on an evaluation of the

the "development of the orderly underlying conditions that are necessary for financial stability," and the IMF's guidance can vary and adapt "to the needs of international adjustment as they develop."[143] Therefore, the advice and recommendations of the IMF concerning states' exchange rate policies can vary considerably depending upon the prevailing ideas at the Fund about the efficacy of particular exchange rate regimes.

However, these prevailing ideas at the IMF are not politically neutral. As we noted in Chapter 2, flexible exchange rate regimes provide international capital with additional political influence in most domestic contexts, and the linkage between global fixed exchange rate regimes and international political order has been the subject of considerable study.[144] Martha Finnemore and Michael Barnett discuss international organizations, including international financial institutions, as bureaucracies.[145] Under these conditions, the literature concerning the organizational behavior of those bureaucracies can be useful in studying the outcomes produced by these institutions. Finnemore and Barnett describe a variety of sources of authority for international organizations, but the most relevant for the study of exchange rate regimes is the legitimizing effect of expertise.

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developments in the member's balance of payments, including the size and sustainability of capital flows, against the background of its reserve position and its external indebtedness. This appraisal shall be made within the framework of a comprehensive analysis of the general economic situation and economic policy strategy of the member, and shall recognize that domestic as well as external policies can contribute to timely adjustment of the balance of payments. The appraisal shall take into account the extent to which the policies of the member, including its exchange rate policies, serve the objectives of the continuing development of the orderly underlying conditions that are necessary for financial stability, the promotion of sustained sound economic growth, and reasonable levels of employment."

[143] *Ibid.*

[144] Eichengreen, "The Endogeneity of Exchange Rate Regimes," and Barry Eichengreen, *Globalizing Capital: A History of the International Monetary System* (Princeton: Princeton University Press, 1996), and Francis T. Gavin, *Gold, Dollars, and Power* (Chapel Hill, NC: University of North Carolina Press, 2004).

[145] Martha Finnemore and Michael Barnett, *Rules for the World: International Organizations in Global Politics* (Ithaca, NY: Cornell University Press, 2004), p. ix.

Finnemore and Barnett explain that providing expertise is one of the functions of bureaucracies composed of functional specialists, and the existence of this expertise within the context of an international organization provides the organization with a "rational-legal" authority.[146] In addition, the specific expertise of international organizations is presented as essentially apolitical, but authoritative. As Finnemore and Barnett explain, "Expert authority also enables IOs to be powerful by creating the appearance of depoliticization. By emphasizing the 'objective' nature of their knowledge, staff of IOs are able to present themselves as technocrats whose advice is unaffected by partisan squabbles."[147] Finnemore and Barnett explain the process by which the IMF's recommendations can acquire considerable authority, particularly in a country such as China interested in both seeking outside advice on financial reform and presenting such reforms as acceptable to the rest of the world. This is one of the explanations for the receptiveness of Chinese financial officials to such technical consultations when the IMF began to recommend more flexible exchange rate regimes following the Asian and Argentine financial crises. China was interested in avoiding a repeat of the Asian financial crisis, and technical knowledge of financial affairs was sparse within Chinese government institutions. The IMF's new ideas concerning the questionable sustainability of fixed exchange rate regimes, therefore, were likely to find fertile ground in the minds of Chinese financial technocrats tasked with avoiding a 1997-style financial crisis in China.

The mechanisms Finnemore and Barnett describe explain how the IMF's technocratic expertise provided a vehicle to present exchange rate flexibility to Chinese

[146] Finnemore and Barnett, p. 24.
[147] *Ibid.*

reformers as advantageous and stabilizing compared to China's pre-2005 fixed exchange rate regime. "The ability to use expertise and knowledge is the Fund's most important source of autonomy. The staff's technical knowledge, solid credentials in monetary policymaking, and experience in the field have made the organization "an authority" and a credible source of policy advice. Its delgated mandate to promote financial stability places it 'in authority' in matters of macroeconomic policy. . ."[148] Finnemore and Barnett argue that within the IMF, Fund staff are interested in providing technical assistance to countries on the basis of the Fund's expertise in improving market efficiency, information disclosure, and limiting the risk of financial crises; technical advice to Chinese officials interested in reforming and modernizing China's financial institutions would definitely fit within that mandate.[149]

The power of these recommendations provided legitimacy to the consensus within the IMF on the desirability of flexible exchange rate regimes in avoiding financial crises similar to those in Korea, Thailand, and Argentina. The political force of these recommendations largely came from the perception of the IMF's objectivity and technical expertise, even though these recommendations were not politically neutral.[150] In China's case, the post-Asian financial crisis debate concerning the conditionality of IMF programs was irrelevant; China was not borrowing extensively from the Fund and Chinese officials were actively seeking technical assistance. The influence of international financial norms substituted for direct, juridical forms of influence, and the IMF's calls for more flexibility in exchange rate systems were reinforced by the authority of the Fund's technical expertise. As Finnemore and Barnett explain, "What makes the

[148] Finnemore and Barnett, p. 50.
[149] Finnemore and Barnett, p. 64.
[150] Finnemore and Barnett, p. 68.

prescriptions of the Fund so authoritative is that they are undergirded by a body of economic analysis that is accepted by a large number of economists in many countries. The Fund's expertise creates some amount of agreement that certain basic features of the Fund's model and stabilization programs are right and true in some objective way."[151] While China was not in need of a stabilization program, the legitimacy surrounding the idea of a broad international consensus behind more flexible exchange rate regimes was a key factor in advancing exchange rate flexibility within Chinese policy circles.

The Notion of Flexible Exchange Rates in China

At the same time that global conventional wisdom was beginning to shift toward the efficacy of flexible exchange rate regimes in avoiding abrupt shocks to the credibility of currency pegs, the Asian financial crisis had startled Chinese policymakers, who were determined to avoid the fates of Thailand, Korea, and especially Indonesia. A new generation of Chinese technocrats took note of the global consensus regarding the lessons of the Asian and Argentine financial crises, and when China's international imbalances intensified starting in 2002, began to question the utility of China's fixed exchange rate regime. Many of these technocrats ended up at the central bank, the People's Bank of China, where they interacted frequently with the IMF and the World Bank. Through these interactions, the PBOC became the primary locus for the "reformers" in China's financial system, who were generally more apt to be Western-educated and interacted with global financial institutions.

[151] *Ibid.*

In addition to the external risks of excessive exchange rate rigidity and the possibility of financial crisis, the reformers at the PBOC began to argue that a more flexible exchange rate regime would allow them to wield a more independent, autonomous monetary policy as a weapon against China's growing internal imbalances.[152] These imbalances included excessive investment and credit growth, which forced China's leaders to face the threats of overcapacity, declining profits, insufficient demand, and another round of non-performing loans in China's fragile banking system. Barry Naughton characterizes most of those interested in exchange rate reform at the central bank as "macro" economists, in contrast to narrower "structural" economists at the National Development and Reform Commission (NDRC).[153] According to Naughton, the "structural" economists basically argued that China's imbalances were due to narrow inefficiencies in each individual sector, while the "macro" economists, represented institutionally at the PBOC and the Ministry of Finance, claimed that China's imbalances were essentially macroeconomic phenomena resulting from China's current and capital account surpluses.[154] As a result, the "macro" economists believed that remedies should be found in monetary policy, either in the form of interest rate adjustments or exchange rate adjustments. However, because China's monetary policy was essentially hamstrung by the combination of capital inflows and the central bank's commitment to the yuan-dollar exchange rate at 8.276, exchange rate adjustment was necessary in order to provide the central bank with a greater degree of monetary policy autonomy.

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[152] Interview 05-13, Interview 06-133, Interview 06-111.
[153] Barry Naughton, "Economic Policy in 2004: Slipping Behind the Curve?" *China Leadership Monitor,* No. 13.
[154] *Ibid.*

The principal arguments of the "reformers" were that moving to a floating exchange rate regime would assist China's economy in shifting toward a focus on domestic demand rather than investment and export-led growth, as well as rebalancing China's economic growth away from coastal export-oriented industry and toward the development of central and Western regions, which was a key priority of the Hu-Wen leadership.[155] Investment and export-led growth eventually faced diminishing returns, and relied upon external demand to sustain China's economy. Higher exchange rates would shift production away from export-oriented industries and boost the purchasing power of China's consumers, encouraging domestic consumption. At the same time, greater movement in the yuan would allow the central bank to raise interest rates and slow the rapid growth of domestic credit and fixed asset investment, which eventually may contribute to inflation and asset bubbles.[156] In addition, an article in the People's Daily explaining the rationale for the July 2005 exchange rate reforms after their announcement drew attention to the risks involved in speculative capital movements that were encouraged by fixed exchange rates, drawing links between these speculative capital movements and the Asian financial crisis, as well as the Mexican peso crisis.[157] The article also drew attention to the fact that it was better to exit a fixed exchange rate regime when times were good and under conditions of capital inflow, rather than under duress, and used the examples of Poland and Thailand as instructive comparisons.[158] The

[155] People's Daily, "RMB Exchange Rate Reform- Decided Out of China's Own Need," http://english.people.com.cn/200507/29/eng20050729_199104.html
[156] Interview 06-120, Interview 05-13, Interview 07-106.
[157] People's Daily, "RMB Exchange Rate Reform- Decided Out of China's Own Need," http://english.people.com.cn/200507/29/eng20050729_199104.html
[158] *Ibid.* The People's Daily article claimed, with reference to Poland and Thailand, "Internationally, since the 1990s, Poland has experienced the evolution from a managed floating exchange rate system under which its currency was pegged to one, or a basket of currencies to a free floating exchange rate system. Because its exchange rate system was actively adjusted in light of changes in domestic and foreign

People's Daily editorial read, "If the exchange rate must be reformed, then an active reform is better than a passive one; reform carried out under revaluation pressure is better than reform carried out under devaluation pressure."[159] Some voices in the Chinese bureaucracy had taken the IMF's lessons to heart, and the Communist Party's primary mouthpiece was happy to use their justifications publicly when discussing the central government's exchange rate reforms.

The IMF's recommendations for additional exchange rate flexibility for China began shortly following the Asian financial crisis, but these initial recommendations were strongly measured by praise for the stabilizing effect that China's fixed exchange rate regime had provided for the region following the Asian financial crisis. While Chinese policymakers often referenced the stabilizing effect of their exchange rate peg on the economies of post-crisis Asia, this decision also reflected technocrats' concerns about devaluation prompting withdrawals of deposits from the banking system.[160] However, the Chinese financial authorities were always aware of the eventual consequences of maintaining a fixed exchange rate regime. Former PBOC Governor Dai Xianglong commented in a statement at the IMF Board of Governors meeting in September 1999 that, "Economic theory and practice have proven that under the current international monetary system, a country cannot have an independent monetary policy, stable exchange rate, and achieve capital liberalization at the same time. The selection of an

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situations, therefore it could avoid to the maximum possible economic-social upheavals. While Thailand had, before 1997, all along pegged its currency to the US dollar without changing its exchange rate system, as a result, the country was compelled to drastically devalue its currency during the Asian financial crisis, thus resulting in the outbreak of the monetary and financial crisis."

[159] *Ibid.*

[160] Edward Steinfeld, "The Asian Financial Crisis: Beijing's Year of Reckoning," The *Washington Quarterly* **21**:3 (Summer 1998), p. 46.

exchange rate regime eventually relies on a compromise of these three objectives."[161] The compromise of monetary policy autonomy, therefore, was an accepted consequence of maintaining exchange rate flexibility among Chinese political leaders following the Asian financial crisis.

The IMF was consistent in advocating a gradual shift toward greater exchange rate flexibility following the Asian financial crisis, and the IMF's calls for reform intensified over time, in line with China's growing payments imbalances. An analysis of IMF Article IV reports concerning Fund staff's consultations with Chinese policymakers reveals that calls for more flexible exchange rates began as early as 1999 (according to IMF staff), and in 2000 within the reports, when IMF Directors noted that "conditions are favorable for moving toward greater exchange rate flexibility to facilitate adjustment to ongoing structural changes and WTO accession."[162] The IMF's argument at that time was that "the renminbi appears broadly in line with fundamentals," so the costs of introducing additional exchange rate flexibility would be minimal.[163] To that end, the Fund advocated a wider trading band around a rate that would be based on a basket of currencies. In 2001, the Fund's logic and recommendations were similar, although from 2000 to 2002 there were no explicit references to the additional monetary policy autonomy that exchange rate flexibility would deliver.[164] In 2002, amid worries about

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[161] Dai Xianglong, Statement at the Fifty-Third Meeting of the Interim Committee of the Board of Governors of the International Monetary System, September 26, 1999, http://www.imf.org/external/am/1999/icstate/chn.htm.

[162] International Monetary Fund Public Information Notice No. 00/71, "IMF Concludes Article IV Consultation with China," September 1, 2000. The reference to IMF recommendations for additional flexibility beginning in 1999 comes from "Transcript of a Teleconference Call on the 2005 Article IV Staff Report on China with David Burton, Director of the Asia-Pacific Department and Steven Dunaway, Mission Chief to China," November 21, 2005, http://www.imf.org/external/np/tr/2005/tr051121.htm.

[163] *Ibid.*

[164] International Monetary Fund Public Information Notice, No. 01/91, "IMF Concludes 2001 Article IV Consultation with the People's Republic of China," August 24, 2001.

deflation in China, IMF Directors argued that China could move to greater flexibility "from a position of strength," and noted that China's real exchange rate had risen by 6 percent since the end of 1999, without impacting the competitiveness of Chinese exporters.[165]

In 2003, the IMF addressed the issue of China's undervalued exchange rate for the first time, and made the argument that additional monetary policy autonomy may be helpful for China's overall macroeconomic management. At the same time, the IMF noted that "there is no clear evidence that the renminbi is substantially undervalued at this juncture."[166] In addition, the Fund's Directors noted that exchange rate flexibility would "help cushion China's economy against adverse shocks, and facilitate adjustment to the major structural reforms that are underway."[167]

Later, as China's current account surpluses and foreign exchange reserves continued to balloon, the IMF grew more pointed in its recommendations for exchange rate flexibility. In 2004, the discussion of the problems from large capital inflows was significant enough to warrant inclusion in the Executive Summary of the Article IV report, where the document noted, that, "Greater exchange rate flexibility would enhance China's ability to pursue an independent monetary policy, as well as adjust to economic shocks and major structural changes."[168] In addition, the report noted that Chinese authorities were concerned about the impact of exchange rate flexibility on employment, noting that authorities believed China's economy needed to generate 20 to 25 million

[165] International Monetary Fund Public Information Notice, No. 02/97, "IMF Concludes 2002 Article IV Consultation with the People's Republic of China," September 3, 2002.
[166] International Monetary Fund Public Information Notice, No. 03/136, "IMF Concludes 2003 Article IV Consultation with the People's Republic of China," November 18, 2003.
[167] *Ibid.*
[168] International Monetary Fund, Article IV Consultation, 2004, p. 3.

new jobs per year for new entrants into the labor market.[169] The Fund argued for a significantly tighter monetary policy in its 2004 report, which would require a more flexible exchange rate regime. This section in particular was revealing concerning the debate at the time:

> While acknowledging the need eventually for increased exchange rate flexibility, the authorities have strong reservations about making an initial move in present circumstances. In particular, they were concerned that a small initial move could exacerbate capital inflows. The staff suggested that, if sizable speculative capital inflows were to continue, a larger initial move would be necessary.[170]

The end result of China's exchange rate reforms in July 2005 was a small initial move of 2.1 percent, suggesting that the views of the IMF's Chinese interlocutors were not necessarily determinative of the final form of China's exchange rate regime.

In 2005, the IMF's Article IV consultations took place before the exchange rate reforms were announced on July 21. The issue of additional exchange rate flexibility occupied a far larger proportion of the 2005 report relative to 2004, where Fund staff argued that the time was right for the introduction of additional flexibility, and delaying such a move would increase the costs of sterilizing capital inflows, risking the autonomy of China's monetary policy, which risked becoming hostage to fiscal objectives. As will be discussed in the next chapter, as capital inflows persisted, China's central bank ended up purchasing large volumes of dollars in the foreign exchange market, because private institutions expected the yuan to appreciate. In order to purchase those dollars, the PBOC provided yuan funds to market participants. In isolation, this would be inflationary, as it

[169] International Monetary Fund, Article IV Consultation, 2004, p. 12.
[170] International Monetary Fund, Article IV Consultation with the People's Republic of China, 2004, p. 12.

expands the money supply, so the central bank sold bonds into the Chinese interbank market and removed the yuan from the banking system temporarily, for the tenor of the bonds. As long as the capital flows continued, however, the central bank had to offer more paper for sale, and was forced to increase interest rates, and its own interest payments, in order to make the paper attractive to commercial banks. Thus, the fiscal costs of sterilization can increase rapidly under conditions of sustained capital inflows. These costs may make it more difficult for the central bank to raise interest rates in order to control massive credit and investment growth, which was the PBOC's primary objective in obtaining more monetary policy autonomy.

The IMF warned about these costs, and according to the 2005 report, their official Chinese interlocutors broadly agreed with their recommendations. As caveats to that agreement, however, the report states that Chinese authorities "broadly shared the staff's views on the advantages of increased exchange rate flexibility over the medium term, but noted that a consensus on the timing of a move had not yet been reached."[171] The Article IV report also noted that Wen Jiabao had commented subsequent to the Fund's consultations, on June 26, 2005, that China planned to "gradually establish a market-based and well-managed floating exchange rate system," and would do so based on "the principles of independent initiative, controllability, and gradual progress . . . in accordance with China's needs for reform and development."[172] The authorities also raised a legion of objections, according to Fund staff, with concerns about "macroeconomic and financial sector stability," the health of the banking system, employment in the agricultural sector, and the general stability that China's exchange rate

[171] International Monetary Fund, Article IV Consultation with the People's Republic of China, 2005, p. 15.
[172] Wen Jiabao quoted within International Monetary Fund, Article IV Consultation with the People's Republic of China, 2005, p. 15.

regime had provided to both China and Asia so far.[173] In addition, Chinese interlocutors drew attention to the lack of "convincing evidence pointing to the undervaluation of the renminbi," which was reinforced by the general indeterminacy of academic and economic analysis on the benefits of fixed versus flexible exchange rate regimes, as discussed in Chapter 2. Based on this, it appears that the advocates for greater exchange rate flexibility within the Chinese bureaucracy were confronted with evidence of the indeterminacy of undervaluation estimates, and opponents of greater flexibility used this evidence to shrink the size of the initial revaluation. This also raises a more interesting point, which is that if there was a broad international consensus on the extent of renminbi undervaluation, this may have been influential within Chinese bureaucratic debates. This is generally supportive of the argument of this study concerning the causative influence of international norms of the importance of flexible exchange rate regimes.

According to the 2005 IMF Article IV report, the Fund discussed potential options for introducing additional exchange rate flexibility, and argued that "this step should be significant enough to improve monetary policy independence and help curb speculative capital inflows by convincing market participants that no further changes were likely soon."[174] In addition, the Fund argued that excessive volatility in the exchange rate was unwanted, because appropriate hedging instruments and strategies had not yet been developed and utilized.[175] As Chapter 6 will discuss, the small size of the move immediately raised additional expectations of another revaluation, but authorities did move forward in developing additional hedging instruments.

[173] International Monetary Fund, Article IV Consultation with the People's Republic of China, 2005, p. 15.
[174] International Monetary Fund, Article IV Consultation with the People's Republic of China, 2005, p. 17.
[175] *Ibid.*

In short, the International Monetary Fund played a critical role, starting in 1999, in continually pushing the issue of additional exchange rate flexibility onto the agenda of Chinese financial technocrats. Based on those technocrats' arguments and recommendations during the debate over China's exchange rate, the IMF's recommendations had a significant influence on the final course of the debate concerning the reform of China's exchange rate regime. The Fund's recommendations were not determinative, but did perform an agenda-setting function. Based on the Fund's Article IV reports, however, Chinese officials were clearly reluctant to move quickly in introducing additional exchange rate flexibility, revealing very typical objections in line with an overall "fear of floating," as well as several concerns specific to China, including impacts on agricultural employment, rural income, and banking sector stability. However, within the exchange rate debate, the IMF played a key role as a consistent advocate for greater exchange rate flexibility with the credibility and persuasive power of an impartial international organization composed of financial technocrats, arguing that they represented China's best interests as well as those of the global economy. The Fund's influence on the Chinese debate came from this credibility and the sustained interactions with Chinese financial technocrats, who both used the Fund's recommendations to bolster their case for additional exchange rate flexibility within inter-ministerial debates. China's financial technocrats were sobered by the experience of the Asian financial crisis, and were determined to modernize China's financial system in order to avoid another crisis; the IMF effectively provided a roadmap, training programs, and international legitimacy for these officials during this process.

One of the primary advocates for a more flexible Chinese exchange rate regime was Zhou Xiaochuan, the governor of the People's Bank of China from December 2002 to the present. However, Zhou's tenure at the central bank extends to 1991, when he was a member of the CCP Party Committee at the PBOC. He successively served as a vice-governor of the PBOC from 1991 to 1995, a director of the State Administration of Foreign Exchange (SAFE), which manages China's foreign exchange reserves, from 1995 to 1998, as Governor of the China Construction Bank from 1998 to 2000, and as the Chairman of the State Securities Regulatory Commission and a member of the PBOC Monetary Policy Department from 2000 until his appointment as Governor of the PBOC in 2002.[176] Zhou is widely regarded both inside and outside the Chinese bureaucracy as a Western-oriented, English-speaking, financially savvy advocate for reform and liberalization of China's financial system.[177] He was quoted within a People's Daily article discussing the advantages of a floating exchange rate system in the context of pressure under a scenario similar to the capital flight during the Asian financial crisis:

> A fixed exchange rate is like a shield in the hand when fighting, however you attack me, I will remain unmoved; if I fail to hold on, the impact will cause influence. A floating exchange rate is like a foam-rubber cushion, if you want to fight your way in, I'll react softly, ok, you've come in, but I won't let you hit me; when you want to quit, I'll give you a pinch and let you go only after you have taken a layer of your skin off.[178]

Zhou's metaphor is interesting because of its near-singular focus on the "enemy" of speculative capital, which reinforces the argument that advocates of exchange rate reform

[176] "Zhou Xiaochuan," Chinavitae.com, accessed October 27, 2007.
[177] Interview 05-13, Interview 05-16, Interview 06-110, Interview 06-120, Interview 07-106.
[178] Zhou Xiaochuan quoted within People's Daily, "RMB Exchange Rate Reform- Decided Out of China's Own Need," http://english.people.com.cn/200507/29/eng20050729_199104.html

were focused on the goal of avoiding another Asian financial crisis. Zhou and other central bank officials were widely regarded, even within the bank, as financial liberals or reformers, in contrast to the more conservative elements of the Chinese bureaucracy reluctant to cede control over such a critical price in the economy.

Another key voice in central bank decision-making was PBOC vice-governor Wu Xiaoling. Wu has spent her entire career at the PBOC, graduating from the central bank's graduate school in northwest Beijing and working in a variety of central bank departments, including the Policy Research Office, the Financial System Reform Department, and the State Administration of Foreign Exchange, where she took over from Zhou Xiaochuan from 1998 to 2000.[179] Wu has argued that the exchange rate would be an effective mechanism to adjust the Chinese economy away from its imbalances, but that various government institutions were preventing the central bank from using this adjustment mechanism effectively.[180] In a People's Daily editorial discussing the logic of reforming China's exchange rate regime, Wu and Zhou, along with PBOC vice-governor Yi Gang, were the only three officials identified by name in discussing the impact of exchange rate reform.[181] Evidence from interviews also placed

[179] China Vitae, "Wu Xiaoling," Accessed October 27, 2007.
[180] Wu Xiaoling speech at Tsinghua University, within conference, *Sustaining China's Growth*, 17 September 2007.

[181] Wu was quoted within People's Daily, "RMB Exchange Rate Reform- Decided Out of China's Own Need," http://english.people.com.cn/200507/29/eng20050729_199104.html. Wen Jiabao was also mentioned in the article, but this is unsurprising, considering the Premier would have to approve the exchange rate reforms that were introduced. The article stated, "Wu Xiaoling, deputy governor of the central bank, recently indicated that enterprises should strengthen study and application of derived tools and actively adapt to changes. The central bank is vigorously promoting the development of derived products and provides society with risk-avoidance tools as soon as possible."

Wu Xiaoling as one of the most important voices in an extremely small circle of PBOC decision-makers advising Zhou Xiaochuan.[182]

In addition to voices within the PBOC, the central bank is assisted by an inter-ministerial Monetary Policy Committee, which serves as an advisory body to bring in outside academic expertise and incorporate representatives of other ministries on the critical issues in contemporary Chinese monetary policy. Typically, the Monetary Policy Committee (MPC) would reserve one of its thirteen seats for an academic member, and over the past decade, these academic members have been vocal advocates of faster financial reform, including faster exchange rate reform, both within the Monetary Policy Committee and in the press. The MPC academic seat has been held by Li Yang of the Chinese Academy of Social Sciences, Yu Yongding, also of CASS, and Fan Gang, of the National Economic Research Institute, successively.

While all three would broadly be characterized as reformist in orientation, Yu Yongding in particular pushed for a more flexible exchange rate regime shortly following his appointment to the MPC in August 2004. Yu argued that the exchange rate regime could be changed without sacrificing the basic stability of the exchange rate, but that rapid adjustments would be harmful for exporters. At the Davos World Economic forum in early 2005, he claimed that the time was right for China to move on the exchange rate, which at the time required a clarifying remark by PBOC vice-governor Li Ruogu that if China made such a move, it would not be based on the level of external pressure.[183] He also argued for higher interest rates in order to control credit and investment growth, which would require greater monetary policy autonomy for the central bank, and

[182] Interview 06-120, Interview 06-113.
[183] Yu Yongding quoted within "China not to revalue exchange rate unless fully prepared- report," Xinhua Finance News, 31 January 2005.

additional exchange rate flexibility. Within this context, Yu argued, "It may be that the exchange rate needs to be sacrificed."[184] Shortly after the exchange rate reforms of July 2005, Yu argued for additional flexibility in order to prepare enterprises for a changing exchange rate environment, claiming, "I think we should allow a bigger band, greater fluctuation and more flexibility. . . .you should make enterprises worry very much about the future, so that they will act to prepare themselves."[185]

While the inner workings of Chinese bureaucratic institutions are notoriously opaque, the importance of the central bank leadership's reformist beliefs was cited repeatedly in interviews both within and outside the PBOC as a critical factor precipitating the reform of the exchange rate regime in July 2005. When the Treasury Department began to meet with Chinese officials concerning the technical requirements for implementing a flexible exchange rate system in early 2004, the only officials in attendance were representatives of the PBOC.[186] In part, this reflected their institutional position as the technocrats who would need to implement such a system, as the meeting was part of a "study group" between both Chinese and American experts which was announced following an APEC summit between President Bush and Hu Jintao in October 2003.[187] Later, once the Strategic Economic Dialogue between China and the United States was established, the Treasury Department even took advice and recommendations from the Chinese central bank concerning ways to present their arguments for greater exchange rate flexibility to the rest of the Chinese bureaucracy, which included more

[184] Yu Yongding quoted within "China should adopt more monetary tightening policies," Xinhua Finance News, 23 June 2006.
[185] Yu Yongding quoted within "China economist calls for greater yuan exchange rate flexibility," Xinhua Finance News, 3 November 2005.
[186] Interview 06-133.
[187] Jane Perlez, "Chinese President to Consider Methods to Float Exchange Rate," *New York Times* 20 October 2003.

conservative elements.[188] Consistently, interview subjects claimed that the only motivation for exchange rate reform within the Chinese bureaucracy came from within the PBOC.[189]

The technocrats at the central bank broadly shared and incorporated the views of the IMF, and they used some of the shared lessons of the Asian financial crisis to create a case for more exchange rate flexibility and more monetary policy autonomy within Chinese political debates. These ideas about the conduct of exchange rate policy and monetary policy were not politically neutral, but represented a broad international consensus within leading international institutions and communities of financial technocrats. Peter Haas has drawn attention to the influence of "epistemic communities" in coordinating policies across nations, by transmitting ideas across societies and into policy debates.[190] These epistemic communities succeed in spreading ideas by relying upon their authoritative expertise within a particular field, with implications for policy, and their influence, according to Haas, is particularly pronounced following a crisis.[191] The Asian financial crisis provided such an opportunity for international financial technocrats, such as those at the IMF, to make a convincing case for more exchange rate flexibility to the Chinese financial experts who were charged with avoiding a repeat of the crisis. As Kathleen McNamara argues, policy-makers can become receptive to these ideas because:

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[188] Interview 06-133.
[189] Interview 06-120, Interview 06-118, Interview 07-101, Interview 06-133, Interview 07-106.
[190] Peter M. Haas, "Introduction: Epistemic Communities and International Policy Coordination" *International Organization* **46**:1 (Winter 1992), p. 1-35.
[191] *Ibid.*

> These beliefs serve as a crucial guide for government officials attempting to analyze the complex technical relationships that make up the macro-economy, providing them with a means-end knowledge that allows for the development of economic policies. In other words, these policy ideas can function like flashlights, guiding policymakers by illuminating a specific path through the darkness of crisis and confusion, and providing policymakers with strategies for governance.[192]

The Asian financial crisis had created tremendous uncertainty regarding China's financial health, and China's financial technocrats, primarily at the PBOC, had offered more exchange rate flexibility as a policy measure that could offer additional levers over the macroeconomy and hedges against financial shocks. However, this alone does not explain why China's top leadership, at the level of the State Council, was interested in or receptive to the idea of exchange rate flexibility as the solution to these problems, particularly given the short-term costs the decision may have exerted on China's economy. The next section explains why China's leadership was open to the growing international consensus on exchange rate flexibility.

Exchange Rate Flexibility and China's Role in the Global Economy

China's leadership was interested in avoiding another Asian financial crisis, but the State Council was particularly receptive to the international financial norms of exchange rate flexibility as part of its financial reform efforts for two reasons. First, China's policy-making process, particularly in economic and financial affairs, was highly receptive to international experience as a source of policy inputs. This provided a channel of influence for dominant international policy ideas. Secondly, the growth of

[192] McNamara, 57-58.

global economic imbalances provided an opportunity for advocates of exchange rate flexibility to paint exchange rate reform as an example of China acting responsibly in the management of the global economy, in line with a more conciliatory and cooperative Chinese approach to international institutions over the past ten years.

Foreign Technical Expertise and Chinese Economic Policy-Making

The Chinese Communist Party has long relied upon the advice and assistance of "foreign experts" in developing and modernizing the Chinese economy. After the establishment of the People's Republic of China in 1949, the CCP relied primarily upon Soviet expertise in establishing and rebuilding China's industrial base following World War II and the Chinese civil war. Following the Sino-Soviet split in the late 1950s, when such assistance dried up, the Chinese Communist Party did not import Western ideas about reforming China's economic institutions until the Deng Xiaoping era in the late 1970s.[193] Throughout the 1980s and 1990s, with a brief hiatus during the period following the brutal crackdown on the Tiananmen Square demonstrations, China began to look to foreign expertise in developing and modernizing its financial system, including the establishment of stock markets, bond markets, foreign exchange markets, and the appropriate regulatory institutions. The modernization of China's financial system, in particular, has relied heavily upon foreign advice and expertise.

Immediately following the Asian financial crisis, financial reformers had political momentum in Chinese domestic politics, led by Premier Zhu Rongji. The severity of the crisis upon the economies of Southeast Asia, particularly in Indonesia, where the Suharto

[193] Anne-Marie Brady, *Making the Foreign Serve China* (New York: Rowman and Littlefield, 2003).

government eventually fell, meant that calls for drastic overhaul of the financial system had more credibility in Chinese politics, and financial reform accelerated rapidly.[194] As Edward Steinfeld commented at the time, "In recent months, decision makers in Beijing have embarked on . . . a wholesale restructuring of the nation's financial system. Moves that have been avoided for many years—moves that many observers thought would never take place in China—are now being pursued with alacrity and determination."[195]

In this environment, foreign models of financial reform provided ready bases of experience that could be transplanted to China's financial system. For example, financial reformers pushed to reorganize the Chinese central bank into a system very similar to the U.S. Federal Reserve, removing the provincial organizational structure and creating twelve regional offices, which assisted the central bank in controlling the money supply, freeing the central bank from the influence of provincial governments.[196] In addition, China's leaders were interested in reforming the essentially insolvent banking system, which dominated financial intermediation in China. Borrowing from U.S. experience following the Savings and Loan crisis in the early 1990s, China set up a series of Asset Management Corporations (AMCs) to assume non-performing bank loans, similar to the Resolution Trust Corporation that worked out non-performing assets in the United States.[197] Following the sale of 1.4 trillion yuan in non-performing assets to the AMCs in 1999 and 2000, the PBOC used $60 billion of its foreign exchange reserves to recapitalize three state-owned banks: Bank of China, China Construction Bank, and the

[194] Steinfeld, p. 39.
[195] *Ibid.*
[196] Kathy Chen, "China Models Central Bank on US Fed," *Wall Street Journal* 7 April 1998, p. A15.
[197] Ma Guonan, and Ben S.C Fung, "China's Asset Management Corporations," Bank for International Settlements Working Paper No. 115, August 2002.

Industrial and Commercial Bank of China.[198] The essential idea of the recapitalization plan was to increase the banks' capital adequacy ratios up to international standards (the Basel I level of 8 percent), solicit foreign investment for further recapitalization, and then list the banks on overseas stock exchanges. Listings of state-owned banks are still ongoing and began in late 2005. Pre-offering stakes in the banks to large foreign banks was necessary not only to legitimize the Chinese state-owned banks in the eyes of foreign investors, but to provide foreign banks with incentives to transfer knowledge and expertise to their partner state-owned banks.

As banking sector reform continued, China relied heavily on international training for key personnel throughout the financial system, with central bankers attending seminars from the Federal Reserve, the Hong Kong Monetary Authority, and the IMF, concerning the conduct of monetary policy and crisis management.[199] The PBOC was a particular locus of international financial education, as one foreign central banker commented that PBOC officials "have basically been all over the world studying things."[200] Interview subjects in regulatory agencies, including the central bank and the China Banking Regulatory Commission, would frequently comment that much of their work involved sharing lessons from international experience, learned via international training sessions, involving bringing China's banks in line with international standards.[201] English skills were requisite for promotion to certain levels in the Chinese Banking Regulatory Commission, because of the volume of work that involved engagement with

[198] *Ibid.*
[199] James Areddy, "China Updates Financial Sector for Global Rivalry," *Wall Street Journal* 2 June 2005, p. A11.
[200] Quoted within Areddy, p. A11.
[201] Interview 06-120, Interview 06-121.

international institutions and training sessions overseas.[202] In restructuring the most important part of its financial system, the banking sector, China relied explicitly on foreign technical expertise and foreign models of reform.

In the course of China's modernization and reform, the country's bureaucratic institutions have relied heavily on foreign consultants and experts in seeking potential policy options to resolve particular problems, especially in the course of financial reforms.[203] When confronted with a problem, Chinese institutions frequently survey other countries' responses to similar problems, and then weigh the costs and benefits of these different approaches.[204] Some interview subjects working in international banks that were strategic investors in Chinese state-owned banks complained about the volume of policy guidance that they were being asked to provide on a regular basis, knowing that they were not the only ones, nor the most influential, in providing detailed research for their Chinese partners.[205] The overall approach, as described by several interview subjects, was to aggregate a number of policy options that were utilized internationally, and attempt to decide how to apply these policies in China.

The weight given to international consensus in financial practices meant that China often attempted to restructure its own institutions in line with international best practices. One interview subject revealed that the Financial Stability Department of the People's Bank of China was created in 2003 largely because other central banks had them.[206] Internationally supervised training for Chinese officials in writing internationally standard financial stability reports followed the department's creation.

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[202] Interview 06-122.
[203] Interview 05-13, Interview 06-135.
[204] Interview 05-13, Interview 06-124, Interview 06-125.
[205] Interview 05-32.
[206] Interview 06-120.

International standards created the demand for these reports and the department, as these functions were not merely reorganized from elsewhere within the PBOC.[207] Presenting Chinese financial institutions as functional equivalents of those in developed countries also served another purpose; the Asian financial crisis largely reflected speculators' fears of an absence of financial supervision and a tight government-business nexus that was referenced as "crony capitalism." Restructuring financial institutions in line with international standards also had an ancillary effect, in hedging against the types of speculative capital outflows seen in the Asian crisis.[208]

For the purposes of analyzing the foreign influences on the reform of China's exchange rate regime, it is useful to examine some of the reforms and adaptations that China has made in order to adapt to the massive capital inflows resulting from China's trade and capital account surpluses, starting in late 2002. Capital inflows were a new challenge for China, and the country lacked an established policy "toolkit" to deal with the macroeconomic consequences of rapidly ballooning surpluses. As a result, China borrowed heavily from international expertise on these issues, seeking opinions from economists regarding the extent of the yuan's undervaluation and the possible options for changing China's exchange rate regime. In addition to the debate over the reform of the exchange rate regime, which will be discussed in detail in the next chapter, China engaged in a bureaucratic debate over the management of its rapidly growing pile of foreign exchange reserves, which reached $1.066 trillion at the end of 2006, $1.528 trillion at the end of 2007, and $1.906 trillion at the end of September 2008.

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[207] Interview 06-120.

[208] Wang Hongying, p. 540-542. Wang does not explicitly claim that the financial reforms initiated were designed to change the Chinese financial system's structure in order to deter speculators, but that the reforms were largely implemented quickly, in line with international standards, to avoid another iteration of the crisis in China.

The eventual outcome of the debate over the management of China's foreign exchange reserves was the establishment of a sovereign wealth fund called the China Investment Corporation. In part, the debate about managing China's foreign exchange reserves stoked some nationalist sentiment, as many believed that China's returns on its US Treasury debt and holdings in US mortgage-backed securities were miniscule, at 4-5 percent, where foreign investors providing US dollars to China's central bank were encouraged to invest at returns of 10-15 percent per annum in their operations within China.[209] Therefore, as China's foreign exchange reserves continued to accumulate, other institutions outside the central bank began to criticize the PBOC's management of those reserves, which were invested primarily in dollar-denominated debt securities. Opinion pieces began to circulate in which officials urged that reserves be put to more productive uses.[210] However, an examination of internationally utilized models for managing foreign exchange reserves was intrinsic to the process of legitimizing alternatives to the central bank's stewardship, and this examination started with a fact-finding trip to Singapore, Japan, and Korea by researchers sponsored by the National Development and Reform Commission.[211] The eventual creation of the China Investment Corporation drew heavily from the Singaporean experience with the city-state's own sovereign wealth fund, Temasek.[212]

The political debate about the formation of the China Investment Corporation was simply the latest chapter in a series of Chinese financial reforms that were heavily

[209] Nouriel Roubini and Brad Setser, Roubini Global Economics, China Trip Report, April 2005, p. 6.
[210] Market News International, "China Gov't Researcher Proposes Spending 'Excess' FX Reserves," 30 October 2006.
[211] Interview 06-128, Interview 06-124, Interview 06-135.
[212] Interview 06-135. According to several sources, Temasek continues to interact frequently with and advise the China Investment Corporation.

influenced by examples from international practice. As the next chapter will clarify in detail, the debate over exchange rate reform also frequently referenced the experiences of other countries moving from fixed to flexible exchange rate regimes, and the conditions under which these states decided to end their pegs. China's leaders were largely receptive to international technical expertise and international standards on the "best practices" of exchange rate policy because this was consistent with historical patterns of China's economic reform, and reform of China's financial system in particular.

A Globally "Responsible" Exchange Rate Policy

China's top leadership was also more amenable to accepting the legitimacy of international expertise and international norms concerning exchange rate policy in part because of a more gradual shift in Chinese attitudes toward international institutions and China's role in the world. As discussed at the end of Chapter 3, Chinese attitudes toward the international system have changed considerably over the past decade, and voices calling for a more active Chinese role within the existing system, rather than criticizing international institutions as hostile to China's interests, began to form the base of a more active diplomatic posture from Chinese officials. Scholars have monitored this more proactive Chinese diplomacy in recent years. Fravel and Medeiros detail a series of changes in China's foreign relations and interaction with international institutions over the past decade, from the expansion and deepening of bilateral relationships, to the resolution of longstanding territorial disputes on less than favorable terms and various

attempts to utilize international institutions to serve China's national interests.[213] These developments, in turn, followed the promotion of a diplomatic corps with more experience interacting professionally outside of China.

Chinese scholars had been debating the efficacy of China's historically cautious approach toward interactions with international institutions as well. Following the NATO intervention in Kosovo in 1999, there was a broad-ranging debate in Chinese foreign policy circles concerning the motivations of U.S. foreign policy and the question of whether the global security environment was still conducive to "peace and development," in Deng Xiaoping's earlier words, or whether the situation had changed.[214] The general conclusion of the debate was that peace, development, and globalization remain the dominant trends in global politics, but that China should do more to expand its influence and shape the international security environment in its interests, particularly in China's immediate periphery.[215] As a result of this notable shift in Chinese foreign policy and a proactive diplomatic effort, there was a virtual sea change in the attitudes of most regional powers toward China's growth between the mid-1990s and the beginning of the 21st century, as China managed to mitigate some of the fears about the country's growth in military and economic power.[216] The concept of a Chinese "peaceful rise" to great power status emerged in intellectual debates as a potential alternative to conceptualize the difference between China's ascendance and the experience of past

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[213] Evan Medeiros and M. Taylor Fravel, "China's New Diplomacy," *Foreign Affairs* **82**:6 (November/December 2003), p. 22-35.
[214] David Finkelstein, *China Reconsiders Its National Security: "The Great Peace and Development Debate of 1999,"* Washington: Center for Naval Analysis, 2000.
[215] Finkelstein, ii.
[216] David Shambaugh, "China Engages Asia: Reshaping the Regional Order," *International Security* **29**:3 (Winter 2004/2005), p. 64.

rising powers that were perceived as threats, such as Germany.[217] Rather than challenging the legitimacy of the international system and its institutions, China has changed its approach over the past decade, by attempting to strengthen its position within that system and within those institutions.

This shift in foreign policy thinking extended to the economic realm as well. Through China's commitment to join the World Trade Organization, which the nation finally achieved in 2001, as well as through dismantling barriers to regional trade, Chinese leaders attempted to create an image of the country as a "responsible" member of the international economic system. Joining the WTO meant conceding the legitimacy of international standards on the conduct of trade and the degree of openness to foreign investors and foreign competitors, even within sectors in China's economy that were dominated by state-owned industry. While China's WTO accession required no commitments to move toward exchange rate flexibility over any particular timetable, the implication of China's membership was that the country was fast becoming a regular, normal member of the international trading system. Inclusion in the global financial system on similar terms seemed to be right around the corner.

In this environment of expanded Chinese engagement with international institutions and greater acceptance of the legitimacy of international commitments, Chinese leaders were more receptive to the influence of international norms concerning the general efficacy of flexible exchange rate regimes than in the past. Trade patterns placed China in a position that was likely unexpected, as the ongoing growth in American current account deficits and global economic imbalances, combined with the existence of fixed exchange

[217] Zheng Bijian, "China's 'Peaceful Rise' to Great-Power Status," *Foreign Affairs* **84**:5 (September/October 2005), p. 18-24, and Robert Suettinger, "The Rise and Descent of 'Peaceful Rise,'" China Leadership Monitor, No. 12, 2004.

rate regimes in Asia, placed China as the key actor determining the pace of adjustment among Asian currencies. Because other Asian countries were often competitive with China in the same export-oriented industries, they were unwilling to allow their currencies to rise unless China did so as well, which placed the Chinese exchange rate policy at or near the center of the issues related to resolving global economic imbalances.

In this environment, calls for China to allow more exchange rate flexibility emerged as a potential solution to growing economic imbalances. As will be discussed in the next chapter, the first complaints came from Japan in late 2002, and were followed by the introduction of the U.S. Congress into the debate in 2003.[218] In the context of China's exchange rate regime, the rising chorus of international pressure on China to allow the yuan to rise was framed by several players as a test of China's commitment to its own image as a responsible player in the international financial system. For example, in a visit to Beijing in late 2007, U.S. Treasury Secretary Henry Paulson commented that movement on the yuan was a test of China's overall commitment to reform and opening of China's financial system.[219] Wen Jiabao, who ultimately must sign off on any decision related to reforming China's exchange rate regime, has often commented on China's position as a "responsible" country, with reference to both the exchange rate regime and the commitment to avoid destabilizing the global monetary system by sending signals that China would rapidly diversify away from the dollar.[220] China accumulated foreign

[218] Interview 05-11.
[219] Xinhua Finance News, "Currency Revaluation Can Drive Chinese Economic Reform – Paulson," 13 December 2007. Paulson commented about the importance of the yuan as a gauge of overall reform efforts in a press conference following the third session of the Strategic Economic Dialogue, held outside of Beijing on December 12-13, 2007. See also Market News International, "US's Paulson: China Needs More FX Flexibility for Effective Monetary Policy," 13 December 2007.
[220] Market News International, "China's Wen: New FX Reserve Agency Won't Hurt US Dollar," 16 March 2007. Wen was quoted as saying, "Within China's foreign exchange reserves, US dollar-denominated assets account for the majority – this is a fact. . . . China's purchase of US dollar assets is mutually

exchange reserves rapidly from 2002 to 2005 as a result of its maintenance of a fixed exchange rate regime, with the majority of these reserves denominated in dollars. As a result, the Chinese central bank reinvested these large flows of dollars primarily in U.S. Treasury bonds and mortgage-backed securities from Fannie Mae and Freddie Mac, and global markets became very sensitive to perceived shifts in Chinese purchasing activities in these markets. China's decision to maintain a tight grip on the yuan had placed the country in an extremely influential position in global markets, and foreign critics were quick to point out that this position required responsible behavior.

Chinese leaders were of course motivated by protecting Chinese interests through exchange rate policy, but the concern at the top levels about the appearance of China as a globally responsible actor provided a channel for international forces to influence China's policy choices over the direction of the exchange rate regime. As the examination of the policy debate over China's exchange rate reform details in the next chapter, following an initial period of resistance, China's top leaders frequently referenced China's exchange rate policies as "responsible," both in the context of restoring stability following the Asian financial crisis and in working to resolve international imbalances. During the Asian financial crisis, this responsibility required maintaining the currency at a stable level, but eight years later, the position viewed as globally responsible had shifted to a call for more flexibility. This formulation of China's global economic role was frequently invoked by the Chinese leadership even before Robert Zoellick's speech referencing American aspirations of China as a "responsible stakeholder" in the

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beneficial. China's establishment of a foreign exchange reserve company will not hurt US dollar assets." Wen also commented, "China considers foreign exchange safety in carrying out the diversification of its foreign exchange reserves."

international system.[221] For example, in the context of the APEC summit in 2003, China's President Hu Jintao commented, while discussing China's exchange rate management during the Asian financial crisis, "We will follow the same approach of responsibility to the renminbi exchange rate issue this time . . . Keeping the exchange rate of renminbi stable serves China's economic performance and conforms to the requirements of the economic development in the Asia Pacific region and the whole world."[222] International factors and the stability of the economies on China's periphery played a significant role in China's decision not to devalue the yuan following the Asian financial crisis, and the country received plaudits for their refusal to engage in beggar-thy-neighbor devaluations.[223] The international recognition that China received during the Asian financial crisis as a source of stability played a role in the Hu-Wen leadership's considerations of future adjustments to the exchange rate regime. China's top leadership was receptive to the international norms surrounding flexible exchange rates because they were interested in being perceived as a responsible player on the global stage, even though this did not mean the wholesale acceptance of foreign demands. This, in turn, was the product of a shift in Chinese approaches toward international institutions that had been emerging over the past decade.

The reform of China's exchange rate regime in July 2005 was the product of the influence of two sets of international norms, which structured and limited the policy

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[221] Robert Zoellick, "Whither China? From Membership to Responsibility," speech to National Committee on US-China Relations, 21 September 2005, http://www.ncuscr.org/articlesandspeeches/Zoellick.htm.
[222] Hu Jintao quoted within Jane Perlez, "Chinese President to Consider Methods to Float Exchange Rate," *New York Times* 20 October 2003.
[223] Leong H. Liew, "Policy Elites in the Political Economy of China's Exchange Rate Policymaking," *Journal of Contemporary China* **13** (February 2004): 21-51.

options available to Chinese decision-makers. The first was a series of shared causal beliefs concerning the efficacy of flexible exchange rate regimes, particularly following the financial crises in Southeast Asia and Argentina, which called the sustainability of fixed exchange rate regimes into question. Through interactions with international institutions, a group of Chinese financial technocrats began to advocate exchange rate reforms consistent with the growing international consensus that exiting a fixed exchange rate regime under conditions of capital inflow was superior to exiting under conditions of capital outflow. The Asian financial crisis played a critical role in focusing the attention of both Chinese policy-makers and financial technocrats on the need for reforms that would avert another iteration of the crisis. Just as Kathleen McNamara argued that the first oil crisis of the 1970s played a key role in eventually forging the consensus for European monetary union, the Asian financial crisis created conditions that both enabled Chinese exchange rate reform and enabled the influence of international norms concerning exchange rate flexibility to serve as guideposts for Chinese policy-makers.

The second set of ideational factors that contributed to the reform of China's exchange rate regime concerned China's position as a globally responsible actor and a "normal" participant in the global financial system. China's approach to exchange rate reform was indicative of a broader shift in Chinese attitudes concerning international institutions and China's role in the world. In an environment of widening global economic imbalances, where China was fingered as one of the obstacles to smooth adjustment, norms concerning the prevalence of flexible exchange rate regimes throughout the world were influential to China's top leadership, who were eager to present China as a "responsible" player in the global financial system. This broader shift

in attitudes toward China's role in the world created a permissive environment for the influence of ideas about exchange rate management that were presented by global financial technocrats as near-consensus positions among large, trade-oriented economies.

Through the operation of both of these sets of ideas, China's top leaders were attracted to the recommendations of financial technocrats at the central bank who were interested in introducing exchange rate flexibility. The financial technocrats at the PBOC believed in the efficacy of a more flexible exchange rate regime largely due to their extended interactions with the predominant ideas at international financial institutions, such as the IMF. When the top Chinese leadership began to look for a solution to the growing attention on China's exchange rate regime, the ideas advanced by the PBOC became attractive precisely because they were in line with the leading international standard practice of the time. Introducing exchange rate flexibility allowed China's top leaders to make the argument that China was acting as a globally responsible player, in line with China's more constructive role in the world.

Ultimately, however, this is a contingent story; exchange rate reform was not inevitable. While the structural power of the dominant norms held by international financial institutions limited the set of options available to China's policy-makers, the position of China's financial technocrats within the bureaucracy was critical. Had different elites, who were less receptive to the IMF's views concerning the efficacy of flexible exchange rate regimes, occupied leading positions within the PBOC, it is likely that exchange rate reform would have been much slower. There was a contentious debate concerning exchange rate reform within the central bank as well, and it was the reform-oriented nature of the central bank's leadership that allowed the PBOC to advocate

exchange rate flexibility to the State Council at a time when there was a favorable audience for their ideas. The ideas of these reformers were not a product of their institutional position, as the central bank was internally divided as well. The next chapter will detail the political debate surrounding China's exchange rate regime, and will then attempt to use evidence from this debate to demonstrate the domestic salience of international norms, both in terms of the efficacy of flexible exchange rate regimes and the need for China to act as a responsible player in the global financial system.

Chapter 5- Foreign Pressure and the Chinese Response

The previous chapter described the process through which ideas about the efficacy of flexible exchange rate regimes appeared in the Chinese debate over exchange rate reform. The next two chapters will discuss both the political and economic arguments in that debate, which resulted in the end of China's explicit fixed-but-adjustable exchange rate regime on July 21, 2005, and a modest 2.1 appreciation against the dollar. China's top leadership in the State Council decided to change China's exchange rate regime as part of an effort to present China as a responsible player in the global financial system and to reform China's financial system in line with an international consensus regarding best practices in monetary affairs. At the start of the debate in 2003, Chinese leaders defended both the existing fixed exchange rate regime and firmly rejected the legitimacy of international calls for reform of the regime. During the debate surrounding the reform of China's exchange rate regime, the rhetoric from China's leaders changed rapidly from defense of the peg to the dollar on national sovereignty grounds to arguments that the market was now firmly in command of the direction of China's exchange rate. Official Chinese rhetoric shifted from defending the benefits of state-directed adjustment to the logic of market-based adjustment in a period

of less than two years, and international political factors, including the influence of international norms, provide the most convincing explanation for this shift and the eventual reform of China's exchange rate regime.

Economic circumstances had changed slightly, but China's leaders ultimately ended the peg to the dollar for the political purposes of presenting China as a normal and responsible player in the global financial system. While foreign political pressure from both Japan and the United States served an agenda-setting role for China's leaders, the resulting exchange rate reforms served Chinese, rather than foreign, political imperatives. Exchange rate flexibility was presented by foreign critics as a test of China's commitment to a responsible leadership role in the global economy, and China's decision to use a fixed or flexible exchange rate regime was not only presented as an important issue for the global financial system but also a test of China's commitment to further economic reform and eventual integration into the global economy. As late as 2007, U.S. Secretary of the Treasury Henry Paulson labeled the reform of the yuan as a "symbol for the pace" of Chinese economic reforms.[224] In turn, Chinese monetary authorities attempted to present China's exchange rate reforms in the context of international norms concerning the efficacy of flexible exchange rates; in public statements, China's leaders overstated the changes from the previous system and emphasized the "flexibility" and the "market forces" operable in the new exchange rate regime, even when the net change from the previous system was not as significant. In short, China attempted to present a small, gradual reform as a fundamental reform bringing its exchange rate regime in line with global norms.

[224] Paulson quoted within Margaret Chadbourn and Logan Wright, "US Treasury's Paulson: China Understands the Need to Adjust RMB," 23 May 2007. Paulson made similar comments at the third session of the SED in December 2007.

The next two chapters will detail the Chinese political debate concerning exchange rate reform, and the process resulting in the announcement of an end to the yuan's dollar peg on July 21, 2005, along with a one-time, 2.1 percent appreciation against the dollar, and the introduction of a new regime permitting more market influence over China's exchange rate. This chapter will discuss the advent of the international pressure on China to reform the exchange rate regime, starting with the Japanese complaints concerning China exporting deflation and continuing with the beginning of the debate in the U.S. Congress concerning China's undervalued exchange rate. In addition, the chapter will discuss the initial Chinese response to this pressure, from both the top leadership and the financial technocrats at the PBOC. The next chapter will discuss the political compromise that emerged after exchange rate reform was on the agenda of China's top leadership, and the complications that explained the timing of exchange rate reform. After discussing the history of the political debate itself, the chapter will attempt to demonstrate the importance of international norms concerning flexible exchange rate regimes within China's domestic politics, using a research framework provided by Andrew Cortell and James Davis.

The Chinese Export Boom in 2002 and Japanese Pressure

As detailed in the last chapter, the IMF had been pushing Chinese officials for more exchange rate flexibility as early as 1999, even while they emphasized that China's commitment not to devalue following the Asian financial crisis contributed to economic stability in the region. The IMF made their case over a period of several years to officials

within China's central bank and the Ministry of Finance. However, the higher levels of China's central government did not seriously consider the possibility of exchange rate reform until around late 2002, when Japanese officials began complaining that China's currency was undervalued, and central government think tanks were tasked with researching policy options for resolving China's growing external imbalances.[225] The Japanese complaints began around February of 2002, when a Liberal Democratic Party (LDP) policy package targeting Japanese deflation announced the party's intention to urge China to revalue the yuan in order to reflect China's growing competitiveness.[226] Many Japanese politicians also felt that the undervalued yuan was effectively worsening Japan's deflation by allowing China to export cheaper goods. Only a week earlier, Japan's Finance Minister at the time, Masajuro Shiokawa, had commented in a plenary session of the Diet, "I believe we should not comment on whether the exchange rate of another country's currency is appropriate or not, and therefore I am not making any statement on this."[227] Shiokawa would go on to become one of Japan's most persistent critics of China regarding the rigidity of the country's exchange rate regime. By March of 2002, he alleged that both the United States and Japan felt "it's pretty irksome" that the yuan was relatively weak, giving China an extra competitive edge, adding that, "Efforts are being made to give rise, internationally, to the opinion" that the yuan was undervalued.[228]

[225] Interview 05-11.
[226] Dow Jones Newswires, "Japan LDP Deflation Package Urges China to Revalue Yuan- Kyodo," 26 February 2002.
[227] Reuters, "Japan Finance Minister Declines to Comment on Yuan," 19 February 2002.
[228] Masajuro Shiokawa quoted within Dow Jones Newswires, "U.S., Japan Displeased With Weak China Yuan," 19 March 2002.

The initial response to these complaints from Beijing was fairly restrained. The head of China's central bank at the time was Dai Xianglong, and in the course of a meeting with Shiokawa in March 2002, Dai reiterated his preference for stable exchange rates, including both the yuan and the yen.[229] Dai had also mentioned in April that he was considering some of the advice from the IMF regarding a change from China's dollar peg to a peg based on a basket of currencies.[230] In May, an official from the National Development and Reform Commission, Wang Jian, commented that, "The current level of the renminbi is very stable and appropriate, so it will not change," while also adding that capital account convertibility would be slow, as "Argentina provided a warning for China."[231] Other remarks reiterated the stabilizing role that China's stable exchange rate had played during the Asian financial crisis. Overall, however, there was little positive response from China's top leaders regarding the growing international pressure for China to change its exchange rate regime. China was committed to its fixed exchange rate regime and the Asian financial crisis had provided a firm warning regarding the rapid liberalization of the capital account. International advice regarding Chinese monetary policy was not warmly received, as the country's leaders believed that they had sacrificed a more rapid Chinese recovery from the Asian financial crisis in order to provide stability to the region.

Later in the year, however, China's external imbalances began to grow rapidly, in the first year of what would become a six-year run of record trade surpluses and rapid

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[229] Dow Jones Newswires, "China Central Bank Dai: Yen Level 'Very Complicated Issue'," 29 March 2002.
[230] Dai's remarks mentioned within Andrew Batson, "China Mulls Easing Limits on the Yuan – Growing Flow of Trade Calls for More Flexible Currency," Dow Jones Newswires, 8 May 2002.
[231] Anthony Rowley, "Beijing, Tokyo Officials Clash Over Yuan," Business Times Singapore, 27 May 2002.

growth in China's foreign exchange reserves. In 2002, China's exports grew by 22.3%, and the country's global trade surplus grew to $30.3 billion in 2002 from $22.6 billion in 2001.[232] In addition, China's foreign exchange reserves, which were a relatively effective indicator of the central bank's intervention into the foreign exchange market in order to maintain the yuan's price at very close to 8.277 the dollar, grew rapidly in 2002, as the central bank added $74.2 billion in reserves, a 35 percent increase in China's total reserves in only one year.[233]

As the economic evidence of the yuan's undervaluation began to build in late 2002, Chinese leaders were primarily concerned with domestic political affairs, rather than international complaints about China's currency. In late 2002 and early 2003, China's leaders were engaged in one of China's most significant political transitions, with Jiang Zemin's era at the pinnacle of Chinese politics coming to an end, and Hu Jintao's just beginning. During these periods of political transition, the incentives for radical policy changes, including reforms to the exchange rate regime, are limited, as individual officials are primarily concerned about avoiding any policy stances that may jeopardize their chance for promotion. During this time, Chinese leaders acknowledged the rising tide of international pressure on China, but strongly reiterated their intentions to maintain the yuan's stability. On December 4, 2002, Dai Xianglong commented that the yuan was at an "appropriate" level, and would probably remain at that level for a few years.[234] Later, early in 2003, China's premier at the time, Zhu Rongji, made a speech to the State Administration of Foreign Exchange (SAFE), in which he claimed that

[232] Data from Stone & McCarthy Research Associates.
[233] *Ibid.*
[234] Xinhua Financial Network News, "Central Bank Governor Says Chinese Yuan Currently At 'Appropriate' Level," 4 December 2002.

maintaining the peg to the dollar had contributed to China's export growth and China's "national strength." Zhu added, "To stick to the policy is in the interests of our country. . . . It has effectively safeguarded the country's economic growth and financial stability."[235]

In an op-ed piece in the Financial Times on December 1, 2002, Haruhiko Kuroda and Masahiro Kawai, the minister and vice-minister for international affairs in Japan's Ministry of Finance, explicitly linked the problem of global deflation at the time with China's fixed exchange rate regime. The two Japanese officials wrote, "China is exporting deflation and its effects are not limited to neighbouring Hong Kong and Taiwan. It is spreading through export growth and a combination of domestic price deflation and an exchange rate pegged to the dollar. Barring undesirable restrictions on its exports, China must either reverse its domestic price deflation, through expansionary monetary policy, or allow the currency to appreciate."[236] In addition, Kuroda and Kawai linked the exchange rate regime with China's global responsibilities, stating, "It is China's responsibility, and its interest as the largest emerging market economy, to contribute to global stability jointly with the US, Europe and Japan."[237]

However, by the summer of 2003, the Japanese criticism of China's exchange rate policies began to wane slightly. Following the summit in Bali in early July, Shiokawa commented that he thought the exchange rate regime should become more flexible, stating, "If you start opening your trade regime and act globally, you should globalize

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[235] Joseph Kahn, "China Plans to Maintain Existing Rate for Currency," *New York Times* 7 January 2003, p. A1. The article also added, "Still, Chinese officials are concerned about keeping the country's present economic vibrancy going through a delicate period of political transition, as a new generation of leaders takes control of China's economic management, beginning in March."

[236] Haruhiko Kuroda and Masahiro Kawai, "Time for a Switch to Global Reflation," *Financial Times* 1 December 2002.

[237] Kuroda and Kawai, *Financial Times* 1 December 2002.

your exchange rate regime, too." [238] However, the Japanese finance minister also added, "Whatever to do is the country's judgment. I have no intention to interfere. I just believe the country's exchange rates should be determined in its own interest."[239] This was a fairly significant climbdown from Japan's previous position, in criticizing China for exporting deflation to the rest of the world. Signaling that this softer line had superceded Japan's earlier criticism of China's exchange rate regime, Japan's vice-minister in the Ministry of Economy, Trade and Industry, Taichiro Nishikawa, argued at an economic summit in Dalian that, "Revaluation is a delicate issue that involves sovereignty . . . Therefore the Japanese government will refrain from commenting."[240]

In addition, the IMF had rebuffed the Japanese claims that China was exporting deflation in its 2003 World Economic Outlook, arguing that "In the case of China, high productivity combined with a de facto pegged exchange rate has led to a sharp price declines in some sectors . . . But even here, its overall trade shares are too small to lead to a generalized deflation among trading partners."[241] Japan had also received little support for its argument that China was exporting deflation at the G7 meeting in Paris in early 2003.[242] Despite rebuffing the Japanese arguments concerning China exporting deflation earlier in the year, the IMF joined the calls for additional exchange rate flexibility in China at the Asia-Europe Meeting in Bali in early July, arguing, "China is encouraged to move toward greater foreign exchange rate flexibility, together with efforts to improve the functioning of the foreign exchange market . . . This could be done initially in a

[238] Channel News Asia, "Japan Repeats Hope for China's Yuan Flexibility," 6 July 2003.
[239] *Ibid.*
[240] Nishikawa comments cited in Wojtek Dabrowski, "The China Factor," Financial Post (The National Post), 23 July 2003.
[241] IMF World Economic Outlook quoted within Takeshi Takeuchi, "IMF Backs China, Undercuts Japan Calls for Stronger Yuan," Dow Jones International News, 9 April 2003.
[242] Dow Jones International News, "Shiokawa: No G7 Support On Deflation But Debate On China," 22 February 2003.

controlled way."[243] Japanese representatives made similar arguments at a meeting of ten European and fourteen Asian nations in Bali in July 2003, and gained slightly more support, as other countries began to pay attention to China's currency regime.[244] However, at the same time, other interests in Japan were placing pressure on the government to back off, because Japanese companies were heavily invested in manufacturing operations in China, and benefited substantially from the expansion in Chinese competitiveness.[245] Even though the Japanese officials refrained from issuing direct pleas for China to appreciate the yuan in the middle of 2003, the international pressure did not similarly relent. As the Japanese backed off, the U.S. Congress started to take up the issue.

Congress Gets Into the Act

As China's trade surplus with the nation's primary customer, the United States, began to balloon in 2002 and 2003, it was not entirely surprising that the imbalance and its causes began to attract Congressional attention.[246] At the time, the U.S. economy was beginning to recover from a recession in 2001, but the recovery was criticized as "jobless", as employment rates did not recover in line with headline economic growth. In particular, employment in manufacturing industries began to decline, particularly among smaller manufacturing enterprises. The decline in manufacturing jobs generated

[243] IMF Statement quoted within Bill Condie, "International Monetary Fund Joins Lobbying for Stronger Chinese Yuan," Evening Standard (London), 7 July 2003.
[244] Nikkei Report, "Global Pressure on China to Revalue Yuan Grows," 9 July 2003.
[245] Interview 05-11.
[246] Thomas Lum and Dick Nanto, "China's Trade With the United States and the World," CRS Report for Congress, Updated August 18, 2006, RL31403. According to Chinese trade statistics, China's trade surplus with the United States grew to $58.6 billion in 2003 from $42.7 billion in 2002. According to American data, the U.S. trade deficit expanded to $123.9 billion in 2003 from $103.1 billion in 2002.

Congressional attention, and the National Association of Manufacturers (NAM) were one of the first organized interests to draw attention to China's exchange rate regime as an irritant in the US-China trade relationship. In a hearing concerning the impact of Chinese imports on U.S. businesses, Frank Vargo of the NAM cited China's rapidly rising competitive challenge in a wide array of sectors, and labeled China's exchange rate policies as a primary cause of the deteriorating U.S. trade deficit. Vargo said, "We must press China to end the manipulation of its currency and allow the yuan/dollar exchange rate to be determined by the market. Since 1994, the Chinese government has artificially suppressed the value of the yuan against the dollar in order to gain a competitive advantage. . . . By some estimates, the yuan is 40 percent undervalued. If this estimate is correct, then the Chinese currency is a major factor in our rising trade imbalance."[247] Throughout the debate, the NAM was a key engine of lobbying pressure on Congress to discuss the inflexibility of the Chinese exchange rate regime.

The first Congressional hearing dealing specifically with the issue of China's currency was held on June 25, 2003, by the House Committee on Small Business. The hearing was focused on the interventions of both the Chinese and Japanese central banks into the foreign exchange market and the title revealed its focus: "The Effects of Foreign Currency Manipulation on Small Manufacturers and Exporters." Several small American exporters described the Chinese policy of pegging the yuan to the dollar as a subsidy and a strategy for export promotion, while also drawing attention to the IMF decisions on

[247] Testimony of Franklin Vargo, National Association of Manufacturers, Hearing before Subcommittee on Commerce, Justice, State, and the Judiciary, House Committee on Appropriations, "Impact of Chinese Imports on U.S. Companies," Federal Document Clearing House, 22 May 2003. Vargo added, "Both in the short and long-term, there may be no other event that could make as large and as fast a difference in U.S. - China trade than having the Chinese currency become market-driven. Both the International Monetary Fund and WTO rules proscribe currency manipulation for the purpose of obtaining a competitive advantage or to interfere with the working of trade liberalization. This is something the NAM and the 80+ member Coalition for a Sound Dollar have been urging the Administration to look at closely."

exchange rate surveillance focused on currency manipulation.[248] One spokesman from the American Textile Manufacturers Institute argued, "What China, Korea, Japan, Taiwan, Thailand, among others, are doing with their currencies is out and out illegal. One way purchases of currency with the purpose of gaining an export advantage is clearly illegal under both IMF and WTO rules. Not only that, these actions are also clearly against the President`s own stated policy that free markets, not export-oriented Asian governments, should determine exchange rates."[249]

This initial hearing highlighted the two central American demands of the Chinese government, which would later become key dividing lines in both American and Chinese debates over China's exchange rate reforms. First, American companies and politicians were complaining about the level of the Chinese exchange rate; the argument was that the currency was objectively undervalued by a certain percentage, estimates of which varied considerably.[250] Second, the argument emerging was that the currency's undervaluation resulted from the fact that China controlled its exchange rate, and therefore the entire exchange rate regime needed to become more flexible, permitting more influence from the market over the yuan's value. While these objectives are not incompatible, different institutions within both the American and Chinese bureaucracies had imbalanced levels of priority attached to these goals. Congress was primarily concerned with the level of the exchange rate, since this was responsible for influencing trade flows and employment

[248] Testimony of Steve Yagle, Reliable Machine Company, Committee on House Small Business, "Foreign Currency Manipulation and its Effects on Small Manufacturers and Exporters" June 25, 2003.
[249] Testimony of Cass Johnson, American Textile Manufacturers Institute, Committee on House Small Business, "Foreign Currency Manipulation and its Effects on Small Manufacturers and Exporters" June 25, 2003.

[250] Stephen Vincent Dunaway and Li Xiangming, "Estimating China's 'Equilibrium' Real Exchange Rate," International Monetary Fund Working Paper, 05/202, October 2005, http://www.imf.org/external/pubs/ft/wp/2005/wp05202.pdf. Estimates of the yuan's undervaluation ranged from zero to 50 percent, according to a survey of the literature by the authors.

in the manufacturing sector. The Treasury Department was interested in a more expensive yuan in order to play a role in the resolution of global imbalances, but Treasury was also interested in the reform of China's financial system, which required the monetary policy autonomy that could only come with a more flexible exchange rate regime, regardless of the yuan's level. While the two institutions could agree on the need for exchange rate flexibility and market-determined exchange rates, the differences in emphasis were apparent in the conflicts between the two institutions over their approach to pressuring China to reform the exchange rate regime. The Congress attached little significance to technical reforms in China's regime that permitted more market influence but did not change the value of the yuan significantly. The Treasury Department was engaged with Chinese financial technocrats on a more regular basis, and publicly noted the progress that their consultations had made in introducing more market influence over the yuan, even though the value of the exchange rate did not move until July 2005.

Manufacturing groups in the United States forced Congress to pay more attention to the issue. On June 7, 2003, fourteen textile industry groups sent a letter to President Bush, asking for more government pressure on China on the currency front, and claiming, "... unless our government acts now, China is poised to seize 65-75% of the U.S. textile and apparel market."[251] U.S. Treasury Secretary John Snow first officially signaled that the United States was interested in a more flexible Chinese exchange rate regime on June 16, 2003, commenting, "We understand that the Chinese government is interested in moving towards market-based, flexible exchange rates and that is something we

[251] Text of the letter cited within Nikkei Weekly, "Pressure on to revalue yuan," 14 July 2003.

support."[252] Snow's comments, made in the United States, elicited quick responses from the State Administration of Foreign Exchange (SAFE) and the PBOC, which reiterated the existence of China's fixed exchange rate regime. The SAFE spokeswoman commented, "The current policy of SAFE is to maintain the basic stability of the renminbi exchange rate against foreign currencies."[253]

The Congressional involvement in the yuan dispute, however, escalated considerably following a hearing of the Senate Banking Committee on July 16, 2003, at which Federal Reserve Chairman Alan Greenspan testified on the state of the U.S. economy and U.S. monetary policy. Two congressmen, Christopher Shays of Connecticut and Jim Leach of Iowa, had asked Greenspan about the Chinese policy of maintaining a fixed exchange rate the previous day, in front of the House Committee on Financial Services, but the issue received a more significant degree of attention in the Senate hearing.[254] During the hearing, New York Senator Charles Schumer drew attention to the loss of manufacturing jobs from his home state, and fingered the Chinese currency regime as the culprit.[255] In addition, Schumer drew attention to China's own

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[252] Grainne McCarthy, "Snow Ups Ante in G7 Bid For China to Revalue," Dow Jones Capital Markets Report, 17 June 2003.

[253] Quotes from SAFE and PBOC representatives were cited within Dow Jones International News, "Wrap: U.S. Treasury Chief Fans Talk of Yuan Revaluation," 17 June 2003.

[254] Hearing of the House Committee on Financial Services on Monetary Policy, Federal Document Clearing House, 15 July 2003. Leach asked the question in terms of market-determined principles, which is how the issue would be framed throughout U.S. discussions with China, stating, "And a major factor, obviously, in international trade is the competitive position of currencies, and as the world has noted the euro, in a flexible exchange rate environment, has strengthened vis-a-vis the dollar, thus helping our exporters, but the Chinese currency remains locked in an unrealistically low fixed relationship with the dollar, and shouldn't the Chinese currency be subject to market forces and allowed, presumably in this kind of economic environment, to appreciate in value?" In response to Christopher Shays's question, which was structured similarly, Greenspan argued that a more flexible exchange rate was in China's interest, as it would allow more control of the domestic money supply. Greenspan said, "If the exchange rate is significantly undervalued, and indeed a reflection of that would be, for example, their accumulation of dollar assets, if that is indeed the case, the accumulation of dollar assets will expand their money supply to a point which will create problems in managing monetary policy and it will be to their interests to change."

[255] Schumer remarked in the Senate hearing, "One of the reasons we lose manufacturing is trade with China and there are the classic free trade arguments about why businesses would go to China. But there's

growing international role and the responsibilities that this role entailed, commenting, "You know, the Chinese seem in a lot of ways to want to be part of the family of nations when it benefits them -- you know, the bigger, more productive nations -- but not when it doesn't. Why wouldn't it help everybody to let the yuan float? And why wouldn't it be a good idea for our government to, sort of, urge the Chinese to make it happen?"[256]

Schumer and other senators shortly thereafter began a process to pressure the Chinese government to change the exchange rate regime. Following the hearing in which Greenspan was questioned, Schumer, Lindsay Graham of South Carolina, Elizabeth Dole of North Carolina, and Evan Bayh of Indiana wrote a letter to Treasury Secretary John Snow asking him to consider the evidence that China was deliberately maintaining its currency at an undervalued level. The Senators wrote, "We are deeply concerned about reports that the Chinese currency, the yuan, is being artificially undervalued, and that this undervaluation may be contributing to the significant job loss the United States has seen in its manufacturing sector."[257] Even in these initial discussions, the contours of the American approach to pressuring China's government over the exchange rate were relatively clear. The ultimate source of the Congressional pressure on China was constituent pressure related to the loss of manufacturing jobs, but the lines of attack from the Congress were apparent even in this initial hearing, and they remained relatively consistent. China's currency regime was presented as a state-controlled anachronism in an increasingly important market-driven economy, and the maintenance of the fixed

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something else that's been happening, and I'd like your comment on that. And that is that the Chinese have tightly pegged their currency. It's a fixed rate. The yuan has been, since 1994, at 8.3 yuan per dollar." U.S. Senate Committee on Banking, Housing, and Urban Affairs Hearing on Monetary Policy, Federal Document Clearing House, July 16, 2003.

[256] Schumer remarks in U.S. Senate Committee on Banking, Housing, and Urban Affairs Hearing on Monetary Policy, Federal Document Clearing House, July 16, 2003.

[257] Text of the Senators' letter quoted within Vicki Schmelzer, "Asian FX Policy Eyed As US Election Issue," Market News International, 17 July 2003.

exchange rate regime was presented not only as a violation of market-oriented principles and the rules of international financial institutions, but an obstacle to China's emergence as a responsible actor in the global economy.

The Debate Begins And Diplomacy Intensifies

Following the Congress's criticism of China's exchange rate policies, the initial Chinese response was fairly muted. There was no official reaction to the charges leveled during the hearings, although the Chinese leadership was certainly aware of the issue. British Prime Minister Tony Blair met with Hu Jintao and other Chinese officials shortly following the Senate hearing, and following those meetings, he noted that Chinese leaders were aware of the rise in international criticism of China's exchange rate policies, even though they found that criticism unusual because of the international community's previous injunctions to maintain the currency's value during the Asian financial crisis.[258] "They do recognise that increasingly as they become part of the global economy there is a responsibility," Blair said.[259] The Chinese leadership had justified their decision to avoid devaluing the yuan following the Asian financial crisis on the grounds of their responsible international role, and even in 2003, the relationship between the exchange rate regime and the perception of China as a responsible actor in the global economy was apparent to the Chinese leadership.

Shortly after the Senate hearings in July, Canada joined the list of countries calling for an end to the yuan's dollar peg. David Dodge, Governor of Canada's central

[258] Reuters, "China 'reluctant' to Adjust Yuan- Blair," 22 July 2003.
[259] Reuters, "China 'reluctant' to Adjust Yuan- Blair," 22 July 2003.

bank, the Bank of Canada, commented, "China and Asia have to be prepared also to play a bit by the rules and in one way or another to allow their exchange rates to move up against the U.S. dollar."[260] European finance ministers began to weigh in as well, as the dollar's depreciation against the euro continued to simultaneously worsen Europe's terms of trade with China. In a relatively short timeframe, China's exchange rate regime had become a hot-button issue in both financial and political circles, and the basic arguments were similar throughout the world; China was chastised for resisting market influence over the exchange rate and for not assuming their share of the responsibility in stemming the growth of global economic imbalances.

The first official Chinese reactions to the increasing scrutiny of the country's fixed exchange rate regime following the Senate hearing came through two channels. The first was an article in the state-run China Daily published August 7 mentioning the content of Wen Jiabao's remarks to a group of foreign bankers. The article claimed, "The premier made it clear that the Chinese government was mindful of the concerns of the international community. But, after careful calculations, the administration reckoned that the current exchange rate complies with the country's reality and can help promote economic development at home and abroad."[261] The second reaction came in the form of the PBOC's quarterly monetary policy report for the second quarter of 2003, which was released in early August. In the report, the central bank adamantly denied any intention to change China's exchange rate policy, stating "We will improve the exchange rate mechanism, based on the principle of supply and demand in the market and the

[260] Dodge comments cited within Wojtek Dabrowski, "The China Factor," *Financial Post* (The National Post), 23 July 2003.
[261] Xin Bei, "Don't Expect Revaluation," *China Daily* 7 August 2003.

maintenance of the managed float."[262] The managed float, in this case, referred to China's pre-2005 policy of only allowing the yuan to move slightly around the level of 8.276 yuan per dollar.

In early September, U.S. Treasury Secretary John Snow traveled to China for the first round of direct diplomacy with the Chinese government that prominently included the exchange rate issue. Before Snow arrived in Beijing, the state-run China Daily published an editorial claiming that "The critics that believe China manipulates the yuan's value assume that every currency in the world should be floated in the market . . .This assumption in itself is porous."[263] As the debate began, Chinese officials and spokespeople regularly disputed the legitimacy of the arguments for flexible exchange rate regimes, and attempted to defend the economic rationale behind the fixed exchange rate regime, while at the same time decrying the politicization of the issue and insisting that China would act on its own timetable, rather than responding to foreign pressure. Until around September 2003, China's resistance to any form of exchange rate reform was vocal and strident.

However, in the course of Snow's meetings, PBOC Governor Zhou Xiaochuan provided the first glimpse of an opening in the Chinese position. In the course of defending the Chinese government's position and the fixed exchange rate regime, Zhou commented, "The market will play a bigger and bigger role in deciding the exchange rate and when the market plays a more decisive role, China will allow a greater floating range

[262] The PBOC Monetary Policy Report was quoted within Agence France Presse, "China Rules Out Major Change in Exchange Rate in Second Half of Year," 5 August 2003.
[263] China Daily editorial quoted within Ted Anthony, "China Denies Manipulation of Its Currency," *Pittsburgh Post-Gazette* 3 September 2003.

for foreign exchange."[264] Zhou also hinted that China's stance on the exchange rate depended upon other countries' opinions of the international economic environment, rather than being entirely a product of the Chinese leadership's views of domestic economic conditions. "If all countries agree that the Asian financial crisis has passed and all the problems left by the crisis are over, China would consider moving the RMB towards a free-floating currency and improve its formation mechanism of the foreign exchange rate."[265] China had received plaudits for maintaining the stability of the yuan during the Asian financial crisis; Zhou's statements implied that if the economic situation had changed, and China's exchange rate regime was no longer viewed as a stabilizing factor by the international community, then the exchange rate regime should also change.

Zhou's remarks were enough to give Snow optimism about the Chinese commitment to reform the exchange rate regime. Following his meetings, Snow reported that he was "encouraged to hear the reaffirmation of China's long-standing goal to move towards greater flexibility" in exchange rates.[266] The White House's view of the Chinese remarks also focused on the apparent Chinese support for market-determined exchange rates. Scott McClellan commented on Snow's trip, "China has indicated in the past that [it] intend to move toward greater flexibility, and this is something we support and encourage. It is our view that currency values are best set in open and competitive markets with interventions kept to a minimum."[267]

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[264] Zhou Xiaochuan quoted within Xinhua News Agency, "China central bank governor -- too early to decide on yuan revaluation," 4 September 2003.
[265] *Ibid.*
[266] John Snow quoted within Peter Wonacott and Leslie Chang, "China's Weak Yuan Is a Plus, Not a Minus, For Many in the West," *Wall Street Journal Europe*, 4 September 2003, p. A1.
[267] McClellan quoted within Anthony.

While Snow may have believed that this was a long-standing goal of Chinese policy-makers, the internal debate over exchange rate policy was only beginning at the time, and the Chinese approach to the issue was difficult to characterize; some officials defended the fixed exchange rate regime, while others discussed the benefits of a gradual introduction of flexibility. Zhou was one of the most financially savvy among the Chinese leadership, and the most inclined toward additional exchange rate flexibility, as mentioned in the previous chapter, but the People's Bank of China was not a particularly powerful institution within the State Council, which would ultimately have to decide upon any exchange rate adjustment.[268] The Ministry of Commerce and the National Development and Reform Commission, with their constituencies within China's state-owned enterprises, were considered far more influential over the central government's decision-making.[269]

Zhou's comments may have opened the possibility of additional flexibility in the eyes of foreign observers, but the political momentum for exchange rate reform was only beginning to build, and the consensus position at the time was still resistance to foreign pressure. For example, shortly following Snow's trip to Beijing, for example, PBOC Vice-Governor Wu Xiaoling, considered one of the advocates of exchange rate reform within the Chinese bureaucracy, dampened expectations of yuan appreciation, stating, "I can't see any possibility of renminbi revaluation in the foreseeable future. The present level of yuan is suitable for growth in China. There is no necessity for yuan revaluation at present."[270] Most Chinese institutions had not seriously considered the reform of the

[268] Interview 05-16, 06-111,
[269] Interview 06-110, 06-118.
[270] Natsuko Waki, "China Central Bank Sees No Present Need to Revalue Yuan," Reuters, 8 September 2003.

exchange rate regime since the Asian financial crisis. The newly appointed Chinese leadership of Hu Jintao and Wen Jiabao had shown only reflexive impulses to resist foreign pressure, suggesting that exchange rate reform was not necessarily a pressing priority, and Zhou's remarks may have reflected the PBOC's Governor's first attempt to use Snow's visit to push the issue.

Protectionism in Legislative Form

While Snow may have been attempting to mollify Congressional criticism by claiming that the Chinese were planning on introducing more flexibility, Congress was not impressed. On September 9, 2003, six senators, including Charles Schumer of New York and Lindsay Graham of South Carolina, introduced legislation (hereafter referenced as the Schumer-Graham bill) that would impose a 27.5 percent across-the-board tariff on U.S. imports from China.[271] The 27.5 percent level was a compromise based on an average of two estimates of the extent of the undervaluation of China's currency, at 15 and 40 percent.[272] However, the Senators advocating the measure were apparently aware that it had very little chance of ever becoming law; their stated desire was to maintain the measure to maximize leverage over the Chinese government on the issue. Schumer commented upon introducing the bill that it was designed "to get everybody's attention," and Graham added, "My hope is that we'll never get to the bill, because this hopefully will be addressed," referring to China's peg to the dollar.[273] In addition, the bill itself

[271] AFX News, "Senators Seek Tariffs Against China In Currency Dispute," 7 September 2003.
[272] Interview 06-251.
[273] Quotes from AFX News, "Senators Seek Tariffs Against China In Currency Dispute," 7 September 2003.

was never as draconian as it was frequently perceived in the media; the bill contained provisions that could delay the imposition of tariffs for more than a year following its passage, and provided a clear path for a presidential waiver of the punitive measures.[274] However, the bill was significant because protectionist measures were explicitly on the table for the first time. In conjunction with the Schumer-Graham legislation, the Treasury Department proposed and supported an alternative measure that was critical of China's exchange rate regime, but did not contain the tariff provisions.[275]

The introduction of the Schumer-Graham legislation had little impact on the debate at first, but became a focal point later, in the spring of 2005. The bill's emergence highlighted the fact that the currency issue created interesting political alliances in Washington, bringing together Charles Schumer, a staunch Democrat from New York attracted to the issue by his concern about the decline in manufacturing jobs, with Graham, a moderate Republican from a southern state concerned about job losses in his state, primarily in the textile industry. A bill bringing these two senators together as sponsors illustrated the salience of the issue in Congress; China was emerging as a convenient bogeyman for a variety of economic ills, and the senators couched the issue in terms of China's own responsibilities as an emerging power in the international system. There was little political cost to continue hammering China on the issue publicly, and Democrats also saw the advantages of criticizing the Bush administration for failing to protect American manufacturing jobs. At a Senate Banking Committee hearing in late October, Schumer commented to Secretary Snow, "The time for diplomatic niceties has

[274] Interview 06-251.
[275] AFX News, "Senators Seek Tariffs Against China In Currency Dispute," 7 September 2003.

passed . . . The administration needs to grow some backbone and take a firm line with the Chinese on the currency issue."[276]

Multilateral Pressure and the Chinese Response

The issue of inflexibility in China's exchange rate regime garnered more international attention as well, following the previously mentioned IMF statement at the Asia-Europe meeting in July. China's leaders had celebrated the nation's entry into the World Trade Organization in late 2001, and criticism of the country's management of its financial system from international institutions called into question China's commitment to its larger objective of integration into the global economy as a significant player. In September, at the G7 meeting in Dubai, the statement emerging from the meeting called for additional exchange rate flexibility, with a focus on resolving developing global imbalances, without mentioning China explicitly. The joint statement claimed, "We reaffirm that exchange rates should reflect economic fundamentals. . . In this context, we emphasize that more flexibility in exchange rates is desirable for major countries and economic areas to promote smooth and widespread adjustments in the international financial system, based on market mechanisms."[277]

However, even this mild criticism of China's exchange rate regime and a restatement of the international consensus behind the principle of market-based determination of exchange rates for "major countries" elicited a much stronger reaction

[276] Neil King and Michael Phillips, "U.S.'s Yuan Rhetoric Carries Trade Risks," *Asian Wall Street Journal* 3 November 2003, p. A1.
[277] G7 Communique, September 19, 2003. Interestingly, China was not mentioned explicitly in a G7 communique until after the introduction of the July 2005 exchange rate reforms.

from Chinese authorities. Later, however, additional signs of the potential for exchange rate reform emerged from various levels of the Chinese bureaucracy. At first, however, the Chinese reaction was defensive. An opinion piece in the state-run China Daily on September 23, 2003, shortly after the G7 statement, entitled "Criticism About Renminbi Refuted," defended China's independence in setting the country's exchange rate regime, arguing that exchange rate regimes were the sovereign decision of the Chinese government. "China has refuted recent United States criticism about its exchange rate policy, reiterating its principles of independence and responsibility in handling the issue. 'The exchange rate system and policy are a country's internal affair and no other country has the right to interfere,' a spokesman for the State Administration of Foreign Exchange (SAFE) added. 'On this issue, China has always been independent and highly responsible, on which the international community has long agreed.'"[278] Interestingly, the spokesperson's statement attacked the legitimacy of international opinion regarding China's exchange rate regime even while defending the country's management of the exchange rate by attempting to claim foreign support for China's actions.

In examining the Chinese reaction to international criticism, the publication outlets that are targeting a foreign audience, such as the China Daily, can be a useful indicator of the message that China attempts to send outside the country, rather than the state's message to Chinese citizens themselves. The initial public approach of China's leaders was to defend China's right to manage its exchange rate, using language concerning China's "internal affairs" that was similar to a typical Chinese defense of the country's sovereignty claims over Taiwan or Tibet. At the same time, a series of statements attempted to place China's actions as well within accepted international

[278] Zhang Dingmin, "Criticism About Renminbi Refuted," *China Daily* 23 September 2003.

standards of behavior. The Chinese approach to the issue was generally to accept the legitimacy of international opinion and practices, and to attempt to place existing Chinese behavior within the bounds of those practices. Another opinion piece in the China Daily in early March 2004 claimed, "It should be pointed out that given the fierce international competition, maintaining the ability to manage the exchange rate helps safeguard a country's "monetary sovereignty" and ease its macro-economic regulation. Currently no country (including the United States) gives up the power to manage its capital accounts, nor does any nation spare efforts to swing the exchange rate of their home currency when it is deemed necessary."[279] This acceptance of the legitimacy of international practices, even early in the Chinese debate over the exchange rate, constrained China's choices when reforming the exchange rate regime. International institutions argued strongly for the principle of exchange rate flexibility, and China's eventual reforms in July 2005 were presented as consistent with those principles of flexibility, even as China continued to intervene in foreign exchange markets to slow the yuan's rise.

Signs of a Shift After High-Level Summitry

Following the G7 statement and Snow's visit to Beijing in September, the exchange rate issue became elevated to the level of heads of state at the APEC summit in Singapore in late October 2003. Presidents Bush and Hu Jintao held a separate bilateral meeting before the summit, and China's exchange rate regime was one topic of discussion between the two leaders. When Bush discussed the possibility of a rapid revaluation of the exchange rate, Hu Jintao pushed back strongly, arguing that China's

[279] Dai Genyou, "Stable Exchange Rate Crucial," *China Daily* 10 March 2004.

financial system was not prepared for a rapid exchange rate adjustment. Addressing a private sector group before the APEC forum, Hu commented, "On the basis of this system, keeping the exchange rate of renminbi stable serves China's economic performance and conforms to the requirements of the economic development in the Asia-Pacific region and the whole world."[280] In a compromise between the two leaders at their bilateral meeting, however, the United States and China agreed to set up a group of technical experts to study the process by which China "could move more rapidly" to a more flexible exchange rate regime.[281] This technical group was announced to a group of reporters by an unnamed senior administration official, who commented on some of Hu Jintao's statements in the bilateral meeting. According to the official, Hu expressed that China shared the goal of market-driven exchange rates, but "China, however, is cautious about moving too quickly toward that goal and feels that rapid changes in the renminbi could lead to unstable conditions - not only in China but in Asia more generally."[282] In addition, Hu added that, "in theory, China supports moving towards a market-determined floating exchange rate. But he did caution that in practice he doesn't think that China is there yet," according to the official's account of the meeting.[283]

The meeting between Bush and Hu signaled a new phase in the debate over China's currency regime. China had now committed, albeit behind closed doors, at the highest levels of the leadership to the legitimacy of the principle of market-determined exchange rates, and the key issue between the two sides centered on the timing of such moves. Rather than defending the principles behind China's fixed exchange rate, if the

[280] Kyodo News, "Hu defends China's currency system, pledges yuan stability," 19 October 2003.
[281] Agence France Presse, "US, China Agree to Study Shift in Yuan," 19 October 2003.
[282] Administration official quoted within Kyodo News, "Hu defends China's currency system, pledges yuan stability," 19 October 2003.
[283] *Ibid.*

account of the senior administration official is to be believed, Hu provided support for the international norm of flexible exchange rates, and argued that China was committed to moving, eventually, on the path to flexibility. This position, if it was sent down the bureaucratic chain within the Chinese government, as evidence from interviews later confirmed, constrained the options for reform of the exchange rate regime that China could eventually choose.

Back in Washington, the Congressional pressure intensified once again when the Treasury Department, in a semi-annual report on currency manipulation released in late October, failed to designate China as a currency manipulator. At the same time, when defending the report against Congressional criticism, Treasury Secretary Snow added, "a pegged exchange rate is not appropriate for a major economy like China and should be changed."[284] Over the following years, the Treasury's semi-annual report to Congress concerning currency manipulation would increasingly become a focus of Congressional criticism of China's exchange rate regime and the Bush administration's handling of the issue.

Following the APEC meeting between Bush and Hu, China made some moderate adjustments to the country's export tax rebates on value-added taxes in order to attempt to limit the country's booming export growth, as an alternative to a revaluation of the yuan. The rebates were effectively a subsidy to the export sector introduced in the aftermath of the Asian financial crisis. Export tax rebates were reduced by an average of 3 percent in mid-October, with the cuts effective at the beginning of 2004.[285] This was

[284] David Williams, "China Escapes US Censure on Foreign Exchange," Agence France Presse, 31 October 2003.
[285] Economist Intelligence Unit, "China Risk: Alert—Tax Change is Response to U.S. Pressure on Yuan," 22 October 2003.

just the first of many adjustments to China's monetary and trade policies announced in the years to come that were designed to slow the pace or cushion the impact of China's capital inflows, without requiring a drastic adjustment of the exchange rate regime. However, the cuts were implemented unequally across industries, and were designed to support exports in capital-intensive industries while slowing export growth in labor-intensive industries.[286] After a few years, the surge in export growth among heavy industrial products caused the Chinese government to effectively reverse these policies.

China's Premier, Wen Jiabao, held the next high-level meeting with Bush in early December 2003, which was his first after Wen's ascent to the Premiership. While Wen's statements hewed closely to the Chinese government's line, there were additional hints developing that China accepted the legitimacy of the principle of market-based determination of the exchange rate. Before Wen Jiabao's visit to the United States in December, he held an interview with Washington Post Executive Editor Leonard Downie in Beijing, where he commented that he did not believe the exchange rate was a major contributor to the bilateral U.S. trade deficit with China.[287] In addition, Wen defended China's ability to set the exchange rate in line with China's own needs, and the condition of the financial sector. In the process of reforming China's financial sector, Wen added that, "While we do so we'll explore how to form a rational mechanism in which the value of the RMB will fluctuate on the basis of market conditions."[288]

In an attempt to mollify growing American criticism of the exchange rate, China signed agreements in advance of Wen's visit to purchase over $6 billion in U.S. exports,

[286] Economist Intelligence Unit, 22 October 2003.
[287] Xinhua News Agency, "RMB Exchange Rate No Major Contributor to Sino-US Trade Imbalance – Chinese Premier," 23 November 2003.
[288] Wen Jiabao quoted within Xinhua News Agency, "RMB Exchange Rate No Major Contributor to Sino-US Trade Imbalance – Chinese Premier," 23 November 2003.

including airplanes, engines, automobiles, and agricultural products.[289] However, lower-level officials continued to stridently defend China's exchange rate regime during the visit. As part of the delegation accompanying Wen Jiabao to the United States, Ma Kai, the head of the National Development and Reform Commission, traveled to New York, where in the course of a press conference, he defended the fixcd exchange rate regime as a contributor to economic stability in Asia, and commented that a change in the yuan exchange rate would not improve the US trade deficit with China.[290] Ma added, "We believe in reforming the exchange rate but if we reform our exchange rate without one of the proper financial conditions present, we will disrupt not only (the) Chinese but the (other) Asian economies as well."[291]

The exchange rate issue was reportedly discussed directly between President Bush and Wen Jiabao during their meetings in Washington. According to a senior administration official quoted in a report of the meeting, Bush said to Wen, in reference to the exchange rate, that "we have to see concrete progress in that regard."[292] During the meeting, options such as a peg to a basket of currencies or a wider trading band for the yuan were discussed, although Wen cautioned that the Chinese banking system was unprepared for a large shift in the value of the yuan.[293] The same senior administration official commented that a meeting in Beijing early in 2004 would "discuss concrete steps

[289] Susan Lawrence and Murray Hiebert, "China-US Trade Row--Money Can't Buy U.S. Love," *Far Eastern Economic Review* 27 November 2003.
[290] Gertrude Chavez, "Exchange Rate Not Factor in US Trade Deficit—China," Reuters News, 8 December 2003.
[291] Ma Kai quoted within Chavez, Reuters News, 8 December 2003.
[292] The quote from Bush attributed to the senior administration official is cited within Adam Entous, "U.S. Presses for Interim Steps from China on Currency," Reuters News, 9 December 2003.
[293] Adam Entous, "U.S. Presses for Interim Steps from China on Currency," Reuters News, 9 December 2003.

that the Chinese can begin taking to liberalize the currency markets."[294] Other signs that the Chinese government was preparing a shift began to emerge as well. On December 22, 2003, the Business Post newspaper, published by China's Stock Exchange Executive Council, cited PBOC and SAFE officials who claimed that the government was studying a plan to link the yuan to a basket of ten currencies.[295]

By the end of 2003, the exchange rate issue had risen from relative obscurity as a Japanese complaint about China exporting deflation to occupy a prominent place in the highest-level negotiations between China and the United States. The efforts of the United States Congress were a key factor elevating the importance of the issue to both the Bush Administration and the Chinese government, but the multilateral criticism of China's exchange rate regime from the G7 and the IMF also played a role. After initially defending China's exchange rate regime as a matter of national sovereignty, and arguing that the timing and scope of any reform would be announced on China's own initiative, both Chinese President Hu Jintao and Premier Wen Jiabao framed the issue in a way that made the maintenance of China's fixed exchange rate regime untenable politically over the long term. In their conversations with President Bush, both implicitly accepted the legitimacy of the principle of market-based determination of exchange rates, and the legitimacy of international opinion in assessing China's "responsibility" in its exchange rate decision-making. The potential policy options in exchange rate reform were just beginning to be discussed by the agencies that would implement the change, the PBOC and the State Administration of Foreign Exchange (SAFE), and there was still strong

[294] Senior administration official quoted within Adam Entous, "U.S. Presses for Interim Steps from China on Currency," Reuters News, 9 December 2003.
[295] Associated Press, "Report: China Studying Possible Switch From U.S. Dollar Link for Currency," 22 December 2003.

opposition to reform from the Ministry of Commerce and the National Development and Reform Commission. However, China's top leadership accepted the legitimacy of international norms of flexible exchange rate regimes, and these principles constrained the debate over exchange rate reform moving forward. China's leaders likely accepted the legitimacy of these principles for the political purpose of presenting the Chinese financial system as consistent with international "best practices" and with China's role as a responsible player in the global financial system, rather than a cost-benefit analysis of the impact of exchange rate reform on China's economic interests. Those cost-benefit analyses were only beginning to be researched within Chinese government institutions, and they did not enter the government's final decision-making process on exchange rate reform until late 2004 and early 2005.

Speculative Capital and the Timing of Reform

Before the first meeting of the U.S.-China bilateral technical cooperation group on exchange rate policy, Chinese institutions began researching the possibility of pegging China's exchange rate to a basket of ten currencies.[296] At this point, these policy proposals were still being investigated by relevant officials in the central bank and were not actively being debated by China's central leadership. However, several Chinese officials commented publicly on the issue in order to reduce the potential for speculation on the currency, and a surge in "hot money" inflows. Chinese leaders were concerned about speculative capital primarily because of the role it had played in the Asian financial

[296] Xinhua China Economic Information Service, "RMB Suggested Pegging With Basket Currencies," 12 January 2004.

crisis, when capital flight stressed several states' capacity to maintain their fixed exchange rates, leading to abrupt and steep currency devaluations. In the Chinese economy at the time, however, these speculative inflows merely added to the liquidity in the Chinese banking system, and forced the Chinese central bank to issue sterilization bonds to soak up the excess liquidity from foreign exchange that was flooding into the country, interested in purchasing any asset that could be denominated in renminbi. By the end of 2003, market expectations of future yuan appreciation were producing real monetary growth in China, and in order to stem this monetary growth, Chinese officials had to defend the credibility of the country's fixed exchange rate regime.

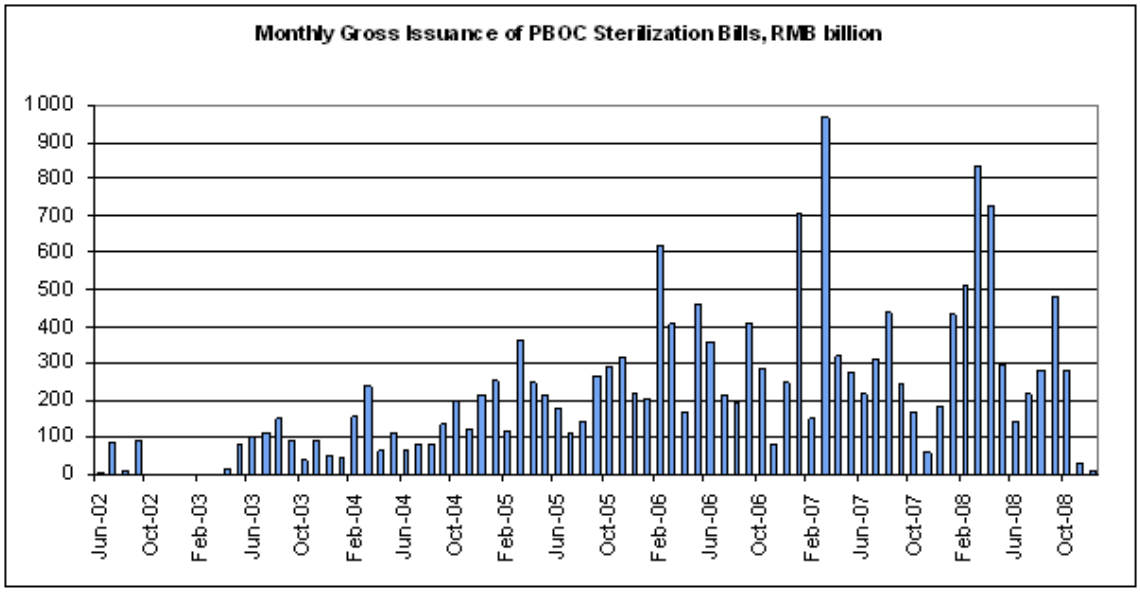

Figure 5.1- Monthly Gross Issuance of PBOC Sterilization Bills
Source: People's Bank of China, Chinabond.com.cn

Chinese officials had to walk a delicate tightrope; they had to publicly insist that no exchange rate reform was likely, so as to discourage speculative capital inflows. At the same time, therefore, China had to resist pressure to float the currency during the discussions with the United States, while reassuring the Americans privately that they

were attempting to prepare for exchange rate reform and shared the same basic principles regarding market determination of exchange rates. Otherwise, American threats of protectionism could have escalated if the private discussions were perceived as being unproductive. However, American officials meeting the Chinese authorities were in a similar bind, as they had to trumpet China's private assurances publicly, particularly in Congress, so as to offset the threat of Congressional legislation that may include protectionist measures. Chinese officials, in turn, were then forced to respond and deny that change was imminent.

Chinese officials began to comment on this dilemma. Guan Tao, who was the head of the policy research office of the State Administration of Foreign Exchange, argued that external conditions were a critical factor determining the timing of exchange rate reform, and that a revaluation could not occur when speculative capital inflows were significant. In an article in the China Securities Journal, he added, "We should start to carry out propaganda and explanation work, with reason and integrity, to counter opinions about a renminbi (yuan) revaluation and win over the understanding and support of the international community. . .That will help create a sound external environment for exploring and perfecting the formation mechanism of the renminbi exchange rate."[297] The Chinese criticism of American pressure was focused not only on the traditional resistance of interference in China's affairs, but also on the speculative capital flows that this pressure encouraged, because of the market expectations that China would move the value of the yuan. While these were market forces compelling exchange rate reform, expectations of policy changes in China were driving these market forces.

[297] Guan Tao quoted within Reuters News, "China Says Speculation Hindering Yuan Reform," 17 February 2004.

Chinese officials attempted to downplay the possibility and significance of exchange rate reform in order to discourage these speculative inflows. Li Deshui, of the State Statistical Bureau, which was later renamed the National Bureau of Statistics, commented in the course of his quarterly statistical press briefing in January that the yuan would remain "basically stable" in 2004, adding, "This policy cannot be changed. . .There have been various guesses on the exchange rate but I think the speculation by some investment banks is not reasonable."[298] Guo Shuqing, who at the time was the head of the State Administration of Foreign Exchange, also attempted to ease speculative pressure on the yuan by distinguishing between reform of the exchange rate regime and a revaluation of the exchange rate itself. Guo commented, "Perfecting the renminbi's formation mechanism does not necessarily mean a revaluation . . . Those who are making a bet on a possible revaluation of the renminbi will probably pay huge prices. There is no currency which can only rise."[299] In the reform of China's exchange rate regime, some speculative capital flows were inevitable, but the political significance of combating these flows was outsized in China, largely because of the legacy of the Asian financial crisis. A rapid exchange rate adjustment could have deterred significant speculative inflows, but the slow-moving, consensus-driven, gradualist Chinese political process encouraged speculators who were convinced that, contrary to Guo Shuqing's sentiments, the yuan had nowhere to go but up.

Bilateral Technical Consultations

[298] Li Deshui quoted within Reuters News, "China to Keep Exchange Rate 'Stable'," 20 January 2004.
[299] Tamora Vidaillet, "China Says Yuan Reform May Not Mean Revaluation," Reuters News, 10 March 2004.

The first bilateral meeting between the United States and China on the exchange rate issue occurred at some point in January 2004, according to a report from an anonymous PBOC official, but a more substantive talk on the technical aspects of adjusting China's exchange rate regime occurred in late February.[300] Before the meeting, however, a report in the China Business Post in early February cited anonymous central bank officials who claimed that the yuan would begin floating within a 5 percent band as quickly as the following month.[301] While the report triggered a denial from the central bank, the specific nature of the proposal led some analysts to argue that the debate over exchange rate reform was shifting from the international arena to Chinese government institutions.[302] Over the same weekend, the G7 released another statement calling for additional exchange rate flexibility, repeating its rhetoric from the September 19, 2003 statement "emphasizing that more flexibility in exchange rates is desirable for major countries or economic areas that lack such flexibility. . ."[303] The statement also claimed, as before, that market-based mechanisms should determine the course of these exchange rate adjustments. While the statement did not single out China specifically, China was one of the only "major countries" that lacked such exchange rate flexibility in the global economy at the time.

In the context of a high-level financial work meeting for government economic institutions, Premier Wen Jiabao offered a rebuttal to the media reports and the G7 statement, as state media reported Wen claiming that China would "maintain the basic

[300] Agence France Presse, "US, China Plan Talks on Yuan- Official," 3 February 2004.
[301] Chris Buckley, "China Is Said To Consider Revaluing Its Currency," *New York Times* 10 February 2004.
[302] Buckley, 10 February 2004. The article cites BNP Paribas China analyst Chen Xingdong, who said, "'It's notable the debate is moving from being an international one to a domestic one."
[303] G7 Statement, February 7, 2004.

stability of the yuan exchange rate at a reasonable and balanced level."[304] This specific formulation would be repeated frequently in the months and years to follow, and would be deployed by a variety of government officials from various institutions. The use of "basic" (基本☒定) to qualify currency stability, however, clearly provided enough wiggle room for the Chinese authorities to introduce incremental exchange rate reforms without contradicting Wen's statement.

Following Wen's denial, a delegation from the Treasury Department met Chinese officials for a two-day technical consultation on February 25 and 26 on the mechanics of reforming China's exchange rate regime. The U.S. delegation was led by David Loevinger, who was Treasury's Assistant Secretary for Africa, the Middle East, and Asia; Loevinger would later be named Treasury's attaché in Beijing, focused primarily on the exchange rate issue.[305] The officials most interested in exchange rate reform among the Chinese delegation were the representatives of the PBOC, according to a participant in the discussions.[306] Members of the Ministry of Finance were also present at the discussions.[307] As the agency responsible for implementing a new exchange rate regime, the central bank would naturally be involved in such consultations, but as mentioned previously, the PBOC was the critical advocate of exchange rate reform within the Chinese bureaucracy. The subjects of discussion ranged beyond the exchange rate to financial regulation, exchange rate risks to the banking system, and financial derivatives, but the adaptation of the financial system to exchange rate-related risks was a critical

[304] Associated Press, "Premier- China to Keep Currency Stable," 10 February 2004.
[305] Theresa Sheehan, "US Treasury – Govt Team En Route to China For 2-Day Tech Visit," Market News International, 23 February 2004.
[306] Interview 06-133.
[307] Dow Jones International News, "US, China Financial Officials Talk; Sudden FX Shift Unlikely," 24 February 2004.

aspect of the talks.[308] Li Yang, the academic member of the PBOC's Monetary Policy Committee, an inter-departmental advisory body, commented at the time that the meeting was primarily focused on exchanging information, while conceding that the exchange rate was a key focus of the discussions.[309] During the meeting, it was agreed that Vice-Premier Huang Ju, who held the portfolio for economic and financial affairs, would travel to Washington for meetings about the yuan, and that Treasury would install someone in a permanent position in Beijing to monitor the yuan issue.[310] Treasury eventually appointed Paul Speltz, the U.S. executive director at the Asian Development Bank, as their first envoy in Beijing.

The Preliminary Debate Within China

Following the first technical consultations with the United States, the domestic political debate within China was still at an early stage. While the PBOC and SAFE had begun to study the potential policy options for introducing more flexibility into China's exchange rate regime, and the top leadership of Hu Jintao and Wen Jiabao had expressed their commitment to the principles of additional flexibility and market determination of exchange rates, other institutions had not yet detailed their positions publicly in this debate. However, the Ministry of Commerce and the National Development and Reform Commission were critical sources of opposition to exchange rate reform within the

[308] Tamora Vidaillet, "China, U.S. Meet on Yuan- No Quick Fixes Seen," Reuters News 25 February 2004, and Agence France Presse, "China Says Small Forex Adjustment Beneficial, Free Float Not Possible," 26 February 2004.
[309] Dow Jones International News, "US, China Financial Officials Talk; Sudden FX Shift Unlikely," 24 February 2004.
[310] AFX News, "China Vice-Premier to Visit US on Yuan Exchange Rate Issue- Report," 1 March 2004.

Chinese bureaucracy. While these institutions were largely silent externally, they represented the key representatives of China's state-owned industry in internal debates within the State Council.

The position of the Ministry of Commerce in opposition to exchange rate reform was influenced not only by the ministry's constituency, but the personalities involved. At the time that the exchange rate debate began within the Chinese bureaucracy, Bo Xilai, the son of Communist Party luminary Bo Yibo, was named as the Minister of Commerce in March 2004, after a stint governing Liaoning province in China's northeast.[311] The Ministry of Commerce in China essentially represents a combination of China's commercial and trade interests, with Bo responsible for both trade-related negotiations with other nations and the health of Chinese industry more generally. The Ministry of Commerce, therefore, based on this institutional position, was always likely to oppose a dramatic appreciation of the yuan, which would weaken China's exporters. True to form, this was the role that Bo played within the State Council, according to officials from the central bank that were interested in pushing for exchange rate flexibility. One PBOC source commented, "Bo Xilai was very influential within these meetings," in his opposition to exchange rate reform within the State Council.[312] Bo's public statements on the exchange rate issue were relatively sparse until the momentum for reform began to build later in 2004. However, his public statements seemed to corroborate the accounts of interview subjects regarding Bo's opposition to a more valuable yuan. Later on in the exchange rate debate, Bo would comment publicly that "There is a lot of discussion and even some U.S. experts think that the currency should stay as it is . . .China is adopting a

[311] AFX Asia, "China's New Trade Minister Faces More Trade Rows, WTO Challenges," 1 March 2004.
[312] Interview 06-120.

very careful attitude, the government will certainly find a suitable political solution to this question."[313] Throughout the debate over the reform of China's exchange rate regime, the Ministry of Commerce was a voice for maintaining the fixed exchange rate and limiting the scope of reform.

The National Development and Reform Commission (NDRC) was one of the most influential institutions within China's State Council. The NDRC replaced China's State Development and Planning Commission, which was the heart of the Chinese government's central economic planning apparatus, allocating credit and production targets to the government's state-owned enterprises. Consistent with this mission, the NDRC's primary interest in exchange rate reform was the predictability of the economic environment, with a more flexible exchange rate regime potentially complicating that predictability. However, because the NDRC has such a broad mandate, including the health of state-owned industry and macroeconomic stability in the real, non-financial economy, the NDRC tended to take policy positions that were closely in line with the consensus of China's top leadership as a whole.[314] Some interview subjects even called the NDRC the "Little State Council," indicating its significance and the breadth of the organization's primary constituency.[315] Each year at the National People's Congress, China's legislature, the NDRC would present a work report alongside the Premier's government work report. In that March 2004 report, Ma Kai hewed closely to the formulation that Wen Jiabao had institutionalized, claiming that, "We will constantly improve the mechanism for determining the exchange rate for the renminbi and keep it

[313] Bo Xilai quoted within Reuters News, "China Says Taking Careful Attitude Toward Currency," 4 May 2005.
[314] Interview 06-118, 06-133, 06-128.
[315] Interview 07-101.

stable at a rational and balanced level."[316] According to interviews within the central bank and other academic institutions, the NDRC was also opposed to exchange rate reform from the beginning, given their interest in the health of state-owned industry and the potential complications that rapid fluctuations in the exchange rate could have for industries that lacked proper hedging tools.[317] However, the opposition of both the NDRC and the Ministry of Commerce did not become as significant until exchange rate reform developed momentum generated by the top leadership, who were facing a rising tide of criticism from foreign sources.

The momentum for exchange rate reform started with the central bank, as discussed in the previous chapter. When the technical consultations with the United States concerning the potential for exchange rate adjustment began, however, technocrats from the Ministry of Finance were also involved in the research and analysis of competing policy proposals. China's Ministry of Finance is traditionally not a particularly influential organization in terms of economic or financial policy-making, but it does interact with its international counterparts, and as a result, the MOF included officials familiar with the international financial system and the IMF's recommendations. The Ministry of Finance exerts the majority of its influence in internal policymaking through decisions such as the timing and size of subsidies to state-owned enterprises and government investment projects.[318] From an institutional perspective, the Ministry of Finance was always likely to oppose additional exchange rate flexibility, as more PBOC authority over monetary policy would detract from the MOF's influence over the

[316] Ma Kai, Report on China's Economic and Social Development Plan, Second Session of the Tenth National People's Congress, 6 March 2004.
[317] Interview 06-119, 06-118.
[318] Interview 06-128.

economy using its primary tool, fiscal policy. Furthermore, as additional monetary policy flexibility would likely mean higher Chinese interest rates, the Ministry of Finance would face higher interest payments on the national debt.

At the time in which China's exchange rate regime emerged as a prominent international issue, China's Minister of Finance was Jin Renqing. Jin's public statements focused on the technical aspects of exchange rate reform, and tended to hew closely to the consensus of the Chinese leadership. Jin called for basic stability of the exchange rate on April 7, 2004, upon meeting with French leaders in Paris, when he said, "The renminbi will remain a stable currency."[319] He also stressed the issue of China's responsibility to the international community at a conference in Germany in early 2004, when he commented on the proposals for exchange rate reform that were being studied, "We are currently considering a more flexible foreign exchange rate policy . . . You can be assured that the Chinese government will continue to act very responsibly."[320]

However, the most ardent supporters of exchange rate reform within the Chinese bureaucracy resided within the People's Bank of China, China's central bank. While most central banks in large economies were largely independent from political influence, the PBOC was not, and required the approval of the State Council in order to implement changes in monetary policy. As a result, throughout the debate concerning changing China's exchange rate regime, there was a disconnect between the international perceptions of the autonomy and authority of Zhou Xiaochuan as PBOC Governor, and the reality of Zhou's highly constrained political position. In the ministerial ranking of

[319] Associated Press Newswires, "Chinese Finance Minister Vows to Keep Currency Policy Stable," 7 April 2004.
[320] Jin Renqing quoted within Dow Jones Capital Markets Report, "China's Jin: China Mulling More Flexible Forex Policy," 1 April 2004.

ministries organized under the State Council, the People's Bank of China is ranked 26th out of 27 ministries, with the Ministry of Foreign Affairs and the National Devclopment and Reform Commission occupying the top slots.[321] While this was partially an artifact of the PBOC's pre-economic reform role as a monobank, allocating credit at the direction of state planners, the central bank's position remained institutionally constrained in the first decade of the 21st century. However, the reform of China's exchange rate regime would require a shift in Chinese monetary policy, so international attention was riveted to Zhou Xiaochuan's words and thoughts on the issue.

At the same time, that international attention generated additional pressure on Zhou Xiaochuan domestically, as many within China equated his advocacy of exchange rate reform with capitulation to foreign demands.[322] Following a one-day trip to Washington on March 26, 2004, for meetings with the IMF, the Treasury Department, and the Federal Reserve Board, Zhou granted an interview to a China News Agency reporter at Dulles Airport. While Zhou claimed that he "did not directly discuss the issue of exchange rate mechanisms" with Treasury Secretary Snow, it seems impossible to believe that Zhou would hold meetings with the IMF, Treasury, and the Fed without discussing exchange rate reform, given the political pressure from the United States at the time.[323] Within the interview itself, Zhou admitted that the meeting "touched upon" China's exchange rate formation mechanism, as well as the issue of a permanent U.S. envoy from the Treasury Department in Beijing.[324] Zhou's attempts to downplay his

[321] State Council of the People's Republic of China, "Ministries and Commissions Under the State Council," http://english.gov.cn/2005-08/05/content_20741.htm.
[322] Interview 07-104, 08-03.
[323] Yu Donghui, China News Agency [Zhongguo Xinwen She], "Exclusive interview: With regard to his busy US trip, Governor Zhou Xiaochuan of Central Bank of China said exchange rate mechanism was not directly discussed," 26 March 2004.
[324] Yu Donghui, Interview with Zhou Xiaochuan, 26 March 2004.

discussion of the exchange rate issue in the media suggest the extent to which he was attentive to opposition within China's domestic political environment, who would later characterize proposals for exchange rate adjustment as caving to foreign pressure.[325] Several years later, at the second meeting of the Strategic Economic Dialogue in Washington in May 2007, Zhou's comments to reporters also emphasized the opposition of domestic exporters to faster yuan appreciation, indicating Zhou's sensitivity to his domestic political position, even as the primary advocate of faster exchange rate adjustment within the Chinese government.[326]

In a rapidly growing but still underdeveloped economy like China's, exchange rate reform was a politically risky issue for its advocates within the central bank. As the analysis of the potential economic costs of exchange rate adjustment in Chapter 2 made clear, there were risks to moving too rapidly, particularly in terms of employment in the export sector. The political concern for many within the Chinese bureaucracy concerned the prospects for continued growth and stability. If exchange rate reform was successful, however, its advocates were unlikely to be able to claim credit, as China was already in the middle of a multi-year economic expansion. However, if there were costs to exchange rate adjustment, its advocates in the PBOC, already weak within the State Council, would likely assume the blame, because economic growth and political stability were critical determinants of the Chinese Communist Party's legitimacy. This was the basic political landscape surrounding the exchange rate regime within China in early 2004, and the net result was a political environment in which the PBOC was the only committed advocate of exchange rate reform, against fairly significant opposition from

[325] Interview 06-135, 07-101.
[326] The author was present as Zhou Xiaochuan rushed out of a meeting with several members of Congress while answering reporters' questions on May 23, 2007.

other ministries. While China's top leaders, Hu Jintao and Wen Jiabao, had made international pledges to move toward additional flexibility and more market-based determination of the exchange rate regime, as of the spring of 2004, there was little political momentum for any particular policy change.

Washington Framing The Issue, Complete With Threats

At the same time as the political debate began in China, the focus on China's exchange rate regime intensified in Washington, with both Congress and interest groups placing pressure on the Treasury Department to assume a tougher line. Throughout the debate, the advantages of market-based adjustment of exchange rates and the principle of China's global responsibility in setting its exchange rate regime were prominently featured within American arguments for exchange rate adjustment. As American groups framed the debate using these principles, Chinese leaders responded by reiterating their commitment to the principles themselves while maintaining the right to reform China's exchange rate regime in their own way and on their own timetable. However, these commitments constrained the eventual form of exchange rate adjustment.

On April 15, 2004, the Treasury Department issued another semi-annual report to Congress on international exchange rates, and while the report did not find that China was manipulating the value of its currency, the report emphasized the disconnect between China's exchange rate regime and China's position in the global economy, as well as the commitments of China's leaders to changing the system. "A pegged exchange rate policy is not appropriate for a major economy in the global system such as China, and the

Chinese government has indicated publicly and at senior levels that it will move to a flexible exchange rate regime."[327]

China's Vice-Premier Wu Yi, who later would head the Chinese delegation in the US-China Strategic Economic Dialogue, returned to Washington for trade-related meetings of the US-China Joint Commission on Commerce and Trade in April 2004. While the drumbeat of criticism of China's exchange rate regime continued, Chinese officials continued to reaffirm the principles of market-based determination of the exchange rate and China's commitment to a "responsible" exchange rate policy, which, based on China's assessment, required "basic stability." Wu Yi commented during her trip to Washington, "According to the situation of economic development, economic performance and balance of payments, we will improve the determinant mechanism of the renminbi exchange rate, bring into full play the role of the exchange rate in resources allocation, phase out inappropriate foreign exchange control measures, and eventually realise the convertibility of the renminbi under the capital account. . .it is in the interest of not only China, but Asia and the world, to keep the renminbi exchange rate relatively stable at a rational and balanced level."[328]

China's Vice-Premier with responsibility for economic and financial affairs (distinct from Wu Yi's trade-related portfolio), Huang Ju, also discussed the issue of exchange rate reform with a group of bankers and officials in Shanghai in mid-April. The text of the speech was leaked to reporters, where it was revealed that he planned to stick to the government's line of maintaining the yuan's "basic stability at a reasonable

[327] Treasury Department report to Congress quoted within Agence France Presse, "US Pressures China to Free Yuan, Says Economy Overheating," 15 April 2004.
[328] Wu Yi quoted within Charles Snyder, "Wu Yi urges US to lift curbs on hi-tech trade," *South China Morning Post* 24 April 2004.

and balanced level."[329] Later, Huang was expected to travel to the United States for more extensive discussions with the Treasury Department and American business interests.

The pressure on the Bush Administration from Congress and lobbying groups concerning the exchange rate regime continued to build in April and May 2004. In response, an unusual joint press conference in late April, including four cabinet members, was called specifically to address the issue of China's exchange rate regime.[330] At this press conference, Treasury Secretary Snow attempted to enumerate the successes of Treasury's engagement with China up to that point on the exchange rate front, to offset the potential for Congressional protectionism. Snow's statement reiterated the Bush Administration's support for market-determined exchange rates, and added, "China now holds a significant place in the international trading system. It is best for the global system, for the United States, and for China itself, for China to move to a flexible exchange rate regime. Importantly, China acknowledges this and is making progress toward this goal."[331]

In addition, Snow's statement indicated that a critical component of American strategy was to influence China's perceptions of its "responsibility" in setting exchange rate policies, by creating a clear multilateral consensus for additional flexibility. As Snow explained, "An important component of our efforts has also been to build international support for our policy. We have worked with the finance ministers in the Group of Seven nations to promote a common view that major economies like China should adopt flexible exchange rates. This view is clearly articulated in the communiques

[329] Reuters News, "China Must Maintain Stable Yuan- Vice-Premier," 15 April 2004.
[330] Keith Koffler, "Bush Officials Say Engagement Policy Is Working With China," CongressDaily 29 April 2004.
[331] Statement by Treasury Secretary John W. Snow on US-China trade Relationship, 28 April 2004, http://www.treas.gov/press/releases/js1483.htm.

that have come out of our recent meetings."[332]

Following this press conference, American pressure groups, unified under the "Fair Currency Alliance," agreed to delay a formal trade investigation of China's exchange rate regime until after Huang Ju's planned visit to the United States in July.[333] Those groups became angrier as Huang's visit was pushed back until mid-September, as the lobbying interests began to suspect that there would not be any progress to report.[334] Huang's September visit was then cancelled, as Chinese officials were reportedly concerned that election-related politics would influence the negotiations with the Bush administration.[335]

However, the American attempt to frame the issue of China's exchange rate reforms in the context of China's global responsibilities forced Chinese officials to respond by reiterating their commitments to those principles. This, in turn, eventually constrained the choices of policy options in implementing exchange rate reforms. An example of the response from China's top leadership came from Wen Jiabao in a press conference in May 2004 in Brussels, when he commented, "We are going to maintain a stable renminbi currency at a reasonable and balanced level, and secondly we are also willing to explore the possibility of a renminbi exchange-rate forming mechanism that will be market oriented."[336] The Chinese leadership consistently responded to the principles of flexibility and market determination, while arguing that changing the exchange rate regime was ultimately a Chinese prerogative.

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[332] *Ibid.*
[333] Reuters News, "US Groups Press for Quick China Currency Change," 10 May 2004.
[334] Doug Palmer, "Bush Bid for China Yuan Revaluation Losing Ground," Reuters News, 4 August 2004.
[335] *Far Eastern Economic Review*, "Intelligence," 16 September 2004.
[336] Wen Jiabao quoted within Paul Meller, "Chinese leader vows to slow growth," *New York Times* 7 May 2004.

Technical Adjustments and Hedging Instruments

As the public political pressure on China's leaders continued to mount, Chinese financial technocrats took smaller steps to prepare for eventual exchange rate adjustment. One of the critical arguments for delaying China's exchange rate reforms emerging from Chinese leaders focused on the fragility of China's financial system, where both banks and corporations had little ability to hedge against financial risk resulting from variable exchange rates. In addition, the Chinese banking system itself was beset by billions of yuan in non-performing loans, and the banks' balance sheets were in the process of being improved through capital injections of foreign currency, during the period that the exchange rate debate began to intensify. Rapid movement of the exchange rate would jeopardize the value of the state-owned commercial banks' capital injections.[337]

In the context of Treasury's ongoing technical discussions with Chinese financial officials, the Chinese government took the first steps toward the creation of onshore foreign exchange derivatives, including swaps and forwards, in June 2004. The China Foreign Exchange Trading System (CFETS) signed a memorandum of understanding with the Chicago Mercantile Exchange (CME) on June 8, whereby the CME would provide CFETS with advice and training on the use of foreign exchange derivatives, which would help to prepare China's financial system to manage risk in the event of a more flexible exchange rate regime.[338] The idea of the agreement would be to set up the markets that would enable Chinese companies to hedge against exchange rate risks.

[337] Interview 05-13.
[338] Ros Krazny, "CME, China's CFETS To Cooperate on Forex Derivatives," Reuters News, 8 June 2004.

Treasury Secretary Snow hailed the memorandum of understanding as "a significant milestone on China's path toward greater exchange rate flexibility."[339]

Following this memorandum, the Shanghai Futures Exchange signed a similar cooperation agreement with the New York Mercantile Exchange, in order to introduce physical delivery futures contracts and trading systems in China, starting with fuel oil futures.[340] The introduction of commodities futures would help to provide Chinese enterprises, particularly in manufacturing, with the ability to protect against rapid movements in commodities prices, which also involved exchange rate risks, as these prices were denominated in foreign currency.

In addition, the three recapitalized Chinese state-owned banks (Bank of China, China Construction Bank, Industrial and Commercial Bank of China) received exchange rate hedging instruments for their large capital injections, totaling $60 billion, in advance of the exchange rate reforms of July 2005. The banks were offered options to sell their foreign exchange back to the central bank's holding company, Central Huijin, at 8.276 yuan per dollar, which was the rate prevailing for the previous decade. However, the banks were forced to wait for three years before selling back their foreign exchange, so that they would not convert it into yuan and use it for regular lending operations. The Bank of China and China Construction Bank, which were recapitalized in late 2003, agreed to purchase the options in January 2005, while the Industrial and Commercial Bank of China received its option agreement shortly after its recapitalization in April

[339] Reuters News, "US Treasury's Snow Says China/CME FX Pact is Milestone," 8 June 2004.
[340] Statement from Treasury Department, "Treasury Efforts Yielding Results on China Currency," 9 September 2004, http://www.treas.gov/press/releases/js1897.htm.

2005.[341] The process of reforming China's exchange rate regime was certain to impact China's fragile banking system, and China's financial regulators attempted to protect the banks against these risks, which required introducing new hedging instruments that had not previously existed. In the case of the state-owned banks' capital injections, the central bank simply assumed the bulk of the exchange rate risk.

China's leaders engaged other countries and independent financial experts for technical assistance as well. Singapore's basket exchange rate system was an early focus of the central bank's research and policy analysis effort, as it represented a compromise between a full floating exchange rate regime and a fixed regime, and technical exchanges between the PBOC and the Monetary Authority of Singapore were reportedly frequent in 2004 and 2005.[342] These technical consultations also occurred frequently with the IMF and the Hong Kong Monetary Authority as well.[343] Technical consultations were not necessarily limited to advice from governments. At an IMF-organized forum in Dalian in May 2004, Chinese officials invited Robert Mundell, an advocate of China's fixed exchange rate regime, along with Ronald McKinnon of Stanford, who held similar views. For the other side of the debate, Jeffrey Frankel of Harvard and Morris Goldstein of the International Institute of Economics argued that a more flexible exchange rate regime would be in China's interests. According to a Wall Street Journal report published after exchange rate reform, a Chinese bank official responded to the forum by commenting that China "planned to follow Mr. Mundell's advice in the short term and Mr. Goldstein's

[341] Bank of China 2006 Annual Report, China Construction Bank 2006 Annual Report, Xinhua Finance News, "China's Huijin Hedges BoC, CCB, ICBC Forex Risk with Options- Report," 9 August 2005.
[342] Audrey Tan, "China Mulls Over Adopting Singapore Currency System," Straits Times, 14 June 2005.
[343] Interview 08-03.

advice in the long term, 'only we're not going to tell you how long the short term will be.'"[344]

China's financial technocrats were responding to the central government's signals, which included the promise of more flexibility in the exchange rate regime. While there was political momentum for the introduction of some degree of flexibility, these technical and small-scale moves were likely not initiated with a particular timetable for exchange rate reform in mind (with the possible exception of Huijin's exchange rate options, which were issued in early 2005). The issue likely did not reach the level of an inter-ministerial debate until the Central Economic Work Conference in December 2004. Until that point, exchange rate reform was still the domain of the financial technocrats, who primarily worked at the PBOC.

G7 and IMF Meetings

In October 2004, China was invited to participate as an observer in regular G-7 meetings for the first time, which occurred following the regular fall meetings of the International Monetary Fund. At the meetings, international criticism of China's exchange rate policies intensified, and Chinese officials responded by committing to additional flexibility in the exchange rate regime. However, in advance of the IMF meetings, U.S. officials pressed their own case strongly, demonstrating China's past public commitments to additional flexibility and emphasizing the necessity of moving faster along this path. John Taylor of the U.S. Treasury Department commented on the

[344] James Areddy, Neil King Jr., Mary Kissel, and Jason Dean, "Behind Yuan Move, Open Debate and Closed Doors," Wall Street Journal, 25 July 2005.

upcoming meeting, "China is a large and growing economy and all of the countries in the G7 have indicated in statements previously how the importance of flexible exchange rates is one that they wanted to stress."[345] Paul Speltz, the US Treasury Department representative to Beijing, argued, "China's leaders have already stated their very clear determination to have China move to a flexible exchange rate. That decision has been made."[346] In addition, Zhou Xiaochuan was cited within a Treasury Department press release, from Assistant Secretary for Public Affairs Rob Nichols, as saying that "building a more market-driven trading system for the renminbi is now a task of top priority."[347] In part, these statements were meant to alleviate domestic political pressure within the United States and demonstrate the effectiveness of Treasury's diplomacy on the issue.

Multilateral pressure on China's fixed exchange rate regime intensified as well. Inflationary pressure in China's economy had picked up strongly in 2004, led by rising grain prices, and this strengthened the international calls for appreciation of the yuan, as the lower prices for imported goods resulting from yuan appreciation would place downward pressure on overall price levels. At the same time, China's real GDP continued to grow at a pace exceeding 9 percent, which made it difficult for Chinese officials to argue that the costs of exchange rate adjustment would be too heavy for the economy to bear. IMF Managing Director Rodrigo Rato commented in the context of the IMF's World Economic Outlook, "Our position is clear. We think there is room to manoeuvre [to] start moving to a more flexible exchange rate system. . . Precisely

[345] John Taylor quoted within Heather Scott, "US Tsy's Taylor: G7 to Stress Flexible FX in Meet with China," Market News International, 22 September 2004.
[346] Agence France Presse, "China's Premier Wen Jiabao Says Reform of Forex Regime in Works," 28 September 2004.
[347] Zhou quoted within Statement of Treasury Assistant Secretary for Public Affairs Rob Nichols on China Currency Petition, 9 September 2004, http://www.treas.gov/press/releases/js1896.htm.

because this is a moment of strong growth in the Chinese economy, this is a very good moment to do it."[348]

The presence of PBOC Governor Zhou Xiaochuan and Minister of Finance Jin Renqing at the G-7 summit, held at dinner, was significant because it represented the first multilateral face-to-face interaction between Chinese officials and the collective group of finance ministers of the world's major economies, who had argued for additional flexibility in China's exchange rate regime in their previous three statements, but had never discussed the issue with their Chinese counterparts in the context of a multilateral summit such as the G-7. The language of the G-7 statement on October 1 was identical to that in the previous two, but the discussion at the meeting did generate an additional pledge from Zhou Xiaochuan and Jin Renqing to work toward greater flexibility in the exchange rate regime, without providing a timetable.[349] A joint statement between China and the United States also called for both countries to "push ahead firmly and steadily to a market-based flexible exchange rate" without indicating the timing of any potential move.[350] Li Ruogu, deputy governor of the central bank, also commented on the timing a month after the meeting, "We will do it according to Chinese reality to move forward steadily and firmly. . . I think it probably needs a couple of years."[351]

By December 2004, Chinese officials at both the top and middle levels of the bureaucracy had committed publicly, in an international setting, to the basic legitimacy of

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[348] Rodrigo Rato quoted within Shi Ting, "Danger Lurks Despite Cooling Measures," *South China Morning Post* 1 October 2004.
[349] Elizabeth Becker, "China Promises Currency Shift But Gives No Date," *New York Times* 2 October 2004. The language of the G7 statement was: "We emphasize that more flexibility in exchange rates is desirable for major countries or economic areas that lack such flexibility to promote smooth and widespread adjustments in the international financial system, based on market mechanisms."
[350] Robert Flint, "Forex View: China Standing Firm on Currency Policy," Dow Jones Capital Markets Report, 4 October 2004.
[351] Jill Dutt, "China Unlikely to Float Currency Soon, Official Says," *Washington Post* 11 November 2004, p. E1.

the principles of flexibility in China's exchange rate regime and permitting more market influence over the level of China's exchange rate. These commitments limited the potential direction that Chinese exchange rate reform could take, and limited the potential policy options that could fulfill these public commitments. These commitments also illustrated the importance of China's self-perception as a "responsible" player in the international financial system, and the influence of international norms in shaping China's commitments to additional exchange rate flexibility. However, the Chinese policy-making process, which depended heavily on a consensus of the central government under the Hu-Wen leadership, had not really yet evaluated the potential policy options for exchange rate adjustment, which had only been studied by the PBOC and the Ministry of Finance up to that point. The financial technocrats at the central bank had prepared for exchange rate adjustment through technical consultations and the introduction of new financial instruments, but the political consensus behind exchange rate reform only began to solidify in the preparations for the inter-ministerial Central Economic Work Conference in December 2004.

Chapter 6- The Political Logic of Exchange Rate Reform

The commitment of China's leadership to the legitimacy of the principles of market determination of exchange rates and the general efficacy of flexible exchange rate regimes constrained the range of choices available for reform. These constraints also narrowed the scope of debate within the Chinese political system, even though the resulting exchange rate reforms reflected the domestic political concerns about a large appreciation of the exchange rate and a significant loss of control over the yuan's movement. By the fall of 2004, Chinese financial technocrats had been preparing to introduce additional flexibility in the exchange rate regime through technical consultations with international financial institutions, other central banks, and acclaimed economists. The Chinese leadership, as well as the governor of China's central bank and the Minister of Finance, had committed publicly, in international forums, to introduce additional exchange rate flexibility. The inter-ministerial political debate within China over how and when to reform China's exchange rate regime, however, was only beginning in the fall of 2004, starting before the Central Economic Work Conference in December. In the course of this debate, the Ministry of Commerce and the National Development and Reform Commission (NDRC) succeeded in forcing the PBOC to scale

back some of its more ambitious proposals for exchange rate reform. The result of these compromises was the exchange rate reforms of July 2005, in which a small initial revaluation of 2.1 percent against the dollar was accompanied by the introduction of additional market influence over the value of the yuan. The political debate and the exchange rate reforms that resulted from this debate indicated the relevance of international norms concerning market determination of exchange rates within Chinese domestic politics, but analyzing the influence of these norms systematically remains challenging.

The Domestic Salience of International Norms

The July 2005 exchange rate reforms were indicative of the influence of international norms and best practices in exchange rate policy on the Chinese leadership. The actual exchange rate reforms were limited, but they allowed Chinese leaders to make claims that China was gradually converging toward international standards of flexible exchange rates and the principles of market determination of exchange rates. International pressure played a critical agenda-setting role in forcing the Chinese government to "do something" about the rising chorus of criticism, because of the importance that the Chinese leadership attached to its own image as a "responsible" actor in the international system. Pressure did not influence the eventual form of the exchange rate adjustment, as this emerged out of an opaque bureaucratic compromise, and most of China's international critics remained displeased with the scope of exchange rate reforms. However, the combination of the emerging international consensus criticizing the

sustainability of fixed exchange rate regimes in the wake of the Asian financial crisis and China's self-image as a responsible actor were the critical forces explaining the timing and form of China's exchange rate reforms.

The narrative of China's exchange rate reforms presented in this study, which emerged throughout years of interviews, may appear compelling in the absence of superior alternatives, but it presents some larger methodological concerns. It is difficult to operationalize and demonstrate the power of international norms in domestic politics in general, and it is even more difficult to do so in an opaque political system such as China's. While the narrative below has been vetted by several official sources with knowledge of the decision-making process within the Chinese bureaucracy, without reading the minds of the top leadership in considering the exchange rate reforms themselves, it is impossible to demonstrate conclusively that international financial standards were influential in determining China's exchange rate reforms. At the same time, constructivist scholars have rarely been able to access the equivalent of minutes from Politburo Standing Committee meetings, and this has not impaired the development of scholarship demonstrating the effectiveness of international norms in domestic politics.

Constructivist scholars have argued for the causative power of ideas in shaping policy outcomes, which necessarily involves an interactive process between ideas and the domestic politics of states. However, there have been few scholarly attempts to systematically identify the influence of norms within domestic politics. In order to determine the domestic salience, in Chinese politics, of international norms concerning the free mobility of capital and the flexibility of exchange rate regimes, the framework

developed by Andrew Cortell and James Davis can be useful.[352] Cortell and Davis use three areas to evaluate the domestic salience of international norms: activity within domestic political discourse, changes in domestic institutions, and analysis of the state's policies, including policies within related issue areas. Cortell and Davis emphasize several factors closely correlated with the domestic salience of international norms that can be tested in the context of China's exchange rate regime.[353] These factors include the cultural match between international norms and China's political culture, repeated declarations by the top leadership concerning the norm's legitimacy, incorporation of the norm into domestic institutions, and linkages of the state's interests to international standards.[354] An evaluation of the domestic salience of international norms in China, using Cortell and Davis's framework, follows the narrative of the political forces producing China's exchange rate reforms in July 2005.

The 2004 Central Economic Work Conference

Every year, the Chinese Communist Party and China's State Council hold an inter-ministerial meeting labeled the Central Economic Work Conference, where various economic ministries report on their activities over the past year and the political leadership of the central government sets priorities in economic work for the following year. The conference is not a forum for debate and decision-making per se, but

[352] Andrew Cortell and James Davis suggest a research agenda in this area in "Understanding the Domestic Impact of International Norms: A Research Agenda," *International Studies Review* 2:1 (Spring 2000), p. 65-87.
[353] Cortell and Davis, p. 73-84.
[354] Cortell and Davis, p. 73-84.

essentially ratifies and institutionalizes the government's priorities.[355] At the Central Economic Work Conference in 2004, the Chinese government stated a clear commitment to reform the basic direction of Chinese economic growth, labeling this approach "the scientific viewpoint of development."[356] The basic direction of the government's desired shift in economic growth was toward domestic consumption and away from reliance upon fixed asset investment and exports.[357] Editorials accompanying the conference in state media called on the government to "overcome the tendency of one-sidedly pursuing quantity and speed, and genuinely shift the focus of economic work to improving the quality and efficiency of economic growth."[358]

The argument for shifting the Chinese growth model was focused on sustainability and improving the "quality" of Chinese economic growth. Rapid expansion of heavy industry in the preceding years risked creating rising energy inefficiency, environmental damage, excess capacity that could depress profit margins, and also failed to generate marginal employment growth at the same speed as investment in consumer-oriented light industry.[359] In addition, Chinese consumption growth had declined as a proportion of GDP over the previous decade, meaning that China's headline economic growth levels failed to translate into commensurate improvements in personal consumption, and therefore, a commensurate rise in standards of living for Chinese

[355] Xinhua Finance News, "China Officials Pledge Economic Stability in 2005; No Clues on Yuan Peg," 7 December 2004.
[356] Editorial in People's Daily, "Put Into Effect Scientific Viewpoint of Development In an All-Round Way," December 15, 2004.
[357] Nicholas Lardy, "China: Toward a Consumption-Driven Growth Path," Institute for International Economics Policy Brief 06-6, October 2006.
[358] Editorial in People's Daily, "Command Whole Situation of Eco-Social Development With Scientific Development Concept," December 6, 2004.
[359] Nicholas Lardy, "China: Rebalancing Economic Growth," In *The China Balance Sheet in 2007 and Beyond* (Washington: Center for Strategic International Studies and the Peterson Institute for International Economics, 2007), p. 5-10.

citizens.[360] While the meeting was closed and the exact arguments advanced at the economic conference remain inaccessible, the editorials accompanying the conference clearly indicated that a shift in the focus of economic policy was underway. China's top leadership of Hu Jintao and Wen Jiabao, shortly after the ouster of Jiang Zemin from his last remaining post in 2004, began to question the basic direction of China's economic growth in the Jiang era, and were focused on rebalancing China's economic growth, emphasizing faster growth in inland regions and rural areas, and in domestic consumption overall.[361]

This shift in the thinking of the central government was a critical enabler of political momentum for exchange rate reform. A more flexible exchange rate regime was consistent with the central government's attempts to rebalance the economy, and American officials made this point to their Chinese interlocutors as well. First, a more valuable yuan would increase Chinese consumers' purchasing power, increasing the affordability and attractiveness of imported products, and reducing China's trade imbalances. This, in turn, would cause a gradual shift of investment patterns, away from export-oriented industries (which would suffer from this shift in the short term) and toward industries focused on domestic consumption. The net result would be a rise in the share of GDP from domestic consumption, and an improvement in citizens' standards of

[360] *Ibid.*

[361] An article in the People's Daily stated the priorities as follows: "Other key points in the arrangement include: control the overall scale of investment in fixed assets; optimize investment structure and make readjustment between investment and consumption; adhere to the development road of new industrialization, speed up economic restructuring and the transition of growth patterns; promote interaction among the east, the central and the west areas of the country, so that they can complement each other and realize coordinated development; continue to implement the strategy of rejuvenating the nation with science and education, speed up the development of various social undertakings; well handle various works concerning people's interests so as to protect social stability; make efforts to promote economic system reforms and raise the level of opening up in an all round way." People's Daily, "Central Economic Conference Makes Arrangement for Next Year," 6 December 2004.

living as consumption rose in line with GDP growth. Secondly, additional flexibility in the exchange rate regime would enable China's central bank to use monetary policy to limit the rapid expansion of fixed asset investment in heavy industry that had helped to create external, regional, and environmental imbalances.

After the Central Economic Work Conference, the central government had delineated its priorities in economic reform in 2005, and advocates of exchange rate reform could argue effectively in internal government debates that a more flexible exchange rate regime fit within those objectives. Economic developments in 2004 strengthened the reformers' case as well. Inflationary pressure had picked up to around 5 percent in the middle of the year as a result of rising food prices, but the central bank only raised interest rates once, by 27 bps in October. Because the central bank was essentially importing US monetary policy, they were constrained in the responses to rising inflationary pressure, as higher interest rates would also attract additional capital inflows.

The Central Economic Work Conference likely discussed exchange rate reform directly, even though the statements from the central government accompanying the conference contained no direct discussion of the exchange rate regime. However, there are some indications that the central government signaled its intention to prepare for more flexibility at the conference itself. Shortly after the conference in December, Chinese interbank interest rates, or the yields on 1-year central bank sterilization paper, began to plunge, while they should ordinarily move roughly in line with U.S. interest rates, which were rising at the time.[362] This drop in interbank rates was consistent with

[362] Interest rate trends from Chinabond.com.cn and Stone & McCarthy Research Associates, as well as data from the People's Bank of China.

the central bank's preparations for an appreciation of the yuan. If Chinese interest rates were roughly equal to U.S. interest rates, there were clear incentives for foreign speculators to invest in yuan-denominated assets if there were expectations of yuan appreciation. By taking steps to reduce Chinese interbank interest rates below U.S. interest rates, as the central bank still exercised a great deal of control over the yields on its bonds, the PBOC essentially created an artificial risk for speculators betting on yuan appreciation, starting in December 2004 and January 2005; speculators would receive a lower rate of return on yuan-denominated assets.

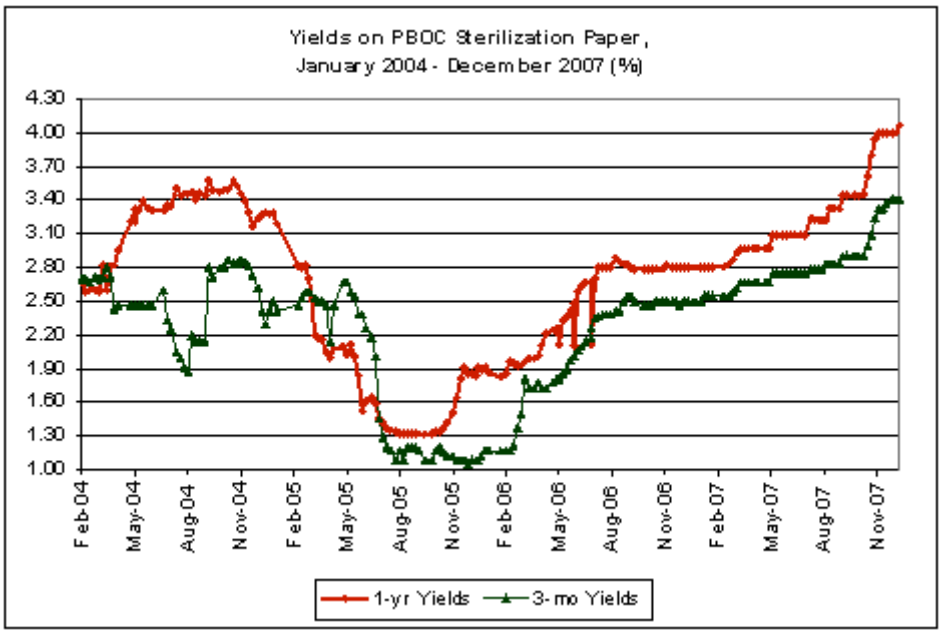

Figure 6.1- Yields on PBOC Sterilization Bills, 2004-2007
Source: People's Bank of China, Chinabond.com.cn.

Therefore, it is possible that the central government indicated that exchange rate reform was a pressing priority at the December 2004 Central Economic Work Conference. Whether that approval happened or not, the shift in the central government's thinking

about economic growth outlined at the conference provided significant political space for the advocates of exchange rate reform within domestic political debates.

Davos and the February 2005 G-7 Meeting

After a year of discussion, the international pressure on China to reform its exchange rate regime was reaching a crescendo. Both the World Economic Forum in Davos, Switzerland and the February 2005 G-7 meeting placed China's exchange rate regime back in the international spotlight. At the Davos meeting, Yu Yongding, an advisor to the central bank, commented to reporters after a dinner meeting, "Now is the time to revalue . . . We need more flexibility. That means revaluation. . . .China is experiencing inflation and a revaluation can help combat inflation."[363] Yu's remarks set of an immediate firestorm, before the PBOC could clarify that this was Yu's personal opinion and was not central bank policy, despite Yu's position as an advisor to the central bank.[364]

After the controversy over Yu's remarks, Chinese officials found themselves in an awkward bind at both the Davos summit and the G-7 summit in London that followed Davos a week later. Chinese officials had to acknowledge that they were making progress toward implementing a more flexible exchange rate regime, without overtly signaling that a change to the current regime was coming. China had accumulated over $100 billion in foreign exchange reserves in the fourth quarter of 2004, as international speculators had begun to pour money into the country, primarily in the form of property

[363] Dow Jones International News, "PBOC's Yu: Now is the Time to Revalue Yuan," 27 January 2005.
[364] Market News International, "China Central Bank: Yuan Revaluation Remarks Not Bank Policy," 28 January 2005.

purchases, in order to take advantage of any upcoming appreciation of the yuan. A signal that a move was coming would result in even faster inflows, and then following the exchange rate adjustment, China could potentially create a rapid capital outflow, with negative implications for the property markets, the liquidity situation in the banking system, and the larger macroeconomy.

At the same time, in order to maintain domestic political support for exchange rate reform, Chinese officials had to maintain that exchange rate reforms were solely a Chinese initiative, and not a response to international pressure. In international settings, however, Chinese officials stressed that the Chinese position was in line with the international consensus on the legitimacy of the principles of currency flexibility and market-based determination of exchange rates, in order to be seen as a responsible player in global financial circles. The acceptance of the legitimacy of these principles eventually constrained the autonomy that China held in restructuring its own exchange rate regime, and led to some convoluted statements by Chinese officials in the runup to exchange rate reform.

For example, Vice-Premier Huang Ju, speaking at Davos, was asked about what the world could expect to see regarding the movement of the yuan in 2005 and 2006. He replied that China would "maintain a stable level for the renminbi," which would apparently downplay any risk of a revaluation or any other reform to China's exchange rate regime.[365] However, in the same press conference, Vice-Premier Huang added, "In recent years, people have paid great attention to the exchange rate - and the Chinese

[365] Huang Ju quoted in Bruce Nussbaum, "Decoding China's Yuan Messages," *Business Week*, 31 January 2005.

government attaches great importance to that."[366] These remarks would appear to signal that China was responsive to the needs of the international community and would therefore be willing to introduce additional flexibility. Li Ruogu, deputy PBOC governor, then commented later in the conference, "Leave this issue (of floating the yuan) to the Chinese people and the Chinese government. We will certainly figure out what is the most suitable approach for China's economic development."[367] China was both interested and uninterested in foreign opinion of China's exchange rate regime.

At the G-7 meeting in London, these contradictions became even more apparent. European Central Bank president Jean-Claude Trichet commented after the meeting that the Chinese participants in the G-7 meeting, which included Zhou Xiaochuan and Jin Renqing, signed onto and accepted the language in the G-7 communique calling for additional currency flexibility.[368] However, at the same time, Zhou Xiaochuan commented before the meeting that, "There will be no change in our policy (on exchange rates)," while also declaring China's intention to "improve our exchange rate setting system."[369]

The multiplicity of messages emerging from Chinese officials in these international economic summits illustrated the conflicting pressures forging the reform of China's exchange rate regime. While international perception of China's exchange rate practices was critical to China's efforts to be perceived as a responsible actor in the global economy, Chinese officials could not commit publicly to a change in the exchange

[366] Reuters News, "China's Huang Says No Timetable for Forex Reform," 29 January 2005.
[367] Xinhua Finance News, "China's Ruogo [Li] Asserts Autonomy in Yuan Decisions," 31 January 2005.
[368] Sivakumar Sithraputhran, "China Seen Inching Closer to Reavaluing Yuan After G7 Meeting," Xinhua Finance News, 7 February 2005.
[369] Allen Feng, "China Central Bank Chief Says No Change in Rate Policy In Near Term," Xinhua Finance News, 7 February 2005.

rate regime, for several reasons. First, such a commitment before a foreign audience would be a political liability for the advocates of reform within Chinese domestic political circles. Secondly, global financial markets would react instantly to the announcement of the change, before the change itself was implemented, triggering the potential for rapid capital inflows, followed by outflows, depending upon the size of the yuan's revaluation. Thirdly, and most significantly, the Chinese government had likely not yet itself decided exactly how it would reform its exchange rate regime at the time of these summits. Instead, China had simply committed to the principles of additional exchange rate flexibility and market-based determination of the value of the yuan. The exact form of exchange rate adjustment required a more delicate political compromise that had likely not yet been ironed out in February 2005. In addition, China would not have benefited by announcing the results of that bureaucratic compromise to global financial markets.

The National People's Congress and Preparatory Financial Reforms

The National People's Congress, the annual meeting of China's legislature, is a relatively weak legislative body that largely approves decisions made by the higher authorities in China's Party-state bureaucratic structure. However, the meeting of the legislature also provides opportunities for policy discussions involving many institutions under the State Council, and policy announcements, particularly in the economic realm,

often follow the Congress in short order.[370] While the proceedings of the Congress are opaque, given the attention attached to exchange rate reform within the government at the time, it was likely that the State Council reached a broad consensus on the direction of exchange rate policy moving forward. Premier Wen Jiabao expanded on his usual commitments to additional flexibility and market influence in China's exchange rate regime in a press conference alongside the NPC meeting. Wen commented, "Our objective for exchange rate reform is to have a market-based, managed, floating exchange rate. . . .when we consider reform plans, our purpose is to make the exchange rate more responsive to supply and demand in the market."[371] In addition, Wen added, "regarding the timing of the reform or specific measures to be adopted . . . maybe they will come unexpectedly."[372]

While the exact size of the eventual revaluation of the yuan was likely still under discussion, China's financial authorities introduced further technical reforms in the financial system to discourage speculative capital inflows and permit more market influence over the exchange rate. Immediately following the NPC meeting in 2005, on March 16, China's central bank announced a cut in the interest rate it would pay to commercial banks on excess reserves held at the central bank, above the central bank's required levels, from 1.62 percent to 0.99 percent.[373] Interbank interest rates, already sinking since November 2004, plunged in response to the news, as the net effect of the measures was to encourage commercial banks to seek higher returns in other financial

[370] For example, the formation of the China Investment Corporation, China's sovereign wealth fund, was announced in outline form shortly following the National People's Congress in 2007, and then additional details on how the organization would be funded were provided in the months following the Congress.
[371] Wen Jiabao quoted within Xinhua Finance News, "China Premier Says Market May Be Surprised by Yuan Reform Plans," 14 March 2005.
[372] *Ibid.*
[373] Market News International, "China Cbank Cuts Interest Rate on Excess Reserves," 16 March 2005.

instruments, rather than parking excess funds at the central bank; the surge in liquidity reduced the cost of funds in the interbank market.[374] By reducing these interest rates, however, the central bank also reduced the rates of return on speculative capital inflows or "hot money" seeking to profit from yuan appreciation, as Chinese interest rates began to diverge from U.S. interest rates, despite the maintenance of the fixed exchange rate.

In discussing these moves in April 2005, an unnamed author, which in Chinese publications can often imply a government source, argued in an opinion piece in the China Business News that the government had deliberately reduced bond yields in order to prevent speculation on currency appreciation. The article claimed, "In lowering the profit on bonds, hot money will only choose to leave the market and, having left, find there is nowhere else to invest."[375] In addition to targeting the rates of return on foreign speculation in the interbank bond market, Chinese authorities were cracking down on the property market as well, believed to be another destination for foreign speculative capital. On the same day as the announced cut in excess reserves, China's central bank allowed commercial banks to demand higher down payments and charge higher interest rates for mortgage loans, in an attempt to curb rapid rises in property prices, particularly in Shanghai.[376]

While the measures may have appeared to be unrelated, they were both tied together by the objective of limiting speculative capital inflows betting on an appreciation of the yuan, which were contributing to Chinese monetary growth and adding to China's

[374] Allen Feng, "China Central Bank Bill Yields Fall on Excess Reserves Interest Rate Cut," Xinhua Finance News, 17 March 2005.
[375] China Business News article quoted within Market News International, "China Interbank rates Tumble on PBOC Reserve Cut," 21 April 2005.
[376] Dow Jones International News, "China Mortgage Lending Rate Reverts to Ordinary Lending Rate," 16 March 2005.

foreign exchange reserves. It would have been extremely difficult for Chinese authorities to introduce more market influence over the exchange rate amid a torrent of speculative capital because these flows would immediately push the value of the yuan sharply higher, which was not the central government's desired outcome, based on repeated statements about maintaining the value of the yuan at a "reasonable and balanced" level. The announcement of these measures on the same day indicated that the government was attempting to create a more favorable environment to introduce additional flexibility into China's exchange rate regime. The announcement of these measures immediately following the National People's Congress indicates that by the middle of March, the Chinese government had already agreed to the basic structure of exchange rate reform that was eventually announced in July: a small initial revaluation, along with a carefully managed float of the exchange rate. The size of that small revaluation and the timing of the reforms were likely still under discussion at the time.

A market-based exchange rate regime required participants willing to provide prices to both buy and sell foreign exchange, serving as market makers. Chinese financial authorities prepared to introduce market makers to provide prices of yuan relative to foreign currencies, naming seven foreign banks and two domestic banks as market makers in late March 2005.[377] These reforms were necessary to provide a transmission mechanism for market signals over the yuan's value, as opposed to that value simply being set by the central bank. Guo Shuqing, head of the State Administration of Foreign Exchange at the time, argued "At the moment, supply and demand of the yuan is under government control and it will only be the right time to

[377] Xinhua Finance News, "China Picks 7 Foreign Banks, 2 Domestic Banks as Forex Market Makers," 28 March 2005.

adjust the yuan exchange rate when a market-oriented demand and supply relationship is established."[378] After the introduction of these market makers, the central bank would simply be the largest participant in the foreign exchange market rather than declaring it would purchase all foreign exchange at a rate of 8.276 yuan per dollar. Later in May, the central bank announced that it would add new foreign currency pairs to the interbank foreign exchange market, mainly involving other foreign currencies and the U.S. dollar, to provide additional experience for domestic foreign exchange traders unfamiliar with market-based exchange rate risks.[379] Interestingly, the central bank's statement announcing the move replaced a statement earlier in the day from the Shanghai Foreign Exchange Trading System, which claimed that the moves would "create the conditions for the introduction of market makers in US dollar against yuan trading in the future."[380] The PBOC statement later in the day eliminated this reference and discussed the moves in terms of improving financial risk management, but the original statement likely revealed the intent of these measures. The central bank was introducing a variety of conditions that would smooth the introduction of exchange rate flexibility, but they also did not want to signal to the market that exchange rate reform was imminent.

The Schumer-Graham Vote and Congressional Diplomacy

In early April, the U.S. Congress again indicated American displeasure with China's failure to reform the exchange rate regime, despite vague commitments from

[378] Xinhua Finance News, "China's Forex Regulator Says Not to Appreciate Yuan in Short-Run," 7 March 2005.
[379] Xinhua Finance News, "China Central Bank Announces Expanding Onshore Forex Trading Tomorrow," 18 May 2005, Interview 05-21.
[380] *Ibid.*

Chinese officials to do so. In part, Congressional criticism reflected concern for the level of the Chinese exchange rate, which affected the competitiveness of Chinese exports in American markets, rather than the level of market influence over the exchange rate. Even though Chinese financial technocrats had introduced a number of steps in preparation for additional flexibility, none of these measures had changed the level of the exchange rate as of April 2005, so the situation for the U.S. Congress and representatives' constituents had also remained unchanged.

However, there was considerable controversy on Capitol Hill regarding the Schumer-Graham proposal to impose a 27.5 across-the-board tariff on all Chinese goods if China failed to reform its exchange rate regime. The bill was blatantly protectionist, even though its sponsors primarily viewed it as an instrument of leverage, and as a result, it attracted some significant opposition, both within Congress and in the Bush Administration. The bill had been proposed in late 2003, but this opposition had prevented it from seeing significant legislative action since that time, and as a result, the level of support for the measure was relatively unclear.

On April 6, 2005, Senators Schumer and Graham attached their China-focused proposal as an amendment to a bill authorizing State Department and foreign aid programs, and a procedural vote was called on whether or not to shelve the measure.[381] Surprisingly to its sponsors and Senate leadership, sixty-seven Senators refused to kill the Schumer-Graham proposal, indicating a broad level of discontent with Chinese currency practices; according to interviews, the margin surprised the bill's own sponsors.[382] The vote caused Schumer to comment on the depth of discontent with China's exchange rate

[381] Jim Abrams, "House Bill Would Force Action Against Undervalued Chinese Currency," Associated Press, 7 April 2005.
[382] Interview 06-251, Greg Hitt, "Senate Slams China Currency Policy," *Wall Street Journal* 7 April 2005.

practices within the Senate, "This is a red-hot issue . . .What it shows is the overwhelming bipartisan sentiment -- from every part of the country -- that the Chinese must once and for all play fair. . . The Chinese give lip service, and don't change."[383] As a result of the procedural victory, the Senate leadership was forced to give Schumer and Graham a vote on their bill in July 2005, in exchange for their withdrawal of the amendment.[384]

The strong show of support for the Schumer-Graham proposal in the Senate dramatically increased the possibility of U.S. protectionism in response to Chinese inaction on the exchange rate front. The proposal's sponsors, in turn, argued that the likelihood of implementing protectionist threats was low, but the proposal would increase leverage on the Chinese. Schumer commented at one point that the Bush Administration had supported his efforts, with administration officials telling him, "Keep it up: you're the only thing we've got to get progress."[385] Analysts in Hong Kong also argued that the threat of protectionism would encourage China to move on the exchange rate front.[386] Strategists from J.P. Morgan in Hong Kong even predicted an exact date for China's exchange rate reforms, on May 8, 2005, after the May Day holiday concluded.[387]

Following the vote on the Schumer-Graham amendment, however, the Treasury Department decided to use the leverage from the threat of protectionist measures in a new round of diplomacy with Chinese officials. Secretary Snow appointed Olin Wethington

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[383] Schumer quoted within Hitt.
[384] Edmund Andrews, "Bush's Choice: Anger China or Congress Over Currency," *The New York Times* 17 May 2005.
[385] Joseph Rebello, "US Senator Schumer Sees China Yielding on Currency Dispute," Dow Jones Newswires, 8 June 2005.
[386] Interview 05-31.
[387] Xinhua Finance News, "Focus- China Will Not Revalue Yuan Next Week Despite Speculation," 12 May 2005. Later, after the exchange rate reforms were announced, the People's Daily editorial justifying the reforms ridiculed these predictions, arguing that China's government had surprised the market.

as a special Treasury envoy, and in the scope of seven weeks between the middle of May and the beginning of July, he took three week-long trips to Beijing, meeting with officials at a large number of institutions within the Chinese bureaucracy.[388] This high-level but relatively quiet diplomatic effort was meant to press the American message that there were potential consequences to Chinese inaction on the currency issue, in the form of the threat of tariffs, and that the Bush administration was running out of time to delay the protectionist measures.[389]

The Chinese response to this high-level diplomatic campaign was to reiterate that China refused to reform its exchange rate regime under pressure, particularly in the form of a potential vote on the Schumer-Graham tariff measure that was scheduled for July. Eventually, Schumer and Graham agreed to delay the planned July vote on the measure after a meeting with Federal Reserve Chairman Greenspan and John Snow, where Greenspan and Snow argued that Chinese exchange rate reform was coming soon.[390] These beliefs on the part of Snow and Greenspan were likely based on the information obtained from Wethington's diplomacy, but according to one interview subject, Snow had made similar claims in the past, only to see no significant change.[391] However, the legislative action on the Schumer-Graham proposal in early 2005 also created some real concerns about protectionism in Chinese policy-making circles, and the result may have been a temporary delay in the introduction of exchange rate reforms, as Chinese officials did not want to be seen as reacting to foreign pressure.

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[388] James Areddy, Neil King Jr., Mary Kissel, and Jason Dean, "Behind Yuan Move, Open Debate and Closed Doors," *Wall Street Journal* 25 July 2005.
[389] *Ibid.* Also, see Andrew Balls, Mure Dickie and Edward Alden, "The US Diplomacy Behind China's Revaluation," *Financial Times* 24 July 2005.
[390] Greg Hitt, "U.S. Senate Clears Trade Pact, Stalls China Vote," *Asian Wall Street Journal,* 4 July 2005.
[391] Interview 06-231.

The Process of Economic Policy-Making and the Political Compromise

In the spring of 2005, following the NPC meetings, Chinese policy-makers were debating the final terms of exchange rate reform, within the confines of the Central Economic and Financial Leading Group (CEFLG), led by Premier Wen Jiabao. Previous accounts of China's exchange rate policy-making placed the leading group as the central decision-making authority over exchange rate policy, deciding between policy inputs chosen by other ministries. Leong H. Liew sets out a basic model of exchange rate policy-making in China that is generally consistent with the process of exchange rate reform from 2003 to 2005, arguing that reforms begin with the formation of policy inputs from various research institutions within the bureaucracy, proceed with the processing of those inputs and evaluation of potential policy alternatives, and then concludes with final evaluation of policy choices and decision-making.[392] Liew makes a distinction between policy-making, or the formation of potential policy choices at research institutions, and policy decision-making, which occurs at the level of the top leadership in the CEFLG, based on the policy inputs that have filtered through preliminary consideration.[393] This was generally consistent with evidence from interviews, which pointed to initial proposals for exchange rate reform emerging in late 2003 and early 2004, and final decision-making occurring between late 2004 and early 2005.

Another assessment of the process of exchange rate policy-making within China from Yi Jingtao argues that there has been a slight change in the policy-making process from the Jiang Zemin era to the Hu-Wen leadership, with the Ministry of Commerce

[392] Leong H. Liew, "Policy Elites in the Political Economy of China's Exchange Rate Policymaking," *Journal of Contemporary China* **13**: 38 (2004), p. 23.
[393] Liew, p. 23.

containing greater influence in the policy-making process after the abandonment of the Central Financial Work Commission in 2003.[394] According to Yi, the PBOC plays a critical role in formulating policy options, because of the technical experience of its staff in interacting with international financial markets and understanding their influence on China's economy.[395] Yi describes the CFELG choosing between the policy options proposed by the PBOC, while attempting to mitigate the negative consequences for the domestic economy.[396] Both accounts, from Liew and Yi, point to increasing pluralization in exchange rate decision-making and increasing professionalization, with policy formulation responsibilities in the hands of financial technocrats capable of assessing the impact of different policy choices on international financial markets, with most of these technocrats residing at the PBOC.[397]

However, exchange rate policy-making was not simply the result of Wen Jiabao's decree, but depended upon building a consensus within the Chinese bureaucracy. Many scholars have pointed to the rise of consensus-based decision-making and a pluralization of inputs within Chinese politics since the Deng Xiaoping era.[398] Exchange rate policy was no different, particularly given the dramatic effects that a change in the exchange rate regime would have on China's domestic economy, and the legitimacy of the Chinese Communist Party in its stewardship of China's economy. Many interview subjects, primarily those from the central bank, pointed to the dramatic opposition to exchange rate

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[394] Yi Jingtao, "China's Exchange Rate Policymaking in the Hu-Wen Era," China Policy Institute and Center for Global Finance, University of Nottingham in Ningbo, China, Briefing Series- Issue 29, October 2007, p. 5-7.
[395] Yi, p. 11.
[396] Yi, p. 9-10.
[397] Liew, p. 51.
[398] For examples of scholarship focused on the new consensus-driven style of Chinese decision-making, see Cheng Li, "The New Bipartisanship within the Chinese Communist Party," *Orbis* **49**:3 (Summer 2005), p. 387-400, and Joseph Fewsmith, "Generational Transition in China," *Washington Quarterly* **25**:4 (2002), p. 23-35.

reform within China's political system, particularly in the Ministry of Commerce and the National Development and Reform Commission, and noted that the eventual reforms reflected concessions to opponents' positions.[399] Guo Shuqing of the State Administration of Foreign Exchange had commented early in 2005 on the need for this consensus in exchange rate policymaking, saying, "We need to adopt a trading band which can be accepted by everyone."[400] The National Development and Reform Commission (NDRC), China's state planning agency responsible for the approval of investment projects, was concerned that rapid fluctuations of the currency would complicate its investment planning, forecasting, and resource allocation. The Ministry of Commerce, which represents China's exporters, was concerned that a higher yuan would destroy the profits of China's low-margin export enterprises, particularly in the textile sector. The concern was political as well; large numbers of potentially unemployed urban residents as a result of the fiat of an unelected government were not conducive to social stability.

According to evidence from interviews, the most critical officials active in hashing out the eventual compromise were Premier Wen Jiabao, PBOC Governor Zhou Xiaochuan, Minister of Commerce Bo Xilai, and NDRC head Ma Kai, who was also the Secretary-General of the CEFLG, where Ma could make known the views of China's state planning agency.[401] This picture of elite-level decision-making concerning China's exchange rate policies was consistent with the accounts of Liew and Yi mentioned earlier. However, neither of the previous accounts incorporates the influence of external

[399] Interviews 06-120, 06-118, 06-110, 07-106, 08-04.
[400] Guo Shuqing quoted within Xinhua Finance News, "China Says Yuan Float Range Needs to be 'acceptable to all parties,'" 14 March 2005.
[401] Interviews 06-120, 08-03, 07-101, 06-113, 06-118.

variables, which were critical to China's exchange rate reform. The policy choices that emerged from China's policy think tanks were ultimately constrained by the commitments that Hu Jintao, Wen Jiabao, and the rest of China's financial leadership had made in international summits during the previous year. China's leaders had committed to additional flexibility in the exchange rate regime, and more market influence over the yuan's value. When the policy instructions to think tanks under the PBOC were passed down from the Chinese leadership, the instruction was to "do something" about the international criticism, rather than simply to restructure China's exchange rate regime optimally.[402] While Liew and Yi both mention that international perceptions of China's policies were one factor considered by China's leaders, a critical part of the story of the 2005 exchange rate reforms was the agenda-setting role that international pressure and principles of market determination and flexibility played in China's exchange rate policy-making. Liew argues that influence over exchange rate policy remained contained within the Chinese bureaucracy, but this does not account for the fact that the options for exchange rate reform had been limited by the principles of international financial institutions, operating outside the Chinese bureaucracy.[403]

When the final form of China's new exchange rate regime was being decided, the basic contours had been set; there would be a small initial revaluation of the yuan, combined with the introduction of additional market flexibility, while maintaining the central bank's ability to control the pace of exchange rate appreciation. According to several accounts, the final decision-making process involved two groups of economic

[402] Interview 06-120, 08-03, 06-118.
[403] Liew, p. 50.

advisers, who convened to decide the appropriate size of the initial revaluation.[404] The group consisting primarily of PBOC officials wanted a 5 percent initial revaluation, while the group more sympathetic to the Ministry of Commerce wanted a lower initial revaluation, in the range of 2 percent.[405] Faced with these competing recommendations, the State Council and its leader, Premier Wen Jiabao, arrived at a level of 2.1 percent for the initial revaluation of the renminbi, for reasons that remain unclear, even years later. One interview subject indicated that a report circulating in the debate at the time indicated that the profit margins in the labor-intensive textile industry were in the range of 2 to 3 percent, and the initial revaluation was limited with the impact on those industries in mind.[406] Another concern may have been the association of one-off revaluation of the currency with foreign pressure, leading officials to minimize the initial one-off adjustment and emphasize the additional flexibility of the exchange rate regime following the initial reform.[407] As a result of the compromise, the PBOC's wish for exchange rate flexibility was granted, but the NDRC and the Ministry of Commerce won key ground as well. The pace of appreciation was to be relatively stable (for the NDRC) and relatively slow (for the Ministry of Commerce), with the initial appreciation limited to 2.1 percent against the dollar. In retrospect, the exchange rate compromise was typical

[404] Interview 06-128, 07-104, Market News International, "China Politics to Outweigh Market Forces on Yuan Rate," 25 July 2005.
[405] James Areddy, Neil King Jr., Mary Kissel, and Jason Dean, "Behind Yuan Move, Open Debate and Closed Doors," *Wall Street Journal* 25 July 2005, Market News International, "China Politics to Outweigh Market Forces on Yuan Rate," 25 July 2005.
[406] Interview 08-03.
[407] Li Yushi, Vice-President of the Chinese Academy of International Trade and Economic Cooperation, under the Ministry of Commerce, commented, "The chief benefit of a basket is that it allows for a more stable currency, but it also means that China doesn't have to revalue the yuan and lose face . . . a direct revaluation means directly bowing to US pressure." Market News International, "China Will Likely Move to Basket Peg for Yuan," 14 July 2005.

of China's consensus-oriented leadership style; faced with competing interests, the State Council gave everyone what they wanted.

This was the basic political compromise reached on exchange rate reform, but the eventual timing of the reform was slightly more complicated. A likely result of the political pressure from the Schumer-Graham vote, as well as other ongoing issues such as CNOOC's proposal to purchase Unocal and a textile export dispute with the European Union elevated the technical issue of adjusting China's exchange rate regime higher into the political hierarchy in China's political system. The State Council's agreement on the level of exchange rate reform was likely reached earlier in the spring, but the Chinese Communist Party's Politburo Standing Committee, the highest decision-making body within the Chinese Communist Party, also weighed in on the issue in late May and early June, likely in response to both the threat of retaliatory tariffs represented by the Schumer-Graham bill and the quiet diplomatic tour by newly appointed Treasury envoy Olin Wethington. The New York Times reported on June 10, 2005 that the Politburo Standing Committee had been actively considering the proposal from the State Council in "almost daily meetings," which would involve a limited initial appreciation and some form of a basket currency peg.[408] According to one source in the report, Zhou Xiaochuan was unable to attend to his family after his mother died on May 31 because he had to appear before the Politburo Standing Committee that morning in a meeting involving exchange rate reform.[409]

The net result of these meetings was apparently a general agreement to push forward with the State Council's exchange rate reforms, along with a strong prohibition

[408] Keith Bradsher, "China Looks at Linking Yuan to Currency Pool," *New York Times* 10 June 2005.
[409] *Ibid.*

against reforming China's exchange rate regime in response to foreign pressure. Following these meetings, a Market News International report on June 21 cited senior government sources claiming at the time, "There are no more debates. The government has taken the two arguments into consideration. They now have a balanced view on this issue."[410] However, the same reports seemed to indicate that the consensus on exchange rate reform had also been present earlier, and that foreign threats had delayed China's reforms, as China did not want to be seen as reacting to external pressure.[411]

Chinese officials quickly resumed discussing the yuan issue in terms of national sovereignty and China's right to reform the exchange rate regime on China's terms. On June 27, Wen Jiabao claimed, "We must uphold the principles of independent initiative, controllability, and gradual progress in pursuing renminbi exchange rate reform."[412] A few days before Wen's comments, Zhu Guangyao of the international department of the Ministry of Finance added, "This is a sovereignty issue. No other country has any say in this."[413] The Chinese insistence on the execution of exchange rate reform on China's initiative, rather than in response to foreign pressure, was one of the key factors leading to the meeting between Snow, Greenspan, Schumer and Graham on June 30, when Schumer and Graham agreed to withdraw their bill in anticipation of China's exchange rate reforms.[414] Snow had received the vague outline of the Chinese plan slightly before he called the meeting with Schumer and Graham, and received more details and the exact

[410] Market News International, "US Pressure Stalls China Plan to Make Small Revaluation of Yuan," 21 June 2005.
[411] Market News International, "US Pressure Stalls China Plan to Make Small Revaluation of Yuan," 21 June 2005.
[412] Wen Jiabao quoted within "China preparing for currency reform, will decide independently how, when-Wen," Xinhua Finance News, 27 June 2005.
[413] Xinhua Finance News, "China Won't Revalue Yuan Under Speculative, Political Pressure," 22 June 2005.
[414] Areddy et. al, *Wall Street Journal* 25 July 2005.

timing around a week before the eventual reforms.[415] A senior official from the Treasury department had commented on the meetings, "The point that [Snow] made was that clearly China was going to announce a reform. It would be very difficult for them to do that in the face of overt punitive efforts on the part of the Congress."[416] Observers had been expecting China to reform the exchange rate regime before Hu Jintao's September visit to the United States, so that the issue would not overwhelm the rest of the visit, and some American government sources had been cited as expecting a Chinese move in August.[417] Exchange rate reform in July may have been another way for Chinese authorities to demonstrate their intention to control the scope, timing, and nature of exchange rate reform.

The Exchange Rate Reforms

Under both domestic and international pressure on the exchange rate issue, China's political system eventually produced a compromise. The compromise developed at the direction of China's leaders in the State Council, who had heard a rising chorus of international criticism over the yuan's valuation and the rigidity of China's exchange rate regime. The compromise solution was to demonstrate some movement toward international standards of market-directed adjustment mechanisms and exchange rate flexibility, in order to both offset the threat of U.S. tariffs and to allow China's leaders to argue that they were taking incremental steps to remedy global economic imbalances. As

[415] Andrew Balls, Mure Dickie and Edward Alden, "The US Diplomacy Behind China's Revaluation," *Financial Times* 24 July 2005.
[416] Balls, Dickie, and Alden, *Financial Times* 24 July 2005.
[417] Market News International, "China Will Likely Move to Basket Peg for Yuan," 14 July 2005.

a result, on July 21, 2005, at 7 pm, using announcements on the central bank's website and national state-run television, China's central bank ended the peg to the dollar and claimed that the PBOC would use a trade-weighted basket of currencies as a reference point for the yuan's movement.

The statement from the central bank said, "Starting July 21, 2005, China will reform the exchange rate regime by moving to a managed floating exchange rate regime based on supply and demand with reference to a basket of currencies. The renminbi will no longer be pegged to the U.S. dollar and the renminbi exchange rate will be improved with greater flexibility."[418] At the same time, the central bank announced that the exchange rate would be changed to 8.11 yuan per dollar, effective immediately.[419] The reform still provided China's central bank with considerable authority over the scope of the renminbi's movement, restricting daily fluctuations against the dollar to 0.3 percent on each side of a daily central parity, set by the central bank before each trading day began.[420] In addition, the reform only claimed that a basket of currencies would be used as a reference point, which still provided the central bank with the ability to control the yuan's movement against the dollar, regardless of how the other currencies in the basket moved.

Domestic and International Reactions

The exchange rate reforms of July 2005 had greater political significance than economic significance. The actual revaluation was extremely small, at 2.1 percent, which

[418] Statement from the People's Bank of China, July 21, 2005.
[419] PBOC Statement, July 21, 2005.
[420] PBOC Statement, July 21, 2005.

was unlikely to influence China's accelerating international payments imbalances. The degree of market influence was also limited, as the central bank declared their intention to manage the pace of appreciation, and would only be using an opaque basket of currencies as a reference point, rather than allowing this basket to dictate the yuan's movement. However, politically, Chinese authorities could point to near-universal acclaim for the reforms, even though this acclaim was highly contingent upon China continuing to appreciate the yuan and introduce more market influence over the exchange rate regime. U.S. Treasury Secretary Snow indicated in a statement that the new regime "is important for China and the global financial system . . I particularly noted China's objective of allowing the market to fully play its role in resource allocation. . ."[421] The finance ministers and central bankers of the G-7 also issued a statement saying, "We welcome the decision by the Chinese authorities to move to a more flexible exchange rate regime. This more flexible exchange rate regime will contribute towards global growth and stability."[422] The IMF also chimed in, claiming, "The change in China's exchange rate regime announced today represents a move in the direction of greater exchange rate flexibility. . . . We would encourage the authorities to utilize fully the scope for flexibility in the new exchange rate arrangement."[423] The United States and international financial institutions applauded China's apparent embrace of the principle of market-based determination of exchange rates and the global consensus behind flexible exchange rate regimes.

[421] Statement of John Snow, U.S. Department of the Treasury, "Snow Statement on China's Currency Reform," 21 July 2005, http://www.treas.gov/press/releases/js2644.htm.
[422] Statement of the Group of Seven Finance Ministers and Central Bankers, 21 July 2005.
[423] Statement of Thomas C. Dawson, International Monetary Fund spokesperson, within Market News International, "Text: IMF Says China FX Move in Nation's Own Best Interests," 21 July 2005.

The Chinese authorities also trumpeted the country's embrace of international principles of flexibility and market determination of exchange rates, even though the actual influence of the market remained limited. The China Daily, in an editorial, called the adjustment "a significant move in the country's market-oriented reforms," while adding that the move demonstrated China's responsiveness to the concerns of its trading partners, stating, "Reform of the foreign exchange system and the renminbi's revaluation is beneficial to the country's major trade partners and the stability of the world's economy."[424] The editorial in the People's Daily justifying the reform, mentioned in previous chapters, cited the acclaim from the United States, Britain, Japan, South Korea, Malaysia, Germany, and other countries upon the introduction of exchange rate reform.[425] The editorial contined, "China once again explains the meaning of 'responsibility' with its actual actions."[426]

However, the general thrust of the People's Daily editorial justifying the exchange rate move was to explain that reform was in China's interests, and was not in response to foreign pressure, which was reformers' primarily domestic political liability. The editorial began by arguing, "The reform is an important policy decision made out of the actual needs of China's reform and development, rather than under certain international pressure."[427] Later, the editorial attempted to summarize, "Renminbi exchange rate reform is by no means 'you want me to reform it,' but rather it is 'I want to change

[424] China Daily cited within US Fed News, "Yuan Revaluation: A Cautious and 'Symbolic' Beginning," 27 July 2005.
[425] People's Daily, Editorial, "Renminbi Exchange Rate Reform—Decided Out of China's Own Need," 27 July 2005, p. 2.
[426] People's Daily, "Renminbi Exchange Rate Reform—Decided Out of China's Own Need," 27 July 2005, p. 2.
[427] People's Daily, "Renminbi Exchange Rate Reform—Decided Out of China's Own Need," 27 July 2005, p. 2.

it!'"[428] However, despite these claims designed to insulate reformers from domestic criticism, international pressure played a critical agenda-setting role throughout the process of exchange rate reform, forcing China's State Council to address the issue and leading to demands on China's financial authorities to "do something" about the issue. While the final form of exchange rate reform, involving a limited initial revaluation and the introduction of more market influence, was the product of a political compromise within China's bureaucracy, the range of policy choices was highly constrained by the political commitments of China's leaders to the principles of flexibility and market determination of exchange rates. The international consensus behind those principles, expressed via both the United States government, the International Monetary Fund, and the G-7 finance ministers, reshaped the Chinese leadership's conceptions of the structure of a "responsible" exchange rate regime, befitting China's role in the global economy.

However, the political debate over exchange rate reform in China was far from over, in both the domestic and international realms. Charles Schumer commented on the reform, clearly attentive to the level of the exchange rate, "This is a good first step, albeit a baby step. . . . It is smaller than we had hoped."[429] Lindsey Graham commented in a statement, "While the initial revaluation was small, it is encouraging. They've taken a small first step which I hope over time will turn into more revaluations and the eventual floating of the Chinese currency."[430] The sentiment expressed in the Financial Times on July 22 was fairly typical of economists evaluating China's move: "Market pressure will

[428] People's Daily, "Renminbi Exchange Rate Reform—Decided Out of China's Own Need," 27 July 2005, p. 2.
[429] Schumer quoted within Henry Pulizzi and Deborah Lagomarsino, "US Officials Welcome China Yuan Move As First Step," Dow Jones International News, 21 July 2005.
[430] Statement of Lindsey Graham, 21 July 2005. Cited within US Fed News, "Sen. Graham Issues Statement on China Revaluation," 21 July 2005.

not go away. Nor will pressure from Congress and the U.S. administration. If Beijing understands that further revaluation and other reforms must follow swiftly, all well and good. But if it thinks it can rest here for a year or two, it is badly mistaken."[431]

However, opposition to faster exchange rate movement remained strong within Chinese domestic politics, setting the stage for future conflict over the terms of the compromise forged by the State Council. While the central bank had gained more control over the daily management of the exchange rate through the July 2005 reforms, the PBOC's leadership was certainly aware of the opposition to rapid appreciation of the yuan within the other ministries responsible for managing the economy. The Ministry of Commerce had limited the size of the initial yuan revaluation, and several interviews attested to Bo Xilai's influential role within the negotiations. The PBOC was still under political pressure, as the NDRC released a report in mid-August calling for yuan appreciation to remain limited to 2 percent and blasting the central bank publicly for grabbing power from the Ministry of Finance through its recapitalizations of commercial banks.[432]

At the same time, the PBOC had lost another battle through its piecemeal reform of the exchange rate regime, by sacrificing the central bank's commitment to a fixed or stable exchange rate in the international financial marketplace. Had China simply maintained the existing exchange rate regime, it is possible that speculators would have eventually given up in attempting to force China to change. However, the incremental move, combined with acceptance of the principles of market flexibility, not only created

[431] Financial Times editorial, "Making Sense of China's Choice," 22 July 2005.
[432] Market News International, "China Economic Planner Says Should Not Let Yuan Rise More than 2 pct," reprinted in Xinhua Finance News, 15 August 2005. Also, see Market News International, "China Yuan Reform Slows As Key Ministries Resist Central Bank," 31 August 2005.

market expectations that the yuan would continue to appreciate, but also effectively removed the possibility that the central bank could credibly step in to limit the currency's appreciation in the future, without significant inflows of speculative capital betting that China will move once again. In other words, the July 2005 exchange rate reforms prevented China's central bank from ever credibly promoting an option such as refixing the currency at 7.8 or 7.5 yuan per dollar. As one Chinese economist stated in an email to the author following the July 2005 reforms, "The decision to move is [the] wrong one. It just made people's expectation of RMB hike self-fulfilling and created further expectations of RMB appreciation. It will result in huge damage to the People's Bank of China's credibility about its commitment to a stable exchange rate policy and courage to face outside pressure."[433] The next chapter addresses many of the economic consequences for China that resulted from the precise form of China's exchange rate adjustment in July 2005.

The Domestic Influence of International Norms in China's Exchange Rate Reforms

Using Cortell and Davis's framework, described at the beginning of the chapter, an attempt can be made to evaluate the domestic salience within China of both international norms concerning the efficacy of flexible exchange rate regimes and the international consensus on market-based determination of exchange rates. China's central bank was primarily concerned with the efficacy of flexible exchange rates, but the Chinese leadership was more concerned with the international consensus behind exchange rates set in open markets. Cortell and Davis's first criterion, concerning norms'

[433] Email from subject of Interview 05-12, 28 July 2005.

presence in domestic political discourse, is perhaps the most difficult to operationalize. Evidence from interviews pointed to the central bank repeatedly arguing for the benefits of additional exchange rate flexibility, on the grounds that it would also enhance monetary policy independence. The precedent of the Asian financial crisis was also a critical reference point for many within the PBOC. However, discourse concerning the benefits of exchange rate flexibility often did not extend beyond the central bank, as other bureaucratic institutions argued that China should resist international pressure and maintain a fixed exchange rate regime. It is more difficult to evaluate the domestic political discourse of the top leadership, not only because of the impossibility of accessing the discourse within internal government meetings, but also because public discourse concerning exchange rate reform from top leaders is usually constructed in order to hide leaders' intentions and prevent additional speculation.

The body of evidence for Cortell and Davis's second and third criteria, however, is generally easier to evaluate. China's domestic financial institutions had to change considerably in order to prepare for additional exchange rate risks, indicating that the norm of exchange rate flexibility was a critical focal point of the resulting financial reforms. This refers mainly to the operating assumptions of the financial technocrats at the PBOC, since they were primarily responsible for introducing the new technical measures to prepare for China's exchange rate adjustment. China's financial authorities allowed commercial banks to purchase options to hedge against exchange rate risk for their $60 billion in capital injections, and prepared additional currency pairs to train Chinese traders in managing exchange rate risks. China's financial authorities introduced a number of hedging tools for Chinese companies to manage their new exchange rate

risks, including yuan forwards, which were launched immediately after the exchange rate reforms of July 2005.[434] In addition, the cooperation agreements with the Chicago Mercantile Exchange and the New York Mercantile Exchange were designed to provide Chinese companies with additional training in managing exchange rate risks from the open market. In early 2006, China's central bank also introduced a new mechanism to set the daily central parity of the yuan each morning, involving bids from market makers, and providing the market with additional influence over the yuan's value.[435] In terms of reshaping and reforming China's domestic financial institutions, China's financial authorities acted in a way that signaled China's commitment to additional exchange rate flexibility and the principle of market determination of exchange rates. However, at the same time, China's financial technocrats were often limited by other economic ministries in the scope with which they could employ this new flexibility, suggesting that the top leadership embraced the legitimacy of the principle of market determination of exchange rates, while gradually managing China's use of the new, more flexible exchange rate regime.

In terms of Cortell and Davis's third criterion, the state's policies themselves, the form of the new post-July exchange rate regime provided strong evidence of the domestic salience of international norms of exchange rate flexibility and market influence over the exchange rate. The reforms themselves permitted more market influence over the value of the yuan exchange rate, allowing fluctuation within a 0.3 percent daily trading band. Later, in May 2007, that daily trading band was widened to 0.5 percent, in a gesture designed to signify China's commitment to additional flexibility in the exchange rate

[434] Market News International, "China To Launch Yuan Forwards Trading by Year-End," 28 July 2005.
[435] Public Announcement of the People's Bank of China, No. 1 (2006), "On Further Improving the Inter-Bank Spot Foreign Exchange Market," 3 January 2006.

regime.[436] At the same time, the July 2005 reforms also permitted a greater degree of market-based adjustment in other related policy areas, including greater latitude by the PBOC to pursue higher interest rates. The central bank sent delegations around the country to tell companies to prepare for a greater degree of exchange rate movement, and also instructed companies to use the hedging tools that the central bank had introduced.[437] The policy adjustments made by the central bank signaled a relatively singular focus on the task of permitting a greater degree of market-directed adjustment in China's economy and additional flexibility in the exchange rate regime.

In addition, the rhetoric of China's top leadership was focused, throughout the exchange rate debate, on the basic legitimacy of the principles of additional flexibility and market-based adjustment, China's commitment to work toward those goals in a gradual and controllable fashion, and at the direction of China's leadership, rather than in reaction to external pressure. China's leaders had emphasized China's global "responsibility" in responding to the Asian financial crisis by maintaining China's fixed exchange rate regime, and also emphasized that global responsibility in the eventual reform of China's exchange rate regime. The rhetoric of China's leaders revealed a considerable focus on the basic legitimacy of the international consensus behind flexible exchange rates, as well as the leadership's desire for China to be seen as a "responsible" actor in the international financial system.

While China's leadership appeared to embrace the legitimacy of international principles regarding flexible exchange rate regimes, this did not produce a policy

[436] David Cohen, "China Hints at Further Appreciation of Yuan," Business Week Online, Economic Focus-From Action Economics, 22 May 2007.
[437] Market News International, "China Yuan Reform Slows As Key Ministries Resist Central Bank," 31 August 2005.

outcome that was identical to the floating exchange rate systems generally present among major currencies in the industrialized world. This is not necessarily surprising, as China's domestic institutions, while attentive to these norms in reforming the exchange rate regime, also produced a unique bureaucratic compromise peculiar to China's domestic political situation. This case suggests that the roles of state institutions and decision-makers still influence responses to structural conditions in the international economy, including international norms concerning the reform of China's financial system. The work of Andrew Cortell, James Davis, and Peter Gourevitch, in particular, highlights the interplay of global norms and domestic political institutions, explaining how global standards can create different economic outcomes in different political and economic systems because of the influence of domestic political institutions.[438] The fact that China's eventual exchange rate reforms may not have transformed China's exchange rate regime into a full float, as other nations may have wanted, merely highlights the relevance of domestic institutions in reshaping the impact of international norms in particular domestic contexts.

Another factor that likely enhanced the domestic salience of the international norm of exchange rate flexibility was the relative lack of experience among China's leaders in managing exchange rate reforms. While there was financial expertise within the Chinese bureaucracy, this expertise was mainly concentrated within the People's Bank of China and the Ministry of Finance, and the PBOC became the primary agent pushing for exchange rate reform within the Chinese bureaucracy. In the absence of

[438] Andrew Cortell and James Davis, "How Do International Institutions Matter? The Domestic Impact of International Rules and Norms," *International Studies Quarterly* 40 (December 1996): 451-478. Peter Gourevitch, "Squaring the Circle: The Domestic Sources of International Cooperation," *International Organization* 50: 2 (Spring 1996): 349-373.

domestic preconceptions about flexible exchange rates, it was easier for proponents of exchange rate reform to enhance the legitimacy of the international norm in the eyes of China's top leadership. The epistemic communities literature has discussed this phenomenon, as Peter Haas explains, "If decision makers have no strong preconceived views and beliefs about an issue area in which regulation is to be undertaken for the first time, an epistemic community can have an even greater impact in shaping their interpretations and actions in this case and in establishing the patterns of behavior that they will follow in subsequent cases regarding the issue area."[439] The relevant epistemic community, as the previous chapters indicated, was located in the consensus of financial technocrats at the International Monetary Fund, and later the PBOC, that fixed exchange rate regimes were largely unsustainable after the Asian and Argentine currency crises. In the absence of a strongly held competing vision of the international financial architecture in the eyes of China's leaders, the international consensus behind flexible exchange rate regimes was a critical force driving the eventual reform of China's exchange rate regime.

[439] Peter Haas, "Introduction: Epistemic Communities and International Policy Coordination," *International Organization* **46**:1 (1992), p. 29.

Chapter 7- The Economic and Political Consequences of the July 2005 Reforms

China's bureaucracy produced a compromise in the exchange rate reforms of July 2005 that was acceptable to interested parties within the Chinese government, in the form of a small, 2.1 percent initial revaluation of the yuan, and a commitment to a relatively slow and stable pace of appreciation over time. The reforms themselves demonstrated to international critics China's commitment to market influence over the exchange rate, and the threats of protectionism faded temporarily. The central bank was given additional exchange rate flexibility, which the PBOC desired in order to give the central bank additional autonomy in setting monetary policy. The commitment to a relatively slow and stable pace of yuan appreciation provided the Ministry of Commerce and the National Development and Reform Commission with time to allow Chinese enterprises to adjust to the new reality of greater exchange rate movement and a more expensive yuan in international markets.

However, the limited nature of the July 2005 exchange rate reforms produced little change in the fundamental economic forces that had induced the PBOC to favor additional flexibility in the first place. The central bank was interested in exchange rate flexibility because it would provide additional monetary policy autonomy, so that the

PBOC could respond to the imbalances produced by massive capital inflows and the impact of external shocks on the Chinese economy. The compromise, in the form of a slow and stable pace of yuan appreciation, limited the benefits of exchange rate flexibility to the PBOC. The slow pace of appreciation meant that the yuan remained a one-way bet, with the market speculating about the pace of appreciation, rather than the direction of the currency's movement. Almost everyone who believed China's currency was undervalued at 8.276 yuan per dollar had not really changed those views with the yuan at 8.11 yuan per dollar. Therefore, the incentives for speculative capital inflows were still quite strong, and in the eyes of some, had grown stronger because China's central bank had now demonstrated that they were willing to change the exchange rate regime, despite the massive volume of Chinese officials' discussion about the state's "sovereignty" in setting exchange rate policy. Many of the initial media reports covering China's exchange rate reforms characterized the move as a response to foreign pressure, strengthening the belief among speculators that China would continue appreciating the yuan as long as the pressure continued.[440]

In addition, the limited change to the exchange rate was insufficient to depress demand for China's exports, increase demand for imports, and reduce China's rapidly growing trade surplus. China's global trade surplus in goods expanded from $32 billion in 2004 to $102 billion in 2005, despite the exchange rate reforms in July.[441] In the next two years it ballooned even further, to $177 billion in 2006 and $262 billion in 2007.[442]

[440] See, for example, Peter Goodman, "China Ends Fixed-Rate Currency," *Washington Post* 22 July 2005, p. A1.
[441] Data from China's General Administration of Customs and Ministry of Commerce.
[442] Data from China's General Administration of Customs and Ministry of Commerce.

Figure 7.1- China's Monthly Trade Balance, 2000-2008
Source: General Administration of Customs (China)

Limiting the impact on exporters was the objective of the Ministry of Commerce's pressure within the State Council, and it had its desired effect of minimizing the costs of adjustment. As a result, the yuan began a slow upward crawl against the dollar, rising by only an additional 0.49 percent by the end of 2005 and by 3.28 percent in 2006.

Therefore, through both the trade account and speculative capital inflows, China was taking in a considerable volume of foreign currency every day following the exchange rate reforms of July 2005. In a market-directed flexible exchange rate regime, that gradual increase in the supply of foreign currency would reduce its price in terms of domestic currency, producing an appreciation of the yuan. However, in China's post-July exchange rate regime, the central bank had declared its commitment not to allow the yuan to appreciate against the dollar by more than 0.3 percent per day. In order to prevent market forces from driving the yuan higher, the PBOC had to therefore continue its intervention in the currency market by buying foreign currency and issuing yuan to the

sellers, China's exporters and commercial banks, as well as foreign speculators, in exchange. Therefore, just as in a fixed exchange rate regime, the PBOC still had no control over the growth of the domestic money supply, as there was little market demand for foreign currency in a situation in which everyone in the market expected the yuan to appreciate. The key debates occupying market participants concerned how fast the PBOC and the State Council would allow the yuan to rise.

The decision to change China's exchange rate regime had not brought the People's Bank of China greater autonomy in monetary policy, as the central bank continued to subordinate its monetary policy to an opaque exchange rate appreciation target that the State Council deemed acceptable for safeguarding political and economic stability. As a result, China's central bank was still unable to use higher interest rates to limit credit and investment growth, which increased the risks of economic overheating over time. The economic consequences of the exchange rate reforms of July 2005 came to dominate Chinese economic policy-making in the subsequent years. China faced large and sustained capital inflows that were primarily the result of market-based reactions to China's undervalued and controlled exchange rate, and China's authorities attempted a variety of economic policies aimed at disrupting various links in China's liquidity cycle, described in the next section. All of these policies have attempted to manage the various consequences of China's capital inflows, without trying to limit the inflows themselves. China's policy-makers addressed a wide variety of symptoms of these accelerating capital inflows, rather than their cause, which was the limited nature of the exchange rate reforms of July 2005.

China's Liquidity Cycle

Since 2002, when China began to face sustained capital inflows, the country's economy has been trapped in a financial cycle that produced a glut of onshore liquidity, with too much money chasing returns wherever they can be found. China entered into this cycle unknowingly, as this was did not appear to be a conscious policy choice by China's leadership, as evidenced by the ad hoc policy-making in response. The liquidity cycle is partially a consequence of China's own political culture favoring a gradual approach to economic reform, and partially a consequence of the export-led orientation of China's economic development since the 1980s. In the case of exchange rates, as discussed in Chapter 2, gradual and halfway solutions between fixed and floating regimes usually produce some consequences that mitigate their effectiveness and the credibility of the regimes in financial markets. China's July 2005 exchange rate reforms reflected the Chinese government's attempt to reconcile the rigidity of the "corners hypothesis" in exchange rate policy-making with China's own gradualist, incremental tendencies in economic reform. Capital inflows were an unprecedented problem for the Chinese bureaucracy, unlike other problems that Chinese authorities had encountered in the past, such as inflation. Some of the ancillary consequences of China's gradual approach to the exchange rate issue prompted the government to introduce additional policy measures in response, and this economic policy-making was ad hoc and erratic, rather than the result of long-term planning.

Capital inflows, in combination with China's exchange rate regime, produced liquidity that fed an ongoing, self-perpetuating cycle that ended up contributing to

additional capital inflows. As more foreign currency entered the country than left China, in the form of the trade surplus, foreign direct investment, and speculative bets on Chinese assets, Chinese companies and banks were forced to decide how to manage these foreign currency assets, since most of their liabilities were domestic, and were denominated in yuan. With the PBOC actively willing to exchange foreign currency for yuan at either 8.276 yuan per dollar, which was the pre-July 2005 rate, or at post-July rates that were slowly appreciating, banks had strong incentives to sell all of their foreign exchange to the central bank as soon as they received it, particularly U.S. dollars. As long as companies and banks believed the yuan would continue appreciating, they continued to sell dollars and receive yuan from the central bank, and the net effect of these sales was an expansion of the domestic money supply resulting from China's capital inflows. This expansion gave banks a large volume of yuan in which to lend to companies, and these companies then invested the funds. As the level of China's exchange rate made export-oriented industry an attractive target for investment, a significant volume of yuan funds was lent to companies actively expanding China's export capacity. The net result of this growth of credit and investment in export-oriented enterprises was a larger trade surplus, which brought in additional capital inflows and strengthened expectations for currency appreciation, intensifying the cycle.

In addition, China's economy became more dependent upon foreign demand for China's exports, as new investment was largely being channeled into industries where domestic demand had not kept up with the expansion of industrial capacity. These were the consequences of the central bank's commitment to purchase foreign exchange at a relatively low controlled rate, whether that rate was fixed or appreciating slowly. The

exchange rate effectively represents the balance between production and consumption in an economy. China's exchange rate regime resulted in excessive production in China, which dwarfed aggregate domestic consumption. As a result, China found consumers of its products overseas, which produced additional capital inflows.

This expansion of the money supply can also produce inflation, which flared up in 2004 and then again in 2007. With a rising supply of money chasing a supply of goods in the domestic market growing at a slower rate, prices are likely to rise. However, in an environment of capital inflows and a controlled exchange rate, China's central bank could not raise interest rates in order to counter the surge in inflationary pressure and dampen demand. As the analysis in Chapter 2 indicated, under conditions of free capital mobility and fixed exchange rates between any two hypothetical countries, interest rates should equalize across borders, as capital seeks its highest potential return. Since China's trade surplus began to balloon in 2004, foreign exchange reserve accumulation has often outpaced the growth of the trade surplus and foreign direct investment, suggesting that speculative capital was flowing into the country to take advantage of the rising yuan. However, China maintains strict capital controls on outflows, and to a lesser extent on inflows; the yuan is not a fully convertible currency, even though there are some wedges in the capital account that have developed in recent years. Hypothetically, these controls on the flow of capital should provide the PBOC with some breathing space for an independent monetary policy, even though the central bank is continuing its one-way interventions into currency markets. Raising interest rates created the potential for further capital inflows, as higher interest rates simply increase the rates of return on yuan-denominated assets, encouraging the movement of capital into China. As a practical

matter, capital flows are not completely free, especially in China, as capital controls have created sustainable differentials between domestic and foreign interest rates over time.[443] Using this relative degree of autonomy in monetary policy, China's central bank attempted to raise interest rates to limit inflationary pressure, raising benchmark lending rates by 0.27 percent in 2004 and then by a total of 1.96 percent in 2006 and 2007. However, concerns about speculative capital inflows often prevented the PBOC from acting more aggressively.

China's inability to control the domestic interest rate and suit it to domestic economic conditions limited the effective pricing of capital. China's post-July exchange rate regime places Chinese authorities in a dilemma regarding the pricing of capital in a monetary environment where the first priority has been slowing the rate of yuan appreciation. Lower interest rates, especially when combined with rising inflation rates, create strong incentives for companies to invest heavily in new projects and expand capacity, as the real borrowing rate is effectively negative. This investment has traditionally been encouraged by local officials interested in improving economic conditions and indicators of economic performance within their jurisdictions, and local officials have effectively pressured local branches of commercial banks to lend in line with local government priorities.[444] On the other end of the spectrum, higher interest rates only increase the costs of working capital loans for Chinese state-owned enterprises that are highly dependent upon loans from state-owned banks, jeopardizing enterprise profitability in the event of a change in macroeconomic conditions. Chinese authorities

[443] Ma Guonan and Robert N. McCauley, "Do China's Capital Controls Still Bind? Implications for Monetary Autonomy and Capital Liberalisation," BIS Working Papers No. 233, August 2007, http://www.bis.org/publ/work233.pdf.
[444] Interview 05-13.

were concerned that a change in macroeconomic conditions and a decline in the financial conditions of state-owned enterprises would create significant political pressure for another banking system bailout, and higher interest rates only increase the risk of default on the enterprises' loans.

The potential consequences of the liquidity cycle extended to the domestic banking system, as this was the channel by which China's exchange rate regime translated into economic growth driven by exports and fixed asset investment, rather than domestic consumption. The Chinese banking system remains relatively fragile. Massive state-directed recapitalizations of state-owned banks, totaling around $500 billion between 1998 and 2006, removed non-performing loans from the banks' balance sheets, preparing them for overseas initial public offerings, which occurred in 2005 and 2006.[445] However, China's financial system depends heavily on bank finance, and outstanding loans in the banking system have exceeded 110 percent of GDP from 2003 to 2007. Despite the banks' listings on international stock exchanges, the banks still allocate capital inefficiently, due to the exchange rate's limitations on pricing capital domestically and the political objectives of the Chinese state. A large proportion of bank loans are still directed to state-owned enterprises, the least productive part of the Chinese economy.[446] Therefore, Chinese banks' loan portfolios remain sensitive to changes in macroeconomic conditions, and significant volumes of loans risk turning non-performing in the event of an economic slowdown.

Hence, monetary authorities have attempted since 2004 to limit the volume of

[445] Ma Guonan, "Who Pays China's Bank Restructuring Bill?" *Asian Economic Papers* **6**: 1 (Winter 2007), p. 46-71.
[446] Wendy Dobson and Anil K. Kashyap, "The Contradiction in China's Gradualist Banking Reforms," October 2006, prepared for Brookings Panel on Economic Activity, September 2006. http://faculty.chicagogsb.edu/anil.kashyap/research/chinabanksoctfullpaper.pdf.

overall lending, particularly to sectors that have revealed signs of overcapacity. A resurgence of non-performing loans may outstrip banks' ability to repay them out of their own profits, and may require another government bailout, creating additional moral hazard issues for bank managers. In short, Chinese economic authorities have been attempting to create a banking system that operates on a commercial basis rather than depending upon a state-directed investment plan. Future bailouts and removals of non-performing loans would jeopardize banks' incentives to operate on a commercial basis, and therefore economic authorities attempted to limit lending levels because of concerns that banks do not allocate capital efficiently, with the credit curbs attempting to reduce the likelihood of another round of non-performing loans.

On the investment side, the primary risk of the liquidity glut in Chinese banks concerned sustained growth of new investment projects in sectors facing overcapacity driving down prices, depressing profits, and generating additional non-performing loans in the banking sector. Over time, investment and export-driven growth faces diminishing returns, unless demand in both global and domestic markets grows in proportion with expanding production. These were the factors compelling Chinese authorities to discuss a readjustment of China's growth model at the Central Economic Work Conference of 2004, even though since that meeting, investment has continued to grow at faster rates than consumption, and now comprises a larger proportion of GDP than a decade ago.

Therefore, China's capital inflows presented significant challenges to the health of the banking system and the economy as a whole. However, China's financial technocrats were not powerless in countering these inflows. The central bank, upon issuing yuan in exchange for foreign currency, could typically take two measures in

response to this expansion of the money supply. First, the PBOC could issue and sell yuan-denominated sterilization bonds into the market, which would simply remove the yuan-denominated excess liquidity created by the capital inflows. Second, the central bank could raise banks' required reserve levels, forcing banks to keep a larger proportion of their deposits at the central bank, rather than lending them out and creating additional loans and more fixed-asset investment.

The PBOC has used both of these tools aggressively to counter China's capital inflows and the imported expansion in China's money supply. However, these measures have ancillary consequences as well, primarily for the domestic banking system, and they are not sustainable in the long term if China continues to face capital inflows on the same scale as in recent years. By keeping domestic interest rates artificially low, the central bank also reduced the yields on its own sterilization bills, because the liquidity glut in China's banking system effectively made the cost of credit, in the form of interbank interest rates, relatively cheap. These sterilization bills now occupy an increasing proportion of the total assets of Chinese banks, and yet their yields barely allow Chinese banks to cover their cost of funds. In addition, the reliance on short-term sterilization paper (largely one-year and three-month bills) means that each year's issuance must be rolled over in the following year, generating a larger cumulative sterilization burden for the central bank. Through sterilization, the PBOC effectively offloads a portion of the costs of maintaining the slow pace of yuan appreciation onto commercial banks, while at the same time attempting to transform the banks into commercially driven enterprises. If Chinese interest rates rose, however, the central bank would be paying higher fiscal costs for its sterilization operations over the long term. The costs of higher reserve

requirements are similar, as banks have to pay depositors to manage their funds, but receive only 1.89 percent in interest on required reserves at the central bank. Chinese banks' reserve requirements reached 17.5 percent of deposits in June 2008, having risen by 10.5 percent since 2004.

In addition, the central bank attempted to discourage speculative capital inflows betting on further yuan appreciation, by artificially reducing interest rates on yuan-denominated assets and creating a gap between Chinese interest rates and comparable dollar-denominated interest rates. Speculators, therefore, would face a cost, in terms of returns, in moving money into yuan-denominated assets. There was considerable evidence that the PBOC used this strategy to prevent capital inflows. In February 2006, PBOC vice-governor Yi Gang commented on the utility of a 3 percent rate gap in increasing carry costs of speculative yuan purchases and limiting pressure on the yuan. PBOC research director Tang Xu commented publicly in July 2006 that the central bank attempted to maintain an interest rate gap of 250 to 350 basis points, and PBOC vice-governor Wu Xiaoling commented in November 2006 that "the interest rate gap has an influence on cross-border money flows."[447] However, most "hot money" or speculative capital coming into China's economy ends up making purchases in property and equity markets, and may be motivated by potential asset price gains, as well as expected currency appreciation. Therefore, an argument can be made that the interest rate gap was not necessarily as influential as eventual exchange rate movements in driving capital inflows into China. The central bank's interest rate gap, however, disappeared abruptly

[447] Xinhua Finance News, "US-China Interest Rates Gap Favorable For Adjustment on Currency Rates-PBOC," 13 February 2006, David Wilder, "China Sticks to Gradual Yuan Change Despite Worries," 20 July 2006, Market News International, "PBOC's Wu: Maintaining China-Int'l Rate Gap Key PBOC Goal," 24 November 2006.

in late 2007, as the U.S. Federal Reserve began cutting interest rates aggressively to deal with the effects of the subprime crisis, and China's central bank was raising interest rates to bring down inflationary pressure, despite the central bank's constraints in monetary policymaking. Like so many other measures in China's liquidity cycle, the use of the interest rate gap to deter speculation proved unsustainable.

The limited nature of China's exchange rate reforms placed the country's monetary authorities in a recurring monetary cycle. As long as the PBOC stood ready to convert foreign currency into yuan at a rate that the market believed would only go higher, capital inflows from China's trade surplus and foreign investment produced foreign exchange reserve growth at China's central bank, and an increase in the money supply domestically. This increase in the money supply produced inflation as well as a surge in domestic credit and investment growth, producing additional industrial capacity. Because China's economic conditions were favorable to exporters, this new industrial capacity was often tilted toward export-oriented sectors, producing additional export revenues from foreign consumers and additional capital inflows. Interest rates could not solve the problem, as reducing interest rates would simply accelerate domestic credit growth and fixed asset investment growth, and raising interest rates would simply bring in additional speculative capital flows. The measures that the central bank used to counter the inflow of domestic liquidity into the banking system impaired the commercialization of the banking system itself.

Breaking China's liquidity cycle required relatively harsh choices for Chinese policy-makers: changing the central bank's commitment to buy foreign exchange at a relatively low rate, extreme restrictions on capital inflows, or the painful adjustment

produced by a slowdown in foreign consumers' purchases of China's exports, reducing China's trade surplus. The exchange rate reforms of July 2005 did not produce China's liquidity cycle; it started earlier with the growth of China's trade surplus in late 2002. However, the limited nature of the exchange rate reforms and the bureaucratic compromise that required slow and stable yuan appreciation created an environment conducive to sustained capital inflows, which intensified China's liquidity cycle. The net effects of the compromise on exchange rate reform in July 2005 included a central bank with severely limited autonomy in monetary policy, a sustained capital inflow that expanded the domestic money supply, and an increasingly imbalanced Chinese economy that was still highly dependent upon fixed asset investment and net exports for growth, rather than domestic demand. Because of the Chinese leadership's commitment to a slow pace of yuan appreciation, China's economic authorities have largely attacked the symptoms of capital inflows, by attempting to remove liquidity from the banking system and using administrative measures to limit lending and investment, rather than attempting to reduce the capital inflows themselves. Rather than limiting China's external imbalances, the gradual and limited form of the July 2005 exchange rate reforms exacerbated the imbalances. China's economic policy-making since July 2005 has been largely focused on attacking the symptoms of those imbalances, rather than focusing on breaking the liquidity cycle and ending China's capital inflows through more aggressive exchange rate reform.

Technical Adjustments and China's New Economic Debates

After the exchange rate reforms of July 2005, China's financial authorities

continued to introduce new technical adjustments to the exchange rate regime, some of which enhanced the central bank's ability to control the pace of yuan appreciation and mitigate some of the effects of China's liquidity cycle. These technical measures also introduced hedging instruments for Chinese corporations, allowing them to adapt to a greater degree of exchange rate volatility. As mentioned in the previous chapter, yuan forwards were introduced shortly after the initial exchange rate reforms in July 2005. The first commercial foreign exchange swap transaction occurred on November 25, 2005, as the central bank agreed to provide ten commercial banks with $6 billion in foreign exchange, to be repaid a year later with 7.85 yuan per dollar.[448] The effect of the swap was to remove yuan from the banking system, acting as a form of sterilization. The 1-year future exchange rate of 7.85 per dollar was widely interpreted as a market signal for the central bank's targeted pace of appreciation in a year's time, but it actually simply reflected the interest rate differential between the dollar and the yuan; the swap would be converted a year later so that if interest rates remained unchanged and the exchange rate was equal to the conversion rate, neither party profited from the transaction. The central bank continued to use swap operations with commercial banks, which were executed at interest rate parity, according to data from interviews, but the size of these transactions remained unclear.[449] In April 2006, a full interbank currency swap market was introduced, allowing banks to swap foreign exchange both with each other and with the central bank.[450]

In addition, before the start of the first trading day in 2006, however, the PBOC

[448] Xinhua Finance News, "China Sets 6 bln USD One-Year Swaps With Local Banks at 7.85 Yuan," 25 November 2005.
[449] Interview 06-132.
[450] Xinhua Finance News, "China to Launch Interbank Market Forex Swaps on April 24," 14 April 2006.

introduced a new mechanism that ostensibly provided more market influence over the value of the yuan, but actually appeared in retrospect to provide the central bank with more influence over the management of the exchange rate on a day-to-day basis. The July 2005 exchange rate reforms had created a daily trading band for the dollar-yuan exchange rate of 0.3 percent on either side of a daily central parity, set by the central bank at the start of the trading day. From July to December 2005, that daily central parity was equal to the previous day's market closing price. However, on January 3, 2006, the PBOC introduced a new system that would permit designated market makers, including foreign banks, to bid on the appropriate value of the daily central parity each trading day, before it would be released at 9:15 am.[451] The move was hailed as a further signal of China's commitment to expanding market influence over the value of the yuan.

However, the process by which the central parity was calculated remained opaque. The PBOC's description implied a mathematical calculation of a weighted average of bids submitted each morning. However, since the exchange rate reforms of July 2005, the dollar has generally been on a depreciating trend against other major currencies. Presumably, therefore, overnight movement in other major currencies would influence the bids that market makers submit to the PBOC each morning regarding the value of the yuan. With the dollar generally lower since the introduction of the central parity system, the expectation would therefore be aggregate appreciation of the yuan in

[451] The statement from the People's Bank of China said: "After the introduction of the OTC transactions, the formation of the central parity of the RMB against the US dollar will be transformed from the previous arrangement based on the closing price determined by price matching transactions in the inter-bank foreign exchange market to a mechanism under which the China Foreign Exchange Trading System shall first enquire prices from all market makers before the opening of the market in each business day, exclude the highest and lowest offers, and then calculate the weighted average of the remaining prices in the sample as the central rate of the RMB against the US dollar for the day. The weights shall be determined by the China Foreign Exchange Trading System in line with the transaction volumes of the respective market makers in the market as well as other indicators such as the quoted prices etc."

the overnight market (each day's close relative to the next day's central parity), which would also be consistent with the appreciation trend in daily trading in Chinese foreign exchange markets. Surprisingly, however, this was not the case. From January 4, 2006 to the last week of 2007, yuan appreciation occurred only during the Chinese trading day, and the daily central parity revealed no aggregate overnight movement of the yuan against the dollar. The daily central parity appeared to provide the central bank with an additional tool to limit the market-driven pace of appreciation and provide a signal to the market regarding the central bank's desired pace of appreciation.

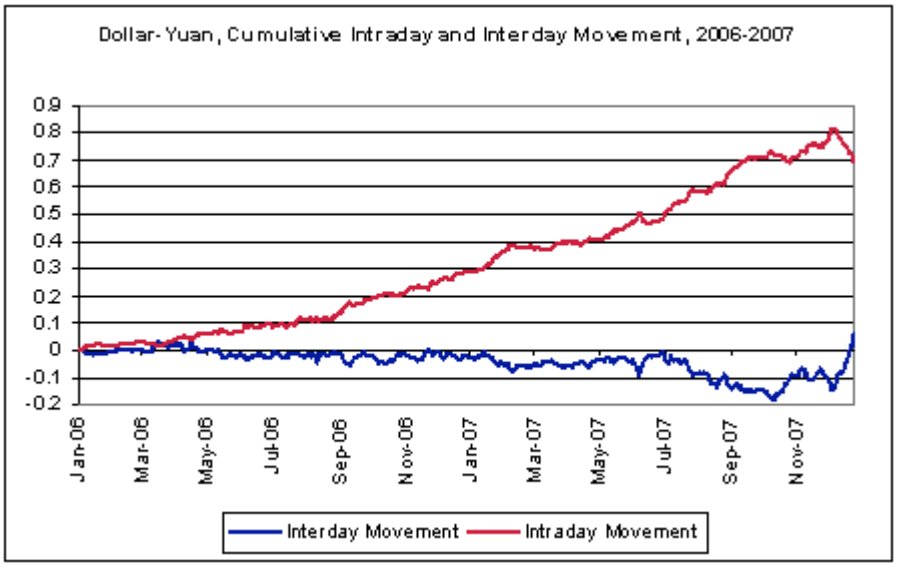


Figure 7.2- Dollar-Yuan, Cumulative Intraday and Interday Movement, 2006-2007
Source: People's Bank of China

Even following the exchange rate reforms of July 2005, the central bank was forced to tread softly in allowing the yuan to rise, because the domestic political opposition in China that had limited the scope of the initial appreciation had not relented. According to data from interviews, the central bank was not necessarily given a set speed

of yuan appreciation by the State Council, but the PBOC's leaders knew that they would face considerable political opposition if they allowed the yuan to appreciate too quickly.[452] The central bank remained the only advocate for faster exchange rate movement in the Chinese bureaucracy following exchange rate reform, although opposition to appreciation faded somewhat at the Ministry of Commerce and the National Development and Reform Commission as China's trade surpluses continued to grow, reaching $177.5 billion in 2006 and $262.2 billion in 2007.[453] The political compromise reached in July 2005 required a slow pace of appreciation, and that slow pace of appreciation prevented costs from forcing adjustment in China's export sector that would reduce China's imbalances. The result was ballooning trade surpluses and foreign exchange reserves.

China's growing capital inflows produced a variety of economic policy debates following the exchange rate reforms of July 2005, but the debates generally focused on three problems, all of which were linked to China's liquidity cycle. The first debate, which generally occurred in late 2006, concerned how China's foreign exchange reserves could be managed more effectively, and the result was the creation of the China Investment Corporation. The second debate focused on how to stem China's trade surplus without appreciating the yuan significantly, and this debate largely occurred in early 2007, resulting in a massive reform of China's export tax rebates. The third debate, which started in mid-2007 and extended until around July 2008, concerned how to manage China's most severe inflationary cycle since the mid-1990s, in an environment where economic authorities are also concerned about a slowdown in China's export

[452] Interview 06-118, 06-135.
[453] Market News International, "Sources: China Government Overcoming Yuan Appreciation Fear," 18 May 2007.

growth. All three of these debates were indirectly the product of China's limited exchange rate adjustments in July 2005, and the resulting capital inflows that intensified China's liquidity cycle following the exchange rate reforms.

Dealing with Dollar Depreciation: The Creation of the China Investment Corporation

The rapid growth of China's foreign exchange reserves that resulted from China's ongoing liquidity cycle created a political debate within China over how these reserves could best be managed. After the Asian financial crisis, in which countries were forced to abandon their dollar pegs due to inadequate foreign exchange reserves and mounting external debt, many in China did not necessarily view the rapid expansion of China's foreign reserves as a financial risk. However, as China passed Japan as the largest holder of foreign exchange reserves, and total reserves then surpassed $1 trillion in October 2006, views began to change within China, as the country had far more reserves than many observers deemed necessary to counter a speculative attack on the currency in the event of capital flight.[454] China's reserves were managed by the State Administration of Foreign Exchange (SAFE), which was governed by the central bank. Because of the potential for China's central bank needing to access its reserves quickly to defend the value of the yuan, the SAFE's priorities were the safety and liquidity of the assets, prompting sizable investments in the safest and most liquid assets on earth: U.S. Treasury bonds.

[454] Interview 06-125, 06-133.

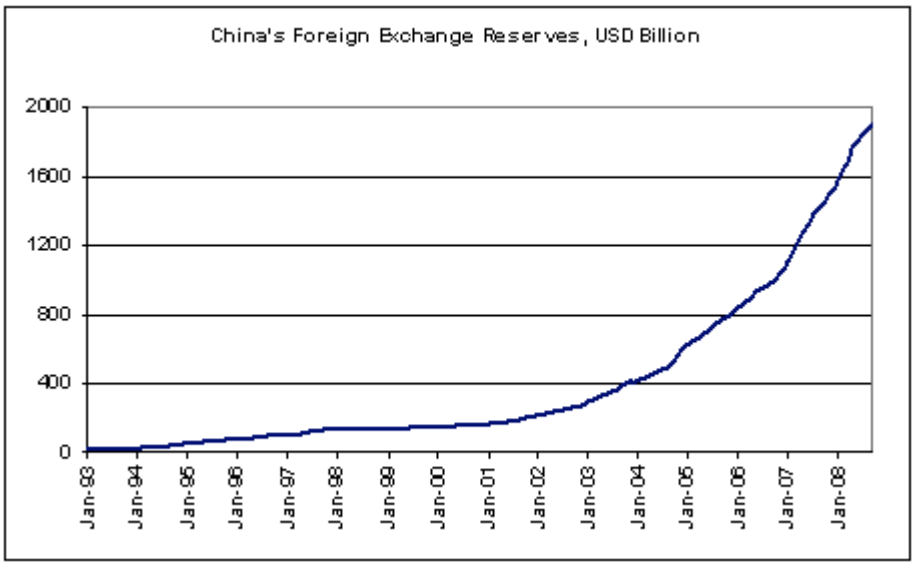


Figure 7.3- China's Foreign Exchange Reserves
Source: State Administration of Foreign Exchange (China)

However, over time, the size of China's reserves grew larger at the same time that the value of the dollar was declining against most major currencies, including the yuan. The SAFE moved a larger proportion of foreign assets into U.S. Agencies, bonds issued by government-sponsored enterprises such as Fannie Mae and Freddie Mac, which trade at a positive spread to Treasuries, with higher yields.[455] However, a critique of the SAFE's management of foreign assets began to develop within China, primarily led by the Ministry of Finance and the National Development and Reform Commission.[456] The critique was largely focused on the low rates of return that the SAFE earned on China's foreign exchange reserves (around 4-5 percent on average, without including dollar depreciation), in comparison with the foreign investments in China that produced the reserves (foreign investors might expect a 10-15 percent annual return, in addition to

[455] Data from U.S. Department of the Treasury, Treasury International Capital System, www.treas.gov/tic/.
[456] Interview 06-124.

yuan appreciation). Powerful voices within China began to call for a separate government agency to invest a portion of China's foreign exchange reserves in assets that would provide a greater return than the Treasury bonds SAFE held. In the summer of 2006, the NDRC sponsored a fact-finding research trip for senior economists to report on the methods that Singapore, South Korea, and Japan used to manage their foreign exchange reserves.[457]

Out of this trip and a resulting political debate that primarily pitted the PBOC against the Ministry of Finance, the China Investment Corporation (CIC), China's sovereign wealth fund, was eventually born. The basic form of the CIC was approved at the National People's Congress in March 2007, bonds to fund the company with $200 billion in foreign exchange were approved in June 2007, and the company formally began operations in September 2007. However, between the discussions of the fund in September 2006 and its formal incorporation in September 2007, China added another $445.7 billion to its foreign exchange reserves, minimizing the effects of the CIC's plan to diversify out of low-yielding dollar-denominated assets. The CIC's first investment, which occurred before its formal incorporation, was a $3 billion stake in the initial public offering of Blackstone, an American private equity firm, announced in May 2007 to coincide with the second round of the US-China Strategic Economic Dialogue, which will be discussed in the next section. The investment went on to lose a significant proportion of its value amid the credit crunch in the fall of 2007.

The CIC has since made other equity investments in U.S. firms such as Morgan Stanley and Visa, but the fund faces the same challenges from dollar depreciation as the SAFE. As long as China manages the gradual pace of appreciation of the yuan, China's

[457] Interview 06-124, 06-125, 06-128.

foreign exchange reserves will face gradual losses in terms of the dollar's depreciation against the yuan. These capital losses do not create direct fiscal costs for the central bank, but they do reflect capital losses for the central bank or the CIC. The CIC was funded by bonds paying a coupon rate of 4.3 percent and 4.45 percent in yuan terms, and therefore, the sovereign wealth fund cannot even break even in yuan terms unless it generates returns exceeding this 4.45 percent plus the rate of yuan appreciation against the dollar. A more aggressive exchange rate reform would induce losses all at once, but may also slow China's capital inflows. However, due to China's liquidity cycle, the country's options for minimizing its losses from the dollar's gradual decline against the yuan were severely restricted, no matter which agency managed China's reserves. The gradual exchange rate reforms produced additional capital inflows which dramatically increased the pool of China's reserves, the challenges for managing those reserves, and the scale of the eventual capital losses on those reserves.

Foreign Pressure, Henry Paulson, and the Creation of the Strategic Economic Dialogue

In addition to the economic pressures of the liquidity cycle, foreign political pressure returned to focus on China's management of the exchange rate shortly after the exchange rate reforms of July 2005. Charles Schumer and Lindsay Graham made a high-profile visit to Beijing in March 2006 to discuss the exchange rate issue with Chinese leaders.[458] Because of constituent pressure that focused on declining American competitiveness, Congress was always more concerned about the level of the yuan

[458] Joseph Kahn, "China Tries to Charm Couple of Senate Skeptics," *New York Times* 23 March 2006.

exchange rate, rather than the flexibility of the exchange rate regime or the reform of China's financial system required to achieve this flexibility. Congress's eyes again turned toward China in May 2006 when the Treasury Department once again failed to designate China as a currency manipulator in its annual report, a decision that Schumer called "a very technical and legalistic dodge" in the process of castigating Treasury Secretary John Snow in a Senate hearing.[459] At the time of the hearing, the yuan had gained only 1.14 percent since the initial 2.1 percent revaluation on July 21, 2005, prompting several Congressional pleas for China to move more aggressively.

The hearing in May was one of Snow's last acts as Secretary of the Treasury, as he was soon replaced by Henry Paulson, the former CEO of Goldman Sachs. The media discussion of Paulson's nomination was heavily focused on his experience in dealing with China, having traveled there over seventy times with the investment bank and developed significant contacts within the Chinese leadership.[460] Paulson was widely seen as an agent more capable of enabling Chinese concessions on the exchange rate issue than his predecessor. Chinese media also played up Paulson's China experience, and generally lauded the choice.[461] On Paulson's first official visit to China, in September 2006, the two governments announced the creation of a new bilateral forum, the US-China Strategic Economic Dialogue, which would meet twice per year. The idea of the forum was to place the issues discussed during the Treasury Department's consultations with the PBOC (including the exchange rate) in front of higher-level players in the Chinese bureaucracy, in the context of a forum that could address a variety of issues in

[459] Schumer quoted within Edward Alden, "Senators Warn Bush on Renminbi," *Financial Times* 19 May 2006, p. 5.
[460] Steven Weisman, "A New Page in the Script for Paulson," *New York Times* 2 August 2006.
[461] A favorable People's Daily commentary in the state media organ's overseas edition was cited within Reuters News, "U.S. Paulson Open To Reason on Yuan- Chinese Paper," 18 September 2006.

the multi-faceted U.S.-China economic relationship, including energy-related and environmental cooperation, civilian air travel, product safety issues, and other trade-related discussions.[462]

The SED provided a forum where U.S. officials could discuss the exchange rate issue with Chinese officials that were closer to the decision-making process, placing the issue repeatedly on the agenda of the State Council. Interestingly, the currency tended to move faster against the dollar during periods surrounding high-level visits by political leaders or legislative events in the United States. During Paulson's first visit to China in September 2006, the yuan appreciated at a much faster rate, rising by 0.61 percent during the month. Later, before the second meeting of the SED in Washington in May 2007, the yuan not only appreciated at its fastest month-on-month rate, 0.74 percent, but also the PBOC widened the daily trading band of the yuan to 0.5 percent from 0.3 percent. This was mostly a symbolic move, given the fact that the central bank's massive intervention into the foreign exchange market was the key factor preventing the yuan from hitting the outer limits of this daily trading band each day. The third session of the SED in December 2007 produced no significant political concessions, but the regular nature of the forum allowed the United States to place the issue of the currency in the spotlight frequently, and forced China's leaders to pay attention to the issue as well. During the December forum, a private meeting between Henry Paulson and Wen Jiabao reportedly produced a comment from Wen claiming that appreciation would continue to be gradual in nature.[463]

The People's Bank of China (PBOC), China's central bank, claimed consistently

[462] Interview 06-133.
[463] Xinhua Finance News, "China's Premier Tells US's Paulson That Yuan Reform to be Gradual," 13 December 2007.

throughout this period that international political pressure played no role in its management of China's exchange rate, particularly on a day-to-day basis. However, the fact that the yuan tended to move more quickly during high-level meetings produced anticipation in the foreign exchange market of faster appreciation during these periods. The foreign pressure, in combination with this Chinese response, indirectly encouraged additional pressure by perpetuating the market perception that political factors influence the rate of appreciation.

However, the resurgence of foreign pressure and the creation of the SED did not change much in terms of China's domestic political opposition to faster appreciation. In addition, the continued association of the yuan with foreign pressure created political capital within the Chinese bureaucracy for officials who resisted that pressure. There was still no apparent constituency in China for significantly faster yuan appreciation, or for bearing the short-term costs of global adjustment in exchange for few appreciable short-term benefits. Because of jockeying in advance of the 17th Party Congress in 2007, no one in Chinese political circles particularly wanted to be identified with any policy choice that diverged significantly from an intra-Party consensus. In this environment, faster exchange rate movement and the resulting impact on China's export sector remained a decision for which no one could get the credit, but someone could get the blame. The intensifying liquidity cycle had not fundamentally changed the domestic political alignments within China over the exchange rate issue, and foreign pressure may have encouraged some opponents of faster appreciation to dig in their heels for their own domestic political purposes.

Tackling The Trade Surplus

While the yuan appreciated at a glacial pace in 2006, the trade surplus began to balloon, the liquidity cycle intensified, and China's capital inflows from the trade account became larger than those from foreign direct investment and speculative capital. With opposition to yuan appreciation still firmly entrenched, as discussed previously, the debate in late 2006 and early 2007 focused on how to limit the size of China's trade surplus by using targeted measures, rather than broad-based tools such as the exchange rate. China's trade surplus hit $177.5 billion in 2006, up 74 percent from the $102 billion surplus in 2005.[464] In the first quarter of 2007, China's trade surplus was $46.5 billion, 102 percent higher than the first quarter in 2006.[465] China's foreign exchange reserves in the first quarter also rose by an astonishing $135.7 billion, more than half of the total rise in 2006. [466] The Xinhua News Agency quoted China's Minister of Commerce, Bo Xilai, as stating that, "The Commerce Ministry will take cutting the trade surplus as this year's top priority in foreign trade work."[467]

Even after declaring the reduction of the trade surplus as a priority, Chinese regulators faced a politically and structurally limited set of options to accomplish this task. It is far easier to utilize administrative controls over rising investment, using instruments such as limits on new land use approvals, than it is to limit the activities of China's export industries. Faster appreciation of the yuan would have contributed to a reduction of the trade surplus over time, but this reduction would require real costs in employment in low-margin, export-oriented enterprises. In early 2007, there was little political will in the Chinese system to bear those costs, particularly in the sensitive period

[464] Data from China's General Administration of Customs and Ministry of Commerce.
[465] *Ibid.*
[466] Data from People's Bank of China.
[467] Xinhua News Agency quoted within Market News International, "China Commerce Minister: Cut Trade Surplus First Priority for 2007," 15 January 2007.

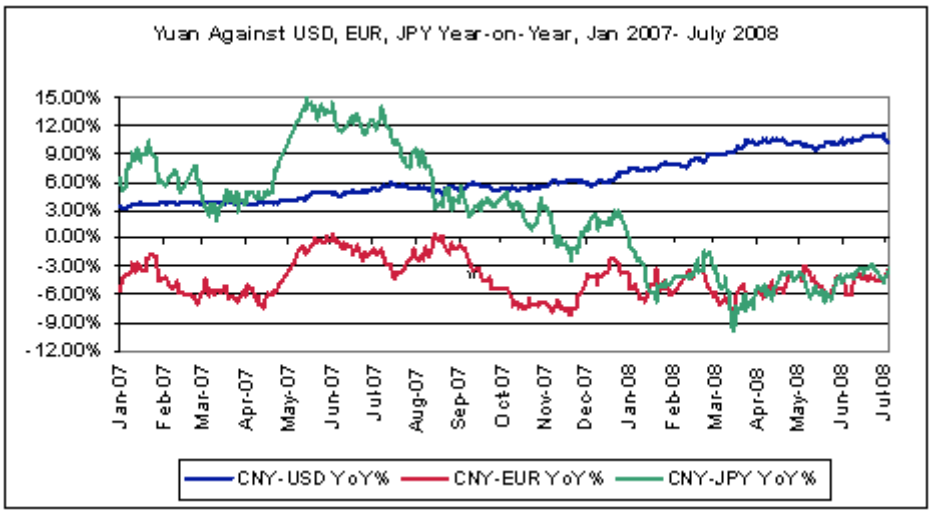
preceding the 17th Party Congress.

Limiting the trade surplus was a key focus of China's high-level Financial Work Conference, held in January 2007. While some voices at the conference favored faster yuan appreciation, others focused on the adjustments to the export tax rebate regime, in which exporters receive rebates for value-added taxes from the central government.[468] By adjusting the tax rebate rates, the government could indirectly assist the development of higher value-added industries, as opposed to labor-intensive final assembly operations. On July 1, the Ministry of Commerce announced reductions in export tax rebates on 2,831 categories of commodities, which represented 37% of all export categories.[469] In response, government think tanks began to predict declining export growth in the second half of 2007.[470] Instead, the second-half trade surplus reached $149.3 billion, up from $112.8 billion in the first half.[471]

One problem that China's Ministry of Commerce faced in trying to limit the trade surplus was linked to the exchange rate regime itself, and the depreciation of the dollar in global markets. The central bank continued to manage the yuan's gradual appreciation against the dollar, and in so doing, led the yuan to follow the dollar lower relative to other currencies. In 2006, the yuan rose by 3.28 percent against the dollar, but depreciated by 7.17 percent against the euro. In 2007, the yuan rose by 6.42 percent against the dollar, but depreciated by 4.06 percent against the euro. This depreciation against the euro

[468] Market News International, "Insight: China Determined to Stop Growth of Trade Surplus," 24 January 2007.
[469] Market News International, "China to Cut Export Tax Rebate on July 1- FinMin," 19 June 2007.
[470] Market News International, "China Comm Min: H2 Trade Surplus Growth To Slow On Govt Moves," 11 July 2007. The article states, "Wang is just the latest government official to predict slowing growth in the second half, following similar forecasts in recent days by the National Bureau of Statistics, National Development and Reform Commission researcher Wang Xiaoguang and Vice-Minister of Commerce Wei Jianguo."
[471] Data from China's General Administration of Customs and Ministry of Commerce.

provided a safety valve for Chinese exporters, as China's trade surplus with Europe began to expand at a faster rate than its trade surplus with the United States. While China claimed to be using a basket of currencies as a reference point, the yuan followed the dollar down at an accelerating pace, which contributed to China's intensifying payments imbalances.



Source: Stone & McCarthy Research Associates, People's Bank of China
Figure 7.4- Yuan Against USD, EUR, JPY Year-on-Year

While China's leaders had discussed the necessity of changing the sources of China's economic growth from exports and fixed asset investment to domestic consumption since 2004, there appeared to be little political will among the Chinese leadership to bear the short-term costs of such a shift, in terms of urban unemployment, and potentially social instability. Another Ministry of Commerce attempt to trim the trade surplus was announced in late July 2007, involving certain products involved in the processing trade. These draconian steps included forcing certain industries involved in

the lower value-added processing trade to register their production contracts and deposit the value of their export contracts and value-added tax in foreign currency in a domestic bank before engaging in production.[472] Failure to complete the contract would then result in forfeiture of the deposit and interest. These regulations would have severely stressed these companies' cashflows, as well as introduced new exchange rate risks during the production cycle. The measures were the most serious actions targeting the trade surplus that the Ministry of Commerce had announced so far, and they were clearly designed to signal the government's intention to reduce the importance of these lower-value-added industries in China's overall external trade.

The regulations were supposed to enter into effect on August 23, 2007, but apparently, these risks were too much for the export sector to bear, and a new Ministry of Commerce circular issued before the rules were effective claimed that companies affected by the regulations could now use letters of credit or other financial instruments instead of cash in order to make the required deposits. In other words, the regulations were effectively scrapped in the face of concerted opposition from exporters in the processing trade. Rather than endure the short-term costs of rising unemployment in low value-added, labor-intensive industries, the Ministry of Commerce backed off, even though the trade surplus continued growing rapidly. Even though these regulations were relatively limited in scope, affecting only $70 billion in processing trade in 2006, according to a Ministry of Commerce researcher, the central government was unwilling to tolerate higher unemployment in order to limit the size of the trade surplus and move

[472] Market News International, "China Targets Cashflows in Trade Surplus Struggle," 27 July 2007.

Chinese industry into higher-technology, higher-value added manufacturing sectors.[473]

The policy reversal concerning these regulations illustrated the political sensitivity surrounding China's exchange rate and the depth of the opposition to faster yuan appreciation. China's central government had attempted to encourage precisely the shift in China's exports--toward higher-technology, higher value-added industries--that the scrapped processing trade restrictions had attempted to elicit. If opposition to restrictions on a limited category of export commodities in the processing trade produced a reaction sufficient to shut down the proposed reforms, even though the basic direction of the policy was in line with the priorities of the central leadership, the opposition to faster yuan appreciation was even more extreme. Unlike these regulations, the exchange rate would affect all prices for China's exporters. The central government's management of the yuan exchange rate reflected a wide-ranging political consensus that was unlikely to change without a significant external economic shock or a reshuffle of China's economic leadership. This political environment and the strategy of managing the exchange rate made it nearly impossible for the Ministry of Commerce to limit the size of China's trade surplus or China's surging capital inflows, which continued to fuel China's liquidity cycle.

The 2007 Inflationary Cycle and Faster Appreciation

The most likely consequence of China's ongoing liquidity cycle, with capital inflows fueling monetary and credit growth, was the return of inflationary pressure.

[473] Zhang Wei, a researcher with the Chinese Academy of International Trade and Economic Cooperation and an advisor to the Ministry of Commerce, argued that the measures, when announced, were a "major reversal" in policy and that "the government is trying to take back control of processing trade." Market News International, "China Targets Cashflows in Trade Surplus Struggle," 27 July 2007.

Inflation picked up briefly in 2004 to peak at 5.3 percent due to rising grain prices, but then relented sharply in 2005 and 2006, when the full-year growth rate of the consumer price index was only 1.5 percent. However, in 2007, inflationary pressure resumed strongly, led primarily by a dramatic surge in meat prices, and pork prices in particular. By November 2007, the growth of the consumer price index hit 6.9 percent relative to the previous year and would surge even higher in early 2008, hitting 8.7 percent in February. These were the highest inflation rates in China since 1996, and they began to worry Chinese authorities, who were concerned about the impact of rising prices on standards of living for China's large rural population. Inflation had correlated with periods of political unrest in the past, and it signaled the turning point of several of China's macroeconomic cycles, when the central leadership slowed the economy harshly in order to prevent inflation from spiraling out of control.[474] At the same time, in 2007, China's stock market was growing at annualized rates faster than 100 percent, drawing deposits out of the banking system, as depositors were earning negative real returns in an environment where prices were rising much faster than interest rates on bank deposits. As a result, to counter this inflationary pressure and the outflows from the banking system, the PBOC raised interest rates six times in 2007, increasing lending rates by 1.35 percent and deposit rates by 1.62 percent. However, the inflationary cycle continued.

[474] See, for example, Victor Shih, *Factions and Finance in China: Elite Conflict and Inflation* (Cambridge: Cambridge University Press, 2007).

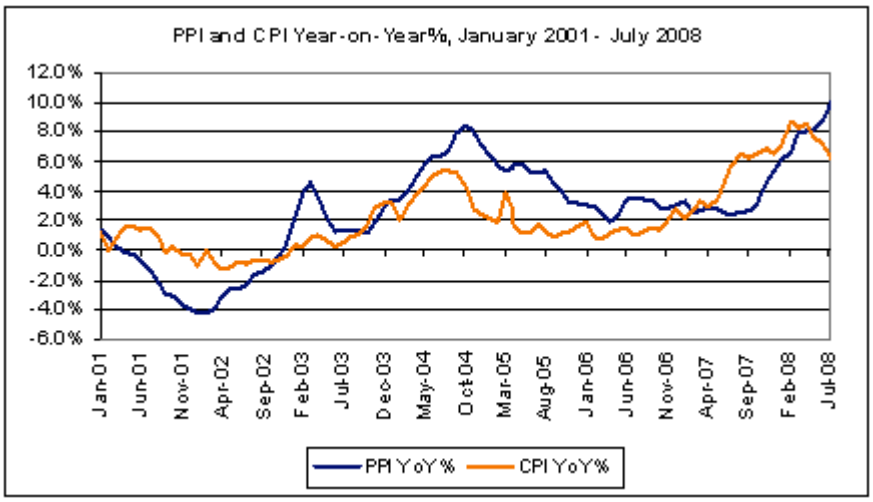


Figure 7.5- PPI and CPI Year-on-Year%, January 2001-July 2008
Source: National Bureau of Statistics (China)

The debate over the causes of the Chinese inflationary cycle split into two camps. These two arguments were characterized most succinctly by Harvard economist Kenneth Rogoff, who wrote in the Financial Times in February 2008 that, "Those who think inflation is caused by too little pork rather than too much money are wrong."[475] In other words, some analysts argued that China had too few pigs, increasing prices of pork and other things, while others argued that China had too much money, with this monetary pressure driving up the prices of everything. In the spring of 2006, the price of pork had declined sharply, inducing many farmers to slaughter their hogs prematurely, facing diminishing returns from continuing to feed them. This glut in supply worsened the downward price pressures, which also meant that farmers chose to cease hog husbandry entirely. As a result, China rapidly developed a pork shortage over the following year, driving up prices of not only pork but also pork substitutes such as beef and mutton; pork

[475] Kenneth Rogoff, "China May Yet Be The Economy To Lose Sleep Over," *Financial Times* 5 February 2008, p. 9.

comprises around 70 percent of Chinese meat consumption.[476] The government stepped in quickly to incentivize farmers to raise hogs again, but it is difficult to rapidly expand capacity in the pork industry, and rising prices persisted in the later months of 2007. If China's inflation problem was caused by too few pigs, there was little that monetary policy could do to counter the inflationary cycle other than limiting the inflationary expectations of the populace. Thus, the focus of several government agencies, such as the National Development and Reform Commission, was on restoring supply to pork markets, rather than raising interest rates.

However, there was considerably more evidence for the "too much money" hypothesis in explaining the Chinese inflationary cycle in 2007. Regardless of the initial trigger of inflationary pressure in the form of pork prices, monetary growth resulting from China's astonishing $461.9 billion in foreign exchange reserve growth in 2007 was also likely having an effect on price levels, particularly in non-food prices. An external supply shock to pork prices, assuming relatively stable monetary growth, should hypothetically push down the aggregate price levels of non-food prices.[477] However, non-food prices began ticking up as well later in 2007 and the early months of 2008, indicating that monetary pressure was having an effect on most prices, and that this pressure was merely being channeled toward higher food prices. In addition, China's producer price index of ex-factory prices began to spike up strongly at the end of 2007, reflecting rising international commodity prices, but also pointing to broader-based price increases down the line for Chinese consumers. China's liquidity cycle had fueled

[476] Data from Beijing Orient Agribusiness Consultants, 2007.
[477] Michael Pettis of Peking University was the first person I had heard describing monetary inflation in this fashion. See also Michael Pettis, "Chinese Inflation: It's Money, Not Pork," *Far Eastern Economic Review* **171**:3 (April 2008), p. 42-45.

considerable capital inflows, and it was difficult for China's economy to grow at a pace exceeding 11 percent per year without triggering additional inflationary pressure.

After five interest rate hikes in the first nine months of 2007 had failed to keep inflationary pressure from accelerating, the PBOC made a different policy proposal to the State Council: allow the yuan to appreciate at a faster rate.[478] Faster yuan appreciation should hypothetically reduce the prices of imported products, including commodities, placing downward pressure on domestic prices and combating inflation. In addition, faster appreciation should hypothetically limit capital inflows by reducing speculative bets on the yuan, forcing the central bank to provide lower volumes of yuan in exchange. However, the vast majority of China's food supply was sourced domestically; this had been an objective of the Chinese state for several years, so faster yuan appreciation placed little downward pressure on food prices, which were the key driver of Chinese inflation in 2007.

At the Central Economic Work Conference in December 2007, however, the State Council seemed to indicate that they had accepted the PBOC's basic argument.[479] The central government announced that the key economic priorities for 2008 would be the "two prevents," or limiting inflation and the risk of economic overheating. In addition, the central government announced that the government's basic monetary policy stance was to shift from "prudent" to "tight."[480] Immediately following the meeting, the yuan rose at its fastest pace since the July 2005 exchange rate reforms, surging by 5.24 percent against the dollar between December 2007 and March 2008, at an annualized rate exceeding 16 percent. In addition, during these months, the central government tried

[478] Interview 08-01.
[479] Interview 08-03.
[480] Market News International, "China Govt Signals Ready to Get Tough on Economy," 5 December 2007.

administrative tightening measures as well, with the National Development and Reform Commission freezing prices on "daily necessities" starting in January, and requiring companies to petition for the right to raise prices.[481] In addition, the PBOC imposed quantitative controls on new loans by commercial banks, requiring that loans be restricted within quotas that were enforced quarterly.

However, the central bank had little to show for its efforts at the end of March 2008. As the economic data for the first quarter was released in mid-April, consumer price growth had accelerated to 8 percent for the first quarter of 2008. There was strong evidence that speculative capital flows had accelerated during this period as well, seeing the potential for faster gains on yuan-denominated assets. Inflation in April surged once more to 8.5 percent, and around the beginning of April, the central government instructed the central bank to begin to slow the pace of yuan appreciation dramatically.[482] Opposition to faster exchange rate movement within China's bureaucracy had softened briefly in the face of expanding trade surpluses, but it quickly regrouped after faster yuan appreciation was unable to tame rising inflation. Ultimately, the inflationary pressure that intensified in 2007 had been driven by the same liquidity cycle that had plagued China's financial authorities since 2002, with expectations of one-way yuan appreciation fueling monetary growth and capital inflows that threatened the Chinese government's ability to manage the Chinese economy.

[481] Market News International, "China Govt Introduces Temporary Price Controls to Combat Inflation," 9 January 2008.
[482] Interview 08-03, and Market News International, "Sources: China Gov't Rethinks FX Policy, Cuts Yuan Rise Pace," 28 April 2008.

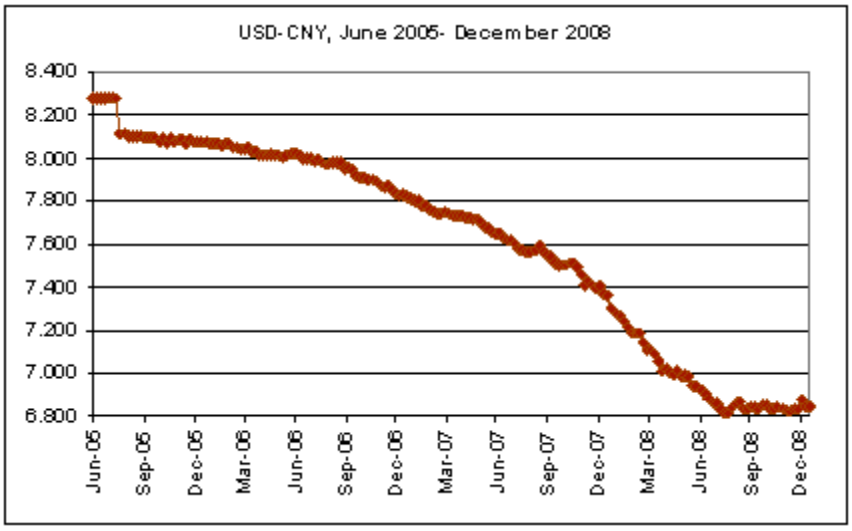


Figure 7.6- Dollar-Yuan, June 2005-December 2008
Source: People's Bank of China, Stone & McCarthy Research Associates

An External Slowdown, With the Yuan Back In Play

China's battle against inflation in 2007 was soon joined by the prospect of a painful exit from the liquidity cycle in the form of a slowdown in foreign consumption of China's exports. If China's exports slowed down, the economy would become increasingly dependent upon domestic consumption; otherwise, the consequences could include overcapacity, declining corporate profits, and a significant volume of non-performing loans in the banking system. China's economic growth had remained highly dependent upon exports and fixed asset investment, and a slowdown in export growth presented significant risks to the health of the economy as a whole. However, the battle against inflation severely complicated economic policy-making, as China had to be attentive to both rising prices and the potential for a slowdown in economic growth. The former would demand a response in the form of monetary tightening, while addressing

the latter would require monetary easing and potentially fiscal policy-led stimulus, which would also be inflationary.

Complicating China's inflation problem, but prolonging China's liquidity cycle, were the actions of the U.S. Federal Reserve, which began cutting interest rates aggressively in late 2007 and early 2008 in an attempt to allow the U.S. economy to recover from the credit crunch that plagued the global financial system following rising rates of default on subprime mortgage loans, with implications for a wide range of securities collateralized by those mortgages. As the Federal Reserve reduced U.S. interest rates, the interest rate gap between with Chinese interest rates quickly disappeared, until Chinese interest rates were around 1.5 percent higher than corresponding U.S. rates in the spring of 2008. In combination with a faster pace of yuan appreciation designed to combat Chinese inflationary pressures, these developments dramatically increased the attractiveness of holding yuan-denominated assets, encouraging additional speculative capital flows into the country.

In addition, China's exports began to slow in the early months of 2008, leading the traditional opponents of yuan appreciation to redouble their opposition to the yuan's faster rise. Chinese import growth began to exceed export growth by a relatively large margin, but this was largely more indicative of rising commodity prices than a surge in domestic demand.[483] Exports to the United States slowed precipitously, growing by only 6.9 percent in the first four months of 2008, while exports to Europe remained relatively

[483] According to data from China's General Administration of Customs, volumes of imported commodities were rising gradually, but the overall costs of those commodities and raw materials were skyrocketing in the first four months of 2008. Calculating the effects of these price increases using the average value/volume ratio in the 2007 trade data from the customs authority, and multiplying by January-April 2008 import volumes reveals that in imports of crude oil, refined oil, iron ore, copper, and steel alone, price increases have accounted for around $30.1 billion in additional import costs in the first four months of 2008. Without these price increases, import growth for January to April 2008 would only be around 17.5% year-on-year, slower than export growth.

strong, as the yuan was still depreciating against the euro while it was rising at a faster pace against the dollar.[484]

However, the export slowdown was enough to trigger a host of complaints to the State Council from exporters and their advocates. An official in the Central Economic and Financial Leading Group reportedly commented, "There've been many calls from the big ministries, especially the Ministry of Commerce, State Administration of Foreign Exchange (SAFE) and National Development and Reform Commission (NDRC). . . They all believe that the yuan's current rise is too fast."[485] Despite the fact that nearly three years had passed since China ended the peg to the dollar, the political environment surrounding yuan appreciation had not changed considerably. The Ministry of Commerce's opposition survived a change in the ministry's leadership to Chen Deming, who commented in December 2007, "I want to say that the Commerce Ministry -- in the past, now and in the future -- has never opposed yuan appreciation. But we do oppose too fast a yuan rise. . . This year's appreciation has been 6 percent and I think that's fast enough. . . . If the yuan appreciates too rapidly, it can cause large fluctuations in our economy and, in turn, affect the global economy and financial markets."[486]

The uptick in speculative capital inflows also played a key role in forcing the State Council to reconsider the pace of yuan appreciation.[487] Following this resurgence, the central bank had little success to show for their desired change in the policy direction; neither inflation nor monetary growth had eased, and exporters were complaining about

[484] Between the last day of March in 2007 and the last trading day of March in 2008, the yuan had appreciated by 9.17% against the dollar, but had depreciated by 7.27% against the euro.
[485] Market News International, "Sources: China Gov't Rethinks FX Policy, Cuts Yuan Rise Pace," 28 April 2008.
[486] Chen Deming quoted within Market News International, "China Vice ComMin Opposes Faster Yuan Appreciation," 12 December 2007.
[487] Interview 08-03, and Market News International, "Sources: China Gov't Rethinks FX Policy, Cuts Yuan Rise Pace," 28 April 2008.

rising costs. In reality, rising wages, land prices, and raw materials costs were probably more influential to exporters' financial health than the pace of currency appreciation. However, the yuan was placed back into play, slowing to a crawl in April 2008 and resuming a more gradual pace of appreciation following that month; in July 2008, the yuan started a five-month period of stability against the dollar. Overseas markets began to expect a significantly slower pace of appreciation, but the yuan was still viewed by most market participants as a one-way bet.[488] This reversal of the more rapid pace of appreciation only prolonged and continued the operation of China's liquidity cycle, nearly six years after China's economy had begun encountering massive capital inflows that resisted the efforts of economic authorities to manage China's rapid economic development.

The Liquidity Cycle and Exchange Rate Reform

The compromise that produced the limited exchange rate reforms of July 2005 was preceded by a well-planned series of technical reforms designed to prepare China's financial system for additional exchange rate flexibility. However, once China's leaders reached the political compromise responsible for the July 2005 reforms, which involved additional flexibility in the exchange rate and a slow and stable pace of appreciation, this decision produced effects that limited China's available options to reduce capital inflows and their consequences, including rapid credit, investment, and price growth. Once

[488] Izham Ahmad, "China Yuan Gains Slow: The End of the 1-Way Bet?" Market News International, 12 May 2008.

China's leaders had adopted the July 2005 compromise as the starting point of their strategy to manage capital inflows, economic policy-making was ad hoc in nature and responsive to the various symptoms of China's massive capital inflows. In other words, while exchange rate reform itself may have involved extensive technical preparation and a cautious approach, the consequences of China's chosen reforms produced a number of ancillary economic effects. China's management of these unintended consequences involved sporadic and reactionary policy responses, many of which curtailed market-directed adjustment mechanisms in the economy, rather than advancing the role of the market.

Because Chinese economic authorities were concerned about speculative capital inflows following the July 2005 exchange rate reforms, they pushed down Chinese interbank rates to maintain an interest rate gap that would punish speculators. When those low interest rates created rapid investment growth, fueled by credit growth from China's capital inflows, risking economic overheating, China attempted to restrict land use to limit new investment projects, canceling worthy projects along with the wasteful. When credit growth became excessive, the PBOC began stuffing banks with low-yielding sterilization paper to mop up excess liquidity, barely allowing the banks to cover their costs. The low costs of capital began to jeopardize the commercialization of China's financial sector, with banks unable to price loans effectively. The central bank also raised reserve requirement ratios aggressively to remove excess liquidity, forcing additional costs on commercial banks. Ultimately, these controls were ineffective in limiting rapid credit and investment growth from China's capital inflows, and inflationary pressure began to develop in early 2007. When depositors sought better returns in the

stock market to hedge against inflation, and equity prices began to balloon, the Ministry of Finance raised transaction taxes, and when this failed to limit asset prices, the central bank began raising interest rates, limiting the sales of sterilization paper. When interest rate hikes had failed to limit inflationary pressure, the central bank switched back to exchange rate adjustment and allowed the yuan to rise at a faster rate, and when that brought additional speculative capital inflows without limiting inflationary pressure, the central government imposed price controls for some goods, instituted quarterly quotas on bank loans, and slowed down the pace of yuan appreciation dramatically to protect exporters.

After the political compromise that produced the limited exchange rate reforms of July 2005, economic policy-making in China was anything but consistent. The Chinese government has chased the liquidity glut through various financial conduits in the Chinese economy, enacting short-term policy measures to tackle the individual symptoms of China's liquidity cycle. By accepting the July 2005 reforms and a slow and managed pace of yuan appreciation as a starting point, however, China's financial authorities intensified China's liquidity cycle, its symptoms, and the risks associated with an economy growing at an extremely rapid pace in an imbalanced fashion. China's financial authorities have battled this liquidity cycle since 2002, and have not yet found a solution to the problem of recurring capital inflows. The nature of China's exchange rate regime remains at the core of this problem. Looking forward, either China will be able to manage the consequences of capital inflows effectively, or the costs of these imbalances will accumulate in Chinese industries, the banking system, the central bank, or the state's fiscal coffers. However, this pattern of economic growth was not inevitable, and the

reactive and inconsistent economic policies China pursued in its attempt to manage the symptoms of the liquidity cycle were largely a consequence of the political compromise concerning the exchange rate reforms of July 2005.

Chapter 8- China's Exchange Rate Regime and the Global Credit Crisis

The last casualty of the Asian financial crisis of the 1990s may be the Chinese economy. The fear of capital outflows and speculative assaults on Asian currencies at the end of the last decade was a critical factor leading Chinese policy-makers to avoid rapid adjustments to China's fixed exchange rate regime, and encourage the accumulation of foreign exchange reserves. The problem, of course, was that markets anticipated further currency appreciation, fueling capital inflows and supplying significant volumes of liquidity to China's economy, which stimulated rapid credit and investment growth. The consequences of these massive capital inflows are more likely to show up in the domestic banking system, rather than in a speculative attack on the Chinese currency, as occurred during the Asian financial crisis of the late 1990s. Yet the lessons of that crisis were influential in shaping China's exchange rate reforms and creating the market expectations of further yuan appreciation that produced rapid monetary growth in China from 2002 to early 2008.

The sustainability of China's liquidity-fueled boom from 2002 to 2008 is now being tested. As the global financial system was afflicted by the most severe contraction of credit in several decades in the fall of 2008, the Chinese economy appeared relatively

unscathed, making a limited virtue out of the financial system's low degree of liberalization and openness to the global economy. However, the consequences of the credit crisis that started in rising default rates among subprime mortgage loans are likely to include significantly slower growth in consumption in the developed economies, which are China's primary export markets. As credit to U.S. consumers becomes more scarce, purchases of Chinese exports will likely slow down as well. Significant investment in China's export-oriented industries, which was encouraged for years by an undervalued exchange rate, will now face a critical test of sustainability. As an undervalued exchange rate directed investments overwhelmingly into industries targeting overseas demand, China's economy may suffer significantly from a slowdown in overseas consumption resulting from a tightening of credit conditions around the globe.

However, the credit crisis has also rapidly changed Chinese perceptions of the benefits of financial liberalization and open capital markets, particularly when those benefits have been touted by Western financial institutions whose solvency came under assault in a very short period of time. China's lack of financial liberalization became a benefit in the short-term aftermath of the crisis, as Chinese financial institutions had little exposure to toxic debt that had crippled Western financial institutions.

Furthermore, the crisis jeopardized Chinese perceptions of the credibility of international financial institutions and the advice they had provided to China concerning the reform of China's financial system, including the reform of the exchange rate regime. In the future, this change in perceptions, along with the domestic political consequences of discredited Western models of financial reform, are likely to slow the pace of financial reform in China, particularly concerning the linkages between China's financial system

and the rest of the world. Immediately following the bankruptcy of Lehman Brothers and the disclosure that Chinese financial institutions faced losses on Lehman Brothers debt that were not insignificant, the Chinese banking regulators reportedly held a meeting warning banks to manage their counterparty risks with foreign financial institutions, particularly those from the United States.[489] In July 2008, China's central bank stopped the yuan's gradual appreciation against the dollar, and that period of stability has continued as the credit crisis intensified. In the face of a likely global economic slowdown, China's policy response has been to seek to maintain growth at any cost, eschewing even its medium-term goals in rebalancing the economy toward domestic consumption. The government quickly responded to increase export tax rebates for even labor-intensive export enterprises such as toys and textiles, which were likely to be phased out if the government were to succeed in its attempt to rebalance the economy.

However, the credit crisis also placed China in an important position within the international financial system, precisely because of China's large holdings of foreign exchange reserves, which were a product of the country's undervalued exchange rate and significant capital inflows. As Western financial institutions rapidly found themselves in need of capital as the credit crisis expanded, several appealed to China's sovereign wealth fund for capital injections. However, given the concerns within the Chinese bureaucracy concerning the solvency of Western financial institutions, the sovereign wealth fund was extremely cautious. The CIC's investments in Blackstone, Morgan Stanley, and even money market funds such as the Reserve Primary Fund had dropped sharply in value, and

[489] Jane Cai and Adam Chen, "Mainland lenders ordered to halt interbank deals with U.S. firms," *South China Morning Post* 25 September 2008.

the State Council was unlikely to approve large new investments in Western financial institutions in such a climate.

At the same time, China's leaders also sought to cultivate the perception that China continued to act responsibly during the credit crisis. China's central bank did not liquidate massive volumes of U.S. Treasury bonds or debt from Fannie Mae and Freddie Mac, even if the SAFE's regular purchases of debt from these enterprises declined dramatically. The yuan did not depreciate against the dollar, despite the onset of severe pain among Chinese exporters. Some of China's reserves had been transferred to the sovereign wealth fund, the China Investment Corporation, and those could have been invested in other Western financial institutions in need of capital. However, the vast majority of China's $1.9 trillion in foreign exchange reserves were already invested in U.S. Treasury bonds and debt and mortgage-backed securities issued by Fannie Mae and Freddie Mac. Therefore, the notion that China could come to the aid of the United States economy and U.S. financial institutions was redundant; China was already heavily invested in the United States, and selling their existing assets to free up cash to buy stakes in U.S. companies would have likely added to the downward spiral of confidence that gripped credit markets in September and October of 2008.

The global credit crisis of 2007 and 2008 elevated China's significance in the global financial system, as one of the creditor nations in the global economy, holding almost two trillion dollars in foreign exchange reserves. However, the critical policy decision that contributed to the accumulation of such massive reserves was the partial and limited exchange rate reform of 2005, which encouraged market expectations of further yuan appreciation. Chinese leaders justified their decision to introduce additional

flexibility into the exchange rate regime on the same grounds as their decisions not to liquidate their holdings of U.S. assets during the financial crisis: they wanted China to appear as a responsible actor in the international system. This perception among the top Chinese leadership that China needed to act responsibly dovetailed with the shared lessons of the Asian financial crisis concerning fixed exchange rates, transmitted through international financial institutions, as critical enablers of China's exchange rate reforms in July 2005.

That notion of China's responsibility in the international financial system is likely to come into question in the coming years, both because the international norms underlying the global financial system are coming under attack, and because China's perceptions of the credibility of international financial institutions are likely to change. China is in the process of erecting buffers between its economy and the international financial system at the same time that the United States is asking China for additional assistance, or at the very least, to play a stabilizing role. Yet it was China's self-perception as a responsible actor in the global financial system, and the importance of the shared ideas among the participants in that financial system that produced the critical momentum behind China's behavior in both circumstances. However, it must have been very apparent to the Chinese leadership as the global financial crisis intensified that the shared wisdom of international financial institutions did not necessarily represent an optimal set of utility-maximizing solutions for the global economy in all circumstances.

The ironies continue. The decision that contributed to China's assumption of such a significant global position in the aftermath of the global financial crisis was also a primary contributor to the imbalances that produced the crisis itself. In providing only

limited flexibility in the exchange rate regime, China's leaders encouraged significant capital inflows betting on further appreciation of the yuan, which added to China's foreign exchange reserves. As the central bank invested those reserves primarily in the United States, by purchasing Treasury bonds and debt and mortgage-backed securities from Fannie Mae and Freddie Mac, long-term U.S. interest rates remained low, even when the Federal Reserve attempted to raise them. As U.S. Treasury Secretary Henry Paulson, on November 12, 2008, commented:

> But let us not forget one fundamental issue which lies at the heart of our problems. Over a period of years, persistent and growing global imbalances fueled a dramatic increase in capital flows, low interest rates, excessive risk taking and a global search for return. Those excesses cannot be attributed to any single nation. There is no doubt that low U.S. savings are a significant factor, but the lack of consumption and accumulation of reserves in Asia and oil-exporting countries and structural issues in Europe have also fed the imbalances.[490]

The undervalued yuan was a primary contributor to the global imbalances that Paulson discussed above. By keeping its exchange rate low, China limited appreciations in other Asian currencies, as those countries did not want to lose competitive advantage for their exporters in competing with Chinese exporters. Chinese reserves ballooned as the dollar depreciated, and the yuan followed the dollar down, even while Chinese leaders argued that they were introducing additional flexibility into the exchange rate regime. Ironically, just as global consumption and Chinese exports looked to be facing their most serious threats in the second half of 2008, the dollar rallied while China limited the yuan's movement against the dollar, causing the value of the yuan to skyrocket against the euro, pound sterling, and other major currencies. By focusing on the nominal dollar-yuan exchange rate, China had attempted to protect its exporters during a period of rapidly

[490] Remarks by Secretary Henry M. Paulson, Jr. on Financial Rescue Package and Economic Update, 12 November 2008, http://www.treasury.gov/press/releases/hp1265.htm.

rising global consumption, and then exposed them to even larger stresses as global consumption growth began to slow sharply.

The uncertainty that emerged following the Asian financial crisis caused Chinese policy-makers to search for answers, and the global consensus that emerged among financial technocrats concerning the efficacy of exchange rate flexibility and the eventual problems of sustainability among fixed exchange rate regimes provided some guidance amid this uncertainty. As the global credit crisis of 2007 and 2008 continues to metastasize, another round of uncertainty is gripping the global financial system, and the previous international norms concerning the best practices of exchange rate policy are now facing significant scrutiny, including skepticism from Chinese policy-makers who view China's limited connectivity with the rest of the global financial system as a virtue, by containing China's direct financial risks. As global consumption growth continues to slow dramatically, the exporting countries around the world are likely to bear the brunt of the adjustment as savings rates in the developed world increase from historically low levels. By attempting to avoid the consequences of the first Asian financial crisis, China's limited exchange rate reforms contributed to global imbalances that were at the heart of the first financial crisis of the 21st century, and China's own economy is unlikely to remain immune to the fallout.

China's Exchange Rate Reforms and International Political Economy

This study sought to answer the question of why China introduced more flexibility into its exchange rate regime in 2005, despite considerable bureaucratic

opposition, following over a decade of policy continuity despite changing economic circumstances. The narrative of the preceding chapters has attempted to explain the importance of ideational factors, including the international consensus behind flexible exchange rate regimes and the Chinese leadership's attempt to cultivate the perception of China as a responsible actor in the global economy. These ideational factors explain the Chinese decision to appreciate the yuan and introduce additional flexibility into the exchange rate regime, contrary to their short-term material interests. China's long-term interests could not be determined by policy makers *ex ante* without reference to theories concerning the relationship between exchange rate management and financial stability, and the lessons of the Asian financial crisis were critical factors informing the Chinese leadership of the problems of sustainability within fixed exchange rate regimes in a world of capital mobility.

These ideational factors are not politically neutral, and emerge from shared understandings of past crises by financial technocrats. China's exchange rate reforms influenced the development of global financial imbalances, and China's central bank became a massive liquidity-generating engine, with yuan pouring into the domestic banking system and foreign exchange flooding into global fixed income markets, depressing interest rates and encouraging further credit creation. As such a key actor in the global financial system, China's domestic political institutions, and the limited nature of exchange rate reform that was acceptable to the Chinese bureaucracy, played a significant role in the development of the global monetary order that was described by various commentators as "Bretton Woods II," with reference to the limited degree of flexibility of the currencies of both Asian countries and oil exporters, who managed their

currencies against the dollar.[491] As such, in the unwinding of that temporary monetary order, the process of China's exchange rate reform is a critical component of the international monetary politics of the past decade.

Given the significance of China's exchange rate policies to the development of global monetary relations in the past decade, the study of China's exchange rate reform does implicate broader debates in international political economy concerning the politics of exchange rate management. The international monetary system is not a constant, but has emerged as the product of multiple decisions made by individual state governments. As Eichengreen's work has demonstrated, the dominant form of exchange rate management in the global economy has varied over time.[492] In the area of exchange rate policy, international economic development does not necessarily involve a linear process of accumulated knowledge; the international consensus behind flexible exchange rates emerged early in this decade in response to uncertainty surrounding past financial crises in Asia and Argentina. However, this consensus was not politically neutral; the consensus behind flexible exchange rates benefited mobile capital, and those benefits may have come at the expense of global economic growth or the sustainability of global and Chinese economic growth. The persistent expectation of yuan appreciation encouraged a wide variety of individuals and companies to move funds into yuan-denominated assets, which fueled asset bubbles in China's property market, and excessive investment in China's export sector.

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[491] Michael P. Dooley, David Folkerts-Landau, Peter Garber, "The Revived Bretton Woods System: The Effects of Periphery Intervention and Reserve Management on Interest Rates & Exchange Rates in Center Countries," NBER Working Paper No. 10332, March 2004, http://www.nber.org/papers/w10332.pdf.
[492] Eichengreen, "The Endogeneity of Exchange Rate Regimes."

Time and the velocity of capital flows should also be examined more thoroughly as a critical variable in international monetary politics. In China's case, the slow pace of exchange rate adjustment was dictated by China's political culture of gradual reforms. Because China's exchange rate adjustment was so gradual, occurring over more than three years, it permitted the accumulation of billions of dollars of additional reserve growth and domestic liquidity from speculative capital flows betting on the likelihood of future yuan appreciation. China's capital controls were able to slow these flows, but if the 20-21 percent appreciation of the yuan against the dollar had occurred over six months, rather than three years, the resulting capital inflows and imbalances would have been far smaller due to transaction costs involved in China's capital controls, even if the domestic adjustment costs were more severe. The pace of exchange rate adjustment, as well as the overall magnitude of adjustment, was a political question in China's case, and warrants examination in other contexts as well.

The case of China's exchange rate reform has implications for the study of the influence of domestic politics on global financial liberalization as well. The consensus behind flexible exchange rate regimes was a contingent phenomenon, which emerged in response to the Asian and Argentine financial crises. Exchange rate reform was not inevitable, and the consequences of these ideas for China's economic development and the growth of global imbalances were significant. These international norms were used within the bureaucracy by a committed group of reform-oriented financial technocrats. However, the case of China's exchange rate reforms questions the benefits of integration into the global financial system for emerging markets, particularly in the form of currency convertibility under the capital account. China pursued rapid integration of its

real economy, in the form of trade, into global markets. However, financial liberalization lagged considerably, as there were only limited windows under the capital account through which individuals and companies could access foreign exchange.

The interesting fact that emerges from an examination of China's experience was that these capital account controls were basically ineffective in a world of rapid capital mobility; the controls prevented massive capital outflows by large, established institutions, but could not prevent large capital inflows and purchases of yuan-denominated assets by hundreds of thousands of individuals and corporations acting even within the restrictive confines of China's controls. These capital inflows, large volumes of which were speculative in nature, had notable consequences for the Chinese banking system's ability to manage the excess liquidity produced by the country's exchange rate policy, and for the central bank's ability to manage China's foreign assets in overseas markets. Just as Japan's experience appreciating the yen following the Plaza Accord provided a cautionary tale for China's financial technocrats, China's experience in pursuit of limited exchange rate reform in combination with the mild relaxation of capital controls may provide a cautionary tale for emerging market central bankers and financial technocrats.[493] The likely responses in other emerging markets may be significantly more restrictive capital controls, as occurred in Malaysia following the Asian financial crisis. For international financial institutions committed to the liberalization of global capital markets, China's experience suggests that partial, half-way attempts at capital account liberalization may not be gradual steps toward eventual openness in the long term, but can create domestic political opposition to further reform; full convertibility of

[493] For a discussion of the Chinese concerns about replicating Japan's experience, see Yi, Zheng, and Chen, p. 206-207.

the yuan under the capital account now appears to have lost momentum within Chinese domestic politics, given the potential for transmission of financial risk. In China's case, partial steps at capital account liberalization in combination with additional exchange rate flexibility were not necessarily consistent with sustainable economic development, by facilitating capital inflows, excess liquidity, and the misallocation of capital within China's domestic financial system.

While this has been an examination of the international political factors that influenced China's exchange rate reforms, the comparative political economy literature could also benefit from an examination of the domestic politics of exchange rates. Discussion of exchange rate policy typically filters into the international political economy literature because of the importance of exchange rates within the global monetary order, but these questions are also significant for the study of the political economy of development. Scholars of East Asian developmental states have emphasized the importance of undervalued exchange rates in driving an export-led development process, but there has been little discussion of the use of exchange rate policy following an export-led boom.

In China's case, the leadership attempted to use exchange rate policy as one tool to reorient China's growth model away from reliance on export and investment-led growth. This critique of the quality of China's growth was motivated by the Chinese Communist Party's own political imperatives; if private consumption growth was not keeping up with headline GDP growth, China's economic growth was producing few improvements in citizens' standards of living, which had implications for the legitimacy of the CCP's one-party rule. Furthermore, such growth was creating vast wealth

disparities within society and across regions; coastal exporting provinces developed rapidly while the hinterland and central China found it difficult to attract foreign investment. Exchange rate appreciation was one instrument that would increase the overseas purchasing power of Chinese consumers, and would drive investment toward industries focused on domestic rather than overseas markets. Yet such a shift had powerful domestic opponents in the provincial governments of export-oriented provinces, and the central government also appeared reluctant to bear the political costs of adjustment, even while they saw long-term benefits for the Communist Party.

Comparative political economy scholarship has often been concerned with the tradeoffs involved in these types of political conflicts, but exchange rate policy has not featured prominently within the field as either an independent or intervening variable shaping development patterns within a domestic context. This study of China's domestic political conflict over exchange rate policy also implicates scholarship concerning the political economy of development, by raising the question of the conditions under which exchange rate policy can overcome problems of state capacity in shaping investment behavior, particularly where there is entrenched local opposition to central government development objectives. In China's case, the limited nature of exchange rate reform was primarily a product of conflicts between the central bank and export-oriented enterprises and their advocates at various levels of government, but these conflicts will take different forms in different domestic institutional contexts. These domestic opponents of more rapid yuan appreciation were in turn influential over the eventual consequences of China's decision to introduce additional flexibility into its exchange rate regime, for both China's domestic economy and the international financial system.

China's decision to reform its exchange rate regime in line with international norms occurred in a different international environment than most scholarship concerning global monetary cooperation, because China decided to introduce additional exchange rate flexibility, rather than subordinating its monetary policy to a global fixed exchange rate system. There is little discussion within the international political economy literature concerning cooperation in a world of flexible exchange rates, rather than fixed rates. A move from fixed to flexible exchange rate regimes is typically viewed as a defection from a global monetary order, as Simmons's work has demonstrated, and literature discussing cooperative outcomes involve the political processes by which global monetary order under fixed exchange rates is constructed, with McNamara and Eichengreen's work featured as prominent examples. However, China's exchange rate reforms definitely represent a form of cooperation with the major powers in the global financial system, as the rest of the world called for Chinese exchange rate flexibility to reduce global imbalances. China was being asked by the international system to assume more autonomy over its monetary policy, rather than passively accepting the monetary policy of the United States.

However, the emergence of global imbalances complicated the traditional power relationships that are implied by the traditional discussion of monetary order in the international political economy literature. In the Bretton Woods system or the gold standard, for example, hegemonic stability theory implies that the central country is

willing to bear costs, such as countercyclical lending, in order to maintain the public good of global monetary stability. In addition, it is generally assumed that the central country or hegemon provides a focal point for other states' policies, and that peripheral countries will attempt to target their own inflation rates by linking their monetary policies to those of the hegemon. Furthermore, the hegemon is supposedly willing to run a trade deficit in order to provide liquidity to the global monetary system. In China's case, however, the United States was attempting to drive Chinese monetary policy in a more independent direction, away from the use of U.S. monetary policy and the dollar as a target of adjustment. In addition, the United States did not appear willing to endure a widening trade deficit for the purpose of maintaining global economic order; in fact, U.S. pressure on China came from lobbies blaming China for the U.S. trade deficit. The case of China's exchange rate reform illustrates that a move to additional exchange rate flexibility can still involve cooperation with the leading powers in the international monetary system, and that the international political economy literature has largely overemphasized global fixed exchange rate regimes as a dependent variable; global monetary cooperation can exist in other forms as well.

Furthermore, the power relationships within global monetary order under a world dominated by flexible exchange rate regimes appear far different than those discussed in works describing the operations of the Bretton Woods system or the gold standard. The peripheral countries, holding current account surpluses and foreign exchange reserves, held far more power over the activities of the global financial system than implied by the traditional IPE literature. The so-called BRIC countries (Brazil, Russia, India, and China), were the largest emerging markets and accumulated large foreign exchange

reserves by managing their currencies against the dollar, while the United States ran ever-larger current account deficits, and the brunt of adjustment was then shifted to those areas with flexible exchange rates against the dollar, such as the euro area. The foreign exchange reserves accumulated by surplus countries then purchased assets that significantly influenced U.S. debt markets, U.S. interest rates, and the independence of U.S. monetary policy.

As the holder of the largest pile of foreign exchange reserves in the world, China's central bank was highly influential in global fixed income markets, and fears of a rapid selloff of Chinese holdings of U.S. assets always lurked among market participants. Of course, such a selloff would have been extremely detrimental to China's material and political interests, but the fact that China and emerging markets held such critical positions within the global financial system is far removed from the portrayal of peripheral countries in the traditional accounts of the operations of fixed exchange rate regimes. It is, however, consistent with accounts such as Francis Gavin's revisionist history of Bretton Woods, in which the United States, far from being empowered by the privileges of the global monetary system, was constantly concerned about its balance of payments and the actions of peripheral states' governments, even to the point of considering a withdrawal of U.S. military forces from the European theatre for reasons related to the balance of payments.[494]

These types of power relationships challenge the traditional portrayal of global monetary order in the international political economy literature. This may simply be an instance of the inapplicability of models from the OECD countries to the new emerging

[494] Francis J. Gavin, *Gold, Dollars, and Power* (Chapel Hill, NC: University of North Carolina Press, 2004).

markets, but Gavin's work suggests that the power relationships involved even in the Bretton Woods system involved a lesser degree of imbalance between center and periphery than hegemonic stability theory would imply. At the very least, the case of China's exchange rate reform raises new questions for the study of global monetary order in a world dominated by flexible exchange rate regimes, rather than fixed rates. Under what conditions do states permit additional flexibility and forego the benefits of a current account surplus? Do these conditions change under different political and electoral systems? Under what circumstances does international pressure from other states in the system produce changes in exchange rate policy in surplus countries?

China's experience suggests that the nature of economic power in the global financial system dominated by flexible exchange rates is not as structured as under a global fixed exchange rate regime. Furthermore, the nature of these power relationships reinforces the importance of ideational factors in generating momentum for China's exchange rate reforms. China did not respond to U.S. pressure to revalue the exchange rate because China was in an unequal power relationship with the United States; China had many areas of leverage, in the form of their holdings of foreign assets. China introduced additional flexibility in its exchange rate regime to demonstrate the nation's responsibility to play a role in adjusting to global economic imbalances for the sake of the stability of the global financial system. These economic imbalances were actually exacerbated as a result of the limited nature of China's exchange rate reform, but the fact that there was any reform at all highlights the importance of international norms in shaping the Chinese leadership's thinking, as reform faced considerable domestic opposition. While this has been a study of the influence of international norms on

China's decision-making, it also suggests that the study of global monetary cooperation requires different independent variables under a system dominated by flexible exchange rate regimes, rather than a global fixed exchange rate system. Monetary cooperation under a system of flexible exchange rates involves different benefits to cooperation, and different costs of defection; the existing literature concerning fixed exchange rate systems provides little insight into the factors that led Chinese leaders to introduce additional flexibility into the country's exchange rate regime.

Exchange Rate Reform and Chinese Policy-Making

The study of China's exchange rate reforms also has implications for analyses of China's foreign policy and the Chinese domestic policy-making process. The legitimacy of the Chinese Communist Party's one-party rule rests heavily upon the government's ability to generate robust economic growth and improvements in standards of living for Chinese citizens. The exchange rate is arguably the most influential price in an open economy, by influencing the rate of inflation and the real purchasing power of citizens, for purchases of both domestic and foreign goods and services. Exchange rate policy heavily influenced the Chinese government's ability to manage domestic economic conditions using monetary policy; in fact, monetary policy autonomy was completely subordinated to China's exchange rate policy. Therefore, the Chinese leadership's treatment of exchange rate policy was a critical issue implicating a central pillar of the Chinese Communist Party's legitimacy. As such, this is a relatively "hard case" for international norms and ideational factors to influence Chinese behavior; if these

variables were significant in driving the reform of China's exchange rate regime, as this study has argued, it suggests that the Chinese policy-making process is more receptive to international norms in other issue areas as well, particularly those where the pillars of legitimacy of the Chinese Communist Party are not directly implicated. Reform of the exchange rate regime was incremental and limited, given the opposition within the Chinese bureaucracy, but the fact that exchange rate reform occurred at all suggests a change in China's self-perception that has been described thoroughly in recent assessments of China's foreign policy.

Recent studies of changes in Chinese foreign policy have focused upon a shift in China's approach to diplomatic affairs and international institutions, particularly those within Asia. China's growing consciousness of the perceptions of Chinese policy decisions by other nations has produced a concerted effort to improve the quality of China's engagement with the rest of the world, in order to minimize misperceptions and misunderstandings. Scholars have commented on the growing Chinese awareness of the security dilemma in Asia, and a resulting shift in foreign diplomacy toward greater levels of engagement, the promotion of economic ties and trade liberalization agreements, the resolution of border disputes, and high-level diplomacy. Many analyses have noted a decisive shift in China's attitude toward international institutions, with a greater emphasis in Chinese foreign policy on working within international institutions in order to provide a greater degree of reassurance concerning China's intentions. Much of China's new diplomatic efforts have focused on economic affairs, and the process of China's exchange rate reform in accordance with international norms represents an effort among the top leadership to work within the confines of the established international economic order,

rather than challenging it directly. However, China's chosen solution was more satisfactory to international political leaders than to global financial markets, where players saw the opportunity for additional yuan appreciation, and global imbalances expanded as a result.

This analysis of China's exchange rate reform also implicates the debate between those who argue China is "adapting" or accepting international rules because they are expedient and those who argue that China is "learning" or accepting the logic and legitimacy of the norms themselves. In the case of exchange rate reform, there is considerable evidence of behavior that can be described as both learning and adaptation. Within China's bureaucracy, a group of reformists within the central bank accepted the legitimacy of international norms concerning the efficacy of flexible exchange rates, and can be described as closer to the "learning" camp. However, for China's top leadership, the content of the ideas about flexible exchange rates was less important than the international consensus behind them, and as a result, the decision made by China's leadership to balance competing interests and introduce a limited form of exchange rate flexibility reflected a form of adaptation to these norms. Exchange rate reform allowed China to make the argument in its foreign policy that it understood the concerns of the rest of the world, and was ready to respond to them, albeit in a limited form. An anonymous senior official from China's Ministry of Foreign Affairs recently discussed China's need to reassure other countries with policy actions, rather than words, when he was quoted within an article in the *China Quarterly*. "'China needs to do tangible things to allay the fears of other countries,' he said. Whether the issue is managing the South

China Sea dispute, the exchange rate of the RMB or trade disputes, he said, 'China should be responsible and capable.'"[495]

The "learning" versus "adaptation" debate carries policy implications, because adaptive behavior would imply that China's commitments to international principles and rules would evaporate should the underlying institutional arrangement falter; adaptation-focused explanations reduce coordinated behavior by China to a question of compliance. However, the case of exchange rate reform suggests that China's compliance with international norms is not necessarily contingent upon formal institutional arrangements. Exchange rate norms are not institutionalized formally in a regime such as the rules of the World Trade Organization. While there is extensive discussion of exchange rate policy within the IMF and other international financial institutions, the fact that a legislative debate emerged within the United States to address this issue illustrates the absence of a ready set of institutional remedies for exchange rate imbalances.

Exchange rate policy is one area, likely indicative of others, where China's changing approach to foreign policy has implicated domestic policy decisions at the same time. China's top leadership may be adapting to the content of the norms concerning the efficacy of flexible exchange rates, but the top leadership has committed to maintaining a "responsible" or constructive role in addressing other nations' concerns about Chinese behavior. While China's leaders cannot ultimately control those perceptions of China, the evidence from the reform of China's exchange rate regime indicates that those perceptions were critical drivers of the set of acceptable solutions that emerged from the policy-making process.

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[495] The quote from a "senior MFA official" is found in Bonnie S. Glaser and Evan S. Medeiros, "The Changing Ecology of Foreign Policy-Making in China: The Ascension and Demise of the Theory of 'Peaceful Rise'," *China Quarterly* **190** (June 2007), p. 306.

Exchange rate policy-making suggests that China's policy-making process may be more responsive to international influence in cases where the government is facing new problems for which there is no preexisting policy toolkit, where the issue involves a certain degree of technical expertise, and where there is a strong domestic institution pushing for reform in line with international standards. Under the Hu-Wen government, policy-making operates largely based on consensus among top leaders and the relevant governing institutions. Scholars have also noted how China's leaders under the Hu-Wen government are prone to technocratic management of several issues, which involves a quasi-scientific approach of dividing problems into relevant pieces and addressing them individually. A set of technocrats with particular responsibility for a given issue area typically draws heavily from a set of international experience with that area, applies those lessons to Chinese conditions, and passes recommendations to the top leadership. This style of policy research was discovered again and again throughout the ongoing process of reform of China's financial system. Under this set of policy-making conditions, international "best practices" are likely to acquire additional legitimacy, assuming that China is concerned about overseas perceptions of its actions; the consensus behind the ideas is more relevant than the content of the ideas themselves. If ideational factors influence Chinese behavior in this form, then even if China's leadership is "adapting" to the norms, formal institutional constraints are less necessary, because changes in Chinese behavior are not related to questions of compliance.

However, this process of policy-making in the case of China's exchange rate reforms reinforces the contingent nature of those reforms; China's exchange rate reform was not inevitable. The exchange rate reforms of July 2005 were heavily dependent upon

the collective interpretation of the lessons of the Asian financial crisis by financial technocrats around the world, and the existence of a committed group of those technocratic reformers situated within the leadership of the People's Bank of China. In addition, the emergence of exchange rate reform was heavily dependent upon the change in the process of governance in China from the era of Jiang Zemin and Zhu Rongji to the leadership of Hu Jintao and Wen Jiabao, justifying Risse-Kappen's focus on domestic structure determining how ideas become relevant within domestic politics, rather than "floating freely." The policy-making process became more consensus-driven; otherwise, the preferences of the top leadership would likely have prevailed over those of reformers at lower levels of the bureaucracy. International norms were the critical variables creating momentum for China's exchange rate reform, but they were only influential because of the highly contingent factors that produced a situation where China's top leaders were receptive to the arguments of the financial technocrats from the central bank.

China's exchange rate reforms also suggest that the process of economic reform is not a linear, gradual process, in which China slowly opens its state-directed economy to market forces in accordance with a predetermined plan set by the central leadership. In fact, economic reform is a distinctly non-linear process, and a path-dependent process. China's exchange rate reform created additional capital inflows which caused the central government to react to liquidity bubbles created in different sectors, from the property market to the equity market to the banking system. The response to these capital inflows was reactive, and reflected a regression in financial market liberalization; China was

forced to repress the activity of the banking system by issuing credit quotas, and the leadership also controlled prices in some markets rather than liberalizing them.

The evolution of China's monetary policy since the exchange rate reforms of July 2005 suggests that short-term crisis management dominated long-term planning in the formation of economic policy. Of course, crisis management is necessary in all states' economic management, but the fact that China's exchange rate reforms actually stalled the process of introducing additional market influence into China's economy questions the traditional narrative of China's reform and opening. Rather than the conventional view of a steady process of development starting in 1978 and proceeding in accordance with a long-term "grand strategy" of economic liberalization, China's economic reforms have in fact been a halting, haphazard process marked by both failures and successes. Policy successes or failures produce bureaucratic interests that defend their new turf from dramatic change, so the path that reform has taken in the past heavily influences the possible directions for reform in the future, as Minxin Pei has argued.[496] China's exchange rate reforms in July 2005 produced conditions that enabled massive capital inflows, forcing the Chinese government to respond with restrictions on credit allocation, investment decisions, and prices that would have likely been unnecessary otherwise; this has stalled market liberalization in several sectors and introduced new distortions into the Chinese economy.

The exchange rate reforms of July 2005 were the most influential Chinese monetary policy decision of the last decade. China's exchange rate policy influenced investment patterns within China, by directing investment toward export-oriented

[496] Pei, p. 122-123.

enterprises that significantly improved China's international competitiveness but also left the Chinese economy heavily dependent upon external demand. China's exchange rate policy also influenced investment patterns in the rest of the world, by reducing U.S. long-term interest rates and encouraging the expansion of credit to U.S. consumers that helped to fuel demand for Chinese exports. The expectation that China would reform its exchange rate regime drove capital inflows into the country, and these inflows fueled a liquidity glut that made it far more difficult for the Chinese government to manage the economy.

The ideas that Chinese policy-makers held about the effects of different exchange rate regimes on real economic factors had an influence on the exchange rate reforms of July 2005. Chinese leaders acted contrary to the short-term material interests of the Chinese state in increasing the flexibility of the country's exchange rate regime, but policy-makers were ultimately persuaded of the long-term benefits of additional flexibility after extensive consultations with sympathetic reformists within the Chinese bureaucracy and the support of international financial technocrats. Ideas are not politically neutral, and in the case of China's exchange rate reforms, the international norms concerning the efficacy of flexible exchange rate regimes facilitated benefits for international currency speculators, who bet not only on the prospect that China might increase the value of the yuan, but profited when yuan-denominated assets surged against the dollar in a predictable fashion, following the introduction of additional flexibility into China's exchange rate regime.

Contrary to the conventional vision of China's economy progressing gradually toward an ideal type of a globally integrated capitalist economic system, this analysis of

the reform of China's exchange rate regime suggests that even an attempt to introduce additional market influence into China's exchange rate policy was not necessarily consistent with the broader objective of the liberalization of China's economy and increasing openness to the global financial system. Just as the reform of China's exchange rate was a contingent phenomenon, this analysis suggests that prospects for long-term economic development are similarly contingent, and depend upon the dominant economic ideas of the era. Global financial institutions' conceptions of their long-term interests are influenced heavily by the shared ideas concerning the lessons of previous crises, and these may not be utility-maximizing solutions in a different economic environment.

China, in introducing more flexibility into its exchange rate regime, was fighting the last war: the battle against the effects of the Asian financial crisis. That fight may have been won at the cost of expanding global imbalances and the resulting fallout of the unwinding of those imbalances. Ideational factors were critical drivers of the reform of China's exchange rate regime, and shared ideas about global markets continue to influence the actual behavior of those markets. In this context, global economic development may remain heavily dependent upon the ideas that policy-makers share concerning market forces; therefore, the processes by which these ideas become relevant and influential to policy-makers are critical to our understanding of how states create the global monetary order and how markets respond to these decisions.

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