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Finance and Development: The Silk Road Economic Belt Initiative

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Finance and Development:
The Silk Road Economic Belt Initiative

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Description

The role of finance in development is widely acknowledged. Credit and debt are crucial to economic development from national infrastructure projects through investment in national champions and small or medium-sized enterprises to microcredit. This stream will examine the political economic impact of the new financial resources and institutional arrangements associated with the Silk Road Economic Belt Initiative and its impact on development, inequality and political possibilities from China and Southeast Asia through to Europe.

Stream Session

Finance and Development: The Silk Road Economic Belt Initiative

Bell, S. & Feng, H. (2013). The PBC and Financial Reforms since 2003. *The Rise of the People's Bank of China*. pp. 289-311. Pages 1-10

Chhibber, Ajay. (2015). "China's One Belt One Road Strategy: The New Financial Institutions and India's Options," Working Papers 15/155, National Institute of Public Finance and Policy. Pages 11-17

Cohen, B. (2013). "The Yuan's Long March". In B. Cohen & E. Chiu, *Power in a Changing World Economy: Lessons from East Asia*. London & New York: Routledge. Pages 18-31

Du, M. (2014). China's State Capitalism and World Trade Law. *International And Comparative Law Quarterly*, 63(02), 426-430. http://dx.doi.org/10.1017/s0020589314000062 Pages 32-36

McNally, C. A. (2012). Sino-Capitalism: China's Reemergence and the International Political Economy. *World Politics*, 64(4), 741–776. doi:10.1017/S0043887112000202 Pages 37-49

Sigurjonsson, F. (2015). Monetary Reform - A better monetary system for Iceland. Reykjavik: Prime Minister of Iceland. pp 20-24, 69-82 Pages 50-54

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Assessing the Banking Reforms

The PBC's approach to banking and financial reform represents a dramatic departure from the traditional state socialist model espoused by the MOF. It is an *ex ante*, proactive strategy to tackle institutional deficiencies of the financial system, rather than the *ex post facto*, passive reaction to bank insolvency. It centers on the idea of market discipline, upgrading expertise and institutional innovation, rather than the traditional approach of lax supervision and fiscal bailouts offered by the old regime. In other words, it seeks to establish sound and sustainable financial intermediation in the emerging market. In describing the PBC's strategy, one of its officials used a Chinese saying, "It's more desirable to teach someone to fish than to offer someone a fish."[15]

The PBC-led bank restructuring represents a systemic effort to tackle difficult challenges in the financial sector. Despite PBC's loss of control of Huijin to the MOF, the reform campaign has been relatively successful in terms of the PBC's initial objectives. The PBC's recapitalization of the banks and the subsequent IPOs helped reduce their NPLs to internationally acceptable standards ("You zhuanjia dui guoyou" 2005). According to the CBRC (2012), the average NPL ratio of Chinese banking institutions stood at 1.77% by the end of 2011, well within the current Basel standards.

To some observers, Chinese banks have been transformed into "the world's most valuable and profitable lenders in terms of market capitalization and absolute profits" (Anderlini 2010a). The *Banker*'s *Top 1000 World Banks 2011* ranking listed 101 Chinese banks, including three of the top ten in terms of capital strength (ICBC, CCB, and BOA, measured by Tier 1 capital), the top two largest banks by market capitalization (ICBC and CCB), four of the top ten in profits (the Big Four), and fifteen of the top twenty-five movers (see Table 11.5).

In terms of asset structure, Chinese banks are also better positioned than most of their Western counterparts, as they were not drawn into the "toxic" mortgage-backed securitization markets. The banks also appear to have a large stock of profits, at least in the short term. Chinese banks now account for the largest slice of global banking profits. Their profits soared by 95% between 2008 and 2010, accounting for 21% of total global banking profits in 2010 ("Chinese Banks Dominate" 2011).

Nevertheless, in the longer term, this round of banking reform is likely to yield mixed results. First, according to Bergera and colleagues (2009), foreign investment will likely improve the efficiency of Chinese banks. Foreign investment appears to have substantial presence in the domestic banking sector, taking over 15% of total equity, and according to Y. Yang (2009), there has been extensive cooperation between Chinese banks and the FSIs (see Table 11.6). Yet given the current restriction on foreign equity in individual banks, the FSIs have had more or less limited presence in the boards and therefore influence. The PBC's intention of introducing international banking expertise was further hampered by the GFC, as some of the major cash-strapped investors withdrew from their Chinese investments.

Despite the seemingly dazzling figures of Chinese banks in world rankings, serious observers would take a rather more sober view of their books. Although major banks in China appear to possess a better asset structure than many of their beleaguered Western counterparts, this may be primarily due to the relative closure of China's domestic financial system to the wider trend of financial globalization, and to the relative underdevelopment of domestic financial intermediation, such as derivatives and securitization. As a CBRC official commented during the global financial meltdown, "we did

Table 11.5. World ranking of Chinese banks, 2011

World rank	Bank	Tier 1 capital (US$ million)	Pretax profits (US$ million)	ROA (%)	CAR (%)	NPL (%)
1	Bank of America	163,626	–1,323	–0.06	7.22	3.27
2	JP Morgan Chase	142,450	24,859	1.17	6.73	6.42
3	HSBC Holdings	133,179	19,037	0.78	5.43	2.36
4	Citigroup	126,193	12,273	0.64	6.59	4.76
5	Mitsubishi UFJ	119,732	9,125	0.37	4.83	1.68
6	Industrial and Commercial Bank of China	113,393	32,528	1.6	5.58	1.08
7	Wells Fargo	109,353	18,700	1.49	8.69	6.96
8	China Construction Bank	95,834	26,448	1.62	5.87	1.14
9	Bank of China	94,579	21,463	1.36	5.99	1.10
10	Royal Bank of Scotland	94,091	–1,471	–0.06	4.14	5.31
14	Agricultural Bank of China	79,285	18,230	1.17	5.08	2.03

Source: "Top 1000 World Banks" (2011).
Notes: ROA, return on assets; CAR, capital assets ratio; NPL, nonperforming loans. End of 2010 figures.

Table 11.6. Business cooperation between Chinese banks and FSIs

Chinese bank	FSI	Area of business cooperation
CCB	Bank of America	Corporate governance, risk management, IT and accounting management, human resources, retail banking, and liquidity management
BOC	Royal Bank of Scotland	Credit cards, financial management, corporate business, and personal insurance
	UBS	Investment banking
	Asian Development Bank	Internal administration, anti–money laundering
ICBC	Goldman Sachs	Investment banking, corporate governance
	Allianz	Insurance, capital management
	American Express	Credit cards

Source: Adapted from Yang Y. (2009).

not drown not because we were good at swimming but because we were far from the water" (Li 2009b).

In fact, China did at one point have a toe in the water. Take securitization, for example, a process that involves packaging the anticipated cash flows of instruments such as loans or receivables into asset-backed securities, which are then sold to investors. It is one of the ways in which assets can be hedged in a derivative market. China launched a pilot program on asset securitization in 2005, but the experiment was put on hold in 2008 in the wake of the GFC when the technique became a byword for problems in the West ("China Revives Credit" 2012). But this did not stop the banks from venturing further into this area. Previous reforms aimed at improving disclosure have had the opposite effect, which saw the banks seek to avoid formal capital adequacy ratios and circumvent credit quotas through informal securitization, moving credit to the off–balance sheet activities, particularly in wealth management products. According to a Fitch estimate, about RMB 2.3 trillion in securitized loans was sitting in off–balance sheet accounts in Chinese banks by the first half of 2010 (Cotterill 2010). The growing popularity of this activity in recent years, particularly since 2009, could result in a pervasive understatement of credit growth and credit exposure, all under the radar of banking regulators. According to the IMF (2011), informal securitization could augment a potential shock and undermine monetary policy effectiveness.

Considering this, the PBC tried to broaden financing categories under its watch, from traditional bank credits to "society-wide financing," involving a range of emerging financing channels including securitization (see Chapter 8). The CBRC also responded by temporarily stopping all informal securitization deals between trust companies and banks. It also asked the banks to bring all off–balance sheet assets that underlay wealth management assets back on their books by the end of 2011 and to set up loss provisions as well as capital against potential losses.[16] In May 2012, after a four-year hiatus, the PBC and CBRC felt comfortable enough to revive the securitization program with a trivial quota of 50 billion yuan, compared with the country's 61 trillion yuan worth of loans (Zheng 2012). Therefore, the reaction by the Chinese financial authorities to the GFC has not seen a halt on reforms, but a cautious and progressive attitude, "a never-ending dance between regulation and allowing much-needed financial innovation."[17] According to Li Daokui, a former member of the PBC's Monetary Policy Committee, "Asset securitization is the road one must follow to achieve modern finance. The key is how to regulate it in a proper manner" (Wang 2012).

Although buoyant about the bank's volume of profits, Zhang Jianhua (2009) of the PBC admitted that profitability remains the weakest link in the bank's performance, which largely rests on interest rate spreads, rather than the diversity and quality of their services. According to the CBRC (2012), total profits of the Chinese banks almost tripled between 2007 and 2011, but their average return on asset ratio (showing how profitable a bank's assets are in generating revenue) and average return on equity ratio (measuring a bank's efficiency at generating profit) had increased by only 0.4% and 3.7% respectively during the same period. This indicates very low profitability on the part of the banks, largely due to their rudimentary business model. Indeed, despite the institutional reforms initiated by the PBC, the banks continue to run on a mostly similar business model of relying on a generous interest rate spread set by the central bank. In a bid to provide a lifeline, the PBC (including Zhou Xiaochuan) believes this is necessary to spur the bank's "maturity" (Shen 2010). As a result, the growth in profitability was mainly attributed to the increase in the size of interest-bearing credit assets, with the bank's net interest income accounting for 66.2% of the total income in 2011 (CBRC 2012).

However, this model, dubbed "eating capital" *(chi ziben)* in China, essentially encourages banks to lend as much as they can until their balance sheets are eroded, forcing them to return to the capital markets for funds in order to meet regulatory requirements. In fact, the banks have quickly "eaten up" their newly raised capital in the post-GFC lending extravaganza to finance the massive government stimulation program, so much so that they have extended hands to market investors again for refinancing after their IPOs. In 2011 alone, fourteen of the sixteen listed banks announced their refinancing programs totaling almost 520 billion yuan ("2011nian shangshi yinhang rongzi" 2011). According to the CBRC, the recently installed international banking regulatory standard, Basel III, will have a "further impact on capital replenishment on China's banking sector" and shareholders' fear of dilution (Ma 2010). This situation has been made even more difficult by the MOF's insistence that the banks pay high levels of dividends. Between 2009 and 2011, the big four commercial banks have raised 622 billion yuan in new capital through bonds and share offerings while paying out 402 billion yuan in dividends (Borst 2011).

More importantly, the PBC-led reform has yet to address the fundamental issue of government intervention in commercial banking as the state remains the largest shareholder of the listed banks. A major setback happened when Huijin was merged into the MOF-controlled CIC, which means the MOF resumed its status as the state supervisor of the banks and therefore its old practices of lax discipline and accountability (Walter and Howie 2011). This was apparently behind the bank's lending spree in 2009, with record lending of 9.6 trillion yuan, under the party-state's pressure to finance its gigantic stimulus package (Chapter 9). Indeed, ICBC admitted in its shareholder circular in 2009 that the Bank was "conscientiously implementing the State's macro economy policy" (Smith 2010).

In addition, the ties between the banks and local governments remain intimate. Such ties saw a large part of the recent credit boom go to finance platforms that are controlled by and serve for local government. According to the National Audit Office, local government debt stood at 10.7 trillion yuan by the end of 2010 (about a quarter of China's GDP), of which 79% was financed by bank credit (Huang 2012). According to a self-assessment by the banks, a minimum of 20% of these debts were unlikely to be repaid (Anderlini 2010a). About 35% of the loans to local governments will be due over the next three years after 2012, but many of them went to infrastructure investments that have not yet started to generate revenues, raising the risk of defaults (Rabinovitch 2012). Facing a pending peak in maturity, Beijing ordered a rollover of local debt of almost 500 billion yuan in 2011, near 18% of the total repayable for the year (Zhong 2012).

In this sense, the latest round of recapitalization by the PBC and the bank's public listing has perhaps only temporarily reduced their NPL ratios to an acceptable level, which, according to the CBRC, stood at 0.9% by November 2011 (Wu and Min 2012). The banks' extremely high exposure to local governments' largesse and real estate projects (see Chapter 9) have given rise to concerns of a potential new wave of NPLs in the medium term. If a further fall of housing prices and a rise of local government defaults are factored in, the NPL ratio could rise by about 5.4 trillion yuan, to 13.4% of total loans (Anderlini 2010c). An investigation by Fitch Ratings (2010) on the irregular practice of "informal securitization" of the Chinese banks, or the repackaging of bank loans into investment products, led to more pessimistic views by the agency with the conclusion that "future asset quality deterioration is a near-certainty—the question is only when, to what degree, and whether it will lead to a crisis."

A more comprehensive assessment of China's financial system stability by the IMF in 2011 was more upbeat. Based on stress tests of the largest seventeen commercial banks jointly conducted with the Chinese authorities, the findings indicate that most of the banks appear to be "resilient" to isolated shocks, including a sharp deterioration in asset quality, a correction in the real estate markets, shifts in the yield curve, and changes in the exchange rate. However, "if several of these risks were to occur at the same time, the banking system could be severely impacted" (IMF 2011, 7).

The early achievement of the banking reforms and the remaining worrying signs of a systemic failure in the banking sector remind us that there is no silver bullet for the myriad chronic problems. Addressing these issues will be an ongoing business for the Chinese authorities, especially as the banks remain state owned and therefore state controlled, eventually backed by "the perpetual put option" (Walter and Howie 2011, 68–73), or the readiness of the state to bail out distressed banks. Despite the various setbacks and deficiencies, the PBC's efforts nevertheless represent a serious first step of a long march to establish more efficient and effective financial intermediation in China. Nevertheless, more bold and radical reforms are needed to build sustainable business models for Chinese banks and to help them toward more commercially oriented lending.

The mixed results of the PBC-led financial reforms also reflect the fragility of market reforms in a transition context, in which progress is often subject to drawn-out battles on two fronts. In ideational terms, as discussed earlier, liberal reformers have to defend their rationale against a surging wave of economic nationalists. More importantly, the fate of the reforms, such as that of the recent round of bank restructuring, hangs on the competition between divergent agendas within the state, between the old planning, administrative allocation agenda and practice, and the new liberal agenda that tries to forge ahead with market reforms and commercial banking practices. The administrative agenda is still apparent, representing a relatively easier, more direct, and more "familiar" solution for the party-state when quick results are imperative, and it often appears more effective than a market approach in China's institutional setting. However, as the costs associated with this short-term strategy emerge, the reformers may be able to gather momentum for further reforms. This largely prescribes the dynamics of institutional change in reform China, which are often embodied in the form of one step forward, two steps back, or two steps forward, one step back. Indeed, gradualism is not just a politically convenient strategy, but also often a result of the conflicts and compromises within the party and bureaucratic elite.

Conclusion

Banking reform in China is a microcosm of the larger, heated struggle to redefine the distribution of authority and the future of China's economic and political institutions. While earlier reforms such as the 1998 recapitalization program was a mostly failed attempt by a politically hesitant leadership and the old planning apparatus, the recent round of reforms initiated in 2003 benefited from the development of new, market-oriented institutions, especially the PBC, that have been taking shape with growing authority and credibility, aided by the pressures of external integration.

Hence, despite substantial inertia and resistance, the key role of the PBC in building a modern financial infrastructure is significant. Through Huijin, the Chinese central bank drew on 10% of the foreign reserves and controlled more than half of the state's financial assets, which enabled substantial financial reforms following the PBC's own liberal agenda. The reforms, which aimed at weakening the central state's dominance in the (distorted) market and transforming the domestic financial intermediaries into more market-oriented commercial institutions, have helped reassure international investors regarding China's banking reforms. However, there are problems with this model, especially continued state intervention in the banking sector under the control of a more conservative MOF, and the bailout of securities companies that are owned by central and local governments, which could generate moral hazard. Overall, however, the PBC's efforts have thus far laid a more solid foundation for China's financial stability and development in a post-WTO era. Further substantial reforms are, however, required.

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Conclusion

During an interview, a PBC official gave a vivid analogy of the politics of reform amidst transition, and the complex institutional challenges it entails: "China is very much like a giant leaking ship. We cannot stop and repair the ship, otherwise it is bound to sink. We have to mend it while it sails until reaching the shore. In other words, we have to reform amidst development, and to develop amidst reform. There is no other alternative."[1] The rise of the People's Bank and the modernization of China's monetary policy that we have examined in the book, illustrates the many complexities, dilemmas, and achievements of an adaptive Leninist party-state in dealing with the gigantic project of systemic transition. We have argued that the process of establishing a more market-oriented central banking system and monetary policy framework is deeply embedded in Beijing's quest for a managed transition featuring drawn-out tensions between planning and market institutions.

Most Chinese political and intellectual elites view the big bang transition approach in Russia and its former satellites as having failed—akin to demolishing the ship and trying to build a new one at sea. The Chinese trajectory has instead featured a more or less "managed" transition, entailing the gradual transformation of the economic system, allowing a market-oriented

China's One Belt One Road Strategy: The New Financial Institutions and India's Options

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China is supporting and creating new organizations to fund its new policy - the Asia Infrastructure and Investment Bank AIIB ($100 billion but could go higher), and New Silk Road Fund ($40 billion). China has also helped create the New Development Bank or the BRICS Bank ($ 50 billion- eventually increase to $100 billion) and the Contingent Reserve Arrangement ($100 billion). The NDB is not directly linked to the OBOR strategy but will fund infrastructure related projects across the world and work closely with the AIIB. It has also proposed the creation of a Shanghai Cooperation Development Bank. These new institutions and funding mechanisms are partly a response to the slow reform at the IFI's, and partly also a channel for China to utilize its vast reserves. After some initial reluctance and opposition several European countries - including the UK and France, Germany, Italy, Spain, [2]Switzerland, Australia, Korea and Russia have decided to become members of the AIIB. Brazil has also decided to join the AIIB as a founding member and this will encourage other Latin American countries to join as well.

These are important developments as China will be able to recycle some of its huge surpluses for infrastructure and investment by creating new mechanisms. This is in contrast to the oil rich countries which relied largely on existing western institutions to recycle their vast surpluses. Nevertheless, the existing IFI's - IMF, World Bank and the ADB – have committed to cooperate with the new Chinese backed financial institutions. To kick-start the ambitious "One Belt, One Road" project the People's Bank of China has also recapitalized the China Development Bank (CDB), the China Exim Bank, and the Agricultural Development Bank of China (ADBC) with US $62 billion.

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[2] See" What are the prospects for the new Chinese-led Silk Road and Asian Infrastructure Investment Bank?

Mario Esteban and Miguel Otero-Iglesias. ARI 23/2015 - 17/4/2015

China's "One Belt One Road" policy focuses on connectivity in many dimensions. It includes trade, infrastructure and telecommunications connectivity called the – "Information Silk Road". China hopes to sign 60 free trade agreements with countries along the new Silk Road. Of these China currently has 12 free trade agreements in place. But the policy goes much broader in also talking about people to people connectivity, cultural exchange and learning from each other's development experience. It also talks about peaceful development as a way of assuaging any fears that China is emerging as a global hegemon or that wants to oppose others.

In his 29 March 2015 speech at the Boao Forum for Asia (BFA) annual conference, President Xi Jinping observed that "the Chinese economy is deeply integrated with the global economy and forms an important driving force of the economy of Asia and even the world at large. [...] China's investment opportunities are expanding. Investment opportunities in infrastructure connectivity as well as in new technologies, new products, new business patterns, and new business models are constantly springing up. [...] China's foreign cooperation opportunities are expanding. We support the multilateral trading system, devote ourselves to the Doha Round negotiations, advocate the Asia-Pacific free trade zone, promote negotiations on regional comprehensive economic partnership, advocate the construction of the AIIB, boost economic and financial cooperation in an all-round manner, and work as an active promoter of economic globalization and regional integration".

Russia may view China's push into Central Asia as a push into its sphere of influence. It has opposed the creation of the Shanghai Cooperation Development Bank and has instead asked China to become a member of the existing Eurasian Development Bank. The USA and Japan have not been so positive on Chinese backed financial institutions and mechanisms on the ground that they are concerned with -their governance and environmental standards. The USA actively lobbied with its Western allies against joining the AIIB but has since relented and promised cooperation with it. Japan so far remains opposed to the AIIB. Thailand and Philippines which were listed as Prospective founding members have so far not signed on to the AIIB to signal their concerns on China's South China Sea claims.

China has stated that its One Belt One Road strategy is not in opposition to the existing regional and other organizations. It intends to enhance the role of multilateral cooperation mechanisms, and make full use of existing mechanisms such as the Shanghai Cooperation Organization (SCO), ASEAN Plus China (10+1), Asia-Pacific Economic Cooperation (APEC), Asia-Europe Meeting (ASEM), Asia Cooperation Dialogue (ACD), Conference on Interaction and Confidence-Building Measures in Asia (CICA), China-Arab States Cooperation Forum (CASCF), China-Gulf Cooperation Council Strategic Dialogue, Greater Mekong Sub-region (GMS) Economic Cooperation, and Central Asia Regional Economic Cooperation (CAREC) to strengthen communication with relevant countries, and attract more countries and regions to participate in the Belt and Road Initiative.

It seeks cooperation from the Russia backed Eurasian Union, Organization for Islamic States (OIC), the South Asian Regional Cooperation body called SAARC and the EU. But questions still remain on the scope and range of the strategy as it unfolds. How China envisages its cooperation with Latin America and the Caribbean and Africa or the Pacific as part of its new Silk Road strategy also remains to be fully clarified? So far Latin America has been excluded from OBOR although China, nevertheless, plans extensive and deeper engagement with Latin America and the Caribbean.

Changes in political climate in individual countries have created roadblocks to China's

With around two billion people projected to be moving into urban centres in emerging and developing countries in the next three decades, there is a great need for major investments in urban infrastructure.

As regards inclusion, infrastructure is crucial for increasing access to basic services for the poor. Infrastructure shortages are very large, as almost 1.5 billion people have no access to electricity, almost a billion people do not have access to clean drinking water and nearly 2.5 billion lack access to sanitation. Helping provide these basic needs is a pre-condition for a more inclusive pattern of growth.

To meet these objectives, Bhattacharya and Romani (2013) have estimated the annual need for infrastructure investment. They project broadly that investment spending in infrastructure (excluding operation and maintenance) in emerging and developing countries will need to increase from approximately US$0.8–0.9 trillion per year currently, to approximately US$1.8–2.3 trillion per year by 2020. These would represent a quantum jump in the share of infrastructure investment in GDP from around 3-4% of GDP to 6-8% of GDP. In amounts the largest needs are in Asia although as a share of GDP the largest requirements are in Africa. The largest share of infrastructure financing would be for energy – particularly for the electricity sector followed by transport, telecommunications and water.

The existing IFI's have not provided enough funds for infrastructure – surprising as they were initially set up for reconstruction and infrastructure. Of the total financing on infrastructure investment of roughly $0.8-0.9 trillion over 50 % comes from national budgets , almost 20% comes from national development banks, 25% comes from the private sector and only 3-4% comes from the existing MDB's and 1-2% comes from south-south flows. The bulk of future financing for infrastructure financing will continue to come from domestic sources and from private financing if the policy and regulatory hurdles preventing private capital – from banks, insurance companies and pension funds and from sovereign wealth funds- from financing infrastructure can be tackled.

Surprisingly, the existing Multilateral Development Banks (MDB's) provide scarce funding for infrastructure finance. The IBRD was setup primarily to provide infrastructure finance but then shifted a substantial part of its funding to other priorities. One of the major criticisms of the Poverty Reduction Strategies (PRSP's)[9] - the main instrument for providing the framework for aid to support economic development and poverty reduction has been its excessive focus on the social sectors at the expense of the infrastructure sector. In Africa more than three fourths of the funding has been on the social sectors at the expense of the infrastructure funding and has hurt growth. In contrast in Asia the balance between social and infrastructure sectors has been better and has helped spur growth.

The MDB's not only can provide finance for infrastructure but can also be a vital instrument for drawing in private capital according to Bhattacharya, Oppenheim and Stern (2015). This they can do by co-financing, policy and regulatory risk guarantees using new and innovative financial instruments. It is hoped that the new financial institutions will have greater flexibility in developing

[9] Budget Support and Aid Effectiveness: The Experience of East Asia by Hiroto Arakawa, Japan Bank For International Cooperation paper presented at conference on Policy Options and Challenges For Developing Asia April 19-20, 2007, Tokyo.

more difficult. The IFI's have begun to change some of their dogmatic thinking and now have more flexibility in their approaches - a process which will be accelerated hopefully with competition from the new financial institutions.

Unlike at the UN, the voting power at IFI's is based on economic size. The richer developed economies were able to call the shots at these institutions. The World Bank President comes from the USA, the IMF is always headed by a European and Japan gets the Presidency of the Asian Development Bank. But voting shares in the existing financial institutions have also not changed sufficiently with the changes in the global economic power. European economies still hold more than 40 percent of the votes while Europe's share in the global economy has shrunk to around 25%. China and other emerging economies have not seen an increase in their voting power commensurate with their global economic power. An agreement to reform the IFI's had been reached in principle but its progress has been very slow.

The Zedillo report that was set up to look into reforms at the World Bank made some important suggestions which were not adopted by the Bank but could be looked at in setting up the new financial institutions. The report was quite critical of the current World Bank arrangement of a resident board that approves all loans. The resident board is both a large financial cost to the bank (US$70 million per year) and an extra layer of management that slows down project preparation – as there is heavy emphasis on project preparation documents that satisfy the Board's one size fits all requirements and makes the bank less efficient. Slowness of project preparation is one of the main criticisms of clients concerning the poor performance of the multilateral development banks.

The Zedillo report recognizes the importance of environmental and social safeguards but argues that the World Bank has become so risk averse that the implementation of these policies imposes an unnecessary burden on borrowing countries. In practice, developing countries have moved away from using the existing multilateral development banks to finance infrastructure because of slow bureaucratic procedures. The enthusiastic response of developing countries in Asia to the AIIB concept reflects their sympathy with the idea that a bank can have good safeguards and still be quicker and more efficient than the existing banks. Not having a resident board will help speed decision making and project preparation – with greater emphasis on implementation.

Important recommendations in the Zedillo report were –

a)Reduce the size of the Board to 20 chairs by consolidation of European seats, creating elected-only chairs and distributing board membership more evenly across constituencies, b) Have a 50/50 voting structure for the Bank between developed and developing countries and a significant increase in the basic shares and hence votes. It sets a clear goal for rebalancing of the ownership of the institution and c) Eliminate the U.S. veto. It also recommended changing leadership selection by eliminating the U.S. prerogative in the World Bank, and the European prerogative in the IMF. While this principle appears to have been adopted at a G-20 summit it remains to be implemented in practice.

3. The New Financial Institutions

The frustration of the emerging economies with the existing financial architecture signalled the idea of BRICS Bank which has now culminated into the creation of the New Development Bank enough. But an important step has been taken to change the global architecture of financing and it remains to be seen how it will be used and developed.

3.3 Asian Infrastructure Investment Bank (AIIB)

The Asian Infrastructure Investment Bank (AIIB) is an international financial institution which is focused on supporting infrastructure construction. The bank was initiated by the government of China[1] and supported by 56 other countries from Europe, Oceania, Africa and South America as members. AIIB is regarded by some as a rival to the IMF, the World Bank and the Asian Development Bank (ADB), which are regarded as dominated by developed countries like the United States. The United Nations has addressed the launch of AIIB as "scaling up financing for sustainable development" for the concern of Global Economic Governance.

The bank was proposed by China in 2014 and at a ceremony in Beijing in October 2014. The Articles of Agreement (AOA) were finalized and open for signature by PFMs from June 2015. The AOA is expected to enter into force and AIIB to be fully established by the end of 2015. As of 15 August 2015 there are 57 PFMs.

The Asian Infrastructure Investment Bank can be construed as a natural inter-national extension of the infrastructure-driven economic development framework that has sustained the rapid economic growth of China since the adoption of the Chinese economic reforms in the 1980's. It stems from the notion that long-term economic growth can only be achieved through massive, systematic, and broad-based investments in infrastructure assets.

3.3.1 Shareholding Structure

The final shareholding structure of the Bank is still unfolding. The following table are amounts for 30 largest countries by notional shareholding at the Asian Infrastructure Investment Bank. The voting shares are based on the size of each member country's economy (GDP PPP) (and whether they're an Asian or Non-Asian Member) and not contribution to the Bank's authorized capital. China's shareholding is 30.34 per cent and it has retained 26.06 per cent of the voting rights with veto powers for certain key decisions. The Philippines and Thailand have not yet signed on to the Bank so the shares could change as new members join.

Table 2. Potential Shareholding at the Asian Infrastructure Investment Bank

Rank	Country	Number of Shareholding Voting Rights		
		Shares	(% of Total)	(% of Total)
1	China	297,804	30.34	26.06
2	European Union	190,698	19.43	
3	India	83,673	8.52	7.50
4	Russia	65,362	6.66	5.93
5	Germany	44,842	4.57	4.15

Mandatory Tender Offer for Pirelli ordinary shares and the Voluntary Tender Offer for Pirelli savings shares. The signing of the agreements indicates that ChemChina, Silk Road Fund, Pirelli management and other partners will join forces in the long term industrial investment in Pirelli as they are all committed to working together to build a market leader in the global tire industry.

May 2012

THE YUAN'S LONG MARCH*

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Can a state manufacture an international currency? After long hesitation, Beijing appears to have made internationalization of the renminbi (the "people's currency") an official policy goal, and a concerted strategy is now being implemented with that lofty ambition in mind. This essay seeks to explain what can be learned from China's internationalization strategy about both the uses and the limits of power in today's world economy. First, to set the stage, the nature of the challenge facing China is briefly explained, followed by an outline of the principal features of Beijing's internationalization strategy. In the central sections of the essay I then take up two critical issues. First is the question of *strategic design*. This is a matter of China's intentions. What are the government's ultimate objectives, and is the Long March properly conceived to achieve them? Second, I evaluate Beijing's choice of *means*. This is a matter of China's statecraft. Have the authorities chosen the right tools and instruments? Are the country's power resources sufficient for the task at hand? Analysis suggests that while China's strategy is soundly conceived, its chosen means may well prove inadequate owing to a range of practical limitations. Progress of the RMB as an international currency will not come easily.

Can a state manufacture an international currency? The question is raised by China's determined efforts to promote the role of its national money, the yuan or renminbi (RMB), as an international currency. After long hesitation, Beijing appears to have made internationalization of the "people's currency"an official policy goal, and a concerted strategy is now being implemented with that lofty ambition in mind. The yuan has embarked on a Long March toward global status, reminiscent of the Long March that was so pivotal in the Communist Party's victory in China's civil war. This is clearly a purposeful act. Power resources are being employed instrumentally to widen foreign use of the RMB; wider use of the RMB, in turn, is expected to enhance Chinese prestige and influence. This essay seeks to explain what can be learned from China's internationalization strategy about both the uses and the limits of power in today's world economy.

The subject of yuan internationalization has drawn a great deal of attention in recent years.[1] For many, internationalization is the RMB's manifest destiny – an irresistible by-product of China's remarkable economic success. Wide use of the yuan is said to be "inevitable."[2] The only question, it seems, is how many years the Long March will take. But is such confidence warranted? In reality, the challenge that China faces is extraordinarily daunting. Success in manufacturing an international currency is by no means guaranteed.

This essay is organized as follows. First, to set the stage, the nature of the challenge facing China is briefly explained, followed by an outline of the principal features of Beijing's internationalization strategy. In the central sections of the essay I then take up two critical issues. First is the question of *strategic design*. This is a matter of China's intentions. What are the government's ultimate objectives, and is the Long March properly conceived to achieve them? Second, I evaluate Beijing's choice of *means*. This is a matter of China's statecraft. Have the authorities chosen the right tools and instruments? Are the country's power resources sufficient for the task at hand? Analysis suggests that while China's strategy is soundly conceived, its chosen means may well prove inadequate owing to a range of practical limitations. Progress of the RMB as an international currency will not come easily. In conclusion, lessons for the study of power in a changing world economy are highlighted.

THE CHALLENGE

A flourishing world economy needs some kind of internationally acceptable money. Otherwise, nations would be reduced to crude barter, severely limiting gains from cross-border trade or investment. From an efficiency point of view, a single supranational currency would seem to be most appealing, since transactions costs would be minimized. But in a fragmented world of nearly two hundred sovereign states, most observers agree, the likelihood of reaching credible agreement on terms for the creation and management of a genuine global money is minimal. From a political point of view the option seems unattainable, even risible. Much more realistic is the prospect that the world will continue in the future, as it has in the past, to rely mainly on a limited selection of national currencies to play vital international roles.

Manufacturing a national currency, history suggests, is comparatively easy – by no means a walk in the park, but certainly doable. A national currency, in principle, exercises an exclusive claim to all the traditional roles of money – medium of exchange, unit of account, store of value – in a single country. For centuries, dating back to the Peace of Westphalia of 1648, governments have claimed supreme authority – sovereignty --within the territorial frontiers of their individual states. In one corollary of the so-called Westphalian system, evident since at least the nineteenth century, most governments have self-consciously sought through legal-tender laws and related regulatory measures to create and sustain a single national currency – effectively, an exclusive "territorial" currency. Control over money, exercised through the coercive powers of the state, came to be considered one essential ingredient of sovereignty. The result is a monetary universe today that consists of a myriad of territorially based national currencies – a structure I have elsewhere characterized as the Westphalian model of monetary geography, based on the norm of One Nation/One Money (Cohen 1998, 2004).

Manufacturing an *international* currency, by contrast, is much more difficult – precisely because of the One Nation/One Money norm. In a world of sovereign states, no government can easily compel outsiders to use its money, whether for trade purposes or as an investment or reserve medium. The capacity for direct coercion is limited. Instead, influence must be exercised indirectly, through other pathways. One pathway might involve bribery in one form or another (a variant of the first face of power). Another might seek to exploit characteristics of systemic architecture to favorably alter incentive structures (the second face of power). And yet another might involve strategies of persuasion, attraction, or co-option intended to work through constitutive impacts on identities and interests (the third face of power). For a government determined to promote internationalization of its currency, the means available are many. Monetary statecraft can be implemented through a variety of instruments, as China's current efforts demonstrate. But there is no assurance that any of them may actually turn out to be successful.

In fact, precedent would not appear to favor the yuan. In modern times, only one country – Japan in the 1990s – has actively sought to manufacture a wider role for its currency (Grimes 2003, 2009); and that campaign turned out to be largely futile. Of the several currencies that have achieved international status over the last couple of centuries -- including the pound sterling, US dollar, and, most recently, the euro – none came into widespread use as the result of official planning by a formal governmental bureaucracy (Frankel 2011). If a national money attained international status, it was because of inherent qualities that gradually came to make the currency attractive to traders, investors, and other interested agents. Internationalization emerged as a result of an unplanned process of competition among currencies, driven by a spontaneous evolution of preferences on the demand side of the market. There is no successful prior model for Beijing's effort to jump-start the process from the supply side – what one source (McCauley 2011) describes as "managed internationalization."

The challenge posed for China, therefore, is clear. If internationalization is to be achieved, the yuan must be able to compete effectively with other widely used currencies. It must be made more appealing to market actors. The question is: Can demand-side preferences be durably modified by state-led measures on the supply side? That appears to be Beijing's intent. The goal is not unreasonable. As the world's second largest economy and leader in global exports, China already offers the foundation of a broad transactional network – a significant source of power. Beijing seems determined to build on that foundation to enhance the yuan's appeal for various cross-border purposes. But whether the goal is attainable is another matter entirely.

THE STRATEGY

Though no precise date can be identified when Beijing first leaned toward the goal of internationalization, a key turning point came in 2006 with publication of a report on "The Timing, Path, and Strategies of RMB Internationalization" by a study group set up by the People's Bank of China (PBOC), China's central bank (PBOC Study Group 2006). "The time has come for promotion of the internationalization of the yuan," the study group argued. Internationalization "can enhance China's international status and competitiveness significantly [and] will increase its influence in the international economy." China will "have a greater say" and will enjoy "a rise in power standing." We "should take advantage of the opportunity," the report concluded. Internationalization is "an inevitable choice."

Many in China's leadership evidently agreed. Within government and party circles a distinct shift of attitude soon became apparent, spurred in particular by the financial crisis that struck the world economy in 2008. With its vast hoard of dollar reserves, Beijing had every reason to feel vulnerable to a sudden shift of exchange rates. Internationalization of the yuan might provide a useful means to reduce dependence on America's greenback.

Elite opinion has by no means been unanimous. In fact, divisions over the issue have been evident in Beijing for some time. On the one side are factions led by the PBOC, who see internationalization as a means to push forward with liberal financial reforms. On the other side are a range of producer interests fearful that wider use of the yuan might drive up its value, eroding export competitiveness, as well as banks and state-owned enterprises that have long benefitted from the government's firm controls over interest rates and credit allocation. Internal cleavages are probably the reason why, to this day, there has never been a formal declaration pronouncing internationalization official Chinese policy. Judging from Beijing's actions, however, it seems quite clear which way the prevailing wind is blowing. By late 2009, as one observer has put it, "The Chinese Government obviously changed its mind and became enthusiastic about RMB internationalization" (Zhang 2009: 24). By 2011, internationalization had assumed a place "at the heart of China's financial strategy," according to an influential advisor to the PBOC.[3]

But how was the goal to be achieved? Up to the time of the PBOC's Study Group report, China had one of the most tightly controlled currencies in the world, hemmed in by all manner of exchange restrictions and capital controls. How could cross-border use of the RMB be promoted if the money was not easily convertible? Moreover, the country's leadership knew that there was no successful model in recent history for manufacturing an international currency. They had no road map to help guide their actions. Not surprisingly, therefore, the government's approach has been noticeably cautious, a careful choreography stressing gradualism above all. Following Deng Xiaoping's dictum to "cross the river by feeling the stones," strategy has developed incrementally in multiple small steps. China's ruling Communist Party is no stranger to the idea of a Long March.

Effectively, managed internationalization has been pursued along two interrelated tracks (Subacchi 2010). One track focuses on cultivating use of the RMB in foreign trade. At the official level, currency swap agreements with foreign central banks have been initiated facilitating use of the RMB as a means of payment. At the private level, regulations have been gradually eased to permit more trade transactions to be invoiced and settled in yuan, bypassing traditional invoicing currencies like the dollar. The other track focuses on use of the RMB in international finance. Emphasis has been placed on the development of active markets for yuan deposits and yuan-denominated bonds, mainly "offshore" in the autonomous region of Hong Kong. Along both tracks, initiatives have been implemented patiently in finely calibrated phases.

Trade track

On the first track the yuan's Long March began in late 2008, when the PBOC set out to negotiate a series of local currency swap agreements designed to provide RMB funding to other central banks, when needed, for use in trade with China. In little over three years pacts had been signed with 18 countries[4] comprising a total value of nearly 1540 billion yuan (roughly $245 billion). Ostensibly, the aim of these agreements was to insure against the kind of risks that could come with another global financial crisis. The availability of RMB funding on an emergency basis would offer China's trading partners a useful hedge against any future liquidity crunch. But the facilities were also designed to supply yuan, when desired, for use in bilateral trade on a more regular basis – in effect, to provide indirect encouragement for commercial use of the Chinese currency. None, however, has as yet been used for that purpose. For the time being China's trading partners still prefer to use the more widely accepted greenback as a settlement currency.

More directly, beginning in 2009, Beijing has gradually widened the range of trade transactions that may be settled in yuan, further promoting the currency's use by non-residents. Informally, the RMB has long been accepted as a settlement currency in border trade with neighboring countries such as Laos, Mongolia, Myanmar, Nepal, North Korea, and Vietnam, resulting in a substantial growth in the volume of yuan bank notes circulating beyond China's borders. Although overall estimates vary widely and are of questionable reliability, it is clear that the numbers are no longer trivial. According to one source (Yu and Gao 2011: 198), as much as 60 percent of cash in circulation in Mongolia may now be RMB. Formal authorization of yuan trade settlement, which began with a limited pilot scheme in 2009, was extended to all Chinese enterprises by early 2012. Additionally, since September 2010, foreign enterprises have been authorized to open cross-border yuan settlement accounts at locally registered banks in China, further expanding opportunities for use of the RMB on a regular basis. And along the way the PBOC has been busily constructing a new China International Payment System, a vital piece of technical infrastructure to facilitate cross-border invoicing and payments. By mid-2011 as much as eight percent of Chinese trade was being settled in yuan, up from essentially zero in previous years.

Finance track

On the second track Beijing has relied heavily on the special status of the autonomous region of Hong Kong, which offers a useful offshore laboratory for experimenting with innovations that the leadership is not yet prepared to introduce "onshore"on the Mainland. As frequently noted (Frankel 2011), this is, to say the least, an unusual pattern. Never before has any government sought deliberately to develop an offshore market for its currency while still maintaining strict financial control at home. In effect, Beijing is drawing up its own road map, relying heavily on the Hong Kong Monetary Authority (HKMA) – de facto, Hong Kong's central bank and chief financial regulator -- to act as its proxy.

As early as 2004 the HKMA launched the RMB Business Scheme, allowing banks in Hong Kong to open yuan deposit accounts for individuals and some enterprises. But the offshore deposit market, informally known as the CNH market,[5] did not really begin to take off until mid-2010, when new rules were issued relaxing restrictions on the yuan activities of Hong Kong banks. Daily trading of the RMB on the Hong Kong foreign-exchange market was now permitted, and local financial institutions for the first time were allowed to open yuan accounts of their own, clearing the way for creation of a wider range of marketable financial products. The result was a swift growth in the total value of CNH deposits, from less than 65 billion yuan ($10 billion) at the end of 2009 to as much as 627 billion yuan ($100 billion) in November 2011, before dropping back below 570 billion yuan in early 2012.

Development of an offshore market for yuan-denominated bonds began in mid-2007, when selected Mainland banks were permitted for the first time to raise funds by issuing RMB bonds in Hong Kong. Progress in the so-called "Dim Sum" bond market, however, was slow until 2010, when permission was extended first to Chinese non-financial firms and then to foreign multinationals doing business in China. Among the first non-Chinese companies to enter, in June 2010, were Hong Kong and Shanghai Banking Corporation (HSBC) and the Bank of East Asia, followed later by such big names as McDonald's, Caterpillar, Volkswagen, and Unilever. In 2011 new issues topped 174 billion yuan ($27.6 billion), up from 40 billion yuan ($6.3 billion) in 2010 and a cumulative total of just 22 billion yuan ($3.3 billion) previously – a not insignificant rate of increase, but still minuscule amounts by international standards.

Finally, parallel to the Dim Sum market, a nascent onshore market for yuan-denominated bonds, centered in Shanghai, has been cautiously cultivated since 2005, when debt sales by non-Chinese issuers – known as "Panda" bonds -- were authorized inside China for the first time. Progress here, however, has been extremely sluggish, even after a well publicized pledge by China's State Council in 2009 to transform Shanghai into an international financial center by no later than 2020. Initially limited just to "eligible" multilateral development institutions, access to the Panda bond market was broadened in 2009 to include locally incorporated subsidiaries of foreign multinationals. But as of the start of 2011, there had still only been five issues in all – two each by the Asian Development Bank and the International Finance Corporation, a branch of the World Bank, and one by Tokyo-Mitsubishi UFJ (China) Ltd, for a total of just 5 billion yuan ($795 million).

STRATEGIC DESIGN

Overall, there seems little doubt that internationalization has indeed assumed a place at the heart of China's financial strategy. But an international currency, clearly, is not an end in itself. Rather, the yuan's Long March must be seen as a means to promote more fundamental interests and aspirations. That raises the question of *strategic design*. What are Beijing's ultimate goals, and is the government's strategy properly conceived to achieve them?

The question of design matters because internationalization is by no means a journey with a single unique destination. Currency internationalization involves multiple roles; the net benefits of individual roles may vary quite considerably; and different currencies may embody diverse mixtures of roles. To design an internationalization strategy properly, a country's leaders must first know what their priorities are; and then, second, be sure to focus their attention on the combination of roles that is most likely to satisfy their ambitions. The task, needless to say, is easier said than done.

Roles and benefits

That currency internationalization involves a multiplicity of roles is widely recognized. There is, in fact, a standard taxonomy for characterizing the roles of international money, which separates out the three familiar functions of money – medium of exchange, unit of account, store of value – at two levels of analysis: the private market and official policy, adding up to six roles in all.[6] Sources generally speak of the separate roles of an international currency at the private level in foreign-exchange trading (medium of exchange), trade invoicing and settlement (unit of account and medium of exchange), and financial markets (store of value). At the official level, we speak of a money's roles as an exchange-rate anchor (unit of account), intervention currency (medium of exchange), or reserve currency (store of value). Though to some extent interdependent, each of the six roles is understood to be distinct in practical as well as analytical terms.

It is also widely recognized that internationalization can also yield significant benefits for an issuing country. In a diverse scholarly literature stretching back decades, drawing from political science as well as economics, a total of some five broad classes of gains can be identified (Cohen 2012a). Briefly, these include:

1. Reduced transactions costs. At the microeconomic level, residents of the issuing country benefit from their ability to do business abroad in home currency, thus lowering exchange risk. In addition, profits in the financial sector may be increased as foreign business can be expanded at lower cost.

2. Seigniorage. At the macroeconomic level, benefits are generated whenever foreigners acquire some amount of domestic money in exchange for traded goods and services. Cross-border accumulations represent an implicit economic transfer that constitutes a real-resource gain for the economy as a whole.

3. Macroeconomic flexibility. Cross-border use of a currency can also loosen the constraint of the balance of payments on monetary and fiscal policy. The greater is the ability to finance external deficits with the country's own money, delaying or deflecting adjustment costs, the easier it is for the government to pursue policy objectives at home or abroad. In effect, the autonomy dimension of power is enhanced. The benefit is typically thought of mainly in terms of economic advantage: the issuer has more latitude to manage domestic employment levels or price behavior. But there is also an obvious political aspect insofar as relaxation of the external payments constraint augments the issuer's ability to promote foreign diplomatic or military interests as well.

4. Leverage. Influence, a form of "hard" power, is a fourth possible benefit of an international currency. The autonomy that derives from macroeconomic flexibility, I have argued elsewhere (Cohen 2006), is vital to creating a capacity for leverage over others. Whether that capacity can be actualized, however, is uncertain and rests on additional considerations. Key is

the degree of dependence that is engendered as foreigners come to rely on the national money for any of several international roles. The dependence of others puts the issuer in a position to exercise influence through its control of access to vital financial resources.

5. Reputation. Finally, at the symbolic level, widespread international use of a currency can promote the issuer's overall reputation in world affairs – enhancing authority, a form of "soft" power. Broad circulation may become a source of status and prestige, a visible sign of elevated rank in the community of nations. Influence may then be exercised through co-option and attraction to shape the preferences of others. Though difficult to pin down empirically, the importance of soft power in monetary affairs has by now been well established by historical and contemporary research (Cohen 1998, Helleiner 2003).

Not all of these five classes of gains, however, can be associated with every role of an international currency. To the contrary, it seems more reasonable to assume that the net effects of the separate roles might actually differ quite substantially, as I have suggested elsewhere (Cohen 2010, 2012a). Perhaps the most critical difference is between the several medium-of-exchange and unit-of-account roles, on the one hand, and the two store-of-value roles on the other. Use of a currency in foreign-exchange trading, trade invoicing, or for official intervention purposes will almost certainly generate some measure of gain at the microeconomic level. But only the store-of-value roles, which by definition imply some level of foreign accumulations, will generate any amount of seigniorage or macroeconomic flexibility for the issuing country – gains that could be quite substantial in magnitude. Neither seigniorage nor greater policy flexibility is possible unless non-residents are willing and able to acquire significant amounts of the country's currency, or assets denominated in the currency, as a store of value. This suggests that the benefits of internationalization are unlikely to loom large if external use is limited alone to trade invoicing or the exchange market, which require minimal working balances at most. A considerable role in financial markets and/or reserves will be needed to make internationalization really pay economically or politically.

Priorities and focus

Seen in this light, Beijing's strategic design would appear to be reasonably well conceived. Attention seems to be focused properly on the combination of roles that is most likely to satisfy the government's ambitions. The Hong Kong and Shanghai Banking Corporation (HSBC 2011: 15) summarizes succinctly: "First trade, then investment; and after that, reserve currency status. That is the road map for the renminbi in a single sentence."

Of course, no one outside the ranks of China's secretive leadership can be sure what the government's priorities really are. Here too there may be divisions behind the scenes. Inferring from years of policy behavior, however, it seems fair to assume that aspirations must include political as well as strictly economic considerations. China may have an interest in saving on transactions costs or garnering a bit of seigniorage. Likewise, it is not unreasonable for the world's biggest exporter to seek to use its own money more to reduce the currency mismatch in its international balance sheet. But from all we know about Beijing's ambitions for a "peaceful rise" to great-power status, we have to assume that some measure of power is being sought as well. At a minimum this would involve a greater degree of autonomy, to reduce a sense of vulnerability to external crises or the tribulations of the dollar. Beyond that it is hard to imagine that China would not also like to attain, ultimately, a greater measure of influence in global affairs. As one informed source suggests, there may be an "economic China" concentrated on economic development and modernization. But there is also a "political China" determined, above all, "to achieve and maintain power in an asymmetric power relation to Western superpowers."[7] "Great powers have great currencies," Robert Mundell, a Nobel laureate in economics, once declared (1993: 10). Political China would appear to agree.

Assuming that to be the case, Beijing's strategy seems right on target. In a separate discussion (Cohen 2010), I have explored the relationship between currency internationalization and state power. My analysis indicates that three of an international money's six possible roles are of paramount importance in promoting an issuing country's power. These are the roles in financial markets, trade, and central-bank reserves. The roles in financial markets and reserves enhance the issuer's monetary autonomy, making it easier to delay or deflect adjustment costs. Autonomy in turn creates a capacity for influence, though whether that capacity can be actualized will depend on additional considerations that may vary widely over time. A currency's role in trade is important, above all, because of its impact on the reserve preferences of foreign central banks. The currency composition of central-bank reserves generally tends to reflect the pattern of currency choice in an economy's international commercial relationships. The more a money is used for each of these three roles, the greater is its contribution to the issuer's power.

It makes sense, therefore, for Beijing to have chosen the two tracks that it has pursued until now. The finance track is critical to establishing the appeal of the RMB as an investment medium, starting with bank deposits and bonds and then, presumably, moving on to a steadily widening range of financial products. Though the financial-market role, on its own, is not apt to add much to China's external power, it is an essential first step toward reserve-currency status, which surely promises a greater measure of influence. A given money can play an investment role even if never used as a reserve currency. The reverse, however, is unlikely ever to happen in a market-based currency system. Monetary history suggests that the investment role comes first and then is followed by a reserve role *in addition*. Certainly that was the pattern followed by the pound sterling in the nineteenth century, which first found an international role as a consequence of London's pre-eminence as a financial center, and only later began to be held by central banks as well. Likewise, it was true of America's greenback, which first rode the rise of New York as a rival to London for foreign lending well before it surpassed sterling as a reserve asset. It is necessary to think in terms of cumulative effects. A state whose currency is used as a store of value in private markets alone gains just the influence created by that role. But a state whose money is used as a store of value by central banks too gains the cumulative effect of both roles.

The link is the trade role, owing to the vital part that the currency denomination of trade plays in determining which among several investment currencies will emerge as well as a favored reserve asset. The issuer of an international money that is used as investment medium alone can aspire at best to little more than some modest modicum of power. But add widespread use for trade invoicing and settlement leading to a reserve role, and soon the issuing country becomes better placed for the exercise of influence. Hence the importance of the trade track, too. Beijing does seem to have gotten the design of its strategy right.

MEANS

But what about Beijing's choice of *means* – its statecraft? Have the authorities chosen the right tools and instruments to make their strategy succeed? Are the country's power resources sufficient for the task at hand? Here we may be permitted a greater measure of doubt.

Preferences and power

Recall the challenge. Though China may aspire to global status for its currency, it cannot directly compel outsiders to use the yuan. There are no legal tender laws at the international level. As indicated, influence in this context must instead be exercised indirectly, through other pathways. One way or another, the RMB must be made to appeal to potential users. In short, it must be made competitive. The question is: Does Beijing have the power to successfully modify preferences on the demand side of the market?

Historically, preferences on the demand side have tended to be shaped by three essential attributes, as I have explained elsewhere (Cohen 1998, 2004). First, at least during the initial stages of a currency's cross-border use, is widespread confidence in the money's future value and usability, backed by political stability in the country of origin. The issuer must have a proven track record of relatively low inflation and inflation variability. It must also have a good reputation for respect of property rights and the rule of law. Second are the qualities of "exchange convenience" and "capital certainty" – a high degree of transactional liquidity and reasonable predictability of asset value. The key to both is a set of well developed financial markets, unencumbered by high transactions costs or formal or informal barriers to entry. The markets must be broad, with a large assortment of instruments available for temporary or longer-term forms of investment. They must also be deep and resilient, with fully operating secondary markets for most if not all financial products. And third, the country must promise a broad transactional network to ensure an ample constituency for its currency, otherwise known as "network externalities." This means an economy that is large in absolute size and well integrated into world markets. No money has ever been adopted widely for international use that was not initially backed by a leading national economy. To the extent that these three qualities have prevailed, a money's appeal was enhanced, encouraging wide adoption.

In China's case, however, only one of the three attributes is manifestly in evidence – a broad transactional network. Economic size stands out as the RMB's trump card: the principal power resource that Beijing brings to the international competition among currencies. The Chinese economy is already a giant among nations – the second largest in the world – and, if recent trends persist, could surpass the United States in as little as another decade. The country is also now the world's leader in exports and second biggest market for imports, creating a considerable potential for network externalities. In monetary matters, by contrast, China remains something of a pygmy, with little direct power. As one observer writes: "China's economic influence still derives primarily from its role in the international trading system, rather than its financial might" (Kelly 2009: 6). If demand-side currency preferences are to be successfully altered in present circumstances, it will have to be by exploiting the country's growing weight in the global economy – what HSBC (2011) calls China's "gravitational pull" – rather than by any inherent comparative advantage in finance.

In fact, that would appear to be the government's intent. Beijing is plainly counting on China's immense leverage as a trading nation, rather than on any financial muscle, to shift preferences in favor of the yuan. The idea seems to be to rely, to the extent possible, on both the second and third faces of power. At one level, it appears, the aim is to reshape incentive structures through the sheer size of the "economic China." That is the second face of power, involving a logic of consequences. The hope, quite obviously, is that outsiders will be induced to shift to the yuan because of the added convenience it offers for doing business with an increasingly important trade partner. At a deeper level, the idea seems to be to remold identities and interests by way of the "peaceful rise" of "political China." That is the third face of power, involving a logic of appropriateness. Internationalization may spread because market actors come to be convinced of its legitimacy -- in effect, a confirmation of the Middle Kingdom's renewed prominence in the community of nations. To paraphrase Mundell, outsiders may come to believe that as an emerging great power, China *should* have a great currency.

Both logics make sense. The importance of China's "gravitational pull" is undeniable. Indeed, internationalization of the yuan is difficult to imagine without it. A broad transactional network is surely necessary. But is it sufficient? As a power resource, is economic size alone enough to make the RMB competitive? About that, an ample dose of skepticism is warranted.

The reason goes back to the multiplicity of roles of an international currency and the considerable differences among them. Economic size is clearly key to a money's role as a vehicle for trade invoicing and payments. In that respect, it is no surprise the yuan has already begun to establish itself as a trade currency, albeit slowly. The share of China's trade that is presently settled in RMB, at about eight percent of the total, is still relatively low; moreover, most transactions reportedly remain limited to Mainland enterprises doing business with their own subsidiaries in Hong Kong rather than with genuinely foreign companies (Cookson 2011). But as China's role in world trade continues to expand, use of the yuan can only be expected to grow.

Economic size, however, matters much less when it comes to the other critical roles that Beijing appears to have targeted in its strategic design – use of the yuan as an investment medium and reserve currency. For those roles other attributes matter more, qualities that in China are still noticeably lacking. Though inflation has not been allowed to pose a serious threat to the yuan's value, China's political regime can hardly be said to inspire a high level of confidence among potential users regarding property rights. The ruling Communist Party remains autocratic in nature and often arbitrary in behavior. The governance structure is not known for transparency or accountability in decision making. It is not even clear whether, over the medium term, political stability can be assured. Nor can China's financial structure be considered anywhere near adequate to provide the liquidity and predictability that market actors would expect. Onshore asset markets are rudimentary at best, and Hong Kong's offshore market – while useful as a testing ground – is too small to carry the load on its own. And of course, as we know, the RMB remains largely inconvertible for residents and non-residents alike.

Should we be at all surprised, then, to see how little progress has been made on the finance track of the yuan's Long March, in contrast to the trade track? If there is any consensus at all among analysts, it is that reform of both domestic financial markets and external capital controls are essential if internationalization is to succeed. In the words of noted economist Jeffrey Frankel

(2011: 13): "If China is not yet ready to liberalize its domestic financial markets [and] to legalize capital inflows... then full internationalization is probably a long way off." Certainly it looks a long way off now.

To be sure, Hong Kong's offshore deposit market has expanded healthily, but that is largely the result of the growing use of the RMB for trade settlement. In the all-important bond sector, progress has been painfully slow for both the Dim Sum and Panda markets. Overall bond-market capitalization inside China is barely one-tenth of that in the United States, offering limited liquidity. Potential investors have been discouraged by still strict restraints over what they can do with their money, as well as by a host of other unanswered questions. Can political stability be assured? Can a government be trusted that remains so autocratic in nature? Will property rights be respected? Hesitation in the face of such uncertainties is only natural.

Economic size, therefore, does not in fact appear to be enough to make the RMB competitive anytime soon. Put differently, Beijing has a serious "fungibility problem." A broad transactional network cannot easily compensate for other critical inadequacies. The separate roles of an international currency call for different kinds of power resources, and these resources are not necessarily interchangeable. In its choice of means – its statecraft -- Beijing would seem to be relying too much on too little.

Command and control

Of course, it is not difficult to understand why Beijing has tried to rely so much on so little. Firm control of financial activity is a central element of China's economic model, an integral part of its authoritarian system of governance. China may no longer be a command economy, but the ruling party clearly wishes to remain in charge.

Despite the remarkable changes that have taken hold in China over the last three decades, it is well understood that the country's distinctive political economy – called by some the "Beijing Consensus" – remains far removed from standard Western models, stressing above all a continuing role for an unchallenged central bureaucracy. As one observer (Halper 2010: 3) describes it, the Beijing Consensus "combines market economics with traditional autocratic or semiautocratic politics... The government maintains central control over a partly liberalized economy." And nothing is more critical to successful control than an ability to manage monetary and financial conditions. Domestically, this means direct authority over interest rates and the availability of credit, enabling the state to allocate resources to favored borrowers and to minimize its own funding costs. Command is exercised through regulated deposit and lending rates, quantitative credit guidance, and bond market rationing. Internationally, control means a closed capital account and managed exchange rate. Financial repression, as economists call it, is a vital cog in the machinery of political autocracy.

It is not surprising, therefore, that even as China's government has adopted internationalization as a goal, it has moved so cautiously and incrementally. The hope, plainly, is to be able to encourage wider use of the RMB abroad without seriously threatening financial control at home. That explains why, for example, so much of the finance track of Beijing's strategy has been carried out in Hong Kong's offshore market, which is largely insulated from onshore markets on the Mainland. It also explains why, as this essay is written, China's leadership is still resisting pressure from the PBOC and others[8] to liberalize domestically or open the country's capital account. To say the least, this is a delicate balancing act. In effect, Beijing has tried to promote internationalization on the cheap – to make as few concessions as possible in terms of financial reform, hoping that economic size alone will manage to do the job.

In the end, however, the balancing act almost certainly will prove untenable. As many observers have noted, yuan internationalization will eventually provide means to "punch holes" (McCauley 2011) in China's capital controls, challenging the government's grip over money and credit at home. And of course, judging from the carefully calibrated choreography that has been followed until now, that would seem to be understood by China's leadership as well. Policy makers appear to recognize that, sooner or later, diminished command is the price they will have to pay for an internationalized RMB. But in the spirit of Saint Augustine – who prayed to the Almighty for celibacy, just "not yet" – it seems that Beijing would prefer to postpone the moment for as long as possible.

CONCLUSION

The lessons from China's experiment with managed internationalization thus seem clear. First, there is nothing in Beijing's experience to suggest that a state *cannot* manufacture an international currency. The first steps of the yuan's Long March have indeed achieved tangible results, particularly along the trade track. Second, however, it is clear that real success is possible only if the right power resources are available and used appropriately. Since for this purpose a capacity for direct coercion is limited, strategy must be more indirect, concentrating on enhancing the national currency's international appeal. But demand-side preferences will not be favorably modified by relying on one attribute alone, such as economic size. On its own, China's "gravitational pull" will not suffice. Other factors – above all, a well developed and open financial structure – must also come into play, and the degree of fungibility among them is low.

In the end, therefore, it is clear that there are limits to the use of power to manufacture an international currency, unless a government is willing to pay the necessary price. For China, the price is financial liberalization and with it a significant modification of Beijing's authoritarian economic model. Currency internationalization is no cinch and cannot be had on the cheap.

NOTES

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1. Among the more notable commentaries in a vast literature are Dobson and Masson 2009; Lee 2010; Peng and Shu 2010; Subacchi 2010; Chen and Cheung 2011; Subramanian 2011; Yu and Gao 2011; Mallaby and Wethington 2012; Prasad and Ye 2012.
2. See e.g., J. Li 2007; Lee 2010; Subramanian 2011.
3. As reported by Dow Jones News Service, 17 February 2011. The advisor was Xia Bin, an academic member of the central bank's monetary committee.
4. As of March 2012 swap agreements had been signed with Argentina, Australia, Belarus, Hong Kong, Iceland, Indonesia, Kazakhstan, Malaysia, Mongolia, New Zealand, Pakistan, Russia, Singapore, South Korea, Thailand, Turkey, United Arab Emirates, and Uzbekistan.
5. The designation CNH for offshore yuan deposits is in contrast to CNY, the designation for onshore yuan.
6. A bit immodestly, I can take pride in originating the standard taxonomy in an early book of mine on the pound sterling (Cohen 1971).
7. X. Li 2010: 13. See also Goldstein 2005; Grimes 2009.
8. See e.g. World Bank (2012), which called for far-reaching economic reforms, including full financial liberalization. The report was published in February 2012 jointly with the Development Research Center, a Chinese government research organization, and was followed by a statement from a senior PBOC official, based on a previously confidential PBOC research project, outlining a three-stage plan for comprehensive opening of China's capital account over the next decade (Sheng 2012).

III. STATE CAPITALISM AND THE LAW OF THE WORLD TRADE ORGANIZATION

Even before its accession to the WTO, the existence of a large number of SOEs in China was perceived as being fundamentally incompatible with the world trading system.[124] The Chinese government's prominent economic role a decade after it joined the WTO throws doubt on expectations that WTO membership would cause China to pull back from market interventions.[125] It is thus necessary to examine what WTO rules are relevant to confront China's state capitalism and to what extent these rules are effective in curbing it.

It is important to note that when China acceded to the WTO in 2001 it agreed to be bound by a large number of special rules that elaborate, expand, modify or deviate from the provisions of the general WTO Agreements. These China-specific rules are set out in the WTO Accession Protocol (the Protocol) and in the more than 140 paragraphs of the Report of the Working Party on the Accession of China.[126] As an integral part of the WTO Agreements, the China-specific rules contained in China's accession commitments are enforceable through the WTO dispute settlement

[122] WTO Appellate Body Report, *China–Measures Related to the Exportation of Raw Materials Restrictions* (30 Jan 2012) WT/DS394/AB/R.

[123] Joint US–China Economic Track Fact Sheet of the Fifth Meeting of the US–China Strategic and Economic Dialogue (7/12/2013) <http://www.treasury.gov/press-center/press-releases/Pages/jl2010.aspx>.

[124] G Hufbauer, 'China as an Economic Actor on the World Stage: An Overview' in F Abbott (ed), *China in the World Trading System: Defining the Principle of Engagement* (Kluwer Law International 1998) 50; See also JH Jackson, 'The Impact of China's Accession on the WTO' in D Cass, B Williams and G Barker (eds), *China and the World Trading System* (Cambridge University Press 2003) 26.

[125] HB Malhotra, Chinese Communists Keeping Hands in All Pockets (30 November 2011) <http://www.theepochtimes.com/n2/business/chinese-communists-keeping-hands-in-all-pockets-151064.html>.

[126] Protocol on the Accession of the People's Republic of China, WT/L/432 (10 November 2001). JY Qin, '"WTO-Plus" Obligations and Their Implications for the WTO Legal System: An Appraisal of the China Accession Protocol' (2003) 37(3) JWT 483.

processes.[127] These disciplines put additional constraints on the activities and financial situation of China's SOEs.

A. The Ownership-Neutral Philosophy of the World Trading System

The post-World War II international trading system is based on rules and principles that often assume the existence of a market-oriented economy where enterprises make decisions on the basis of economic factors rather than government directives.[128] Still, the WTO does not prescribe any particular economic system for its members and states with non-market economies have been accepted into the GATT/WTO membership.[129] In addition, most GATT/WTO rules address governments only in their role as regulator of economic activities. Little is said about government participation in economic activities through SOEs. Indeed, the GATT/WTO does not impose on members any particular obligations with respect to property ownership.[130] A WTO member is free to establish and maintain SOEs if it wishes to do so.

There are several reasons for the WTO's ownership-neutral position. First, as Qin points out, a basic principle of public international law is that each state has the sovereign right to choose freely its own political, social and economic system. States still hold divergent views as to the proper roles of the government and the state-owned sector in the national economy and finding the right mix of public and private ownership remains a challenge for many countries.[131] Second, governments may instruct SOEs to engage in numerous forms of business practice that discriminate against foreign goods and services and possibly undermine the GATT/WTO commitments.[132] Such restrictive practices may include being the exclusive importer/exporter of a product, using government funds for subsidizing domestic production and trade, and controlling product standards, etc. However, such practices are not restricted to entities that are owned or controlled by the state. Besides, the underlying sources of such trade distortion are usually the special rights and privileges which are enjoyed by SOEs.[133] Thus public ownership is not what matters. The regulatory focus should be on the behaviour of those SOEs which are granted

[127] WTO Appellate Body Report, *China–Measures Affecting Trading Rights and Distribution Services for Certain Publications and Audiovisual Entertainment Products*, WT/DS363/AB/R (21 December 2009) paras 133–140.

[128] WJ Davey, 'Article XVII GATT: An Overview' in T Cottier and P Mavoidis (eds), *State Trading in the Twenty-First Century* (the University of Michigan Press 1998) 21.

[129] JH Jackson, *The World Trading System: Law and Policy of International Economic Relations* (MIT Press 1997) 328.

[130] PC Mavroidis and T Cottier, 'State Trading in the Twenty-First Century: An Overview' in Cottier and Mavoidis (n 128) 3.

[131] Qin (n 99) 899–900.

[132] EU Petersmann, 'GATT Law on State Trading Enterprises: Critical Evaluation of Article XVII and Proposals for Reform' in Cottier and Mavoidis (n 128) 72.

[133] ibid.

special rights and privileges.[134] Finally, from a practical point of view, how capital should be formed and whether or not SOEs should be dismantled are fundamental choices of domestic policy making. International law cannot, nor should it, prescribe such basic choices if it is to remain effective.[135] Accordingly, it is suggested that the WTO law should not take sides by prescribing basic choices related to the organization of its members' economy and remain neutral as regards questions concerning the formation and ownership of capital, whether private or public.[136]

Based on this reasoning, WTO disciplines contain few rules specifically relating to SOEs. With respect to trade in goods, GATT Article XVII sets out the basic disciplines concerning state trading firms, but Article XVII does not refer to the ownership of such entities.[137] Similarly, although the SCM Agreement expresses a preference for privatization in developing countries, it does not impose any obligation regarding SOEs.[138] Of course, whether the ownership-neutral philosophy of the GATT/WTO permits it to respond effectively to all the challenges posed by SOEs is a debatable issue.

B. State Trading Enterprises

The original parties to the GATT were aware of the danger that some Member governments might create SOEs in order to circumvent their obligations under the GATT. At the same time, those parties could not agree on imposing greater restrictions on SOEs than on private enterprises.[139] Consequently, only a few provisions in the WTO Agreements explicitly address SOEs. The most important is Article XVII of the GATT 1994. Article XVII:1(a) requires that State Trading Enterprises (STEs) shall act in a manner consistent with the general principles of non-discriminatory treatment under the GATT. Article XVII:1(b) requires that STEs shall make any purchases or sales solely on the basis of commercial considerations. Article XVII is intended to ensure that members do not use STEs to escape or circumvent their GATT obligations.[140]

The implications of Article XVII for SOEs are limited. First, Article XVII is applicable only to STEs, a term which has never been clearly defined in the

[134] BM Hoekman and P Low, 'State Trading: Rule Making Alternatives for Entities with Exclusive Rights' in Cottier and Mavoidis (n 128) 329.

[135] T Cottier and P Mavoidis, 'Conclusions: The Reach of International Trade Law' in Cottier and Mavoidis (n 128) 400.

[136] ibid 397.

[137] Qin (n 99) 900.

[138] Art 27.13 of the SCM Agreement.

[139] Xuejun Xie, 'WTO Rules on State-Owned Enterprises and Implications for Chinese SOE Reforms' (2002) 3(6) Perspectives <http://www.oycf.org/oycfold/http://docs/Perspectives/18_093002/WTO_Rules.htm>.

[140] WTO Appellate Body Report, *Canada–Measures Relating to Export of Wheat and Treatment of Imported Grain*, WT/DS276/AB/R (30 August 2004) para 85.

GATT.[141] A working definition was developed during the Uruguay Round for the purpose of notifying the WTO of such enterprises:

> Governmental and non-governmental enterprises, including marketing boards, which have been granted exclusive or special rights or privileges, including statutory or constitutional powers, in the exercise of which they influence through their purchases or sales the level or direction of imports or exports.

Significantly, this definition covers a private enterprise that receives some special rights or privileges that can influence the level or direction of trade.[142] On the other hand, SOEs are excluded from the definition unless they have a special right or privilege and they influence the level or direction of trade through their purchases or sales.[143] The special right or privilege granted need not be a monopoly position.[144] When China acceded to the WTO in 2001, China was obliged to allow all enterprises in China to trade in all goods by 11 December 2004, except for those specified in Annex 2 of the Protocol.[145] By virtue of a special national treatment clause in the Protocol, this right to trade is also extended to all foreign individuals and entities, which have either invested in or are registered in China.[146] Thus only a limited number of Chinese SOEs may be labelled as STEs under the WTO law.

Second, the coverage of Article XVII:1 is fairly limited. It is unclear whether the obligation of STEs to 'act in a manner consistent with the general principles of non-discriminatory treatment under the GATT' refers only to most-favoured nation treatment of trade with other countries or also national treatment of imported and like domestic goods. In several GATT disputes, Panels have ruled in favour of the narrower interpretation.[147] In addition, in *Canada–Wheat*, the Appellate Body concluded that Article XVII:1(a) sets out an obligation of non-discrimination and that Article XVII:1(b) clarifies the scope of that obligation.[148] The Appellate Body rejected the US argument that XVII:1(b) establishes a separate, general competition-law-type obligation on state trading enterprises to follow 'commercial considerations' in all of their purchases and sales.[149] As a result, Article XVII:1 allows STEs to act in an anti-competitive manner insofar as such action does not violate the obligation of non-discrimination.[150]

However, although the general thrust of Article XVII of the GATT 1994 is weak, Chinese SOEs are not able to benefit from such weakness. The Protocol extends the WTO disciplines concerning STEs to all Chinese SOEs, regardless of whether they engage in export or import trade.[151] The Protocol requires the

[141] WTO, Technical Information on State-Trading Enterprises <http://www.wto.org/english/tratop_e/statra_e/statra_info_e.htm>. [142] Qin (n 99) 901. [143] Petersmann (n 132) 80.
[144] WTO (n 141). [145] Art 5.2 of the China's Accession Protocol.
[146] JY Qin, 'Trade, Investment and Beyond: The Impact of WTO Accession on China's Legal System' (2007) China Quarterly 726. [147] Petersmann (n 132) 80–1.
[148] WTO Appellate Body Report, *Canada–Wheat* (n 140) para 145. [149] ibid.
[150] Nakagawa (n 93) 6. [151] Qin (n 99) 884.

Chinese government to ensure that all SOEs operate according to market economy principles and also requires it not to meddle with the autonomous operation of SOEs. Specifically, it provides that:

> China would ensure that all state-owned and state-invested enterprises would make purchases and sales based solely on commercial considerations, eg, price, quality, marketability and availability, and that the enterprises of other WTO Members would have an adequate opportunity to compete for sales to and purchases from these enterprises on non-discriminatory terms and conditions. In addition, the Government of China would not influence, directly or indirectly, commercial decisions on the part of state-owned or state-invested enterprises, including on the quantity, value or country of origin of any goods purchased or sold, except in a manner consistent with the WTO Agreement.[152]

SINO-CAPITALISM
China's Reemergence and the International Political Economy

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Comparative Capitalism and Sino-Capitalism

Contemporary capitalism appears anything but cast in stone. From the domestic to the global level, almost every element of political economic organization and governance faces constant uncertainty and volatility. Since the dominant approaches to comparative institutional analysis—from rationalist and economic institutional to sociological and historical approaches—assume the stability of institutional arrange-

[19] For the history of global capitalism, see Frieden 2006.
[20] For a conceptualization of a clash between European and American capitalisms, see Albert 1993.

ments, these confront difficulty in capturing the dynamic institutional transformations and feedback loops shaping contemporary capitalism.

Nonetheless, pertinent insights for the study of China's emergent political economy can be drawn from frameworks in the comparative capitalism literature, including the varieties of capitalism (VoC) approach.[21] The origins of this literature date to pioneers such as Andrew Shonfield[22] and Alexander Gerschenkron,[23] whose works lay out how capitalist systems can differ in fundamental institutional terms. Despite the convergent force of developments on the global level, therefore, marked differences have emerged among national capitalist institutions.[24] This has become even more apparent with the demise of communism and central planning. As capitalism's ideological competitor faltered, a hitherto largely neglected problem came to the fore: the differences between capitalist political economies themselves.

The key contribution of the comparative capitalism literature is that it focuses squarely on how modern capitalism represents a heterogeneous force.[25] Capitalism is in this sense not a monolithic, impermeable bloc that is ideologically coherent but rather is a complex socioeconomic system that adjusts to the various ways of different nations, cultures, and times.[26] In particular, the VoC approach has distinguished two generic varieties: liberal market economies, chiefly the capitalist systems derived from Anglo-American traditions; and coordinated market economies, represented by Germany, Japan, and several North European and Alpine political economies.[27] Each of these varieties is characterized by its own complementary set of institutional arrangements. These complementarities shape unique varieties of capitalism and, equally important, influence their innovative performance and economic competitiveness. It is not that one set of institutional arrangements is intrinsically better than any other, but rather that different sets of institutions create dissimilar competitive advantages that nonetheless can be equal in terms of economic performance. Complementarity is thus vital for understanding why capitalist institutions

[21] Hall and Soskice 2001. A number of approaches have either preceded or paralleled the VoC approach in comparative capitalism. All aim to classify existing types of capitalism and to probe the causal relationships between the institutional features of a given type of capitalism and its economic performance. See Jackson and Deeg 2006.

[22] Shonfield 1965.

[23] Gerschenkron 1962.

[24] Goldthorpe 1985; Kitschelt et al. 1999.

[25] Jackson and Deeg 2006.

[26] Albert 1993.

[27] Hall and Soskice 2001.

vary; that is, institutional isomorphism creates different trajectories of path-dependent institutional development over time.

The VoC approach has met with several criticisms.[28] First is that it focuses exclusively on the nature and sources of variation in the institutionally more stable political economies of advanced industrial nations.[29] It thus fails to capture the rich and dynamic variety of new forms of capitalism in emerging market economies, including political economies shaped by state capitalist and transnational influences.[30] Philippe Schmitter, for instance, suggests that the dichotomy between liberal and coordinated market economies is too primitive in its attempt to capture all VoC and that greater attention needs to be paid to the degree of stateness permeating a given form of capitalism.[31] Certainly, a system as a whole can be capitalist while guided by state influences, such as indicative state planning, public ownership of the commanding heights of the economy, and the strategic use of state fiscal incentives.

Another major issue concerns the nature of complementarity. Conceptions in the VoC framework initially saw complementarity as different institutions aligning to reinforce each other's incentives, thus creating institutional coherence with few contradictory incentives.[32] Economic competitiveness emerged from an institutional fit in which institutions shaped clear sets of linearly aligned incentives. In this view, purer VoC of both the liberal and the coordinated market economy varieties performed better than mixed systems such as those found in France or Spain.[33]

This emphasis on institutional fit or coherence becomes especially problematic when applied to China because of the complexity of its emergent capitalism. The nature of the country's economic development has been characterized by the adaptation and hybridization of a variety of strategies of economic organization, technological innovation, and industrial policy. As the following analysis details, the major characteristic of Sino-capitalism is the juxtaposition of state-led developmental institutions top-down and private entrepreneurial networks bottom-up, often resulting in contradictory incentives and friction. In Sino-capitalism, institutional complementarity is based on a basic compensatory mechanism whereby institutional arrangements com-

[28] See the excellent analysis by Pontusson 2005.
[29] Streeck and Yamamura 2001.
[30] Nölke and Vliegenthart 2009.
[31] Schmitter and Todor 2010.
[32] Amable 2003, 60; Hall and Soskice 2001.
[33] Hall and Soskice 2001.

pensate for each other's weak points rather than pushing incentives in the same direction.

Several analyses highlight the importance of compensatory institutional complementarity, stressing that institutions can balance certain incentives, such as extreme self-interested behavior, and make up for each other's deficiencies.[34] Thus, Lane Kenworthy argues that VoC with mixed institutional arrangements can perform just as well as purer, more coherent cases.[35] And John Campbell uses the US financial crisis to demonstrate that highly coherent sets of institutional arrangements that reinforce each other's incentives can precipitate a crisis, since they can reinforce the wrong sets of incentives.[36] Compensatory institutions are therefore perhaps just as important as coherent reinforcing sets of institutions, if not more so.

Institutional complementarities obviously come in different forms, and counterbalancing, hybrid, and even contradictory sets of institutions can coexist with reinforcing institutions. There is perhaps no perfect way of organizing capitalism. Rather, institutional innovation via learning, political struggle, and competition can over time build institutional infrastructures sustaining politicoeconomic stability and capitalist development.[37]

The conceptualization of Sino-capitalism proposed here is broader and more fluid than the precise yet static models put forward in the VoC analytical framework.[38] It also contradicts some of the major findings of this framework by proposing that hybrid compensatory institutional arrangements can work just as well as coherent reinforcing institutions. Nonetheless, an understanding of Sino-capitalism can derive intellectual guidance from the comparative capitalism literature.[39] First, comparative capitalism approaches highlight the heterogeneous nature of contemporary capitalism. A number of historical, geographic, political, geopolitical, and socioeconomic factors create different trajectories of institutional development that result in fundamentally different institutional, ideational, and political arrangements across the globe. China's reemergence is thus generating a new form of capitalism that draws on Western, Asian, socialist, and historical and modern Chinese elements.

[34] Crouch 2005a; Crouch 2005b; Campbell 2011.
[35] Kenworthy 2006.
[36] Campbell 2011.
[37] See Campbell 2011; Crouch 2005a; Aoki 2001.
[38] Amable 2003; Hall and Soskice 2001.
[39] Jackson and Deeg 2006.

Second, comparative capitalism approaches elucidate different possibilities for how institutional complementarities can work. In Sino-capitalism, two sets of institutions are central, each with its own inner logic and internally reinforcing incentives—the state-guided realm and the entrepreneurial private realm. While these two sets of institutions compensate for each other's weaknesses and meld, especially at the local level, they also stand in contradistinction to each other. Added to this are substantial influences emanating from the global capitalist system that have led to the adaptation of both liberal Anglo-American and Asian developmental institutions.

Finally, the study of comparative capitalism draws attention to both the timing and the massive heft of China's capitalist development. Sino-capitalism is emerging in a highly globalized system, more deeply integrated into global production and knowledge networks than were earlier developers in Asia. Most significantly, Sino-capitalism is based on what could potentially become the globe's largest political economy. China is not just Germany or Japan. With 1.3 billion people, its population is four times the size of the United States, creating enormous economic potential on a continental, even global scale. China's rise thus represents the first time historically that the Anglo-American model of capitalism has been challenged to this extent, perhaps finding an equal rival within coming decades.

Sino-Capitalism

The term Sino-capitalism was first used with respect to overseas Chinese political economies, especially in Southeast Asia.[40] One application of the term links it to Thaksinism, the populist neoauthoritarian, hard-line economism for export employed by the former Thai prime minister.[41] Sino-capitalism in this context implies networked corporate empires (based partially on Chinese ethnicity) and authoritarian market policies of no-holds-barred economic development.

The conception of Sino-capitalism employed here takes these antecedents into account but also attempts to provide a more specific institutionally based definition that builds on the comparative capitalism literature. Most fundamentally, Sino-capitalism is a hybrid consisting of several interrelated codependent compensatory institutional arrangements. Hybridization emerged because China took a gradual,

[40] Koon 1997.
[41] Thornton 2006.

experimental approach to economic reform that made use of market-oriented rules-based, inter-personal networked, and statist strategies.[42] By practicing "upgraded authoritarianism," China has found highly innovative policies and institutions to master complex challenges; that is, an "intriguing interplay between development planning and policy experimentation" contributed to China's economic success.[43]

Three institutional spheres are particularly significant in Sino-capitalism.[44] First, rather than relying purely on well-defined and enforced legal codes, Sino-capitalism makes heavy use of interpersonal relationships utilizing common Chinese cultural norms that cultivate long-term reciprocal personal relationships, known as *guanxi* in Chinese. The result is the proliferation of informal business networks that create production and knowledge clusters, often with global reach.

Second, as China is a late developer, the role of the state has been magnified. Sino-capitalism represents a "Gerschenkron Squared" form of late capitalist development that assigns the Chinese state a leading role in fostering and guiding capitalist accumulation.[45] Sino-capitalism thus encompasses a new application of state-led, state-coordinated, or state-guided capitalism.

Finally, China's rapid economic growth has occurred in a highly globalized era. Enormous international competition for trade and investment has conditioned Chinese policies to some extent, especially as these pertain to China's entry into the World Trade Organization (WTO). Clearly, China absorbed a host of institutional arrangements as it entered the global capitalist system during a period of heightened globalization. This hybridization has allowed some of the dominant Anglo-American institutions and values to enter China, creating a "market-liberal form of state capitalism."[46]

Network or Guanxi Capitalism

Sino-capitalism incorporates aspects of the ideal-typical form of "Chinese capitalism" found in overseas Chinese business communities. Based on a patriarchic structure of family ownership and control, intricate networks of reciprocity (*guanxi*), and a close interplay between political and economic entrepreneurship, it has become prominent throughout Southeast Asia, Hong Kong, and Taiwan.[47] As China em-

[42] Pang 2009.
[43] Heilmann 2010, 110.
[44] McNally 2008.
[45] Gerschenkron 1962.
[46] ten Brink 2010; ten Brink 2011; also Chu and So 2010.
[47] On the ideal-typical form of overseas Chinese capitalism, see Redding 1990; on Asian business networks, see Hamilton 1996.

barked on its reform policies after 1978, overseas Chinese business interests were the first to invest. In this process, overseas and Mainland Chinese business networks melded, generating part of China's export-manufacturing juggernaut. Within Mainland China, however, the role of the traditional paternalistic family business diminished, while the importance of more non-family-based networks increased.[48]

Sino-capitalism clearly does not resemble a purely state capitalist system. There are certain twists, since institutionally Sino-capitalism encompasses production clusters based on highly entrepreneurial and flexibly networked systems of small and medium-size firms. *Guanxi* and other Chinese cultural norms support these networks, though these norms are not the only ones. More rules-based scientific and knowledge networks can take on central roles as well.[49]

Guanxi or network capitalism has created deep structural changes in China's political economy.[50] Private business interests have gradually gained political leverage as marketization and capital accumulation progressed. And rather than engaging in confrontation, holders of private capital have become increasingly embedded in the Chinese party-state, creating an alliance of political and economic elites.[51] While this system has given rise to widespread corruption and rent seeking, the combination of Leninist control and relentless private capital accumulation has engendered continuous institutional adaptation.[52] The result has been a dynamic efficiency that is strengthening both state and capital in mutually reinforcing cycles.[53]

Due to bottom-up entrepreneurial networks, the Chinese political economy contains a distinct duality or dialectic: the state controls finance and the commanding heights of industry, while most competitive sectors in retail and manufacturing are populated by private (both foreign and domestic) or hybrid ownership firms. The Chinese state's continued dominance over crucial aspects of the economy is therefore tempered by the entrepreneurship and dynamism of China's network capitalism. Successful institutional hybridization in the Chinese system has allowed these two dissimilar types of capital accumulation to coexist and become codependent.

China's capitalist development therefore relies to a considerable

[48] This is in part due to the one-child policy and the wrenching social dislocations of the Maoist period. See Lin 2010.

[49] Hsu and Saxenian 2000.

[50] McNally 2011.

[51] Dickson 2008; McNally and Wright 2010.

[52] Tsai 2007.

[53] The process of "mutual empowerment" that ultimately underlies capitalist development has been conceptualized by Kohli and Shue 1994.

extent on a myriad of small- and medium-scale entrepreneurial ventures. Sociocultural institutions such as *guanxi* practices have allowed Chinese entrepreneurs to link up with state officials, access finance, overcome government indifference, build trust, and compensate for institutional uncertainty.[54] Common cultural norms and language also aided overseas Chinese entrepreneurs to penetrate China's initially difficult investment environment, thereby integrating coastal areas with international production and marketing networks.[55]

State-Led Development

State intervention has undoubtedly played a crucial role in China's capitalist transition. At the outset of reforms in 1979, the Chinese Communist Party (CCP) faced economic stagnation at home.[56] It also realized how other East Asian economies had managed great spurts of industrialization.[57] Under the leadership of Deng Xiaoping the CCP thus mustered the political will to sustain disruptive developmental dynamics. Reforms strengthened and legitimized already existing autonomies at the local level, giving local cadres political space for a variety of ever bolder economic trials. Reforms in the CCP's nomenklatura system—the system that is responsible for party personnel appointments—also created new incentives for cadres to improve local economic performance.[58]

The combination of these measures created the political autonomy for local cadres to circumvent central rules restricting market transactions, foreign investment, and local capital accumulation. Cycles of induced reforms unfolded, where each small step at liberalization created pressures for further liberalization.[59] Seen from a somewhat different perspective, top-down Leninist incentives focused on economic performance encouraged local governments to compete vigorously for investment capital. This interjurisdictional competition created a form of "de facto federalism" that led to the gradual liberalization of China's economy and triggered substantial improvements in China's investment climate for both domestic and foreign investors.[60]

Besides utilizing top-down Leninist incentives, the Chinese party-state was able to retain control over the commanding heights of the

[54] Wank 1999.
[55] Zweig 2002; Hsing 1998.
[56] Naughton 1995.
[57] Cumings 1989.
[58] Huang 1996; Edin 2003.
[59] Jefferson and Rawski 1994; Naughton 1995; Solinger 1989.
[60] Zheng 2007.

economy throughout the reform period. State firms and state research institutes continue to shape most direct developmental interventions, undertaking projects fraught with risks or long repayment horizons.[61] In addition, an ambitious effort at state enterprise reform starting in the mid-1990s created a much more profitable state sector. Most small and medium-size state firms were privatized, while large state enterprises were corporatized under the "Modern Enterprise System."[62] This involved the clearer exercise of property rights under newly corporatized firm structures, which opened the door to corporate restructuring, listings on stock markets, and more profit-driven incentive structures.[63]

The large, centrally controlled state enterprises were then subsumed under the control of the State-owned Assets Supervision and Administration Commission (SASAC) in 2003. This commission exercises quasi-trustee control over state-owned assets. It oversees government holdings, appoints boards of directors in conjunction with the party's central Organization Department, and directs large mergers, combinations, acquisitions, and divestments. SASAC's remit not only suggests state control but also contains elements of state corporate steering and transformation. Consequently, the Chinese state sector is populated by very large state-owned enterprises that in 2006 constituted only 8 percent of all industrial firms but produced 36 percent of industrial value added and 44 percent of recorded industrial profits.[64] Currently, most significant state firms are profit oriented and their major operations are in units listed on stock markets. Large state firms also continue to have preferential access to loans, land, and subsidies.[65]

Obviously, the state sector continues to loom large over the Chinese political economy. While state firms retreated from the most competitive and least profitable sectors, they have kept a tight grip on a wide range of critical industries. These include oil, gas, and mining; the production of basic producer goods such as nonferrous metals, steel, and petrochemicals; essential network industries in telecommunications, transportation, and utilities; and all major banking and financial institutions in China.

This direct control over economic matters via state-owned or state-sponsored ventures continues to enable central and local authorities to allocate financial resources and guide economic activities. In addition,

[61] Nolan 2001.
[62] McNally 2002.
[63] SASAC 2003.
[64] Wildau 2008, 27.
[65] Li and Xia 2008, 44.

the Chinese state has undertaken several phases of bureaucratic reforms. The Chinese state bureaucracy has now become much better suited to the demands of a developing and globalizing market economy.[66] The state, though, has retained institutions to implement industrial policy. Of note is the National Development and Reform Commission, which emerged after the 2003 central bureaucratic reforms as a hub for steering industrial development and upgrading.[67]

These features raise some comparisons with East Asia's "developmental states," but China's state apparatus is not as institutionally coherent and has not perfected market-conforming methods of state intervention in the economy.[68] Rather, detailed industrial policy implementation has often been frustrated by the complex and multifaceted nature of China's state apparatus.[69] Intense rivalries among Chinese state agencies and local governments put considerable implementation constraints on indicative planning and market-conforming state interventions. In fact, overlapping and incongruous features have created glaring local government interventions that run counter to central policies.

Nonetheless, the Chinese state has retained enormous leeway in its ability to intervene in the economy via the Leninist party-state, control over the commanding heights of industry and finance, and the substantial regulatory purview of local and central state formations. In the final analysis, China must be seen as a late developer undertaking a form of state-led development. Gerschenkron's insights provide some comparative political economy pointers in this regard. In his view, the timing of a political economy's entry into the global capitalist system directly influences the shape of its capitalism.[70] Earlier and later capitalist developers differ fundamentally in terms of the institutional arrangements supporting capital accumulation. Generally, in later developers the role of the state is magnified and state coordination is much more closely linked to high finance and industry. New institutional solutions are adapted to enhance the capacity of states to coordinate or even directly manage great spurts of industrialization.

China entered the global capitalist system after large-scale industrial and financial competitors were already well established. Like other late developers, China invariably modeled itself on already developed

[66] Zheng 2004; Yang 2004.
[67] Saich 2004.
[68] Johnson 1982; Wade 1990.
[69] Howell 2006.
[70] Gerschenkron 1962.

economies, often copying institutional arrangements and technologies to give itself an "advantage of backwardness" by adopting best practices rapidly throughout the economy.[71] Therefore, from a Gerschenkronian perspective, China emerges as a third-generation late developer. Top-down Leninist party-state incentives, state control over the largest firms, and a wide array of regulatory tools have all been crucial factors in China's capitalist transformation. Nonetheless, this is a form of capitalism that relies on a uniquely compensatory institutional structure whereby state capitalist features are balanced by vibrant entrepreneurial private capital accumulation and, as the next section elaborates, the development of a relatively internationalized and globally enmeshed economy.

Adaptation of Global Influences

China's entry into the global capitalist system during an era of intense globalization stands in contrast to the experiences of the economies of Japan, South Korea, Taiwan, Hong Kong, and Singapore. These late developers faced global capitalist competition under the postwar (1945–80) "embedded liberalism," which espoused a fairly tightly managed system of economic exchanges.[72] They also benefited from being front-line states in the Cold War, obtaining privileged access to US markets and technology.[73] China, by contrast, belongs to a more contemporary wave of industrialization in East Asia, a wave that roughly began in the 1980s alongside the acceleration of neoliberal globalization.

The strengthening forces of globalization presented China with both opportunities and challenges and to a considerable extent shaped policy. Compared with earlier developers in East Asia, China adopted more free-market principles. These principles include substantial access by foreign capital to China's manufacturing and retail sectors; the relatively rapid development of stock markets and intensive use of Hong Kong's internationalized capital markets; and the fact that Chinese banks do not practice share ownership in industrial firms.[74] Especially noteworthy is China's opening to foreign direct investment. While overseas Chinese capital played a crucial role at the beginning, later on more globalized players used China's coastal areas as manufacturing platforms, servicing customers in North America, Europe, and Japan.[75]

[71] The original formulation of this insight with regard to Imperial Germany is in Veblen 1915.
[72] Ruggie 1982.
[73] Stubbs 1999.
[74] Lee, Hahn, and Lin 2002; Chu and So 2010.
[75] Hsing 1998.

Finally, despite China's socialist legacy, concerted efforts have been made to increase labor-market flexibility, especially regarding the hiring and dismissal of employees. This was aided by the timing and sequencing of foreign direct investment that weakened labor's role even in the more regulated state sector.[76] China has thus been able to establish one of the most flexible labor markets in the world.

Faced with strong international pressures to open China's domestic economy to foreign trade and financial flows, China entered the WTO in 2001. China's accession protocol included stringent commitments to reduce import barriers and to end discrimination against foreign companies that go well beyond those agreed to by other emerging market economies, such as India and Brazil.[77] Neoliberal globalization thus prodded the Chinese government to develop one of the highest "absorption capacities" for the forces of globalization among developing economies.

Clearly, some of China's developmental policies, especially in terms of openness to foreign investment and trade, stand in marked contrast to East Asia's earlier developers. However, in other respects Chinese policies have followed Japan, Taiwan, and South Korea quite closely. China, too, has used programs of subsidized investment in "strategic industries," pursued an export-led growth strategy, and suppressed domestic consumption while encouraging high savings and investment rates. Most prominently, China is following its Asian predecessors by employing exchange rate controls to maintain an undervalued currency that fosters export performance. Despite some liberal impulses, therefore, China's development policies feature a substantial role for the state and have emphasized the development of domestic industry and technology.[78]

In sum, the growth of Sino-capitalism implies that the global system will be faced with a developing economy that, while exhibiting low degrees of institutional certainty and predictability, contains considerable industrial, technological, and financial capacities. How Sino-capitalism will influence the shape globalization takes in future years is still open to question. However, it is highly likely that Sino-capitalism will become the second most important player globally, soon to rival the still dominant Anglo-American form of capitalism.

[76] Gallagher 2005.
[77] Edmonds, La Croix, and Li 2008.
[78] Edmonds, La Croix, and Li 2008.

3 The money creation mechanism

A stable and adequate money supply is a fundamental requirement for a well-functioning economy. Excessive expansions/contractions of the money supply can lead to inflation/deflations of the price level as well as booms/busts in economic activity.

Until recently, the process of money creation has been widely misunderstood. Most economic textbooks explained money creation based on the "money multiplier model", but as will be explained in Chapter 3.1 this is not what happens in reality.

According to the money multiplier model the Central Bank is in control of the total money supply. By creating a certain amount of base money and setting a reserve requirement that banks must abide by, the Central Bank is assumed to control the total money supply available to the economy.

However, the reality in Iceland and elsewhere is very different. Commercial banks create new money when they make loans and are not as constrained in their money creation as the multiplier model suggests. In reality, the Central Bank of Iceland (CBI) has very limited means to affect how much money is created by the commercial banks. Furthermore, as a rule, commercial banks have expanded the money supply much faster than the growth rate of the real economy, with much of the newly created money going into property and financial asset markets.

In the following sections, the money creation process will be detailed both for commercial banks and the CBI. In addition we will look at the incentives driving banks to create too much money. We also look at the CBI's tools to restrain money creation and why these tools have been largely ineffective.

3.1 How commercial banks create money

> *"The process by which banks create money is so simple that the mind is repelled." Kenneth Galbraith*[4]

A commercial bank creates new bank deposits when it advances loans. These bank deposits are liabilities (IOUs) of the bank, which represent a promise to deliver cash on demand to the deposit owner, or to make an electronic payment to a third party on the owner's request. Deposits can therefore be used to make payments in the economy through debit cards and electronic fund transfers.

[4] Galbraith K. (1975) *Money: Whence It Came, Where It Went*, Ch. III, p. 18

A bank does not need to acquire money from a saver before it can make a loan to a borrower. Through some simple double entry accounting, when a bank lends money, it increases both the quantity of money in the economy, as well as the quantity of debt. The Bank of England explains this process in the following way:

> *"Commercial banks create money, in the form of bank deposits, by making new loans. When a bank makes a loan, for example to someone taking out a mortgage to buy a house, it does not typically do so by giving them thousands of pounds worth of banknotes. Instead, it credits their bank account with a bank deposit of the size of the mortgage. At that moment, new money is created."*[5]
>
> *"Money creation in practice differs from some popular misconceptions - banks do not act simply as intermediaries, lending out deposits that savers place with them, and nor do they 'multiply up' Central Bank money to create new loans and deposits."*
>
> ...
>
> *"In the modern economy, most money takes the form of bank deposits. But how those bank deposits are created is often misunderstood: the principal way is through commercial banks making loans. Whenever a bank makes a loan, it simultaneously creates a matching deposit in the borrower's bank account, thereby creating new money.*
>
> *The reality of how money is created today differs from the description found in some economics textbooks:*
>
> - *Rather than banks receiving deposits when households save and then lending them out, bank lending creates deposits.*
> - *In normal times, the Central Bank does not fix the amount of money in circulation, nor is Central Bank money 'multiplied up' into more loans and deposits."*[6]
>
> *"In fact, when households choose to save more money in bank accounts, those deposits come simply at the expense of deposits that would have otherwise gone to companies in payment for goods and services. Saving does not by itself increase the deposits or 'funds available' for banks to lend. Indeed, viewing banks simply as intermediaries ignores the fact that, in reality in the modern economy, commercial banks are the creators of deposit money.*

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[5] Bank of England (2014)

[6] Bank of England (2014)

...[R]ather than banks lending out deposits that are placed with them, the act of lending creates deposits - the reverse of the sequence typically described in textbooks."[7]

BOX 3.A

What central bankers have said about money creation

"The actual process of money creation takes place primarily in banks." - Federal Reserve Bank of Chicago, 1961, p. 3;

"By far the largest role in creating broad money is played by the banking sector ... When banks make loans they create additional deposits for those that have borrowed." - Bank of England (2007)

"Over time... Banknotes and commercial bank money became fully interchangeable payment media that customers could use according to their needs" - ECB, 2000.

"Contemporary monetary systems are based on the mutually reinforcing roles of Central Bank money and commercial bank monies." - BIS, 2003.

"The commercial banks can also create money themselves... in the eurosystem, money is primarily created by the extension of credit.." - Bundesbank, 2009

Note that a bank can also create money in this way when they buy assets, such as government bonds, property or buildings. Just as with a loan, the acquired property is recorded as an asset on the bank's balance sheet and the bank increases the seller's deposit with the equivalent value, recorded as a liability of the bank.

Commercial banks also handle physical cash, accepting money for deposits and providing cash when customers withdraw money from deposits. When a customer deposits cash at the bank, the cash (notes and coin) becomes property of the bank and the customer's deposit is increased. The deposit signifies the bank's liability to the customer. When a customer withdraws cash at the bank or via ATM, his deposit is reduced by the same amount.

Commercial banks both create and delete electronic money (in the form of deposits). Deletion of money happens when a bank accepts a deposit as repayment of a loan, or when a bank sells an asset and accepts a deposit as payment. Through simple double entry bookkeeping, the liability (the deposit account) is debited and the asset (such as a loan account) is credited. Both sides of the balance sheet are reduced.

[7] Bank of England (2014)

It should be noted that only commercial banks and savings institutions (deposit taking institutions) are able to create money in the form of deposits. Investment banks do not offer deposits to the public and are not able to create money. Investment banks can only lend pre-existing money (although this money normally takes the form of deposits that were previously created by banks).

Because commercial bank lending increases the balance of the borrower's bank account without decreasing the value of anyone else's account, the additional deposit increases the level of money in the economy. If banks increase the money supply more than is needed in the economy this can lead to rising prices of products (inflation) or rising asset prices (asset price inflation, and often bubbles).

Commercial banks in Iceland have created approximately ISK 486 bn[8] or 91% of the money supply (M1). Notes and coins issued by the Central Bank of Iceland (CBI) account for only 9%.[9] This situation is far from unique to Iceland; in most countries commercial banks create the bulk of the money supply.

BOX 3.8

What is money?

Definitions of "money" may vary, but for the purpose of this report we use the term to signify money that is accepted as payment in commerce and can be used to settle debts and taxes. These requirements are met by coin and notes created by the CBI and demand deposits that are created by commercial banks.

The total amount of notes, coin and demand deposits available in the economy is termed the money supply (M1).

Term deposits, savings accounts, bonds, shares and various liquid assets are sometimes called "near money". But as such assets are normally not accepted as payment for taxes or debts, and cannot usually be used to make payments in commerce, they are not money in the strict sense.

What gives money its value?

The value of money is fundamentally based on law as well as supply and demand for money. In Iceland, the law states that the ISK is valid payment for financial obligations. The CBI has monopoly on the creation of notes and coin, but the CBI has only indirect means for

[8] Central Bank of Iceland, year end 2014.

[9] See chapter 4.1 for a more detailed description of the money supply categories.

influencing how much deposit-money is created by commercial banks.

The gross demand for money is affected by various factors such as the size and growth rate of the real economy, and the financial sector. Demand for ISK is also affected by the fact that taxes can only be paid in ISK, thereby creating an underlying demand for ISK by taxpayers.

It is probable that most of the deterioration in the value of the ISK is the result of banks creating deposits faster than was needed by the economy i.e. the supply of ISK grew much faster than the demand for ISK.

Because commercial banks create the bulk of the money supply, their lending decisions influence the general price level and monetary stability. The CBI is charged with the task of maintaining price stability, but it creates only a fraction of the money supply directly and must rely on indirect methods for affecting how much money the banks create.