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Size Matters? Renminbi Internationalization and the Beijing Consensus

CHEN Weitseng

lawchenw@nus.edu.sg

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Weitseng Chen[1]

Abstract

To explore whether a China model exists, this essay focuses on the size factor that is often mentioned as a vital factor accounting for China's economic success. It selects China's ambitious scheme for internationalizing the RMB and examines how the size factor plays out in policy making. China's extremely large economy indeed enables it to diversify institutional settings for the Scheme (e.g. pluralist capitalism can be observed in different pilot zones), while maintaining minimally-efficient economies of scale in each of its policy experiments (e.g. capital flow through restricted mechanisms is sufficient enough to make a significant change even though the capital control remains in place). However, the size factor also poses great challenges to China, including problems of coordinating its large economy, the governance problems that confront extreme market variations, and systemic risk amplified by the large and heterogeneous economy. All that said, the merits of the Scheme are rather in line with the values of neoliberal economics underlying the Washington Consensus. Also, the size factor played a key role too in determining currency policies in other Asian countries during their transitions. This essay concludes that it is difficult to establish any form of Beijing Consensus, or China model, in the context of the RMB internationalization.

[1] Assistant Professor, National University of Singapore Faculty of Law. J.S.D. (2007), Yale Law School; Hewlett Fellow (2008), The Center on Democracy, Development, and the Rule of Law (CDDRL), Stanford University. The author would like to thank Dan Awrey, Michael Bridge, Christopher Bruner, Wei Cui, Chien-Hsun Chen, Florian Gamper, Tjio Hans, Jedidiah Kroncke, Alex Loke, Curtis Milhaupt, Tomoo Marukawa, Dora Neo, Dan W. Puchniak, and Michael J. Trebilcock for helpful discussions and comments. Email: weitseng.chen@nus.edu.sg.

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I. INTRODUCTION

Internationalization of *Renminbi* (RMB) has become a new buzzword, leading to various theories about its impact and prospects. "Currency War", a best seller in China that Chinese leaders have reportedly read, engages in a conspiracy theory depicting how the United States and its investment banks made the US dollar the international reserve currency. Commentators have therefore established that currency internationalization requires strong state action at a critical juncture. The British pound, for example, remained the dominant currency even after the United States replaced the United Kingdom as the biggest economy in the late 19th century. Not until after World War II did the United States spend nearly two decades pushing the US dollar to the pinnacle by using the post-war economic conditions in the United Kingdom to its advantage. It has also been argued that the transition to a high-growth economy requires exogenous "accidents and good fortunes" that break the path dependence and institutional equilibrium at a lower level of growth.[2] Interestingly, this sounds very similar to the recent comment of Zou Xiao-chuan, the President of the People's Bank of China (PBoC):

[2] Gary Becker, Kevin Murphy and Robert Tamura, "Human Capital, Fertility, and Economic Growth," *The Journal of Political Economy* 98 (1990): 14.

"RMB internationalization requires luck and opportunity, and the [recent] global financial crisis is the one."[3]

The long-term goal of the RMB internationalization scheme (the "Scheme") is to make the Chinese yuan an international settlement, investment and reserve currency. With RMB as the settlement and investment currency, China no long needs to accumulate large amounts of foreign reserve due to foreign exchange; rather, foreign direct investment (FDI), as well as overseas revenues of Chinese export firms, could flow directly into domestic markets in RMB without conversion. Chinese firms will also be free from currency exchange risks. At present, to manage its immense foreign reserve, China has no better option than to purchase US treasury bonds, thereby subjecting the value of its assets to the fluctuations of the dollar and US monetary policy. Perhaps more importantly, if the RMB becomes an international reserve currency, China may resort to printing RMB to diffuse its own economic risks, similar to what the US Federal Reserve did during the recent financial crisis. There is no doubt that China would be able to exert more influence on the global stage with a genuinely internationalized RMB.

Considering its revolutionary goal, does the Scheme construct any part of the Beijing Consensus (i.e., the Chinese Model) that my fellow contributors of this book aim to unpack? How and to what extent does the Scheme overrule the policy prescriptions made by the Washington Consensus based on neoliberal economics? Are the policies that China has been implementing for the Scheme so unique that one may claim that the Beijing Consensus exists? With these questions in mind, this chapter examines the Beijing Consensus and searches for the Chinese Model for law and economic development in the context of RMB internationalization.

The balance of this chapter proceeds as follows: Part II reviews the recent developments of RMB internationalization, aiming to frame issues from the perspective of law and development. Part III goes on to identify the challenges confronting the Scheme and argues that internationalization of the RMB is more of a domestic project than an international one in terms of implementation. The major challenges are caused by China's extremely large-scale economy and significant regional variations in market conditions. Part IV analyzes China's approach to coping with these challenges by way of legal engineering, dealing with size disadvantages by leveraging size advantages, in particular. This chapter concludes in Part V by offering a tentative view on whether the Beijing Consensus exists in the context of RMB internationalization.

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[3] Chen Fashan and Liu Caiping 陈法善 and 刘彩萍, "Renminbi Guozihua Bu Shixian Anpai Sudu Jiezhou Shidian" 人民币国际化不事先安排速度节奏时点 [Pace, Number of Steps and Timeline Regarding the Internationalization of Renminbi not Predetermined], *Caixin*, March 11, 2014, http://finance.caixin.com/2014-03-11/100649710.html.

II. RMB INTERNATIONALIZATION AND LAW AND DEVELOPMENT

A. Recent Developments

To pave the way for RMB internationalization, China has implemented a number of ambitious policies. To begin with, a set of initiatives has significantly increased the total amount of RMB circulated offshore, with the aim of increasing the global demand for Chinese yuan. With legal constraints first lifted in 2007 and then again in 2010, for example, domestic and Hong Kong banks are able to issue RMB-denominated bonds traded outside China, commonly known as "dim sum" bonds, which have dominated the Asian capital markets ever since.[4] Furthermore, to improve the liquidity of offshore RMB, the PBoC has signed bilateral currency swap agreements with 32 countries as of May 2015, creating a number of offshore RMB settlement and trading centers in places such as Australia, Hong Kong, Korea, London, Malaysia, Singapore, and Taiwan.[5] Previously, such settlement was not legal unless done through designated domestic banks or banks in Hong Kong. In Europe, a huge "Euroyuan" market is expected to pick up in a way similar to how in the 1970s the offshore US dollar created the Eurodollar markets that have played a major role in the global capital market ever since.[6]

Following a similar rationale of promoting the use of RMB internationally, Beijing made a few bold, if not controversial, moves more recently. The BRICs New Development Bank, the Asian Infrastructure Investment Bank (AIIB) and the Silk Road Fund were all created between 2014 and 2015 and have the potential to diversify China's foreign reserve management and to expand the offshore reserve of RMB. The United States and its allies such as Canada, Australia, and Japan tried to boycott the AIIB but failed in the end.[7] Claiming the move as a "diplomatic triumph," Beijing launched the AIIB with commitment of up to $100 billion, with the reported aim of competing with, if not replacing, the Asian Development Bank. The AIIB is likely to use RMB in the future for its loans and foreign aid; as such, the AIIB "represents the first serious institutional

[4] Weitseng Chen, "Institutional Arbitrage: China's Economic Power Projection and International Capital Markets," *Columbia Journal of Asian Law* 26 (2013); Terry E. Chang, "Slow Avalanche: Internationalizing the Renminbi and Liberalizing China's Capital Account," *Columbia Journal of Asian Law* 25 (2011).

[5] Ulrich Volz, "RMB internationalization and currency co-operation in East Asia," *Universität Leipzig Working Paper Series*," Wirtschaftswissenschaftliche Fakultät, No. 125 (2013): 6.

[6] Beginning in 2014, the British pound was being traded with RMB directly. This is said to be a milestone in establishing the "Euroyuan", like the "Eurodollars" decades ago. Other currencies that are allowed to trade directly with the yuan include the US dollar, Japanese yen, Australian dollar, New Zealand dollar, Russian ruble and Malaysian ringgit. This unlocks a great deal of potential for the investment community. Jeanny Yu, "Yuan to Trade Directly with UK Pound: Today's Change Replaces System of Referencing the Two Currencies' Rates against US Dollar," *South China Morning Post*, June 19, 2014, http://www.scmp.com/business/banking-finance/article/1535833/yuan-trade-directly-uk-pound.

[7] Daniel Runde, "AIIB And US Development Leadership: A Path Forward," *Forbes*, April 30, 2015, http://www.forbes.com/sites/danielrunde/2015/04/30/aiib-us-development-leadership/; Hong Yelin, "The AIIB Is Seen Very Differently in the US, Europe, and China," *The Diplomat*, May 8, 2015, http://thediplomat.com/2015/05/the-aiib-is-seen-very-differently-in-the-us-europe-and-china/.

challenge to the global economic order established at Bretton Woods 70 years ago", according to a former senior economic advisor for the Obama administration.[8]

Another high-profile initiative is the Shanghai Free Trade Zone (SFTZ) established in 2013, which was accompanied by unprecedented deregulation of the banking sector and foreign exchange markets. Five private banks have been incorporated and foreign banks can provide full services within the zone subject to limited capital control. These reforms have changed the dynamics of China's state-dominated banking sector. To introduce more competition into the allegedly-inefficient banking industry, Beijing lifted the controls on bank lending rates nationwide in July 2013, and it plans to liberalize savings rates too in the next year or two.[9]

Thus far, the Scheme appears to be bringing about rapid changes in the institutional configurations of several cornerstones of Chinese state capitalism: the banking sector, corporate governance, and securities and capital market regulations.

B. The Washington Consensus Revisited

On account of RMB internationalization, has the Scheme shed any light on the idea of the Beijing Consensus? Yes, but perhaps in a reverse manner. As a matter of fact, it is difficult to find an overarching policy that carries out more policy prescriptions from the Washington Consensus in one go than the Scheme. Reflecting neoliberal economics, the Washington Consensus suggests, for example, that the state liberalize interest rates and make exchange rates competitive, and that fiscal discipline be in place to reduce the need for governmental subsidies that distort the banking system. The Washington Consensus also suggests that the state should welcome FDI and lift capital account control, and that FDI needs to be channeled to industries monopolized by state-owned enterprises (SOEs) to improve efficiency. The past two years have seen the PBoC implementing all of these prescriptions by way of the Scheme.

In fact, the PBoC is even more liberal than some veterans of neoliberal economics. In a recent paper, Ronald McKinnon of Stanford University, the economist famous for his theory about the sequence of financial and banking reforms in developing countries, advised against China's rapid liberalization policy (especially regarding exchange rate control) as part of the Scheme.[10] Interestingly, Chinese scholars disagree and argue for aggressive reforms for internationalizing RMB.[11] Policymakers in China and liberal

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[8] RT Network, "China Launches New World Bank Rival," *RT Network*, October 24, 2014 , http://rt.com/business/198928-china-world-bank-rival/.

[9] In the short term, the overhaul is also seen as an effort to help China's economy, because lifting the control of lending rates could prompt banks to inject more capital into the economy.

[10] Ronald McKinnon and Gunter Schnabl, "China's Exchange Rate and Financial Repression: The Conflicted Emergence of the RMB as an International Currency," *China and the World Economy* 22(3) (2014).

[11] Yong-Ding Yu, "Comment from the editor-in-chief," *China and World Economy* 22 (2014): 32. The underlying disagreement is an empirical one. Yu, among other Chinese scholars, suggests that the current level of the RMB has been close to equilibrium and there exists little room for further

economists in the West have switched positions this time, with the Scheme appearing to reinforce the value of the Washington Consensus, rather than a Chinese model.

Different scholarly perceptions of RMB internationalization account for this position switch. Academics in the West generally think that the Scheme will not proceed without causing economic volatility in China and the region in the short term, such as sudden appreciation of the Chinese yuan owing to investors' expectations and speculation.[12] It remains questionable in the long term whether it will overturn the dominance of the dollar. One solution suggested is to reform the problem of imbalance within the current dollar-centered settlement and reserve system.[13] In comparison, despite fierce debates about implementation strategies, Chinese academics generally think that the Scheme is not only viable but also necessary, especially considering China's advantageous market condition---the extremely large-scale economy. The following section aims to examine the pros and cons of this condition from a law and economic development perspective.

C. Development Theories of RMB Internationalization

It is not too difficult to conclude that the Scheme, if successful, will significantly change the global balance of power, politically and economically. On account of the revolutionary outcome, academics have established various theories of currency internationalization and therefore foresee different prospects for the RMB as international currency. Many of these analyses resonate with classical law and development debates about the relationship between development, democracy, and the rule of law.

The first theory is that only countries with advanced Western capitalist economies may make their currency international reserve currency, the reason being that full currency convertibility and deep capital markets are the prerequisites for currency internationalization. The former allows both foreign and domestic investors to freely convert currency without any restrictions, whereas the latter helps channel capital inflow into various investment markets rather than speculative areas, such as real estate markets that would lead to asset bubbles. Both prerequisites rest on various institutions that are only available in a mature capitalist economy, including market transparency, a solid financial sector, good corporate governance, and effective law enforcement.[14] From this

significant appreciation. In comparison, McKinnon disagrees and suggests that the RMB will appreciate significantly if the capital control is lifted. McKinnon thinks that drastic appreciation of RMB will trigger appreciation of other currencies in Asia and greatly impact the Asian economy as a whole. See McKinnon and Schnabl, "China's Exchange Rate and Financial Repression."; "People's Republic of China: 2010 Article IV Consultation—Staff Report" (July 2010), IMF, http://www.imf.org/external/pubs/ft/scr/2010/cr10238.pdf; Nicholas R. Lardy, *Sustaining China's Economic Growth: After the Global Financial Crisis* (Washington D.C.: Peterson Institute for International Economics, 2012), 105.

12 McKinnon and Schnabl, "China's Exchange Rate and Financial Repression."

13 Ibid.

14 Tung Chen-yuan, Wang Guo-chen and Jason Yeh, "Renminbi Internationalization: Progress, Prospect and Comparison," *China and World Economy* 20(5) (2012).

perspective, unless China streamlines its state-private relationship, strengthens its banking sector and improves its corporate and capital market regulations, it will not be able to introduce full currency convertibility and push the RMB to become an international reserve currency. Otherwise, it will harm China's economy eventually since domestic markets may fail to digest such immense capital inflow. As such, it is unlikely that the RMB will become an international reserve currency anytime soon.

The second theory, with a focus on the political system, suggests that only a democratic country may make its currency international reserve currency.[15] Foreign investors will not have their wealth denominated by the currency of a country that is politically unstable due to lack to transparency, accountability and checks and balances. Since the early nineteenth century, the leading international currencies have been those of countries with democratic political systems where there are constraints on the executive, that have built a durable political climate, and where creditors are well represented.[16] The choice of international reserve currency manifests the trust of global communities in a specific country's polity, which does not and will not manipulate its markets or currency even in the face of variations in its domestic political and economic climate. One example of such trust is that the value of the US dollar remained stable even after the US federal government was forced to shut down due to budget deficits and a political stand-off between the Democrats and Republicans in 2013. As such, unless the value of RMB has the capacity to remain stable even if the Chinese government is compelled to shut down for some reason, RMB is unlikely to become an international reserve currency. This theory is not arguing that China has to become a democracy, but it does suggest that significant political reforms are necessary for the Scheme.

Interestingly, there has been little discussion of one factor that the Chinese often bring up in the context of China's economic development. That is, the large-scale economy: whether the large scale is necessary and advantageous for internationalizing the currency. The immense market scale of the US, Japan, and the European Union (EU) are vital for maintaining the USD, Yen and Euro as international reserve currency. However, this theory is a bit ambiguous because of an outlier: the Swiss Franc of Switzerland, one of the favorite international reserve currencies issued by a small economy with less than half of the population of Shanghai alone---fewer than eight million people.[17] Nevertheless, this theory addresses a commonly-shared view that hasn't been systematically scrutinized in law and development literature: the size factor. How does the size factor play itself out in the process of policymaking and implementation of development policies such as the Scheme? To what extent does this size factor constitute a Chinese model? Conversely, the size factor may make China's experiences too unique to be a general development model but rather Chinese exceptionalism.

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15 Barry Eichengreen, "Number One Country, Number One Currency?," *The World Economy* 36 (2013).

16 Ibid.

17 The Swiss Franc is legal tender only in Switzerland, the tiny principality of Liechtenstein, the Italian enclave of Campione d'Italia, and the German town Büsingen with a population of less than 2000 residents.

D. Size Matters, But How?

Commentators often attribute China's economic success and influence to the large size of its economy and workforce.[18] National champions, as the biggest Chinese SOEs such as SinoPec, China Mobil, and the big four banks are referred to, have been created by corporate re-structuring and soon became the dominant market players in both domestic and international markets.[19] For instance, mega IPOs of the Industrial and Commercial Bank of China, the Agricultural Bank of China and, recently, Alibaba.com, broke financial history records in less than a decade. Continuing expansion of the domestic consumer market provides Chinese firms with new markets, unlike the firms of other leading East Asian economies that need to go abroad to find new customers.

Historically, however, academics often regard large size as a negative factor for the development of a national economy and political power. One of the most prominent views is expressed by Fernand Braudel, famous for his theory of civilization and capitalism. Braudel pointed to France's large size as a major obstacle to France becoming a dominant power. [20] The large size dispersed limited financial resources, created difficulties in coordination, and increased various governance costs such as those for the military and transportation.[21]

Other theories about the development of various institutions also share a similar view. Corporate organization theorists, for example, point out that large firms are usually responsive to institutional innovation, but they respond at a slow pace. Some large Japanese firms are often referred to as cases in point.[22] Additionally, social norms and relational contract theories suggest that in an economy where firms and individuals rely on network or reputation mechanisms to enforce contracts, the expansion of markets would fail such mechanisms due to the increase in the costs of maintaining networks or

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[18] "China, Size Matters," Romeo Orlandi, http://www.albertoforchielli.com/2014/05/22/china-size-matters/; D. Daniel Sokol, "Law and Development—The Way Forward or Just Stuck in the Same Place?," *Northwestern University Law Review Colloquy* 104 (2010): 242.

[19] Weitseng Chen, "From the Middle East to the Far West: What Can Chinese Overseas Investments Tell Us About Law and Development and Global Regulatory Regimes?," in *Converging Regions: Global Perspectives on Asia and the Middle East* Nele Lenze and Charlotte Schriwer (eds.) (England: Ashgate Publishing: 2014) ; Peter Nolan, *Is China Buying the World?* (Cambridge: Polity Press 2013); Lin Li-Wen and Curtis J Milhaupt, "We Are The (National) Champions: Understanding The Mechanisms Of State Capitalism In China," *Stanford Law Review* 65 (2013).

[20] Fernand Braudel, "Vol. II: The Wheels of Commerce—Civilization and Capitalism: 15th-18th Centuries" (New York: University of California Press, 1992).

[21] Ibid.

[22] For example, Christina Ahmadjian and Patricia Robinson found that the larger the firms were, the less likely they were to respond to the Japanese recession in the 1990s by downsizing and deinstitutionalizing Japan's well-known permanent employment system. Christina L Ahmadjian and Patricia Robinson, "Safety in numbers: Downsizing and the deinstitutionalization of permanent employment in Japan," *Adminstrative Science Quarterly* 46(4) (2001).

acquiring information.[23] Similarly, a large-scale economy may also make a centralized regulatory regime that primarily functions to coordinate between market players less effective.[24]

In Chinese financial history, the immense size of market has also served as a negative factor for governance. Leading up to the 19th century, numerous dynasties faced extreme difficulties in issuing sufficient currency made of a consistent quality of copper, especially after the southern economy boomed. The limited reserve of copper led to a dilemma: An insufficient money supply would obstruct cross-border business transactions in a large economy; but to issue more currency containing less copper would incentivize the private sector to store old currency of better quality and also to make illegal currency because of lowered costs.[25] As a result, many emperors were compelled to tolerate privately-made currency in order to sustain the economy.[26] A similar challenge confronted both Chinese emperors and French kings: the difficulty in aggregating limited resources in a few financial centers, unlike Venice, Sienna, or Amsterdam at the time. Max Weber also pointed to this financial constraint as one major reason why capitalism did not emerge in pre-modern China.[27] How are we to reconcile conflicting views about the size factor in the Chinese context?

The size factor poses two major challenges to the state and other market players: coordination problems in an extremely large-scale country and the difficulty in finding a proper governance model that can accommodate significant variations in market conditions among regions. To begin with, coordination failure leads to fragmentation of power, giving rise to incoherent policymaking and inefficient law enforcement and policy implementation.[28] Coordination problems can nonetheless be largely dealt with by legal engineering, albeit not entirely, since the function of law is not only to protect rights but also to coordinate market players. As Milhaupt and Pistor argue, the function

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23 E.g., Weitseng Chen, "Arbitrage for Property Rights: How Foreign Investors Create Substitutes for Property Institutions in China?," *Washington International Law Journal* 24(1) (2015): 87-88; Eric A. Posner, *Law and Social Norms* (Cambridge, MA: Harvard University Press, 2002).

24 Curtis Milhaupt and Katharina Pistor, "The China Aviation Oil Episode: Law and Development in China and Singapore," in *Law and Economics with Chinese Characteristics: Institutions for Promoting Development in the Twenty-First Century,* David Kennedy and Joseph E. Stiglitz (eds.), (United Kingdom: Oxford University Press. 2013).

25 Chu Jia-Min 朱嘉明, "Cong Ziyou dao Longduan: Zhongguo Huobi Jingji Liangqiannian"从自由到垄断：中国货币经济两千年 [From Laissez-faire to Monopoly: The Monetary Economy of China—Past and Present], Vol. 1 (Taipei: Yuan-Liou Publishing Company, 2012): 130.

26 Ibid.

27 Ibid, at 70 and 80.

28 Daron Acemoglu and James A. Robinson, *Why Nations Fail: The Origins of Power, Prosperity and Poverty* (New York: Crown Publishing Group, 2012)

of law in transitional countries like China is more about coordination than rights protection.[29]

Secondly, significant variations in market conditions may fail a centralized and generalized rule-based governance regime. Michael Dowdle argues that North Atlantic capitalism developed the modern rule of law system as a response to the need to govern their economies based on mass manufacture of standardized products to be distributed in largely hegemonic markets.[30] However, China is different because its markets are not only extremely large but also significantly vary between regions.[31] Deviations from the conventional rule-based legal system are therefore unavoidable and necessary in order to govern China's economy.[32] All in all, whether China may benefit from its large-scale economy depends on the capacity of its legal institutions to solve the problems of coordination between the center and the regions, SOEs and private firms, foreign and local firms, the offshore and onshore markets, and the state and market mechanisms, and whether it is able to develop a suitable governance model to accommodate the extreme variations in market conditions.

Coordination problems and variations in market conditions happen to be the two major challenges confronting the Scheme. For example, one prerequisite of RMB internationalization is full currency convertibility, which incentivizes investors to store their assets in large denominations of RMB without liquidity concerns.[33] However, the introduction of RMB's full convertibility requires the lifting of capital control and would affect every aspect of China's monopolistic financial and business sectors, which currently vary across regions and render coordination extremely challenging. The lifting of capital control would also invite speculative investors and hot money would flow into shallow investment areas such as the real estate market, which are prone to asset bubbles. Regions whose growth relies on fixed-asset investment (e.g., construction of official buildings and residential complexes) would be particularly vulnerable.[34] Additionally,

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29 Curtis J. Milhaupt and Katharina Pistor, Law & Capitalism: What Corporate Crises Reveal About Legal Systems And Economic Development Around The World (Chicago: University of Chicago Press, 2008).

30 Michael Dowdle, "China's Present as the World's Future: China and 'Rule of Law' in a Post-Fordist World," in *Chinese Thought as Global Theory* Leigh K. Jenco (ed.) (SUNY Press, 2016).

31 Ibid.

32 Ibid. See also Bob Jessop and Sum Ngai-Ling, *Beyond the Regulation Approach: Putting Capitalist Economies in their Place* (Cheltenham: Edward Elgar Publishing, 2006).

33 Full convertibility here refers to full convertibility of capital account. China has achieved full convertibility on all current account transactions and the government approves all bona fide requests for foreign exchange for current payments and transfers. *People's Republic of China-Selected Issues: IMF Staff Country Report 97/72 (September)* (Washington: IMF, 1997); Javier Kurien and Bernard Geoxavier, "Roadmap for the RMB Internationalization: Navigating the Rise of China's Currency,"*Harvard Kennedy School Review*, May 2, 2013, http://harvardkennedyschoolreview.com/a-roadmap-for-rmb-internationalization-navigating-the-economic-and-political-challenges-to-the-rise-of-chinas-currency/.

34 Yasheng Huang points out that, beginning in the 1990s, regional governments reversed their early policies of encouraging the private sector and began favoring fixed-asset investments (FAIs). This

informal financial sectors could be further fed by cheap capital. Provinces with problems of underground banking, which is unregulated and non-transparent, could be hit badly should a liquidity crisis occur. Moreover, capital flight would be fueled by full convertibility, especially from regions with problems of rampant corruption and corporate irregularities. Overall, more developed cities such as Beijing, Shanghai, and Guangzhou may benefit from the open policies of the Scheme, but peripheral cities and provinces that have heavily relied on the support of state-owned banks will not, at least in the short term. More sophisticated SOEs and private firms that are competitive and export-oriented (and therefore bear more currency exchange risk) may benefit, but small and mid-sized companies that are less competitive and focus on domestic rather than export markets will not.

In short, the size factor is not as positive as would be expected; to the contrary, it usually creates great difficulties for rising powers. The next section examines the strategies that Beijing has adopted to cope with the problems of coordination in its large-scale economy and extreme variations in market conditions in order to proceed RMB internationalization.

III. CHALLENGES FOR RMB INTERNATIONALIZATION

A. Challenges From Within Rather Than From Abroad

In terms of implementation, internationalization of RMB is more of a domestic than an international project. To pave the way for the Scheme, a great deal of reforms are required at home. However, the problems of coordination and extreme variations in market conditions pose tremendous challenges for such reforms.

In contrast, the Scheme has gone relatively smoothly at the international level, if not too fast. This is primarily because of the view shared by central bankers around the world that alternative reserve currency serves their best interest. Eswar Prasad uses the phrase "Dollar Trap" to describe the frustration of many central banks with the dominance of the US dollar.[35] As the US dollar remained the safest means of hedging risk and storing values even in the middle of the 2008 financial crisis, compared to other options, foreign investors were compelled to subject the value of their assets to the United States' expansionary monetary policy and dollar fluctuation at the time. As a result, many countries such as India, France, and Russia started to turn their heads towards the RMB

policy reversal severely damaged China's private sector and entrepreneurship as a whole. Also, FAIs in land, assets, and buildings controlled by governments (excluding investments in SOEs) more than tripled from 2.3% of the total FAIs in 1990s to 7.2% in 2002. Yasheng Huang, "Debating China's Economic Growth: The Beijing Consensus or The Washington Consensus," *The Academy of Management Perspectives* 24 (2010), 41.

[35] Eswar S. Prasad, *The Dollar Trap: How The US Dollar Tightened Its Grip on Global Finance* (United States: Princeton University Press, 2014).

as a possible alternative to the greenback.[36] Many global central banks and regulators also offer a welcoming climate for the Scheme. From having an insignificant share of the global market in 2011, the RMB has since overtaken at least 22 currencies to claim the spot behind the US dollar, the Euro, the British pound, and the Japanese yen as the fifth-most widely used payment currency internationally as of 2014.[37] International progress seems to have been achieved much faster than expected.[38] The question is, however, whether the institutions at home will be able to catch up in order to support the fast progression.

B. Large Scale Dilemma

On the one hand, China's extremely large market provides the Scheme with a huge advantage; on the other, it faces the problems of coordination and market variations. The experiences of the US and the EU are two similar cases in point. In the 18th century, the British tried to stop colonial New England from printing its own paper bills, lest British banks lose their markets to trade, settle, and lend British pounds in New England.[39] The response from the US founders was the consensus that the thirteen states be united to create a large enough market to confront the political and economic challenges from Britain. A more recent case is the creation of the Euro zone. The EU began as a political project to integrate small European states and then proceeded as more of a monetary project to create a market large enough to support its new single currency. The outcome is the massive EU economy, which accounts for about 31% of world output.[40]

In both cases, the size of the market was crucial for the adoption of the new currency, because the costs of switching to a new currency would be less if market scale could amplify the benefits of switching, such as diversifying the government's finance options and facilitating cross-state transactions. However, the costs of creating a large market are not minor. Aside from the military and economic confrontation in the US in the 18th century, tremendous integration costs were incurred in the EU, legally and economically. For instance, the German constitutional court needs from time to time to scrutinize issues

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[36] Todd Buell, "China currency set for international role, says ECB Board Member," *The Wall Street Journal*, February 26, 2014, http://online.wsj.com/news/articles/SB10001424052702303801304579406612508072596.

[37] Anjani Trivedi, "Use of Yuan as Global Payment Currency Fails," *The Wall Street Journal*, March 26, 2014, http://online.wsj.com/news/articles/SB10001424052702304688104579462870399966210.

[38] From the speeches given by top policy makers, one can easily tell that Beijing has been satisfied, and somehow surprised, with the outcome.

[39] Claire Priest, "Currency policies and legal development in colonial New England," *Yale Law Journal* 110 (2001).

[40] Lim Ewe-Ghee, "The Euro's Challenge to the Dollar: Different Views from Economists and Evidence from COFER (Currency Composition of Foreign Exchange Reserves) and Other Data," *International Monetary Fund Working Paper Series* WP/06/153 (2006):10, https://www.imf.org/external/pubs/ft/wp/2006/wp06153.pdf.

such as the constitutionality of delegating monetary power to the European Commission.[41] The most recent case is Greece's debt crisis in the summer of 2015.

In the case of China, it fortunately has the natural benefit of a sizeable market, facing neither blunt military and economic threats such as those that colonial New England received, nor the financial and legal integration costs that the EU has been painfully coping with. Its immense market creates a large demand for RMB, not only from the booming domestic economy but also from foreign investors that aim to benefit from China's consumer market. However, as discussed, the obstacles to the internationalization of the RMB come primarily from large and heterogeneous domestic markets, not from abroad.

As a matter of fact, these domestic challenges concern not only the policy prescriptions of the Washington Consensus but also one of the biggest criticisms of the Washington Consensus: the lack of a sequence for implementing its varying policy recommendations. The Scheme is associated with a wide range of regulations regarding banking, securities, capital markets, and currency exchanges, and no other areas of policy debates are more sequence-oriented than the reforms therein.. Empirical evidence shows that, if the sequencing goes wrong, hyper-inflation (e.g., Latin America), staggering recession (e.g., Japan) or even economic crisis (e.g., Iceland or Greece) may follow.[42] However, the more variations in market conditions there are, the more complex the sequence of policy implementation tends to be.

The other core policy of the Scheme—lifting of capital control—has faced great challenges of a similar nature concerning sequencing. Global financial crises have caused the conventional wisdom about the liberal policy of capital control to be questioned. The IMF and the World Bank, together with numerous economists, used to advocate fiercely for the lifting of capital control as a key approach to ensuring that developing countries benefit from foreign investment. However, the 2008 financial crisis, together with subsequent crises in Europe, demonstrate that free capital flow allows speculative investors to create various asset bubbles in emerging economies and then quickly pull their money before bubble bursts. In light of this hard lesson, the IMF has finally recognized that the variations in domestic market conditions matter and therefore modified its position: a certain level of capital control may be desirable for developing countries as a complementary regulatory tool.[43] In China, in contrast, the Scheme seems to be moving in the opposite direction of this paradigm shift.

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[41] Carsten Gerner-Beuerle, Esin Küçük and Edmund Schuster, "Law Meets Economics in the German Federal Constitutional Court: Outright Monetary Transactions on Trial," *German Law Journal* 15(2) (2014): 281; Christian Hofmann, "A Legal Analysis of the Euro Zone Crisis," *Fordham Journal of Corporate & Financial Law* 18(3) (2013): 519.

[42] Volz, "RMB Internationalization and Currency Co-operation".

[43] Naoyuki Yoshino, Sahoko Kaji and Tamon Asonuma , "Dynamic Transition of Exchange Rate Regime in China," *China and World Economy* 22(3) (2014); Jonathan D. Ostry et al., "Managing Capital Inflows: What Tools to Use?," *Staff Discussion Note Series* SDN/11/06 (2011),

C. Heterogeneous and Fragmented Markets

Aside from regional and sectorial variations, problems of extreme market variations can also be observed in specific markets and their respective regulatory structures pertinent to the Scheme: capital markets, foreign exchange markets, and banking sectors. Whether the Scheme is viable depends on how China deals with such complex and diverse market conditions in these markets.

To begin with, China's capital markets, which are tied to the success of the Scheme, are very segmented due to capital control: There is the market of A shares, denominated in RMB, available only to Chinese citizens; the market of B shares, denominated in foreign currency, originally reserved for foreign investors, although Chinese citizens may now hold these shares as well; and the market of H shares, which are shares listed by Chinese firms on the Hong Kong stock exchange.[44] As a result of establishing this structure, Chinese policymakers can collect household savings through capital markets but also tap into foreign investment without exposing the domestic economy to destabilizing capital flows.[45]

This segmentation stemmed from the inconvertibility of the RMB and was based on the logic of erecting firewalls between foreign and domestic markets, reflecting the policymakers' response to extreme variations in market conditions. While the firewalls prevent a potential chain reaction in the face of systemic risks caused by existing institutional deficiency and exposure to speculative investment, large-scale markets nevertheless allow each market unit sufficient economies of scale that can make a significant change. However, the problems with China's fragmented capital markets have been well-documented, and include immense arbitrage, insider trading, and weak and inefficient law enforcement.[46] In the absence of well-functioning institutions, lifting capital control under the Scheme may lead to market inability. In fact, it has been reported that deregulating capital control as a result of the Shanghai-Hong Kong Stock

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https://www.imf.org/external/pubs/ft/sdn/2011/sdn1106.pdf; Volz, "RMB Internationalization and Currency Co-operation": 369.
For example, in his talk given at NUS on November 2014, Martin Wolf also suggested Indonesia consider capital control to deal with immense hot money as a result of expansionary monetary policies in the US, Japan and China.

44 Additionally, "Red-chip", "P-chip" or "S-chip" refer to overseas Chinese firms that are listed and traded on foreign exchanges (e.g. S-chips are Chinese firms listed on Singapore Stock Exchange).

45 Barry Naughton, *The Chinese Economy: Transitions and Growth* (Cambridge: MIT Press, 2007), 470-71.

46 See, e.g., Donald C. Clarke, "Law Without Order in Chinese Corporate Governance Institutions," *Northwestern Journal of International Law and Business* 30(1) (2010); Tan Lay-Hong and Wang Jiangyu, "Modeling an Effective Corporate Governance System for China's Listed State-Owned Enterprises: Issues and Challenges in a Transitional Economy," *Journal of Corporate Law Studies* 7(1) (2007): 143 ; Satyananda J. Gabriel, *Chinese Capitalism and The Modernist Vision* (Oxon: Routledge, 2006); Yong Kang, Lu Shi and Elizabeth D. Brown, "The Rand Corporation, Chinese Corporate Governance: History and Institutional Framework", *Rand Corporation Technical Report Series* TR-618-RC (2008), http://www.rand.org/pubs/technical_reports/TR618.html.

Connect served as the major factor leading to the dramatic collapse of China's stock markets in the summer of 2015.[47]

Secondly, the foreign exchange rate markets pose a challenge of coordination to Chinese policymakers.[48] RMB internationalization requires liberalization of the foreign exchange rate because full currency convertibility cannot co-exist with foreign exchange rate control. Although this control is a rather centralized policy set by the central bank, liberalizing and replacing it with a market-oriented regime would involve every level of the regulatory system and requires complex legal and financial engineering. Tasks include, for example, how to create foreign exchange markets with a functional pricing mechanism to determine the exchange rate, how to select banks that have capacity to operate the markets, or how to create and coordinate varying monitoring mechanisms and regulatory bodies to supervise the markets.

The challenge for the Scheme, then, is whether the PBoC can coordinate its financial institutions and local governments in order to create a market environment that allows banks to price their foreign exchange transactions. Currently, the largest state-owned banks monopolize about 95% of foreign exchange transactions, with the exchange rate largely decided by the PBoC.[49] As such, before they are given clearance to participate in this market, all banks need to acquire the capacity to run this new business. In other successful cases, this liberalization has appeared to be a long journey. For example, Taiwan adopted a capital control and foreign exchange policy very similar to China's throughout its economic take-off period. Taiwan's Central Bank began experimenting with the free foreign exchange market in 1979.[50] It took this much smaller economy ten

[47] Du Yi-Huan, "It is the Public Security That Saved China's Stock Markets," *Common Wealth Magazine*, July 9, 2015, http://www.cw.com.tw/article/article.action?id=5069089#.

[48] The conflict between RMB internationalization and foreign exchange rate control can be best explained by the "impossible trinity", a trilemma that every central bank faces. The trilemma means that any state can only choose two of the three policy options: fixed exchange rate, free capital flow, and independent monetary policy. If the state intends to manipulate and maintain a fixed exchange rate, it has to compromise either free capital flow or independent monetary policy; neither is desirable under the RMB internationalization scheme. It is like setting up an auction house while also wanting to decide the sale price.

[49] Chu, "Cong Ziyou Dao Longduan: Zhongguo Huobi Jingji Liangqiannian": 386.

[50] In the beginning of the process, five selected banks were allowed to create a foreign exchange market among banks and established a joint committee to decide their own exchange rate. Four years later the Central Bank of Taiwan expanded this institutional experiment by setting the once-centralized exchange rate based on the rates determined by the five selected banks. Finally, in 1989, the Central Bank abolished foreign exchange rate control entirely in the belief that the banks had obtained the skills necessary to decide foreign exchange rates for themselves. Hsu Cheng-Ming 许振明, "You jinrong zhiyouhua yu guojihua de guocheng tan jinrong jianli" 由金融自由化与国际化的过程谈金融监理 [Financial Liberalization, Internationalization and Supervision], *National Policy Foundation Policy Reports* 090-039 (2001), http://old.npf.org.tw/PUBLICATION/FM/090/FM-R-090-039.htm.

years to coordinate and train banks to operate this new foreign exchange market.[51] This could serve as an indicator of the coordination challenges that the PBoC faces.

Thirdly, the other fragmented sector is the banking system. Top Chinese banks have gone through significant reforms in the past decade through internationalization. However, regional banks are slow to adapt to changes. Nicholas Lardy points out that the banking sector is one exception to an overwhelming trend of privatization across industries in China between 2008 and 2013, and that this sector remains inefficient.[52]

Banking is all about risks: how to assess and distribute the risks. Before RMB internationalization lifts capital account control, banks need to obtain expertise in order to evaluate their risk portfolio, as well as the capacity to operate in a relatively free market environment without the government's subsidies. Without such capacity, banks may not be able to carry out a vital task that the Scheme requires: to determine interest rates. As a result, the lifting of capital control is probably the perfect recipe for failure in the banking sector. In the face of negative savings rates, for example, Chinese households would withdraw their savings from state banks and hold their assets in foreign currency or deposit them elsewhere (e.g., informal financial institutions, private banks, or foreign bank branches in China that offer higher savings rates) if they are given the option. This would lead to a liquidity crisis. Nevertheless, banks' capacity varies across the country and even within the same bank. A bank's branch offices in tier-one cities may be very different from those in tier-three cities in terms of capacity to evaluate borrowers' creditworthiness, assess the risks of their own financial products, and develop diverse and competitive revenue sources.

To sum up, the immense and fragmented capital markets, foreign exchange market and banking system pose great challenges to RMB internationalization. In particular, lifting of capital control has historically and empirically proven to be a risky and difficult process. The orthodox solution, as a rich body of literature suggests, centers on identifying the sequence for implementation; for example, liberalization of lending rates should happen earlier than that of savings rates, deregulation for institutional investors prior to individuals, or outbound FDI prior to inbound FDI.[53] In this regard, a number of

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[51] One reason for the long duration of currency reform in Taiwan is that its economy depended more on domestic capital than FDI, compared to that of China. In China, FDI as well as securities investors from overseas have injected immense capital into the banking sector, thereby granting more leverage for the regulators to carry out reforms. One case in point is the successful reform of non-performing loans (NPLs) in the 2000s. Nevertheless, China's approach has also been criticized in that the NPLs remain a part of the state-banking system and make the state bear the final liability for them.

[52] Nicholas Lardy, *Markets over Mao: The Rise of Private Business in China* (Washington D.C.: Peterson Institute for International Economics, 2014).

[53] Ronald I. McKinnon, *The Order of Economic Liberalization* (United States: The John Hopkins University Press, 1991). Justin Yifu Lin, the Peking University economics professor and former Vice President of the World Bank, also expressed a similar view: "Although the yuan will be playing an increasingly important role…its ascendance to fully fledged reserve currency status must await

East Asian countries such as Japan, Korea and Taiwan have arguably demonstrated the "right" sequence of financial and banking reforms.[54]

However, the sequence approach assumes that each policy being implemented paves the way for subsequent ones, which can "wait" and are largely segregated from the impact of previous reforms. This linear assumption is more likely to stand in a small economy, or a large but hegemonic economy. In contrast, in large or heterogeneous markets, various sectors and policies are usually far more interdependent. The larger or more fragmented the market is, the less likely it is that such linear assumptions can stand. Coordination may also become more costly and ineffective, making the implementation of such sequential reforms difficult and distorted. The "right" sequence would therefore be difficult to identify or may not even exist.

IV. China's Response by Leveraging the Scale

To implement the Scheme, as discussed, China needs to cope with three challenges: (1) extreme variations in market conditions; (2) coordination difficulties; and (3) systemic risks magnified by a large-scale economy. In response, China seems to have adopted a number of shrewd strategies commonly seen in *Taiji,* the Chinese martial art: coping with problems of scale by leveraging the scale.

A. Institutional Diversification

China's first response to heterogeneous market conditions was to diversify institutional settings rather than adopt a general rule-based regulatory regime. To begin with, institutional experimentation is being conducted in various regions as a response to regional variations. The most high-profile experiment is the SFTZ, which covers a combined area of nearly thirty square kilometers in Shanghai. It aims to "explore new routes and systems for China's opening-up policies, to accelerate the transformation of how government functions… [and] to pioneer innovative ideas that can be replicated in the future in other parts of the country."[55] In August 2013, the National People's Congress passed an unprecedented resolution, suspending major corporate law regulations on matters relating to foreign firms' investment within the SFTZ for three years: "After three years, new institutions that have proven workable may continue; otherwise the original regulations should be restored and resume."[56] Additionally, the State Council also suspended twenty-seven regulations with respect to specific industries (e.g., shipping and car manufacturing), corporate entities (e.g., joint venture and wholly-foreign-owned enterprises), and administrative procedures (e.g., approval of

substantial reform of its financial markets." Justin Yifu Lin, Against the Consensus: Reflections on the Great Recession (New York: Cambridge University Press, 2013): 170.

54 Hsu, "You jinrong zhiyouhua yu guojihua de guocheng tan jinrong jianli."

55 "Introduction: China (Shanghai) Free Trade Zone", Official website of the SFTZ, http://en.china-shftz.gov.cn/About-FTZ/Introduction/.

56 "Decision of the Standing Committee of the National People's Congress on Authorizing the State Council to Temporarily Adjust the Relevant Administrative Approval Items Prescribed in Laws in the China (Shanghai) Pilot Free Trade Zone." Ibid.

manufacturing license or market entry).[57] Other measures necessary for the Scheme have also been adopted within the SFTZ, including lifting of capital account restrictions, legalization of private banks, and liberalization of banking savings and lending interests through which banks will be able to freely assess their risk exposure and reflect such risks to the interest rates free from government intervention.

Moreover, other pilot zones with different institutional settings catering to different regions have been created. Qianhai Pilot Zone is most representative. Established in 2011 and located next to Hong Kong, Qianhai Pilot Zone aims to develop an onshore RMB financial center by replicating Hong Kong's institutional environment. It replicates HK's low tax regime, invites professionals and consultants from Hong Kong to join the management teams, models its dispute resolution institution (i.e., arbitration) on Hong Kong's and hires legal professionals from Hong Kong.[58] While the SFTZ is conducting comprehensive experimentation, Quinhai is focusing more on financial services.[59]

Institutional diversification exists not only geographically but also caters to specific business groups or sectors. To deal with the fragmented capital markets, the Scheme's solution is to drill several holes in the firewalls of capital control. These mechanisms (i.e., the holes) include, for example, the Qualified Foreign Institutional Investors (QFII) and the Renmibi Qualified Foreign Institutional Investors (RQFII), which was introduced more recently.[60] As a way to selectively lift capital account control, QFII and RQFII grant direct access to China's fragmented capital markets to foreign institutional investors that meet certain qualifications, such as Morgan Stanley and Columbia University. Due to the desire of offshore investors to benefit from China's markets, the capital flowing in through these tiny holes is nevertheless immense -- so China is now benefitting from the scale advantage.

In short, institutional diversification makes the best use of scale advantages. While each unit of diversification may address varying institutional demand by region and by

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57 "The Decision of the State Council on Adjusting Temporarily Administrative Approval Items and Special Administrative Measures for Access Prescribed by Related Administrative Regulations" (4 Sep. 2014).

58 "Qianhai shengang xiandai fuwuye hehuoqu" 前海深港现代服务业合伙区 [Qianhai Shenzhen-Hong Kong Modern Service Industry Cooperation Zone], Government of Shenzhen, , http://www.szqh.gov.cn:81/ljqh/qhjj515/qhdsj/.

59 The development of the Qianhai Pilot Zone has triggered debates in Hong Kong. Some commentators, including HK legislators, hold the view that Qianhai is being developed by the central government in order replace Hong Kong, of which Beijing does not have a full control. Hong Kong Economic Journal 信报, "Ling Jian Jinrong Chengshi Qianhai Qudai Xianggang "另建金融城市前海取代香港 [Qianhai: Creating a new financial center to replace Hong Kong?], Hong Kong Economic Journal 信报, http://forum.hkej.com/node/60537.

60 QFII and RQFII are mechanisms adopted by the Scheme to recycle offshore RMB back to domestic markets, so that offshore RMB can substantively contribute to Chinese economy. Such recycling is prominent and crucial for offshore USD and the US economy. The success of the USD relies on effective recycling mechanisms. For example, oil dollars in the Middle East can be recycled back to the US market through the sovereign wealth funds in the Middle Eastern countries.

sector, each is nonetheless large enough to maintain sufficient economies of scale.[61] The aggregation of such economies of scale in turn provides greater leeway for policy choices and institutional design.

B. Pluralist Capitalism

Institutional diversification further denotes the idea of pluralist capitalism in China. Take the SFTZ and the Quinhai Pilot Zone as examples: Both are created by the state in order to advance the internationalization of RMB and provide guidance for future reforms. Literature often refers to this interventionist approach as state capitalism. Nevertheless, multiple state capitalisms seem to co-exist here as the two pilot zones represent different models of capitalism.

For one, the Quinhai Pilot Zone is modeled on Hong Kong, a classical model of laissez-faire capitalism. The British colonial government implemented the "positive non-intervention policy," under which business decisions are left to the private sector with minimal governmental intervention in the form of tax incentive packages. Competition law, for example, has developed slowly, and market monopolies are largely tolerated.[62] Milton Friedman described his meeting in 1963 with the architect of the non-intervention policy, then financial secretary John Cowperthwaite. In response to Friedman's query about the paucity of statistics, Cowperthwaite described his firm belief in laissez-faire capitalism: "If I let them compute those statistics, they'll want to use them for planning."[63]

In comparison, the SFTZ appears to model Singapore, the opposite model to that of Hong Kong. Singapore's interventionist approach is summarized by Goh Keng Swee, the former deputy prime minister and Singapore's economic architect: "[the laissez-faire policies of the colonial era] had led Singapore to a dead end, with little economic growth, massive unemployment, wretched housing, and inadequate education…thus [we] had to try a more activist and interventionist approach."[64] For example, the Economic Development Board, set up in 1961, geared Singapore's industrial strategies, labor policy, and education system towards meeting Singapore's economic goals by way of tax incentives, investment in strategic industries, and global network building. In its heyday, there were more than 600 state-owned enterprises and government-linked companies,

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[61] Michael Dowdle. "On the Public-law Character of Competition Law: A Lesson of Asian Capitalism," *Fordham International Law Journal* 38 (2015): 10.

[62] The Hong Kong government passed its first ever antitrust law in 2012. Nevertheless, it is still not uncommon for monopolies to perform evil tactics like attempting to eliminate competitors by predatory pricing.

[63] Milton Friedman, "The Hong Kong Experiment," *Hoover Digest*, July 30, 1998 http://www.hoover.org/research/hong-kong-experiment.

[64] Devan Nair, *Socialism that Works: The Singapore Way* (Singapore: Federation Publications: 1976), 84.

many of which were run on commercial principles and were profitable and internationally competitive from the outset.[65]

Interestingly, Chinese policymakers for the SFTZ and commentators are not shy about expressing their ambition to replace Singapore eventually. China has been sending their officials and senior bank managers to Singapore for professional training at universities, government-linked companies and sovereign wealth funds. In fact, companies from Singapore are the SFTZ's primary targets to attract: as of September 2014, nearly six hundred companies from Singapore have established subsidiaries and branch offices in the SFTZ.[66] Singapore's model of state capitalism is behind the SFTZ's institutional design for the implementation of the Scheme.

Again, experimentation with multiple capitalisms evidences the way in which China leverages its scale advantage. Both the "Hong Kong model" in Quinhai Pilot Zone and the "Singapore Model" in the SFTZ aim to improve China's institutional capacity to run a genuine market economy for the sake of the implementation of the Scheme. Reforms necessary for the Scheme are being carried out within the zones, but the state remains present to ensure that the model of pluralist capitalism serves the Scheme well.

C. Bridging and Institutionalization

To cope with the problems of coordination in large-scale and fragmented markets, Chinese regulators try to bridge multiple markets, foreign markets included, and institutionalize certain market experimentations at the regional level.[67]

Bridging occurs in different forms. For example, to bridge onshore and offshore RMB markets, Beijing has been signing currency swap agreements with foreign jurisdictions. Under these swap agreements, foreign regulators may exercise their swap rights in the face of increasing demand for RMB and then inject more RMB into foreign markets. The total amounts of such swap rights to be granted by the PBoC constitute bargaining power between China and its foreign partners.

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[65] Neo Boon Siong and Geraldine Chen, *Dynamic governance: Embedding culture, capabilities and change in Singapore* (Singapore: World Scientific Publishing: 2007), 92.

[66] "Xinjiapo jin 600 qiye ruzhu Shanghai zimaoqu: Xinjiapo meiti ping zimaoqu yunxing yinian chengxiao" 新加坡近 600 企业入驻上海自贸区 [Nearly Six Hundred Singapore Firms Joined Shanghai Free Trade Zone], Economic and Commercial Counsellor's Office of the Embassy of the People's Republic of China in the Republic of Singapore 中华人民共和国和国驻新加坡共和国大使馆经济商务参赞处, ,
http://sg.mofcom.gov.cn/article/fuhua/tzdongtai/201410/20141000768457.shtml.

[67] A number of strands of literature use different labels to coin this working relationship between regulators at the central and regional levels. E.g., Wei Cui, in his chapter of this book, discusses "Federalism, Chinese style" proposed by Gabriella Montinola, Yingyi Qian, and Barry Weingast. Here the author simply uses "regionalization" to describe a working relationship between regulators of different levels and jurisdictions. See Gabriella Montinola, Qian Yingyi and Barry R. Weingast, "Federalism, Chinese Style: The Political Basis for Economic Success," *World Politics* 48 (1996).

Another recent bridging initiative is the Shanghai-Hong Kong Stock Connect. The rationale is that the larger the capital markets are, the more liquidity the markets possess, and therefore they are more efficient and better economies of scale can be created. In theory, China has a number of models to choose from for bridging domestic and foreign stock exchanges, including secondary listing, cross-listing and a national security market model used by American regulators for the market linkage between Europe and the US. Given China's size and lower integration costs, Beijing regulators chose the most aggressive model: a direct linkage between China and offshore markets.[68] The next steps are probably to link to Singapore, and thereby to the ASEAN markets in the south, as well as to the Taiwan Stock Exchange in the east.[69]

In comparison to bridging, institutionalization occurs at the domestic and regional levels. As discussed, China needs to liberalize its interest rates to reduce opportunities for arbitrage and speculative investments after lifting capital account restrictions. It could be risky if such liberalization goes too fast, because banks will not yet have the capacity to decide on optimal market savings rates by evaluating their risk portfolios fairly. As such, the central government has chosen to assist localities in institutionalizing existing practices.

For example, Wenzhou, a city once famous for informal banking, is where the experimentation of free interest rates is being conducted at the moment. Beginning in 2012, private lenders and financial institutions in Wenzhou were allowed to determine their own savings rates, while the government is only playing a coordinating role.[70] Numerous working units, established in Wenzhou and in other partner cities where Wenzhou's financial institutions have a strong presence, collect a variety of information concerning savings rates (e.g., rates, mortgages, collateral, pledges, and other security packages). A centralized system set up by the Wenzhou regulators computes and publicizes these statistics every day. The government is not currently deciding the rates but allows them to be predicable and stable by releasing market information.[71] Market players appear to adapt themselves quickly to this nascent market mechanism. Private lenders depend on this disclosure system to determine interest rates when lending to their

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[68] David Donald, "Beyond Fragmentation: Building a Unified Securities Market in China (And Asia)," (2016), Jiaxiang Hu, Matthias Vanhullebusch, and Andrew Harding (eds.) *Finance, Rule of Law and Development in Asia: Perspectives From Hong Kong, Singapore and Shanghai* (Brill, 2016).

[69] Ibid. Also, Singapore and China began integrating their securities markets in 2013. See "SGX and China Securities Regulatory Commission Establish Direct Listing Framework," WongPartnership, , http://www.wongpartnership.com/index.php/files/download/1134.

[70] Shangguang Sha Sha and Han Chi 上官莎莎 and 韩驰, "Zhou xiang quanguo de 'Wenzhou zhishu' wei lixi shichanghua toushiwenlu" 走向全国的"温州指数"为利率市场化投石问路 [Wenzhou Index and National-wide Marketization of Interest Rates]," *Wenzhouwang* 温州网, http://news.66wz.com/system/2014/11/03/104261941.shtml

[71] In a way, this approach is very similar to the role the US Federal Reserve plays. The Fed does not explain its policies but lets these policies be predicable by releasing signals and communicating with the private sector regularly. See, Janet Yellen, "Speech: Vice Chair Janet Yellen at the Society of American Business Editors and Writers," Board of Governors of the Federal Reserve System, April 4th, 2013, http://www.federalreserve.gov/newsevents/speech/yellen20130404a.htm.

family members, relatives and business partners. Given the experiment's initial success, the Wenzhou government has vowed to establish roughly one hundred private micro-lending firms with estimated capital of RMB 80 billion.[72]

D. Risk-sharing and Cost-bearing

The sheer size of the Chinese economy magnifies any systemic risk. The success of reforms therefore also rests on sufficient risk-sharing institutions, which may encourage risk-taking, innovation, and institutional experimentation. In their paper analyzing why China once led but fell far behind England economically after the 16th and 17th century, Avner Greif et al. argue that the configurations of various risk-sharing institutions (e.g., patent and social welfare systems) account for the distinctive growth trajectories and outcomes in the two ancient empires.[73] In the context of RMB internationalization, two general approaches are adopted to deal with large systemic risks: (1) to contain the risks in a smaller sub-system; or (2) to distribute the risks to an even larger pool.

First, the pilot zones are sub-systems that can contain the risks within the zones. Private banks, for example, are only allowed within the zones. Their more competitive lending and savings rates will therefore not draw clients and drain cheap capital away from state-owned banks outside of the zones. Enforcement of anti-money-laundering regulations has been strengthened accordingly to prevent speculators from abusing the free capital account within the SFTZ.[74] In fact, some commentators advocate a higher financial firewall between SFTZ and the rest of China so that speculators will not use the lifting of capital control within the zone to their advantage. Such a firewall approach creates an inherent dilemma: it will not be effective in isolating risks if the firewall is too soft, but if the firewall is too high and stands for too long, the scale of the SFTZ will not itself be large enough a pool to support the internationalization of the RMB.[75] This dilemma explains why foreign investors and banks, instead of calling for stronger firewalls, have started complaining about the slow progress of deregulation.[76]

The second approach is to distribute risks to a larger pool.[77] Global capital markets serve as a key mechanism of international risk-sharing, as they distribute the risks of a

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[72] Chen De Rong, "Wenzhou Jinrong Gaige Zaichufa" [The Restart of Wenzhou's Financial Reform], *China Reform*, no. 340, March 2012.

[73] Avner Greif, Murat Iyigun and Diego L. Sasson, "Social Institutions and Economic Growth: Why England and Not China Became the First Modern Economy," Working Paper, http://dx.doi.org/10.2139/ssrn.1783879 .

[74] In the SFTZ, residents, individuals and corporate entities alike can apply for resident accounts that allow them to freely wire capital in and out without approval in advance.

[75] McKinnon and Schnabl, "China's Exchange Rate and Financial Repression."

[76] Michelle Chen, "Reform paralysis, slow progress cloud Shanghai free trade zone project," *Reuters*, September 15, 2014, http://www.reuters.com/article/2014/09/14/china-shanghai-ftz-idUSL3N0RB1JR20140914.

[77] In fact, one major function of making a currency an international reserve currency is to enable the country of the currency (e.g., the US or China) to distribute domestic economic risk internationally, if necessary. While expansionary monetary policy may be used to bail out domestic firms and

specific foreign issuer to international investors.[78] As discussed, the Scheme is more about domestic reforms. Whereas deregulation of the domestic banking and foreign exchange markets requires a gradual approach to improving the capacity of banks and related market players, capital markets appear to be easier to strengthen in a quick fashion. Chinese firms have also been aggressively accessing international capital markets to compensate for their domestic governance deficiencies and to facilitate their capacity building.[79] Overall, China's attempt to overhaul and bridge multiple capital markets under the Scheme is in line with the theory of capacity building for risk-sharing.

E. Summary

All in all, China needs to strike a balance between efficiency and diversity when implementing the Scheme. Governance structure with too much diversity would be inefficient and thus make the economy inefficient, albeit highly resilient. Conversely, governance that puts too much emphasis on efficiency may indeed be highly efficient but will reduce diversity.[80] The literature on East Asian capitalism has unveiled a shared model of economic success in Asia in light of this dilemma. Compared to North Atlantic capitalism, Asian capitalism (primarily referring to the "Asian Tigers") focuses on productive adaptability to sudden market changes rather than on exploiting economies of scale based on mass production, standardized processes, and general rule-based governance structure.[81] In comparison, however, China's large-scale economy enables China to engage in both approaches, multiple state capitalisms included, to implement the Scheme.[82]

V. A CHINESE MODEL?

The large size factor indeed accounts for China's institutional design for the Scheme. China's extremely large-scale economy affects integration costs, diversification of institutions, the ability to bear inefficiency, the capacity for risk-sharing, the freedom to conduct institutional experimentation, and the ways in which its legal system codifies and formalizes norms and market practices. For example, in terms of institutional

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boost domestic economy, it leads to depreciation of the currency and hence decreases the value of assets denominated in that currency and held by global investors.

[78] Shigeru Iwata and Shu Wu, "Stock Market Liberalization and International Risk Sharing," *Journal of International Financial Markets, Institutions and Money* 19(3) (2004); Vadym Volosovych, "Risk Sharing from International Factor Income: Explaining Cross-country Differences," Applied Economics 45(11) (2013): 1435.

[79] Chen, "Institutional Arbitrage: China's Economic Power Projection and International Capital Markets."

[80] Michael Mainelli and Bob Giffords, "Size Matters: Risk and Scale," *The Journal of Risk Finance* 11(3)(2010).

[81] Bob Jessop and Sum Ngai-Ling, *Beyond the Regulation Approach: Putting Capitalist Economies in their Place* (Cheltenham: Edward Elgar Publishing, 2006); Dowdle. "On the Public-law Character of Competition Law".

[82] Kanishka Jasuriya, "Institutional Hybrids and the Rule of Law as a Regulatory Project," in *Legal Pluralism and Development: Scholars and Practitioners in Dialogue* Brian Z. Tamanaha, Caroline Sage and Michael Woolcock (eds.) (Cambridge: Cambridge University Press: 2012).

diversification, while each unit may produce sustainable and minimally efficient economies of scale, the state shrewdly coordinates various market players to aggregate and leverage such economies of scale to further advance the Scheme. Some strategies such as linkage of foreign exchange rates and bridging capital markets are only possible in this kind of large-scale economy. In this way, China is able to borrow more time for difficult reforms, especially those involving lifting capital control and introducing full currency convertibility.

However, the size factor is a common constraint that other economies have to deal with in the context of currency policy, too. Singapore, for example, initially chose a non-internationalization policy to prevent its small economy from speculative attacks. Even at a later point when Singapore decided to cease this policy and lift capital control, the size factor led to the choice of its exchange rate-centric model to manage the full currency convertibility on the capital account, leaving interest rates to be determined freely by market forces.[83] The rationale for this lies in the small size of its economy. Having to coordinate with only a few major players in its banking sector, the authorities felt comfortable letting interest rates be decided by the market,[84] giving up the monetary tool of interest rate adjustment commonly seen in capitalist economies.[85]

In contrast to Singapore's exchange rate-centric model, Taiwan adopted a very different model to manage its capital account also because of the larger size of its economy: an interest rate-centric model.[86] Categorized as a typical Asian state capitalism along with Singapore, Taiwan nevertheless has to deal with more complex issues due to more market players, various levels of localities, and diverse institutional settings. Prior to its overhaul of the financial sectors in the 1990s, Taiwan faced very similar challenges to those faced by China at this time, including financial repression imposed in order to aggregate private capital for quick state-led industrialization, the inefficiency of the state-owned banks that dominated the financial sector, immense bad loans caused by the moral hazard inherent in the state banking sector, and underground banking where small and middle-sized firms obtained capital. Taiwan is geographically small but economically large enough to demonstrate institutional issues similar to those that China has to cope with. Its authoritarian political system also faced sufficient dissenting voices to make the state continually pursue reforms, albeit incrementally, in order to minimize potential backlash.

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83 Ong Chong Tee, "Singapore's Policy of Non-Internationalization of the Singapore Dollar and the Asian Dollar Market," *BIS Working Paper Series* No. 15 (2003).

84 DBS, one of the largest banks in Singapore, is a spin-off of the Monetary Authority of Singapore (MAS), the central bank of Singapore.

85 Ong Chong Tee, "An exchange rate-centered monetary policy system: Singapore's experience," *BIS Working Paper Series* No. 73 (2013): 308; Chow Hwee Kean, "Managing Capital Flows: The Case of Singapore," *ADB Institute Discussion Paper Series* No. 86 (2008):15.

86 Compared to Singapore's exchange rate-centric model, Taiwan's interest rate-centric model is less clearly formed, as Taiwan's Central Bank still monitors and adjusts the exchange rate from time to time through open market operations.

In fact, many of the policies adopted by the SFTZ are identical to those Taiwan implemented to refine its banking sectors in the 1980s and 1990s, including the negative list, QFII, and an open policy with respect to private banks. Like China, Taiwan was aware of the need to reform the domestic banking institutions before introducing full currency convertibility. Both were also under similar and tremendous pressure from the international community, especially the United States, regarding alleged manipulation of the currency exchange rate. Effective experimentation was conducted in Taiwan too, but on a much smaller scale. [87]

The EU is another example of the scale effect. The Euro is also based on the immense scale of the EU's economy. However, the EU remains incapable of fully maximizing the synergies due to various obstacles to the integration of non-homogeneous economies in Europe.[88] The rocky integration of small economies is the source of the problem, as member states remain independent and are guided by different policies. In this regard, the EU faces difficulties with respect to regional variations among member states similar to those in China. All in all, the size factor does not seem to be unique to China and it is therefore difficult to claim a Chinese model, or the Beijing Consensus, in the context of currency policy.

VI. Conclusion

The size factor has often been mentioned by both scholars and practitioners as one of the most vital factors accounting for China's economic success and international influence. This theory sometimes shows its merit in fields beyond economics. A scholar of electrical engineering once told the author that China demonstrates an equation for innovation: a large-scale consumer market naturally leads to technological innovation. Size definitely matters for institutional innovation, too, but how it matters remains unclear and context-dependent. RMB internationalization is arguably the most revolutionary scheme China is currently carrying out. As such, this chapter explores how China's unique size factor plays out in the Scheme, aiming to apply this scrutiny to shed light on the idea of the Beijing Consensus.

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87 Taiwan established one of the earliest special economic zones in the world to diversify its institutional settings. Frederic C. Deyo, "Addressing the development deficit of competition policy: the role of economic networks in Asian Capitalism and the Regulation of Competition," in *Asian Capitalism and the Regulation of Competition: Towards a Regulatory Geography of Global Competition Law*, Michael W. Dowdle, John Gillespie and Imelda Maher (eds.) (Cambridge: Cambridge University Press, 2013), 283.

88 For example, while debts are denominated in Euros, they are issued by separate nation-states that have varying credit quality and liquidity risks and are subject to different legal procedures. There is also no benchmark Euro asset like the US treasury bonds; instead, twelve different issuers participate in the Euro government securities market. Lim Ewe-Ghee, "The Euro's Challenge to the Dollar: Different Views from Economists and Evidence from COFER (Currency Composition of Foreign Exchange Reserves) and Other Data,": 14; Gabriel Galati and Phillip Woolridge, "The Euro as a Reserve Currency: A Challenge to the Pre-eminence of the US Dollar?," *International Journal of Financial Economics* 14(1) (2009): 12.

Given institutional constraints at home, the implementation of the Scheme has more to do with domestic reforms than an international agenda, and it faces more challenges from within than from abroad. The large-scale factor is not as positive as would be expected; rather, it poses great challenges to China, including problems of coordinating its unprecedentedly large economy, the governance problems that confront extreme market variations, and the resulting systemic risks that are amplified by such a large and heterogeneous economy. In essence, challenges result not only from the identification of reform measures but also in determining the sequence for implementing such measures, challenges that reflect the inherent limitations of the Washington Consensus.

In response, China appears to leverage its large-scale economy to compensate for and cope with the disadvantages of scale. China's extremely large economy enables it to diversify institutional settings while maintaining minimally-efficient economies of scale in each unit of institutional experimentation, and to improve its ability to utilize risk-sharing institutions both domestically and internationally. By the same token, pluralist capitalism can be observed in the Scheme as well, as evidenced by the SFTZ in Shanghai aiming to replicate the Singapore model and Quinhai in Guangdong province mimicking the Hong Kong model. Experimenting with both of these policy designs simultaneously is probably only possible in a large economy.

Besides the implementation strategy, China needs to contemplate its responsibility as an issuer of a major international reserve currency. The RMB's impact on the global financial order would be enormous. For example, in the face of financial sanctions imposed after its intrusion in Ukraine and Crimea, Russia circumvented these bans, which prevent Russian firms from raising long-term debts in dollar-dominant capital markets, by prompting more companies to use RMB.[89] The yuan-ruble trade on the Moscow Exchange therefore jumped tenfold in 2014.[90] If the RMB becomes as widely used as the US dollar, China, like the United States, will obtain extensive jurisdiction over foreign entities that use RMB. It is extremely crucial to create a set of accountable, impartial, and transparent mechanisms for exercising such expanding regulatory power. Otherwise, the internationalization of the RMB would lead to increasing international disputes rather than financial stability and fairness. Backlashes against the RMB would occur, similar to what we have witnessed to date against the US dollar's dominant status.

All in all, does the scrutiny of RMB internationalization suggest a Chinese model or construct any aspect of the Beijing Consensus? Indeed, China's experiences are in contrast to the conventional regulatory model, forged from the experiences of advanced industrialized nations where immense and economically-coherent markets have led to

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[89] Nevertheless, the "smart sanctions" based on Russian firms' need for US capital or USD assets seem to have harmed Russia's economy terribly. Kathrin Hille and Roman Olearchyk, "Plunging Rouble Raises Spectre of Fresh Financial Crisis for Russia", Financial Times, November 7, 2014, http://www.ft.com/intl/cms/s/0/6c059328-666d-11e4-9c0c-00144feabdc0.html#axzz3vbsuscAE.

[90] China Daily, "Russia Turns to RMB to Thwart Western Sanctions," *China Daily*, November 14, 2014, http://www.china.org.cn/business/2014-09/25/content_33609143.htm.

abstract and rule-based regulations at the national level. China's unprecedentedly large and heterogeneous markets are likely to require highly diverse configurations of regulatory models. Nevertheless, in the context of the Scheme, the merits of China's various reform approaches are rather in line with the values of neoliberal economics underlying the Washington Consensus, as evidenced by the reform measures China is currently pushing in order to internationalize RMB.

This chapter also demonstrates that the size factor has played a role in determining currency policies, not only in China but also in other Asian countries during their transitions. While Singapore illustrates how a small-size economy led to its exchange rate-centric model, Taiwan provides a contrasting example as to how a mid-size economy gave rise to an interest rate-centric model. In essence, deviations from orthodox policy prescriptions are inevitable due to the local political economy, existing institutional settings, or the dynamics of the global balance of power. The question is, then, to what extent may we characterize these deviations as the Beijing Consensus, or mere path dependence?[91] Given the neoliberal nature of the Scheme and various other measures relating to the implementation of the Scheme, it is fair to conclude that Beijing in fact follows the policy prescriptions under the Washington Consensus for creating a potential game changer for the global financial world. In other words, this chapter opts for the latter interpretation—that is, the Chinese experience is mere path dependence as opposed to being a form of the Beijing Consensus.

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[91] Mariana Mota Prado and Michael Trebilcock, "Path Dependence, Development, and the Dynamics of Institutional Reform," *University of Toronto Law Journal* 59 (2009); Michael J. Trebilcock and Mariana Mota Prado, *What Makes Poor Countries Poor? Institutional Determinants of Development* (Cheltenham: Edward Elgar, 2011).