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Research Report

The Chinese Yuan: Influence of interest groups examined

BOFIT Policy Brief, No. 6/2017

Provided in Cooperation with:

Bank of Finland, Helsinki

Suggested Citation: Fung, Kwok-chiu; Aminian, Nathalie; Korhonen, Iikka; Wong, Keith K. P. (2017) : The Chinese Yuan: Influence of interest groups examined, BOFIT Policy Brief, No. 6/2017, Bank of Finland, Institute for Economics in Transition (BOFIT), Helsinki, <https://nbn-resolving.de/urn:nbn:fi:bof-201705191302>

This Version is available at:

<https://hdl.handle.net/10419/251668>

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BOFIT Policy Brief
2017 No. 6



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Keith Wong

The Chinese yuan: Influence of interest groups
examined



Bank of Finland, BOFIT
Institute for Economies in Transition

BOFIT Policy Brief
Editor-in-Chief Juuso Kaaresvirta

BOFIT Policy Brief 6/2017
19 May 2017

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ISSN 2342-205X (online)

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Contents

Abstract	3
1. Introduction	4
2. Institutional and Political Aspects of Chinese yuan Setting	5
3. Interest Groups in the Government, State-Owned Sector and the Private Sector.....	7
4. An Economic Model of the Political Economy of the Chinese yuan and International Trade.....	8
5. Conclusion	11
References	12

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The Chinese yuan: Influence of interest groups examined

Abstract

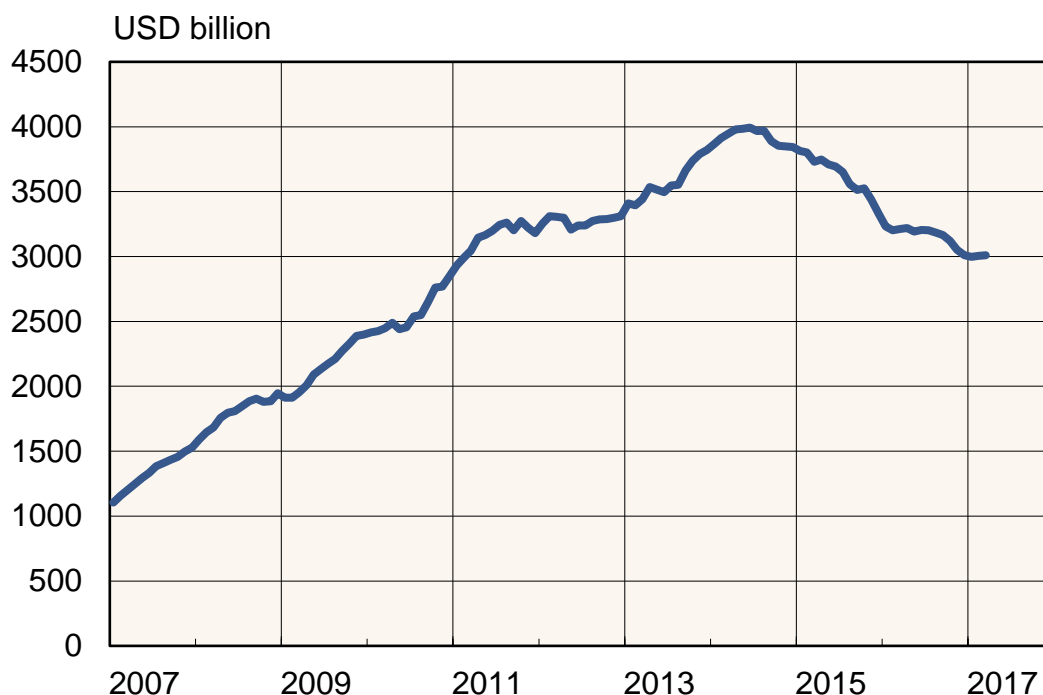
In this paper, we provide an analysis of various interest groups in trying to affect the exchange rate determination and the direction of exchange rate policies in China. Given that the People's Bank of China is not an independent central bank, additional actors such as the Ministry of Commerce (*MOFCOM*), Ministry of Finance (*MOF*), the National Development and Reform Commission (*NDRC*), the State-Owned Assets Supervision and Administration Commission (*SASAC*) all have incentives to influence the Politburo Standing Committee (*PBSC*) as well as the relevant Leading Small Groups (*LSGs*). To enrich the discussions on the political and institutional aspects of the yuan, we also provide an economic lobbying model incorporating imperfectly competitive tradable sectors to shed light on our unique case of Chinese currency determination and exchange rate policy in the presence of these interest groups.

Keywords: China, exchange rate, political economy, interest groups

1. Introduction

As of the end of January 2017, the People's Bank of China (*PBOC*, 中國人民銀行) reported that the level of its foreign reserves dropped to below US\$ 3 trillion to US\$2.998 trillion (although it jumped back to US\$3,008 billion at the end of March, 2017, see Figure 1). Part of this decline is due to the depletion of the foreign reserves in defending external value of the Chinese yuan, also called the renminbi. One estimate shows that since mid-2015, the Chinese central bank has spent about US\$800 billion to slow down the yuan's depreciation against the U.S. dollars.

Figure 1. China's international reserves, USD bn



Source: SAFE

In this paper, we will provide an up-to-date examination of the Chinese yuan, highlighting the important roles of *interest groups*. We would like to emphasize here one general important point about Chinese economic and exchange rate policies: most economic researchers *do not* sufficiently appreciate the fact that even in a centralized government system like China, there are important interest groups that would attempt to sway economic and financial policies. Furthermore, it is perhaps even less discussed that pressure groups exist in the *government*, in the *state-owned sector* as well as in the *private sector* which have strong incentives to influence the Chinese exchange rate policy. We think our study can contribute to this important but relatively neglected policy and research area. We will first study the institutional and political aspects of the determination of the Chinese yuan. Next, using a simple political economy model with imperfect competition, we will also examine the economic and lobbying aspects of the setting of the Chinese currency.

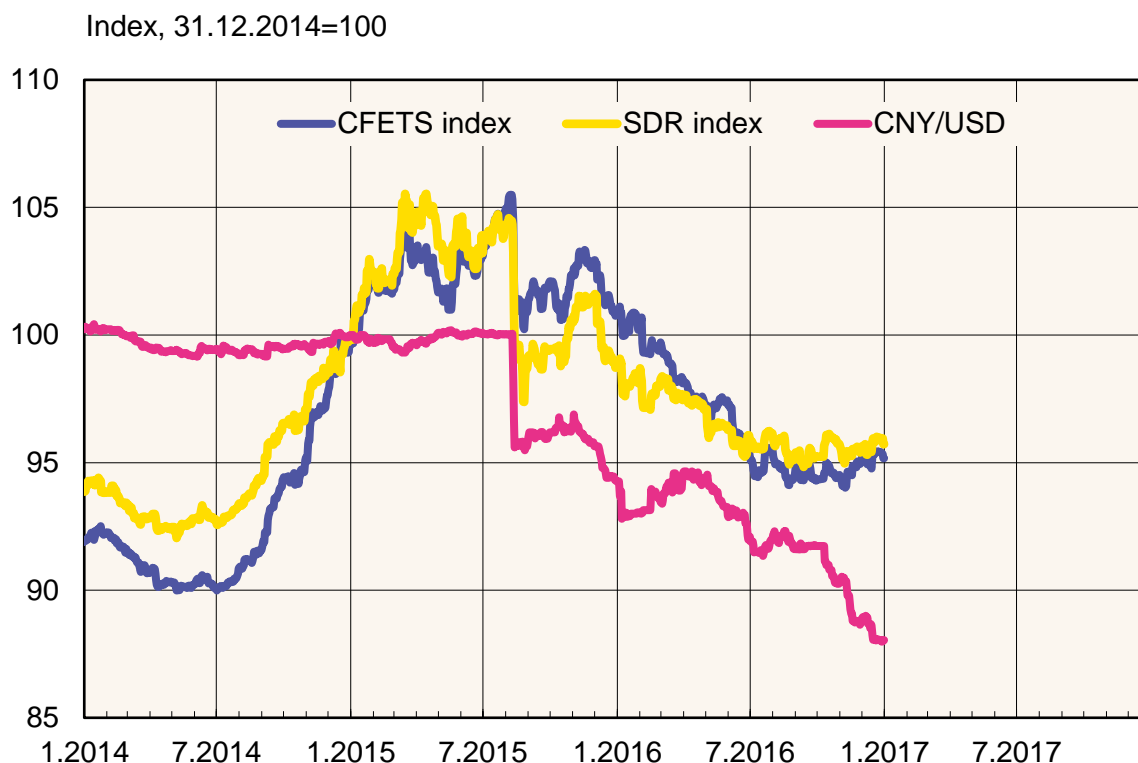
There are many relevant prior studies on the Chinese yuan (Korhonen et al. 2015, Korhonen and Ritola 2009, Rautava 2016a, Rautava 2016b, Aminian et al. 2016, Fung 2016a, Fung 2016b,

Wong 2003a, Wong 2003b, Kratz et al. 2016, Frankel 2012, Yu 2014, for example). As we mentioned above, one motivation for our particular study is that this important research area has been relatively neglected in the economics and finance literature. There are two additional major reasons why we would like to examine this line of research. First, as demonstrated by events from August 2015, the 1.9% devaluation of the Chinese yuan triggered a panic in the global stock market (Lau 2016a, Lau 2016b, Lau 2016c). Thus it is clear that fluctuations of the Chinese exchange rate can affect sentiments and can have global financial repercussions. Second, the Trump Administration has put the rise of China in general and Chinese trade and exchange rate in particular at the center of its foreign economic policy. Chinese exchange rate will in the foreseeable future continue to attract international attention. For these and other reasons, we believe that our paper is timely and can make a contribution to policy discussions as well as to the academic literature.

2. Institutional and Political Aspects of Chinese yuan Setting

Institutionally, we first focus on the People's Bank of China (*PBOC*). There are three major elements influencing the setting the yuan exchange rate (Prasad 2016, Lau 2016c, Mizuho Bank 2016, Fung 2016b). First, we have reference pricing. Each morning, the People's Bank of China sets the opening price for trading on the Chinese Foreign Exchange Trading System (*CFETS*) for major currencies. Even though the exact calculations are not known, at present the *PBOC* supposedly set the yuan's daily mid-point rate against the U.S. dollar based on both the previous day's 4:30pm closing price and changes in the yuan's daily trading in the past 24 hours against its trade-weighted basket. But according to some reports, to curb intra-day speculative trading, the *CFETS* changed the reference period of yuan trading against the currency basket from 24 hours to 15 hours in February 2017 (He 2017, Shri Navaratnam and Kim Coghill 2017). Furthermore, starting December 29, 2016, the number of currencies included in the currency basket was increased from 13 to 24 (Mizuho Bank 2017). Second, there is the 2% bi-directional band against USD, while the band is wider against other major currencies. In other words, the yuan can go up or down 2% from the daily reference rate against USD. This band, at least technically eliminates the automatic one-sided bet that the Chinese currency used to face. Economically, of course, we can still have uni-directional bet due to some analysis of economic fundamentals or perceived momentum (Cain et al. 2016). For example, since June 2014, the People's Bank of China is estimated to have lost almost US\$1 trillion in foreign reserves. Various factors were attributed to have caused this. Legal and illegal capital outflows have found their ways to destinations outside of China (China Daily 2017). Some firms have found it useful to repay their US\$-denominated debt during this period. Lastly, the People's Bank of China is perceived to have used a fair amount of reserves to defend the depreciating Chinese currency. These factors may contribute to the market expecting continued weakness of the Chinese currency (China Daily 2016). Nonetheless, the trading band around the daily central parity rate determines the maximum amount of intra-day volatility. The third and last element of the yuan setting is that it is a managed float. The People's Bank of China does intervene to prevent "excessive" exchange rate fluctuation. For example, one estimate shows that just in September 2016, the People's Bank of China spent US\$27 billion in interventions to support the depreciating Chinese currency (Fung 2016a). Figure 2 shows evolution of two indices, one of the yuan against the US dollar, and the other more broad-based CFETS basket index. Downward movement signifies depreciation, and August 2015 obviously stands out. It should also be noted that more broadly-based currency index has not depreciated nearly as much as the yuan against the US dollar.

Figure 2. CNY/USD and CFETS indices



Source: Reuters and BOFIT calculations

The mechanism of setting the reference rate also has changed over time. Between August and December of 2015, the primary factor for setting the reference rate was the closing rate of the previous day. During that period, the yuan was fixed within 0.02% of the previous closing rate on average. Since January 2016, the yuan's closing rate one day and the reference rate next day is no longer strongly tied anymore. Most researchers now conclude that the process of yuan setting is non-transparent and are subject to change. The near consensus view is that the determination of the yuan exchange rate by the People's Bank of China is *opaque*.

Despite the difficulty of fully understanding the changes to the yuan rate, particularly major and abrupt changes, it is nevertheless important to look more closely at the exchange rate determination in China. As mentioned earlier, in August 2015, the People's Bank of China surprised the market and devalued the yuan by 1.9%. Chinese stocks dropped in value by close to 25% in two weeks after the August devaluation. U.S. and global stocks also responded negatively, with the Dow Jones at one point experiencing triple digit losses. This example illustrates the potential *global* impact the yuan rate can have and highlights why despite the opaqueness, we need to examine deeper the question of Chinese yuan determination.

If we were looking at a central bank like the European Central Bank (ECB) or the Federal Reserve (the Fed), we may be tempted to focus on the institutional structure of the People's Bank of China and the speeches of its governor (ECB- or Fed-watching). As is well-known, the governor of the People's Bank of China since December 2002 is Zhou Xiaochuan (周小川). Currently there are seven deputy governors, with fifteen members in the monetary policy committee of the PBOC.

However, for the case of China, it is also important to examine the *political* aspects of the role of the Chinese central bank in determining the yuan (Globalization Monitor 2010, Lawrence and Martin 2013, Wen 2012, Fung 2016a.). In reality, unlike the Fed and ECB, the PBOC is *not* an

independent central bank. It does not determine the yuan rate alone. According to the Law of the People's Republic of China on the People's Bank of China: "...the People's Bank of China shall under the leadership of the State Council, formulate and implement monetary policies and exercise supervision and control over the banking industry." In addition, Article 5 states "the People's Bank of China shall report its decision to the State Council for approval concerning the annual money supply, interest rate, foreign exchange rate and other important matters specified by the State Council before they are implemented...." (Lawrence and Martin 2013, Wen 2012, Fung 2016b, Kennedy 2016).

As we all know, the State Council (國務院) is the chief administrative body of China, currently chaired by Premier Li Keqiang (李克強). It has four vice premiers. It also includes heads of all major government departments and agencies with approximately twenty-five ministries included.

However, major exchange rate changes are seen to be determined ultimately in the Politburo Standing Committee (PBSC 中央政治局常務委員會) (Lawrence and Martin 2013, Wen 2012, Fung 2016a, Fung 2016b). Currently, there are seven members in the 18th Politburo Standing Committee. The PBSC is headed by President Xi and it includes Premier Li. The 19th Party Congress is scheduled to take place later this year in 2017 and major changes to the memberships of the PBSC are expected.

For economic and financial policy discussions, including the direction of exchange rate policies, usually different ministries and the PBOC will present their opinions at the State Council working conferences. Policy preferences by different affected parties will be reported to the PBSC before a final decision is made. Different entities will try to influence the State Council and the PBSC directly or indirectly (Kennedy 2016, Lawrence and Martin 2013, Wen 2012, Fung 2016a).

3. Interest Groups in the Government, State-Owned Sector and the Private Sector

With respect to the exchange rate, naturally different economic entities in China can have different objectives. Relatively few studies have investigated the roles of bureaucratic institutions and different Ministries in China in influencing policies. Some exceptions include Jones (2017), Lai and Kang (2014), Fung (2016a), Kennedy (2016), Wen (2012), Globalization Monitor (2010), etc.. Exporters can lobby the local and provincial Chamber of Commerce as well as local representatives of the Ministry of Commerce (商務部). The Ministry of Commerce usually prefers a weaker value of the yuan to spur exports. Since 2016, the PBOC itself seems to prefer a gradual depreciation as in line with "market forces". This will also reduce foreign exchange interventions and arrest the further loss of foreign reserves. The Ministry of Finance (MOF 財政部) may want to reduce potential export rebates. To conserve revenue, the Ministry of Finance may prefer a stronger exchange rate. For the National Development and Reform Commission (NDRC 國家計劃委員會), which is tasked to upgrade the industrial structure of the Chinese economy and to re-balance the economy towards services and consumption, it may favor an appreciating exchange rate. In addition, we have to consider also the state-owned sector. The State-Owned Assets Supervision and Administration Commission (SASAC 國有資產監督管理委員會) tends to lobby for slowing the depreciation of the yuan. This is due to the fact that big state-owned firms such as the shipping firm China Cosco and the Chinese national airlines (e.g. Air China) have had large amount of US\$ debt. One estimate shows that a 3% yuan depreciation could add more than US\$25 billion to the annual interest payments of Chinese firms. Thus, the state-owned enterprises (SOEs) may have added a strong voice in influencing the exchange rate. The People's Bank of China, Ministry of Commerce, Ministry of

Finance, SASAC and NDRC all can influence the State Council and the PBSC over the Chinese exchange rate. The importance of lobby groups is again recently highlighted in a speech by President Xi to the Central Party School: “Cadres should strictly watch themselves, and avoid being influenced by *interest groups*....” (Mai 2017, Xinhua 2017).

Under the Xi Administration, new Leading Small Groups (*LSGs* 领导小组) have been formed. Traditionally, managing the economy in China is in the job portfolio of the Premier. Now it is seen to be at least under the partial control of the President. *LSGs* were in existence in China before. In the 1990s Leading Small Groups were used more for policy discussion and coordination. During the Mao era, some *LSGs* were seen to be used to take power away from the traditional political structures. Now the *LSGs* are seen to be decision making bodies.

After the Third Plenum of the 18th Chinese Communist Party (*CPC*) Congress in November 2013, the Comprehensive Deepening Reform *LSG* was created. The new *LSG* is chaired by President Xi. One major specialized subunit of the Deepening Reform *LSG* is the Finance and Economics *LSG*, seen as a top decision making body on Chinese economic issues. Even with new centers of political and economic power, our vision of interest groups lobbying to influence exchange rate policy remains valid. Instead of *MOFCOM*, *MOF*, *PBOC*, *NDRC* and *SASAC* lobbying exclusively the Politburo Standing Committee (*PBSC*), these pressure groups, representing their own bureaucratic interests as well as the various private sector and state-owned sector interests, will also attempt to influence the relevant Leading Small Groups (*LSGs*) over the Chinese yuan policy. To sum up, we have ***Interest Groups with Chinese Characteristics***. Even with the different Chinese institutions, political structures and governance, there are still interest groups attempting to influence the yuan rate and changes to exchange rate policy. In particular, the Ministry of Commerce (*MOFCOM*), the Ministry of Finance (*MOF*), People’s Bank of China (*PBOC*), National Development and Reform Commission (*NDRC*) and State-Owned Assets Supervision and Administration Commission (*SASAC*), representing bureaucratic, state-owned sector and private business interests are active relevant lobbying agents to attempt to influence the Politburo Standing Committee (*PBSC*) and the various Leading Small Groups (*LSGs*) over the Chinese exchange rate policy.

4. An Economic Model of the Political Economy of the Chinese yuan and International Trade

In this section, we provide a simple political economy model of the Chinese yuan. Given that we have established the relevance of interest groups in the special Chinese context, we provide here a political economy model with oligopolistic tradable firms (Fung, Lin and Chang 2009, Fung, Garcia-Herrero and Siu 2010, Grossman and Helpman 1994, Aminian, Fung and Tse 2016). Suppose in China there are two sectors, one formal and one informal (the numeraire) sector. The formal sector is the tradable sector, with one exporting firm (producing good x) and one import-competing firm (producing good y). The fraction of population who are owners in the export sector is α^x , while the fraction of the population with a direct stake in the import-competing sector is α^y . Only the fractions of the population that have stakes in earning rents in the export and import-competing sectors form interest groups. $1 - \alpha^x - \alpha^y = \alpha^m$ is the fraction of the population that is politically inactive (e.g. the migrant workers). The population is normalized to one. In the export sector, the Chinese firm exports to the U.S. market, while in the import-competing market, the Chinese firm competes with the U.S. exporting firm in China. The profit functions in the export and import-competing markets are, respectively,

$$\Pi^x(x, x^*; e) = x e p^x(x + x^*) - c(x) \quad (1)$$

$$\Pi^{x^*}(x, x^*) = x^* p^x(x + x^*) - c^*(x^*) \quad (2)$$

$$\Pi^y(y, y^*) = y p^y(y + y^*) - c^y(y) \quad (3)$$

$$\Pi^{y^*}(y, y^*; e) = [1/e] y^* p^y(y + y^*, e) - c^{y^*}(y^*) \quad (4)$$

where e is the yuan/US\$ rate, x^* is the output of the U.S. firm in the United States, y^* is the quantity of American exports by the U.S. exporter to China, c is the cost function for the Chinese exporter, c^* is the cost function of the U.S. import-competing firm, c^y is the cost function of the Chinese import-competing firm, c^{y^*} is the cost function of the U.S. exporting firm, p^x is the price x and x^* , and p^y is the price of y and y^* .

With Cournot-Nash competition, a rise in e (a yuan depreciation) will raise profits of the Chinese exporting and import-competing firms. For a representative member of the three groups in the economy, indirect utility functions for member of each group V^i are:

$$V^i = \Pi^i / \alpha^i + CS^i$$

with $i = x, y$ and m and CS being consumer surplus.

Without lobbying and with *collective leadership*, the Chinese Politburo Standing Committee (*PBSC*) is assumed to be benevolent and chooses e to maximize national welfare W :

$$W = \alpha^x V^x + \alpha^y V^y + \alpha^m V^m$$

This is the benchmark case of a welfare-maximizing collective leadership government. Suppose we now allow bureaucrats and Chinese firms (including *SOEs*) to lobby various ministries to ask for changes in yuan-dollar exchange rate. Political groups offer political resource schedules to influence the setting of the exchange rate and changes to exchange rate policies. The Chinese government takes the political resource schedules as given and maximizes a weighted sum of the political capital contributions and the national welfare. In equilibrium, the political capital contribution schedule of each interest group is given by:

$$\alpha^i V_e^i = \lambda_e^i \quad (5)$$

where λ is the political capital contribution schedule. The Chinese *PBSC* now maximizes:

$$V^G = (\beta - 1)[\lambda^x(e) + \lambda^y(e)] + W$$

With $\beta > 1$. Using the political groups' equilibrium conditions, we can write the first order condition for the Chinese policymakers under interest group influence to be:

$$V_e^G = \beta(\alpha^x V_e^x + \alpha^y V_e^y) + \alpha^m V_e^m = 0$$

The above yields the interest group-determined yuan/US\$ exchange rate. Since $\beta > 1$, the Chinese *PBSC* attaches a greater weight on the interest groups that provide political capital contributions compared to a welfare-maximizing collective leadership government. The above analysis shows that at least some elements of the political economy of the Chinese yuan can be formalized. The interest group-determined yuan exchange rate is generally different from the welfare-maximizing yuan exchange rate. Even in a centralized government, various actors, including state-owned enterprises (*SOEs*) have channels to influence financial and exchange rate policies.

Suppose we consider the case of *centralized leadership*, when it is particularly important to focus on a few top (or even just the top one or two) policymakers and their immediate advisers – this type of analysis on Chinese economic and exchange rate policy we can loosely call *Zhongnanhai* (中南海) -watch. As mentioned earlier, under the Xi Administration, new Leading Small Groups have been created, including the Finance and Economics *LSG*. This can be interpreted as shifting the portfolio of guiding the economy from the Premier to that under the control by the inner circle of the President. One inner circle member may be the prominent economic adviser Liu He (刘鹤), director of the Finance and Economics *LSG*, who supposedly published a front page article in *People's Daily* criticizing the Premier's economic policies. In contrast to collective leadership, the centralized leadership can be interpreted to be putting more weight on personal political capital. In our model, the centralized leadership can be assumed to maximize an objective C^G :

$$C^G = (\beta^* - 1) Z(\text{IP}) + (\beta - 1)[\lambda^x(e) + \lambda^y(e)] + W$$

where Z is the utility function of the centralized leadership, which is increasing in an index of personal political capital and $(\beta^* - 1)$ is the weight attached to Z , with $\beta^* > 1$. To sum up, we have

In our economic model, the yuan exchange rate is determined theoretically by pressure groups/ministries utilizing political resources to influence the Chinese policymakers.

Both collective leadership as well as centralized leadership can be formalized in our interest group model with imperfectly competitive tradable firms.

The centralized leadership case can give higher or lower yuan rate, depending on whether a devaluation can increase or decrease the personal political capital of the centralized leadership and his inner circle. For example, it is observed that under the Xi's administration, political and social control has become much more important, moving closer to a form of centralized leadership. The current and future yuan exchange rate policy process will likely put more weight on $Z(\text{IP})$.

Last, we can examine the case of U.S. government negotiations with China on the Chinese yuan. We assume that the Chinese policymakers care about its economic relationship with the U.S., for example, based on the Chinese administration's "New Type of Great Power Relationships". The

U.S. exporters and import-competing firms lobby the U.S. government for a higher yuan rate. In response, the U.S. government may also want a politically-determined yuan/\$ rate. Suppose the Trump administration does not label China as a currency manipulator. Instead the U.S. government continues to put China on a Monitoring List for its exchange rate policy and may put diplomatic pressure on Chinese government in other areas, e.g. in the U.S.-China Strategic and Economic Dialogue (*S&ED*). In that case, the objective of the U.S. government with respect to the yuan rate can be captured in V_{Gus} . In bilateral forums, the bargaining between U.S. and Chinese governments can be described as Nash bargaining with a and b as respective bargaining power.

$$\max_e M(e) = [V_G(e)]^a [V_{Gus}(e)]^b$$

In sum, the U.S. government can be interpreted as another interest group in the model.

Allowing foreign pressure can be interpreted to be having an international interest group in our model and will theoretically make yuan exchange rate stronger.

5. Conclusion

To understand some important Chinese economic and financial policies, perhaps one needs to not only look at the Chinese issues economically, but also fully understand the special Chinese characteristics, i.e. including an examination of its institutional and political features. We attempt to examine the links between the Chinese yuan exchange rate, international trade disputes and politics. We first examine the exchange rate policy institutionally, focusing on the People's Bank of China (*PBOC*). We then examine the issues politically, highlighting the role of the State Council and the Politburo Standing Committee (*PBSC*). We also examine the rising importance of the Leading Small Groups (*LSGs*) under the Xi Administration as well as the emerging centralized leadership. We also provide a simple economic model of the political economy of the Chinese yuan, incorporating imperfectly competitive tradable firms. We extend the model to include international negotiations over the yuan. We show theoretically that international negotiations can be akin to adding an international interest group to the model and this can potentially change the determination of the yuan exchange rate. Finally we would like to conclude by highlighting a *general* point about economic or exchange rate policy setting in a centralized government like China. In the future, the precise institutional structure or political environment can evolve. For example, for our particular case, the Chinese yuan may eventually switch to a floating regime. Even then, *interest groups with Chinese characteristics* will continue to be relevant in understanding future financial and exchange rate policies, including when and how much occasional foreign exchange rate interventions will occur.

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