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The Impact of China's Internal Financial Repression on External Financial Power

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Abstract

This article explains the theory of financial repression and international financial power, adopts a comparative empirical approach, and uses the influence of Japan's political and economic system in the 1980s on Japan's international financial power as a reference to discuss the relationship between China's internal financial repression and external financial power. The result shows that China's financial repression system is conducive to the development of China's relational financial power, and is not conducive to the acquisition of structural financial power and institutional financial power. Therefore, in order to enhance China's acquisition of external financial power under the existing financial suppression system, we need to properly handle China's creditor country status, foreign exchange reserves, and rights and responsibilities in the Bretton Woods institutions. At the same time, it is necessary to enhance the international attractiveness of China's financial market and promote the internationalization of the RMB.

Keywords

Financial repression; Financial liberalization; International financial power.

1. INTRODUCTION

In recent years, China has become increasingly prominent in the framework of the international financial system. In 2007, China established a sovereign wealth fund to improve the performance of foreign exchange reserve management and offset excess liquidity, and China entered the ranks of the world's largest creditor countries. Since the 2008 financial crisis, China has gradually accelerated the internationalization of the RMB. In 2009, the "Detailed Rules for the Implementation of RMB Cross-border Trade Settlement" was promulgated. In 2010, China became the second largest economy in the world. In recent years, China has continuously strengthened its voice in the world economy through policies and strategies such as the "One Belt and One Road", Asian Infrastructure Investment Bank, Shanghai Cooperation Organization and other international organizations.

As China's financial influence increases, we have noticed the influence of China's internal financial system on the development of domestic financial influence. In the 1970s, American economists McKinnon and Edward Shaw introduced the concept of "financial repression" into economic literature for the first time by analyzing the actual situation in developing countries. As the largest developing country in the world, China certainly has financial repression. However, in order to explore the relationship between China's political and economic system and the acquisition of international financial power, we have to try to understand China's current financial repression system and related concepts of financial power.

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2. CHINA'S FINANCIAL REPRESSION SYSTEM

2.1. Theory of Financial Repression

Since the study of McKinnon and Edward Shaw, many scholars have studied the field of financial repression in developing countries and have achieved many research results. Through many scholars' research on financial development theory, financial repression can be summarized as a series of policies adopted by a country's government to restrain the development of the financial system in order to achieve policy goals. According to the IMF financial reform database, measuring a country’s financial repression can be analyzed from the financial repression policies adopted by a country’s government, including: credit control and reserve restrictions, interest rate control, banking entry restrictions, banking freedom, financial supervision Efficiency, capital project control and capital market control.

At the same time, in the financial development theory, financial repression is closely related to financial constraints, financial liberalization, and financial deepening. The study of financial repression is inseparable from the discussion of the other three theories. After proposing the theory of "financial repression" in developing countries, economists put forward the theory of "financial deepening". The main idea is to loosen government departments' control over the financial system, liberalize interest rates and exchange rates so that they can fully Reflect the market situation and then adjust the market mechanism. It is to achieve financial deepening and promote economic growth through financial liberalization. At the same time, economists believe that the financial liberalization strategy derived from financial deepening theory requires strict conditions, which developing countries do not have. Therefore, developing countries do not have the prerequisites for financial liberalization, so they cannot promote financial deepening. In this case, the implementation of "financial constraints" is a feasible way. The theory of financial constraints refers to the fact that the government implements a series of financial policies such as creating rental opportunities in the private sector to prevent the harm of financial repression and prompt banks to actively avoid risks. These financial policies include the control of deposit and loan interest rates and restrictions on market access. The government can play an active role by adopting policies to create conditions for the banking system and encourage it to actively explore new markets for savings mobilization, thereby promoting financial deepening.

Therefore, we cannot ignore the development of financial liberalization to promote financial deepening, while discussing the financial repression system of developing countries.

2.2. The Main Manifestation of China's Financial Repression

2.2.1 Bank dominates the financial system

After more than 30 years of development after reform and opening up, China has formed a financial structure with the People's Bank of China occupying a leading position, with five major state-owned commercial banks as the mainstay, 12 joint-stock commercial banks and other financial institutions as the supplement. In order to achieve the fundamental role of banks in the allocation of resources, the bank-led financial system is implemented with a series of "financial restraint" institutional arrangements, including interest rate control, capital account control, capital market control, and banking access restrictions.

China's financial system is dominated by a banking industry featuring administrative control of interest rates and a high degree of state-owned, thereby guiding funds to support state-owned sectors in the economy and promoting the implementation of industrial policies. The state-owned ownership of important financial institutions and the upper limit control of deposit interest rates can ensure the low financing costs of state-owned enterprises and reduce government borrowing costs, and ensure the country's low sterilization costs. So in the face of

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huge current account surpluses, they can prevent the domestic currency from appreciating sharply and allow them to obtain huge amounts of foreign exchange reserves.

2.2.2 Interest rate controls still exist

Before the reform and opening up, China's interest rate was basically a fixed interest rate determined by the central bank. With the advancement of interest rate marketization, market interest rates gradually surfaced under the influence of changes in capital allocation and financing environments. However, China's capital market has not yet been fully liberalized, and a market interest rate environment in which the supply and demand of funds determines the level of interest rates has not really formed. On the one hand, the real interest rate has always been lower than the market interest rate, especially since 2002, the deposit interest rate is often lower than the inflation rate, and the real interest rate is often negative. On the other hand, loan interest rates have been maintained at a relatively low level for a long time based on lower deposit interest rates. Although the People's Bank of China has decided to fully deregulate the loan interest rate of financial institutions since July 20, 2013, there are potential market problems in unilateral marketization of loan interest rates before deposit interest rates are already under control and other supporting mechanisms have not been improved.

2.2.3 Reserve System

In addition to relatively strict controls on deposit and loan interest rates, the People's Bank of China also frequently uses the deposit reserve ratio to regulate the operation of the financial market. Especially during periods of macroeconomic fluctuations, the deposit reserve ratio often becomes the preferred adjustment tool of the People's Bank of China. Although the deposit reserve ratio is an important monetary policy tool for the central bank to control the money market. However, during periods of economic volatility, the frequent use of deposit reserves will cause disorder in financial activities and deepen financial repression.

Although China is gradually lowering the deposit reserve ratio in order to promote financial deepening and release the vitality of funds, the deposit reserve ratio is still relatively high. In 2012, the People's Bank of China reopened the road to interest rate liberalization, but the 20% deposit reserve ratio is equivalent to lending 20% of deposits to the central bank. At the same time, the central bank only paid 1.62% interest, which was far lower than the central bank’s 3.25% bill cost (the statutory deposit reserve interest rate in 2012 was 1.62%, and the one-year benchmark deposit interest rate before the adjustment was 3.25%). This is essentially "hidden taxation" of commercial banks. The excessively high deposit reserve ratio has caused a large amount of loan funds of commercial banks to be used up, and bank funds have become scarce economic resources. When the credit market is in short supply, in order to obtain funding sources, commercial banks often use loan interest rates close to the underground financial market to frantically absorb reserves. At the same time, as the supply of funds is in short supply, commercial banks increase the proportion of high-interest loans to loans, and first of all ensure the loan demand of high-quality "golden customers". Those small and medium-sized enterprises with relatively small financial strength, especially privately-owned small and medium-sized enterprises, will inevitably not be able to obtain sufficient development funds. As a result, China's current financial system has been inhibited in meeting credit demand and supporting local economic development. This is the "financial repression" of China's financial system related to "high deposit reserves."

2.2.4 Capital account control

China has always implemented a relatively strict capital control system, but with the continuous intensification of world economic integration and financial liberalization, China's foreign exchange management system is also undergoing market-oriented reforms. In 2005, the exchange rate reform abolished the fixed exchange rate system pegged to the US dollar, and began to adjust the exchange rate with reference to a basket of currencies, and implemented a

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managed floating exchange rate system. The goal of continuous improvement of the exchange rate system is to realize the convertibility of the RMB capital account and promote the internationalization of the RMB. At the end of 2015, the RMB was included in the International Monetary Fund's special drawing rights basket of currencies, marking an important step in the internationalization of the RMB. However, in the second half of 2018, as the depreciation of the RMB continued to increase and the international trade environment continued to deteriorate, the main task was to maintain the stability of the domestic economic and financial environment. Therefore, China needs to maintain necessary capital account controls to guide capital flows.

2.2.5 Banking entry restrictions

For a long time, China has strictly restricted the entry of private capital and foreign capital into the banking industry. However, with the development of financial liberalization, China has gradually liberalized market access restrictions on the banking industry. On July 5, 2013, the General Office of the State Council issued the "Guiding Opinions on Financial Support for Economic Restructuring, Transformation and Upgrading". The ninth opinion stated that "expansion of private capital into the financial industry, attempts to initiate and establish private capital "Private banks that take risks", thus China has relaxed the entry of private capital into the banking industry. In opening up to the outside world, China is gradually relaxing the entry conditions for foreign banks, encouraging equity cooperation, and realizing strategic cooperation through foreign equity participation in Chinese banks and Chinese equity participation in foreign banks. In addition, the Legislative Affairs Office of the State Council has continuously revised and improved the regulations on foreign-funded financial institutions, exploring the gradual relaxation of the entry threshold for foreign-funded banks and improving the convenience of foreign-funded banks in conducting business. This will support the construction of the Shanghai Free Trade Zone and the Financial Reform Pilot Zone, the Silk Road Economic Belt and the 21st Century Maritime Silk Road.

In summary, with economic globalization and integration, China is seeking to open up its financial markets and increase the degree of financial liberalization. However, in China, the government still leads the allocation of financial resources, resulting in the inability to allocate financial funds on demand, and the phenomenon of "financial repression" still exists.

3. INTERNATIONAL FINANCIAL POWER

3.1. Definition and Classification of Financial Power

There are few systematic theoretical discussions on international financial power in the literature, and most of them focus on the instrumental use of international financial power. Ken Miller believes that by directly or indirectly supporting exports, China has accumulated huge foreign exchange reserves, thus gaining unprecedented international financial power. Daniel W. Drez believes that the international financial power of creditor countries can be divided into deterrence and coercion. Deterrence means that the creditor country has sufficient foreign exchange reserves to automatically deter the debtor country and reduce the possibility of the debtor country causing trouble in other policy conflicts. Coercion refers to forcing the debtor country to make concessions, usually by threatening to withdraw investment or reduce the purchase of new debt, adjust the structure of foreign exchange reserves, and slander the debtor country's currency.Both scholars regard foreign exchange reserves as the focus of international financial power. At the same time, the concept of financial power is widely used in the literature of international political economy. Susan Strange believes that the concept of power needs to be broadened, which should include structural power and connected power. Structural power refers to the ability to influence the ideas of other countries, the credibility of other countries, the prosperity of other countries, and the ability to determine how other countries do things. Associated power refers to the ability of one country to let another country do what it does not

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want to do. Therefore, Strange believes that relational power is implemented through the use of direct pressure, while structural power is more of an indirect form of power.

Learn from Sandra Ship's research on financial power in the book "China in Global Finance". We can understand financial power as the ability of a country to influence other countries through its financial relationship. At the same time, through the study of power in international political economy, financial power is divided into relational, structural and institutional financial power.

Among them, relational financial power refers to the ability of a country to directly influence other countries through the use of financial pressure. Structural financial power refers to the ability of a country to indirectly influence other countries through the structure of the international financial system. Institutional financial power refers to the ability of a country to indirectly influence other countries through the decisions of international financial institutions.

3.2. Sources and Mechanisms of Various Financial Powers

3.2.1 Relational financial power

As far as the definition given above is concerned, relational financial power is the ability of a country to directly influence the behavior of other countries through its financial relations with other countries. The main mechanism for creditor countries to use their disposable relational financial power. In terms of incentives, it is to provide credit. In terms of pressure, it is the recovery of loans, the refusal to provide loans, and dumping of the debtor’s currency to manipulate its exchange rate. Therefore, a country's creditor status can be regarded as its main source of relational financial power.

3.2.2 Structural financial power

Structural financial power can be divided into six sub-areas from the perspective of its achievable goals. They are the power to delay adjustment of deficit, the power to delay adjustment of surplus, the power to project macroeconomic preferences, the power to shape international financial rules, and the power to shape The power of economic geography and the power to reconstruct economic interests. In terms of adjusting deficits and adjusting surpluses, a country’s power to delay mainly comes from the country’s international solvency, which is its foreign exchange reserves and external borrowing capacity. The external borrowing capacity of a country depends on the international attractiveness of its financial market and the evaluation of its reputation by foreign investors. In addition, the projection of macroeconomic preferences includes not only a country’s domestic policy choices, but also through the function of currency anchors. At the same time, the trend of international rules needs to consider the international dominance of a country's currency and the regulation and control of the country's financial market.

Therefore, the main mechanism of structural power is the ability of a country to attract international capital. This is not only due to the depth and openness of the country’s financial market, but also from the international status of the country’s currency.

3.2.3 Institutional financial power

Relational financial power is exercised directly, while institutional financial power is exercised indirectly through the decisions of international financial institutions. Since the International Monetary Fund and the World Bank are the most important financial institutions in the current international financial structure, the main source of a country’s institutional financial power is the country’s voting rights, paid funds and their representation. The main mechanism for exercising institutional financial power is the influence of a country on the loans provided by these institutions and the conditions on which the loans are provided.

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4. RESULTS AND DISCUSSION

In order to ensure the scientificity, rigor and credibility of academic research, this article introduces related theoretical concepts and analyzes the actual situation in China, and links the political and economic system of China's current financial system with that of Japan's post-war financial system. Therefore, this article chooses the comparative empirical method and uses the influence of Japan's political and economic system in the 1980s on the country's financial power to explore the relationship between China's financial repression and international financial power.

4.1. Financial Repression Is Conducive to Obtaining Relational Financial Power

In the early 1980s, Japan entered a period of rapid increase in capital exports and a substantial increase in overseas asset accumulation following successive years of trade surpluses and current account surpluses in its balance of payments. At the end of 1985, Japan's overseas net assets balance was 129.8 billion U.S. dollars, surpassing the world's major creditor countries, Britain and West Germany, and ranking first.

Just like Japan in the 1980s, China's increasing financial influence is mainly due to its becoming one of the world's major creditor nations. In 2006, China's foreign exchange reserves exceeded one trillion U.S. dollars, surpassing Japan to become the country with the largest foreign exchange reserves in the world. And it can be seen from Figure 1 that the scale of China's foreign exchange reserves has always shown an increasing trend from 2006 to 2014, but declined in 2015 and 2016 due to the massive outflow of capital. In 2017, the country implemented strict capital controls centered on foreign exchange, and restricted capital outflows, which led to a rebound in foreign exchange reserves in 2017.

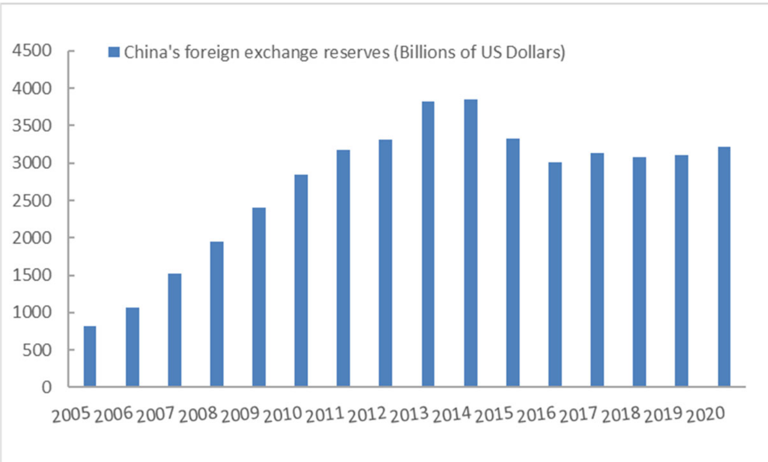

Figure 1. China's foreign exchange reserves
Source: Wind database

As shown in Figure 1, although China's foreign exchange reserves are affected by capital outflows, the overall scale remains relatively high. Just looking at the size of China's foreign exchange reserves, China has sufficient relational financial power. However, China's huge foreign exchange reserves are brought about by the high "double surplus" in the balance of payments, including current account surplus and capital account surplus. Analyzed from the current account, China's financial repression system makes China rely on the development model of investment and exports, and this model has brought a large amount of current account surplus and huge foreign exchange reserves. Therefore, through the financial restraint system, the government is allowed to accumulate surplus in the form of foreign exchange reserves and

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control the influence of the reserve accumulation currency, so that the government can exercise a high degree of normalization of the country's capital outflow, which is beneficial to the development of relational financial rights.

4.2. Financial Repression Is Not Conducive to Obtaining Structural Financial Power

In the 1980s, Japan began the process of financial liberalization. Japan’s financial liberalization includes interest rate liberalization, business operation liberalization, market access liberalization, and capital flow liberalization. After World War II, Japan’s low interest rate policy prevented banks from performing their functions of information production and risk management, resulting in inefficient markets and distortions in the Japanese economy. Therefore, Japan has accelerated the pace of reform and developed "new financial products", including allowing banks to issue transferable deposit certificates (CD), free floating deposit interest rates, and allowing the issuance of market interest rate-linked certificates of deposit (MMC). In terms of business operations, the Japanese government has abolished restrictions on the business area of financial institutions, allowing banks to engage in securities businesses such as the buying and selling of public bonds and raising new public bonds. At the same time, securities companies can also handle government bond-guaranteed loans. In terms of financial markets, the Japanese government further opened up the yen bond market, abolished relevant regulations for non-residents to purchase yen bonds and established an open treasury bond market. In 1980, Japan revised the "Foreign Exchange and Foreign Trade Administration Law", abolished foreign exchange management, no longer imposed restrictions on foreign exchange deposits and loans, and stipulated that residents have the freedom of foreign exchange deposits and loans, as well as securities issuance, investment, and capital transactions. The internationalization of enterprises and the entry of foreign capital into Japan provide conditions. On December 1, 1986, Japan established the Tokyo Offshore Financial Market. It is different from the integrated internal and external markets of London and Hong Kong, but an external financial market, whose nature is the same as that of New York and Singapore. The opening of Tokyo's offshore financial market has also made Japan's financial liberalization and internationalization a big step forward. The increase in the degree of financial liberalization in Japan has made its financial market strong internationally attractive, which is conducive to its acquisition of structural financial power.

Unlike Japan’s financial system that continues to be under pressure from liberalization, the development of China’s financial market has been restricted by financial repression. For a long time, China’s debt market has been largely dominated by bond issuance by government agencies and state-owned financial institutions. Under the financial repression system, a bond market with significant market capacity can only exist when residents are not provided with investment to replace bank deposits. Because this alternative investment will lead to capital outflows from the state-controlled banking sector. Therefore, China's bond market cannot play a role in risk pricing, and it can hardly attract international investors. At the same time, the development of China's stock market is still immature. "Policy market" is a policy-driven market, which is a major feature of China's stock market. As a market regulator, the phenomenon of interfering in the stock market is a manifestation of the "policy market." Therefore, China's stock market is not driven by economic fundamentals, but by government decision-making, which also lacks international appeal.

Because the liberalization of China's financial market is incompatible with its financial repression system. As long as China is unwilling to carry out fundamental reforms of its financial system, it will not be able to obtain structural financial power derived from the international attractiveness of financial markets. China's financial repression system will also prevent China from gaining structural financial power by turning its currency into an international reserve currency. Because this also requires the internationalization of China's financial markets.

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4.3. Financial Repression Is Not Conducive to Obtaining Institutional Financial Power

After Japan became a major international creditor nation in the 1980s, it struggled to win the voting rights of the International Monetary Fund and the World Bank. In 1986, Japan raised its voting rights to 6.7% by making donations on the condition of increasing voting rights in the World Bank during the capital increase negotiations of the International Development Association. In 1990, when Japan announced that it would provide 4.5 billions of US dollars to support the US's "Brady Plan" to solve the debt problems of developing countries, the member states of the International Monetary Fund agreed to increase capital by 50%, from 120 billions of US dollars to 180 billions of US dollars. At the same time, in order to strengthen Japan's voting power in the two major institutions, Japan challenged the "Washington Consensus" and proposed the Asian Monetary Fund initiative to provide stronger support for the acquisition of institutional financial power.

With the transfer of power in the world economy, China has successfully secured an increase in its voting rights in the International Monetary Fund and the World Bank in recent years. At present, China's voting rights in the International Monetary Fund and the World Bank are only behind the United States and Japan. As a result, China's institutional financial power is clearly on the increase. However, under the financial repression system, China is not as eagerly as Japan was vying for power in the Bretton Woods institutions. In comparison, China is more concerned about maintaining domestic economic growth and stability. Therefore, when the Bretton Woods institutions urgently needed other sources of financing, China was extremely hesitant to provide funds that were not in return for an immediate increase in voting rights, and missed the opportunity to further increase its institutional financial power.By influencing loans and additional conditions for loans provided by international financial institutions, institutional financial power enables a country to advance its economic interests or achieve foreign policy goals. However, these goals can also be pursued through the use of a country's relational financial power, which will make the development of institutional power dispensable to a certain extent.

5. CONCLUSION

From the above analysis, it can be seen that China's financial repression system prevents it from gaining structural power. This is caused by the incompatibility between the financial repression system and the development of financial markets that can attract international investors. And it is precisely because of the existence of China's financial repression system that the control of foreign exchange reserves is conducive to maintaining current account surpluses, and it is conducive to the acquisition of relational financial power by curbing currency offset costs when facing large current account surpluses. The financial repression system is very conducive to obtaining relational power, and tends to make the development of institutional power dispensable to a large extent.

Therefore, in order to enhance China's acquisition of external financial power under the existing financial suppression system, we need to properly handle China's creditor country status, foreign exchange reserves, and rights and responsibilities in the Bretton Woods institutions. At the same time, it is necessary to enhance the international attractiveness of China's financial market and promote the internationalization of the RMB.

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