



# Reprint of: Reserve accumulation and exchange rate policy in China: The authoritarian elite's aim of political survival



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## ABSTRACT

Since the Asian financial crisis of 1997–1998, China has significantly increased its foreign exchange reserves. We argue that the resulting abnormal levels of currency reserves accumulated by Chinese authorities are not intended to maximize the citizenry's economic welfare, as in a mercantilist or a precautionary account, but rather to forestall the elite's own political demise. This goal has been pursued mainly by generating large current account surpluses through manipulation of the renminbi exchange rate. The Chinese elite has sought to promote the acceptance of this policy by influencing the costs of collective action taken by winners and losers.

## 1. Introduction

China's foreign exchange reserves have risen significantly since 1997. Their share of gross domestic product (GDP) increased from 15.4 to 42.0 percent, which translated into China holding the world's largest reserves of foreign exchange. These developments have incited considerable debate over China's currency policy and its reasons for accumulating reserves. Much of the literature has argued that Chinese authorities have pursued a neo-mercantilist policy: manipulating the exchange rate of its own currency, the *renminbi*, in order to achieve high GDP growth and thereby improve the economic welfare of its citizens (Dooley et al., 2004). Other scholars disagree, arguing that China's large and persistent trade surpluses instead reflect a high level of domestic savings undertaken for precautionary reasons (Caroll and Jeanne, 2009; Durdu et al., 2009; Jeanne and Ranci ere, 2011).

However, the empirical evidence indicates that forecasts based on these two hypotheses underestimate China's actual reserves (Edison, 2003; Park and Estrada, 2009). For that reason, we must reconsider the country's motives for accumulating such extensive currency reserves. The standard accounts just described explain the phenomenon in terms of the utility-maximizing behavior of individuals, yet in so doing they disregard the political motivations for the behavior of China's authorities.

Our paper adopts the political economy perspective and hypothesizes that—under authoritarian regimes even more so than in democracies—the main objective of policy makers is their political survival (Bueno de Mesquita et al., 2003). Unlike the case of a democracy, an authoritarian government's loss of power involves not only the political process but also the political structure; indeed, it implies the fall of a regime.

Starting from this hypothesis, we offer an alternative explanation for China's accumulation of reserves. This explanation presumes that, during the last few decades and especially since the Asian financial crisis (AFC), China's political elite has sought to protect itself from the risk of sudden stops and from financial crises more generally—toward the end of promoting its own political survival and that of the regime (Shih, 2008). The mechanism employed (i.e., accumulating reserves) has been pursued mostly by way

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of persistent current account surpluses. Normally, a country with a current account surplus will also have a deficit on the capital account of the balance of payments. In contrast, for two decades China has been running “twin surpluses”, or capital account surpluses together with current account surpluses (Prasad and Wei, 2005). The latter are enabled by long-term undervaluation of the renminbi (RMB).

Protracted maintenance of an undervalued currency is possible only if the regime can sterilize currency flows and is willing to adopt forms of financial repression. Such a policy will necessarily result in winners and losers (Bai and Qian, 2010; Kroeber, 2016). By intervening in the matter of collective action costs, the Chinese elite has managed to boost its support from the winners while containing opposition from the losers.

The rest of our paper proceeds as follows. Section 1 reviews the relevant literature on China's accumulation of massive foreign reserves over the last two decades. In Section 2 we present a model à la Besley and Persson (2011); we use this model to demonstrate that, when an authoritarian regime faces a threat to its survival resulting from a sudden stop or a financial crisis, the regime tends to accumulate substantial currency reserves in order to preserve its power. Section 3 presents the results of econometric estimates that support the hypothesis of persistent RMB undervaluation in real terms. Empirical evidence for the precautionary behavior of authoritarian leaders is given in Section 4, where a panel data estimate shows that the authoritarian countries in Southeast Asia tend to hold higher amounts of reserves than do the democratic countries in that region. A persistent undervaluation of the exchange rate has inevitable repercussions on income distribution; we show in Section 5 that an authoritarian regime, as that of China, can (more easily than a democratic regime) deal with interest groups opposed to a certain currency policy because it can more easily manipulate the costs of collective action. The paper concludes with some suggestions for future research.

## 2. Relevant literature

The significant increase in foreign currency reserves in the majority of emerging countries, and especially in China, has led to reconsideration on the theoretical level of factors that determine the demand for such reserves. In the past, most accounts of these determining factors were rendered in terms of cost–benefit analysis (Heller, 1966); the current tendency is to derive the optimal level of reserves from the behavior of rational and utility-maximizing agents. Extant theories attribute the accumulation of foreign exchange to either a precautionary motive or a mercantilist motive.

The *mercantilist* motive is invoked by Dooley et al. (2004), who argue that the Chinese elite seeks to absorb the unskilled labor surplus in the manufacturing industry. To achieve this goal, China's leaders deliberately resort to an undervalued real exchange rate for RMB. Several mechanisms have been described whereby undervaluing the exchange rate increases output growth. Ghosh and Kim (2009) consider an economy in which policy makers find an undervalued exchange rate to be advantageous because its effects are similar to those of a subsidy on exports. In particular, if the economy features spillover effects on productivity then undervaluation makes the country's tradables sector more competitive internationally.

Similar arguments are used by Rodrik (2009), who maintains that undervaluation of the exchange rate by emerging and developing countries makes it possible for them to increase profits in the tradables sector, which is penalized more than the nontradables sector by the institutional inefficiency afflicting these countries. The expansion of the tradables sector, in turn, increases output growth. In all the works we have cited, the accumulation of reserves is a purely unintentional side effect of undervaluing the exchange rate for the sake of output growth.

A *precautionary* motive, in contrast, is attributed to the reserve accumulation by emerging countries (and China) when viewed as the desired effect of domestic savings exceeding investment; this phenomenon is signified by persistent current account surpluses. Among the contributions that make reference to the precautionary motive, two different strands can be identified. The first strand addresses on the heightened risk of a sudden stop in a context of financial globalization and high volatility of capital. In this context, accumulating reserves makes it possible to reduce the probability of a sudden stop, a fall in output, and a consequent decline in consumption (Caroll and Jeanne, 2009; Durdur et al., 2009; Jeanne and Rancière, 2011). The second strand examines the repercussions—on the behavior of families and enterprises—due to imperfect financial markets in emerging countries. Here, either families (Wen, 2011) or enterprises (Song et al., 2011) face stringent borrowing constraints and so must maintain high savings rates, leading to large current account surpluses.

Finally, the literature based on the precautionary motive also includes contributions that attribute the accumulation of reserves by emerging countries to the pursuit, by policy makers, of financial stability when capital is highly volatile. Thus Obstfeld et al. (2010) explain the reserve accumulation in terms of an emerging country's goals to foster development of its domestic financial system, to promote that system's integration internationally, and to combat the “fear of floating”. The last objective stems primarily from the need to boost trade and to avoid destabilizing effects on the economy when liabilities are dollarized (Calvo and Reinhart, 2002). Taking this perspective, Hur and Kondo (2011) develop a model in which reserve holdings by emerging countries are a response to their risk of foreign debt rollover.

The empirical research based on these theoretical schemes tends to underpredict reserve levels not only in emerging countries but also, and of more interest to our paper, in China (Aizenman and Marion, 2003; Edison, 2003; Park and Estrada, 2009; Jeanne and Rancière, 2011).

So that we can better understand why China holds such large amounts of currency reserves, this paper employs an interpretive scheme in which it is assumed that—should a sudden stop or financial crisis occur—the political elite is more likely to lose power under authoritarian than under democratic governance. This hypothesis is justified when one considers how crisis-induced political instability that would only temporarily hamper a democratic government might lead to the fall of an authoritarian regime. That difference accounts for our hypothesis that an authoritarian regime's elite is concerned mainly with their own survival and so must devote careful attention to threats, both internal and external.

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