Union for Radical Political Economics presents

Monetary Policy and Dollar Policy

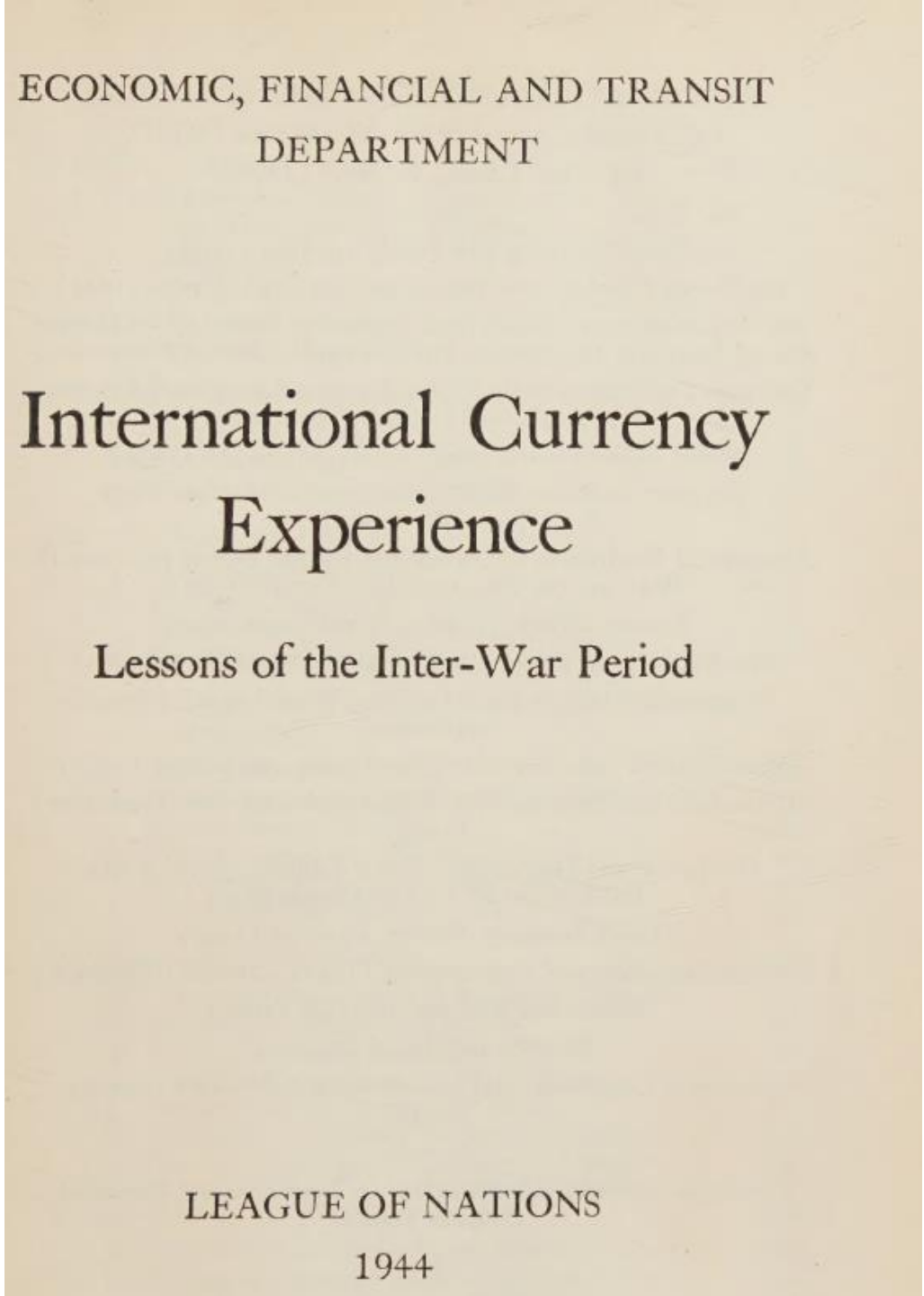
A talk by **Jan Kregel**

Marx- Volume II: Capital Accumulation Reproduction Schemes: Simple v Expanded Reproduction based on balance between two sectors of the economy :

- **Department I** produces **means of production** (machines, raw materials,— bought by *other* capitalists).
- **Department II** produces **means of consumption** (the goods and services for *personal* consumption)
- **Simple Reproduction** (Schumpeter: Stationary State – no money is needed)
  - Classical Savings assumptions – Kalecki: ”Workers spend what they get capitalists get what they spend” (Kalecki: Capitalists don’t need money)
- Keynes in the Treatise on Money talks about available and non-available goods
- **Extended reproduction** to expand it must **accumulate** new means of production and hire more labor power = **Net investment**.
- In Treatise it is household voluntary Saving v Capitalists’ Investment: Stationary balance S=I
- **Realisation Crisis:**
  - **How to help out domestic Capitalists’ deficient purchase of Department I:**
  - **Military Keynesianism - Government deficit buys Department I military goods**
  - **Rosa Luxembourg – Imperialist expansion Exploitation foreign labour**
- **Nationalism (no more colonization) -- Foreign Governments/Capitalists buy Department II outputs**
    - **Developing country capitalists import Department II goods from Developed Capitalists**
    - **Finance by Cross-border lending from Developed to Developing countries**
    - **Import substitution -- No Department I Development– Debt—led non-Development**

- Stationary State under (multi) Nationalism:
  - Balance in import and export of each country Department I & II
  - Current account balances offset across countries
- Developing countries export Department II goods) = import of Department II goods
  - Again no money needed – no capital account balance
- This was the Ragnar Nurkse solution in the League of Nations analysis of InterWar Hot Money
  - Requires coordination of national policies across countries to limit imbalances
- This was Bretton Woods Objective
  - IMF stabilisation fund to enforce Departmental balance
    - Federal reserve aggregated domestic reserves, IMF aggregated international reserves
    - via commitment to intervene to stabilize exchange rates
    - Costs of reserves in loss of domestic sovereignty in IMF adjustment programme
- Reserve based financial system
  - Use domestic currency to borrow reserves to stabilize foreign exchange market
  - Parity exchange rates to 1: gold, no gold, so to US dollar
    - Dollar became reserve currency (because US had all the gold and all the Department I goods that post war Europe and new Nations needed
  - IMF became Global Federal Reserve
- BUT this repeated the flaw of the pre-war Gold Standard

Ragnar Nurkse:
post mortum
on the 1930s experience
of restoring the Gold Standard:
What were the experts thinking?



Nurkse on Inter war Currency experience

After the devaluation of the gold bloc currencies in September 1936, the flexible gold-settlement system was given a formal basis under the Tripartite Agreement; the United States Treasury provided a market for gold at the new price fixed in January 1934, and in most other countries the market price of gold was determined directly or indirectly by the current rate of exchange on the dollar.

But in reality there were two competing monetary demands: one for legal cover to "support" national currency and credit structures and the other for international currency. The national currency and credit structures could not have been expanded without drawing upon the stock of international currency. An increased demand for international currency, on the other hand, could not have been met without forcing a contraction in the cover base through contraction in national currency and credit supplies.

Schumpeter on Keynes' Supranational bank

With the exception of the *Treatise on Probability*, Keynes never wrote another work in which the hortatory purpose is less visible than it is in the *Treatise on Money*. It is there all the same, and not confined to the last book (VII), in which, among other things, we find all the essentials of Bretton Woods—what an extraordinary achievement! Primarily, however, those two volumes are no doubt Keynes' most ambitious piece of genuine research, of research so brilliant and yet so solid that it is a thousand pities that the harvest was garnered before it was ripe. If only he had learned something from Marshall's craving for "impossible perfection" instead of lecturing him about it! (*Essays*

Reserves and Synchronization

Under a regime of stable exchanges, the need for international currency {could be} reduced or eliminated … with very close coordination of domestic policies affecting national incomes and prices in the various countries.

Thus it is theoretically conceivable that, with appropriate management of the domestic conditions of supply and demand, each country's foreign receipts and payments, including any commercial and investment loans, could always be kept in balance, so that the exchange rate, though stable, would always constitute an equilibrium rate in this sense.

The reserve requirements might perhaps be regarded as an attempt to enforce precisely such synchronization. Even without any legal percentage ratio, there would, of course, still be a minimum—namely, zero—, and if a central bank saw its international cash reserve approach that minimum, it might feel compelled to take action tending to reduce domestic credit and national income and so restore equilibrium in the balance of payments.

Thus a certain measure of synchronization might still take place. It is clear, however, that if a large part of the international cash reserve is virtually blocked through legal cover requirements, the volume of international currency proper is less than it would otherwise be, so that countries are called upon to keep more closely in step with each other if stability of exchanges is to be maintained. The smaller the total volume of international currency, the less latitude there is for individual countries,

if one country's reserve is persistently growing too large or too small, that country would need to take measures (such as exchange-rate adjustments) designed not merely to bring its balance into equilibrium, **but further to create, for a time, a deficit in place of the previous surplus or a surplus in place of the previous deficit, so as to reverse in some degree the previous change in the reserve position**. But if in fact a persistent and considerable shift in reserves has been allowed to occur in the past, maldistribution is a fait accompli which it may be difficult or impracticable to reverse by methods suitable for dealing with current disequilibria in balances of payments.

Gold Standard rules to Gold Buffers

The Gold Standard "system imposed no close restraints on simultaneous movements in the same direction. In the interests of exchange stability it required above all conformity on the part of its members. Conformity was achieved to some extent automatically through the unimpeded influence of foreign demand on a country's export earnings, domestic income flow and capital outlay ;

all that was required for this purpose was that countries should not attempt to control their national income and outlay by deliberate measures—a requirement which in the age of laissez-faire was generally fulfilled.

To reinforce this influence, there existed "rules of the game" which prescribed that changes in a country's gold reserve should be accompanied by multiple or at least parallel changes in the domestic credit supply, or at all events that nothing should be done to offset any automatic effect which gold movements might produce in that direction.' In this way gold generally acted or was expected to act as a "conveyor" or "transmitter."

During the inter-war period, gold and other **international reserves came instead to serve more and more as a "cushion" or "buffer." There was evidently a growing reluctance on the part of individual countries to submit to economic fluctuations originating abroad; there was a growing desire for economic stability ; there was a growing realization of the need to maintain national income and outlay so as to secure an adequate level of employment.**

As part of this general trend, the practice of neutralizing the effect of gold movements on the domestic credit base became increasingly common. This tended indeed to keep the domestic money supply more stable, but it was not by itself sufficient to offset the effects of a fall in foreign demand on a country's exports and hence on its domestic income, expenditure and employment. It is clear, however, that international currency reserves in their role as shock-absorbers are capable of serving this wider purpose as well.

Thus at a time of general depression any single country seeking to expand effective demand and employment at home needs a buffer reserve of international means of settlement to meet the adverse balance likely to result from the increase in its national income as compared with income abroad.

The buffer function of international cash reserves becomes even more evident in the case of a country which continues to maintain its national income at a high level when a depression occurs in some other country or countries.

A reserve of international liquidity enables the country in question to meet the adverse balance likely to develop in these circumstances. Depression abroad means a fall in the demand for its exports. If employment at home is to be maintained, the decline in foreign expenditure on its export products needs to be offset by an increase in domestic expenditure.

According to Charles de Gaulle, President of France: “The present monetary system consists in the exorbitant privilege enjoyed by the United States of being able to cover is balance of payments deficit with its own dollars” (February 4, 1965).

Since the US controls the creation of dollars, this means that there is no limit on the resources that the US can acquire from its trading partners – its trade deficit is unlimited.

{Note that the US in fact never paid with dollars, but with private and government dollar denominated claims.. in the 1970s the private claims were Eurodollars, in the 1980s and after government debt}

More specifically, under the Bretton Woods system of par exchange rates this means that the US does not have to take measures to stabilize its exchange rate: “the dollar is our currency, but it is your problem” according to the Nixon Administration Treasury Secretary John Connally.

Dilemma of international monetary system: First for UK

- Perhaps the difficulty can be made vivid by assuming a perfectly mobile international monetary system, in the sense that the rate of every foreign exchange is rigidly fixed, so that there is no expense in remitting funds from one country to another, and that the financiers of every country are completely indifferent as to where they lend their money, merely seeking the highest rate of interest. It is evident that in such conditions the rate of interest would have to be the same throughout the world. …Thus the degree of its power of independent action would have no relation to its local needs.
- **This, then, is the dilemma of an international monetary system-to preserve the advantages of the stability of the local currencies of the various members of the system in terms of the international standard, and to preserve at the same time an adequate local autonomy for each member**
- **over its domestic rate of interest and its volume of foreign lending**.
- I fancy that some advocates of the general return to gold after the war did not fully foresee how great the urge would be towards local autonomy and independent action.
- —that even a small and temporary divergence in the local rate of interest from the international rate may be dangerous. In this way adherence to an international standard tends to limit unduly the power of a central bank to deal with its own domestic situation so as to maintain internal stability and the optimum of employment.
- The problem presents itself in different forms to debtor and to creditor nations respectively. It is likely to prove more severe and intractable in the case of a debtor nation than in the case of a creditor nation, because it is easier to lend less in an emergency than to borrow more.
- Keynes: *Treatise on Money, Vol II*

Keynes: 19th century did this

- “The nineteenth-century free trader’s economic internationalism assumed that the whole world was, or would be, organized on a basis of private competitive capitalism and of the freedom of private contract inviolably protected by the sanctions of law—in various phases, of course, of complexity and development, but conforming to a uniform type which it would be the general object to perfect and certainly not to destroy.”
- BUT: “**Progress was based on income and wealth inequality** produced by economic relations in which “interference of frontiers and of tariffs was reduced to a minimum, … The various currencies … all maintained on a **stable basis in relation to gold** and to one another, **facilitated the easy flow of capital and of trade** to an extent the full value of which we only realise now, when we are deprived of its advantages. Over this great area there was an **almost absolute security of property and of person**.” (1971a: 9)

Capital Flows and Economic Structure

Balogh (1949), Balogh. and Schumacher, (1949) Early criticism of the Bretton Woods Agreements e.g. focussed on **the unbalanced productive structure** that characterised most developing countries and the problems of primary commodity dependence and the appropriate balance between investment to expand income via the multiplier effect and expansion of consumption goods to ensure an accommodating expansion in real incomes and domestic consumption. Rather than Soviet style quantitative planning, early development theorists built on the experience of war planning to formulate development strategies based on sectoral interrelations such as represented by input output tables that were becoming popular in the 1950s.

Kalecki (World Economic Report, 1954 Chapter 2, 1954) identified the importance of the balance between investment and consumption in his analysis of the performance of socialist economies in the post-war period:
"The rate of increase in output of producers' goods in relation to the national product was considerably accelerated in 1950 and 1951. … The rapid rise in the output of producers' goods in conjunction with a significantly slower increase in the production of consumer goods in general, and of food in particular, led to persistent pressure of demand upon supply. … In order to deal with the resulting strains on their economies, most of the countries applied similar emergency measures, … associated with changes in the price and wage structure. … real wages were in many instances barely maintained, or even declined." The point was also raised in the work of Kaldor (1964a,), Diamand (1978), Prebisch (1961) and others.

Chairman Mao "On The Ten Major Relationships" April 25, 1956

"The emphasis in our country's construction is on heavy industry. …But it definitely does not follow that the production of the means of subsistence, especially grain, can be neglected. Without enough food and other daily necessities, it would be impossible to provide for the workers in the first place, and then what sense would it make to talk about developing heavy industry? Therefore, the relationship between heavy industry on the one hand and light industry and agriculture on the other must be properly handled. In dealing with this relationship we have … done better than the Soviet Union and a number of East European countries. The prolonged failure of the Soviet Union to reach the highest pre-October Revolution level in grain output, the grave problems arising from the glaring disequilibrium between the development of heavy industry and that of light industry in some East European countries -- such problems do not exist in our country. Their lop-sided stress on heavy industry to the neglect of agriculture and light industry results in a shortage of goods on the market and an unstable currency. We, on the other hand, attach more importance to agriculture and light industry. We have all along attended to and developed agriculture and have to a considerable degree ensured the supply of grain and raw materials necessary for the development of industry. Our daily necessities are in fairly good supply and our prices and currency are stable.

The problem now facing us is that of continuing to adjust properly the ratio between investment in heavy industry on the one hand and in agriculture and light industry on the other in order to bring about a greater development of the latter. the proportion for agriculture and light industry must be somewhat increased."

Keynes on financialization and Imperium

- The nineteenth century carried to extravagant lengths the criterion of … “the financial results,” as a test of the advisability of any course of action sponsored by private or by collective action. The whole conduct of life was made into a sort of parody of an accountant’s nightmare.
- Instead of using their vastly increased material and technical resources to build a wonder city, the men of the nineteenth century built slums; and they thought it right and advisable …because slums, on the test of private enterprise, “paid,” whereas the wonder city would … have been an act of foolish extravagance, which would, in … financial fashion, have “mortgaged the future”—though how the construction to-day of great and glorious works can impoverish the future, no man can see until his mind is beset by false analogies from an irrelevant accountancy.
- Even to-day I spend my time …in trying to persuade my countrymen that the nation as a whole will assuredly be richer if unemployed men and machines are used to build much needed houses than if they are supported in idleness. For the minds of this generation are still so beclouded by bogus calculations that they distrust conclusions which should be obvious, out of a reliance on a system of financial accounting which casts doubt on whether such an operation will “pay.”
- We have to remain poor because it does not “pay” to be rich. We have to live in hovels, not because we cannot build palaces but because we cannot “afford” them. …
- We destroy the …countryside because the unappropriated splendors of nature have no economic value. we …ruin the tillers of the soil and destroy the age long human traditions attendant on husbandry, if we could get a loaf of bread thereby a tenth of a penny cheaper. “

Keynes: Keep finance Domestic

- **“I sympathize, therefore, with those who would minimize, rather than with those who would maximize, economic entanglement among nations….**
- **above all, let finance be primarily national.** **“National Self-Sufficiency,” Yale Review,** July 1, 1933
- “During the nineteenth century and up to 1914 the flow of capital funds had been directed from the creditor to the debtor countries, which broadly corresponded to the older and the newer countries, and served at the same time to keep the balance of international payments in equilibrium and to develop resources in undeveloped lands” …. in the 20th century, “capital funds flowed from countries of which the balance of trade was adverse into countries where it was favourable. This became, in the end, the major cause of instability.” … “nothing is more certain than that the movement of capital funds must be regulated” (Keynes 1980, 31).
- “It is, therefore, a serious question whether it is right to adopt an international standard, which will allow an extreme mobility and sensitiveness of foreign lending, whilst the remaining elements of the economic complex remain exceedingly rigid. If it were as easy to put wages up and down as it is to put bank rate up and down, well and good. But this is not the actual situation.
- A change in international financial conditions or in the wind and weather of speculative sentiment may alter the volume of foreign lending, if nothing is done to counteract it, by tens of millions in a few weeks. Yet there is no possibility of rapidly altering the balance of imports and exports to correspond” (Keynes 1971, 300).
- Advisable domestic policies might often be easier to compass, if the phenomenon known as “the flight of capital” could be ruled out. The divorce between ownership and the real responsibility of management is serious within a country, when, as a result of joint stock enterprise, ownership is broken up among innumerable individuals who buy their interest to-day and sell it tomorrow and lack altogether both knowledge and responsibility towards what they momentarily own.
- There may be some financial calculation which shows it to be advantageous that my savings should be invested in whatever quarter of the habitable globe shows the greatest marginal efficiency of capital or the highest rate of interest. But when the same principle is applied internationally, it is, in times of stress, intolerable—I am irresponsible towards what I own and those who operate what I own are irresponsible towards me….
- But experience is accumulating that remoteness between ownership and operation is an evil in the relations among men, likely or certain in the long run to set up strains and enmities which will bring to nought the financial calculation.”

Bretton Woods – Failure foreseen

- Erik Hoffmeyer: “the Bretton Woods system. … the general idea was that some sort of restrictions on capital movements was necessary. On this point Keynes especially was very clear: ‘It is widely held that **control of capital movements, both inward and outward, should be a permanent feature of the postwar system**.’.” (Hoffmeyer 1978, 23).
- Jacques de Larosière: “Little had been said at Bretton Woods on the desirability of countries’ liberalising capital movements. … This meant that capital flows to developing countries were predominantly official in nature. …These flows were concentrated on large public infrastructure projects. Only a small proportion went into the private sector” (Larosière 1996, 4).
- In the words of Gabriel Hauge “the growing part played by the international market in transmitting capital across the world represents an important change of recent years. … **However, the channelling of a greater proportion of capital through the international market has important implications**…” (Hauge 1978, 8–9).
- Yusuke Kashiwagi, **“If surplus investment funds continue to be channelled mainly into money games instead of being invested to create real capital, the world's productive activities may not rise to higher levels, a growing tempest of trade friction may spread across the world, and the debtor developing countries may be crushed by their growing mountain of debts.”** (Kashiwagi 1986, 2).

Bretton Woods Breakdown: Liquidity shortage in the presence of excess liquidity

- Symthsonian/Jamaica: Abandon Stable Exchange Rates
- Abandon Role of IMF as enforcer of "domestic policy uniformity"
- Abandon IMF as source of global reserve balances
- Change in regime to open international capital flows
- **Private banks now provide global reserves balances**
  - **With the help of the 1970s petroleum surplus recycling**
- **Private (US) banks replace IMF as source of US$ reserves**
- **Rise of Money managers directing global capital flows**
- Sharp expansion in capital flows – and current account imbalances
- Dollar remains global reserve currency for new "non-system"
  - Developed/then Developing countries go into external deficit
- Domestic currencies become an "Asset class".
  - Need US $ to counter currency speculations

“a market-based monetary (non) system”

Guido Carli, Governor, Bank of Italy “**during this period the international monetary system shifted out of the domain of the official international institutions: the private banking system took over the functions proper to an official institution**. … [From the] assumption by the private banking system of the function of a clearing union, which according to Keynes ought to have been performed by the International Monetary Fund … certain conclusions may be drawn. The most important, I think, is that **there is at present no international monetary system, that is, there is no official institution … the function of creating international liquidity has been transferred from official institutions to private ones**” (Carli 1976, 6).

Joannes Witteveen: “**rapid growth of international lending by commercial banks through Euromarkets and other offshore markets,** The role of governments in this financial system has weakened and could be described by saying that **governments now participate as partners with commercial banks in a market-based monetary system**.” He even notes that “Many central banks, acting like private investors,” (Witteveen 1983, 4–5). “**there is at present no international monetary system. Our monetary system is in a rather frightening state.”**

Gabriel Hauge (1978, 5) “**we do not have a monetary system,** rather an improvised network of arrangements serving the financial markets around the world.”

Alan Greenspan: “**The global financial system has been evolving rapidly in recent years … resulting in a massive increase in capital flows. … We do not as yet fully understand the new system's dynamics**. We are learning fast and need to update and modify our institutions and practices to reduce the risks inherent in the new regime.” The “new system dynamics” was thus characterised by the recognition that the main problem facing international financial stability was no longer current account crises, but capital account crises (Greenspan, 1998).

Expanded reproduction – all nations expand at same rate
BUT Developing Countries
no Department I)
subsistence or peasant agriculture (zero labour exploitation – slavery) Department II

Developing countries:
negative Current Account Balance (imports of Developed Department I goods)
Balanced by Developed countries Capital account deficit (foreign lending)
Centre Periphery/Monocommodity Dependence/Latin structuralism
Colonies were prevented from developing Department I
Department II could not generate export sales/declining terms of trade/ to finance imports of Department I goods from Developed countries

Two Major problems of BW:
Impact of Unregulated capital flows on Divergence in DI/DII balance across countries
Detrimental Impact of unregulated Capital flows on DI/DII balance representing national policy space

Capital Flows and the Structural production Balance

The uncontrolled import of finance for capital investments could thus to put pressure on both domestic prices and the external account, leading to pressure for higher domestic wages and increased borrowing to finance the increasing debt service. As governments often respond to domestic pressure to improve economic conditions with deficit expenditure programs, the result was a combination of rising fiscal and external deficits, rising debt service and declining real income growth.

Thus while it may appear that profligate governments' fiscal and expansionary monetary policies are the proximate cause of inflation and fiscal deficits in developing countries the primary cause may have been the result of the impact of capital inflows on the balance between investment consumption. The application of austerity policies may thus simply aggravate these imbalances without addressing the cause.

In sum, dependence on foreign finance reduces domestic policy space in ways that have adverse real economy effects without necessarily correcting for 'unsustainable' current account deficits. While capital controls are therefore in order to enhance domestic policy space and permit proactive government fiscal intervention, they must be part of a coordinated program to balance the impact on investment and consumption.

It’s the Private Capital Flows!!

- And their impact on balance of Department I relative to Department II
- And the role of private investors in domestic capital markets deciding to finance Department I output
  - Or just capital market speculation
  - Carry trade
- Keynes: Speculation v. Industry finance
- Liquidity preference
  - If US interest rates are below expected appreciation of US assets adjusted for exchange rates borrow dollars and hold in US capital markets
  - If domestic rates are below expected appreciation of US assets adjusted for exchange rates borrow cheap and lend in US capital markets
- US loses Department I, it becomes a Department II Economy!
- Final consumption in GDP – 80% percent (China 56%)
- China is a Department I economy

How is China Different?

- Chinese Characteristics: rights not things
- IMPERIUM: CCP Sovereignty
- CCP controls property in land
- CCP controls domestic banking and financial system
- CCP controls foreign capital rights – < 50% joint ventures
- CCP controls foreign investment of external surplus
- CCP controls Investment/Consumption balance – Commanding Heights

- DOMINIUM: Individuals – rights of usufruct
- Farmers have right to decide land use
- Local Authorities have right to allocate land use

Market Socialism with Chinese Characteristics

After Mao's death the survivors of the cultural revolution were faced with a chaotic economic and political system unable to provide domestic subsistence.

The 1977-8 discussions dominated by Deng called for abandon of the class struggle as the basis for policy while preserving the political dominance of the CCP.

This involved learning from the success of the second and third world economies, and in particular the lessons of the advanced market economies via official fact-finding missions to Europe, Japan.

It could not rely on government finance since there was little fiscal revenue and it had no financial system to provide support.

China Read Schumpeter and Japan/Germany

- “The money market is always, as it were, the headquarters of the capitalist system, from which orders go out to its individual divisions , and that which is debated and decided there is always in essence the settlements of plans for future development. All kinds of credit requirements come to this market; all kinds of economic projects are first brought into relation with one another, contend for their realization in it; all kinds of purchasing power, balances of every sort, flow to it to be sold.” (Schumpeter, 1934)
- “The creation if purchasing power by banks … is always a question, not of transforming purchasing power which already exists …but of the creation of new purchasing power out of nothing – out of nothing even if the credit contract by which the new purchasing power is created is supported by securities which are not themselves circulating media – which is added to the existing circulation.

How China diverged from the “Avramovitch Plan”

- A 3 Stage 'debt sustainable' development scenario
- 1. Domar stability condition met while the country invests in production and export capacities financed by positive net inflows.
- 2. New investments and exports grow more rapidly than the overall economy; steady reduction in the rate of net capital inflows.
- 3. Net capital flows reverse and the accumulated stock of external debt is gradually repaid as productivity, net exports and the external surplus rise.
- 4. After 50 years the country becomes a net foreign lender.

- Three problems. Stage 1 - debt ratios may well exceed values associated with short-term sustainability -- capital reversal jeopardizes completion.
- **China used domestic financial system; kept capital inflows shackled to minority joint ventures.**
- Stage 2 -- successful export expansion makes the country more attractive to foreign investment, causing an increase rather than a decrease in the rate of capital inflow, accompanied by appreciation of the exchange rate and wage pressure threatening export capacity. {Inflation was only a problem in 1988/9 during transition to market pricing.}
- **China kept capital, exchange and interest rate management**
- Private markets will not lend for fifty-year terms that such a scenario requires --lending will have to have a large official component, or intermediated by an international financial institution.
- **Here China benefitted from WTO adhesion and the sharp increase in external surplus to use it to become a foreign lender in support of continued expansion of domestic investment and exports via financialization methods.**

Avramovic D. (1958), *Debt Servicing Capacity and Postwar Growth in International Indebtedness,* International Bank for Reconstruction and Development, Economic Staff, Johns Hopkins University Press, Baltimore.
Avramovic, D. et al. (1964), *Economic Growth and External Debt*, International Bank for Reconstruction and Development, Economic Department, Baltimore.
Kregel, J. (2007) “Rethinking debt sustainability in the context of the millennium development goals,” Banca Nazionale del Lavoro Quarterly Review, September.
Kregel, J. (2004), "External financing for development and international financial instability", G-24 Discussion Paper Series, no. 32, October, UNCTAD.

Socialist Market Capitalism with Chinese characteristics - nationalizing private interests and using markets to build “productive forces”

The first and most fundamental change was to abandon the vertical integration of production imposed by autarchy via opening the economy to “produce what the world market wants and to buy from abroad what China needs.” This involved rejection of the soviet style planning which had been dominant under Mao.

Collective agriculture was replaced by the “household contract responsibility system” which allowed individual famers leeway in determining what was planted and leaving production over the target to the producer for rudimentary market distribution.

However, producers were not granted the property rights to the land, only the right to determine was planted and to dispose of surplus. The State retained property ownership and represented the Chinese characteristic of the system.

The system was a stop-gap emergency which predated the Third Plenary Session of the 11th CPC Central Committee and in 1980 was limited only to severely impoverished areas marked by the “three dependencies”—dependencies on grain relief, livelihood subsidies, and production loans in the expectation that the commune system would eventually be resumed. It was not until Document No. 1 of 1982 was farmers’ autonomy in choosing production methods affirmed and Document No. 1 of 1983 subsequently provided theoretical endorsement, describing the system as “a great creation of Chinese farmers” and “a new development of the Marxist cooperativisation theory in China.”

Policy regarding hired labour followed a similar path. Initially, some central leaders believed that “hiring labour” constituted exploitation and was incompatible with the socialist system, and therefore demanded correction. Some researchers cited Capital, where Marx once stated that having “four helpers and three apprentices” did not constitute exploitation. Accordingly, the central government set a rule that hired labour “could not exceed seven people.” Later, this limit was broken. Although top leaders once attempted to impose new restrictions, they could not stem the tide, and the policy limitations eventually faded away.

Zhao Shukai, Journal of Central China Normal University, no. 1 (2020). Du Runsheng, The Course of China’s

Rural Reform, 2006 International Food Policy Research Institute.

- The reform of the system was extremely successful and was eventually extended to the commercial and manufacturing system, but most importantly to the financial system.
- Recognising the success in Germany and Japan in producing rapid growth in the post-war period, China also retained government ownership and control over the financial system, first in the creation of a series of market entities, owned and controlled directly or indirectly by the Government.
- And provided government control over foreign capital inflows
- Basically this was to apply the principle used in agricultural to create institutions that operated according to market principles but without private ownership.

Core Arguments on Chinese Development Finance:

Chen Muyang - *The Latecomer's Rise*_ Policy Banks and the Globalization of China's Development Finance

Liu Zongyuan Zoe *Sovereign Funds* - how the communist party of china finances

China has built a *dual financial architecture*—policy banks and sovereign leveraged funds—that allows the Party-State to mobilize capital at scale without relying on fiscal surpluses or commodity rents.
This architecture blends **state guarantees**, **market-based financing**, and **political control**, enabling China to:

- finance domestic industrialization and urbanization,
- support overseas expansion of Chinese firms,
- reshape global development finance norms,
- and pursue geopolitical objectives through capital rather than direct coercion.

Both Chen and Liu show that China's model is neither "state capitalism" nor a classical "developmental state." Instead, it is a financialized Party-State, where bureaucratic competition, sovereign guarantees, and leveraged funds jointly mobilize capital for strategic ends.

. Chen: Policy Banks and the Globalization of Development Finance

1. Policy Banks as Market-Based but State-Backed Institutions

Chen argues that China's policy financial institutions (PFAs) are not simply tools of state intervention.
Instead, they are **market-facing financial instruments** that substitute for direct fiscal subsidies from central goverment budget.

Key features:

- They issue bonds backed by **implicit sovereign guarantees**.
- Domestic savings—especially via commercial banks—are the main capital source.
- They operate commercially but with **policy mandates**.

This hybrid model allows China to deploy large-scale capital without expanding the fiscal budget.

The Chinese Development Bank Model: FILP + KfW Hybrid

China Development Bank (CDB) modeled itself on:

- **Japan's FILP** (state-coordinated domestic savings mobilization)
- **Germany's KfW** (sovereign-guaranteed bond issuance)

CDB bonds:

- carry **zero-risk weighting** from regulators,
- are purchased mainly by domestic banks,
- enjoy sovereign credibility without being counted as government debt.

This structure creates a *quasi-fiscal* financing channel outside the formal budget.

Domestic Development Finance Innovations

Chen details how CDB and other policy banks transformed China's domestic financing landscape:

a. Local Government Financing Vehicles (LGFVs)

- Emerged after 1994 fiscal reforms restricted local borrowing.
- Banks evaluate LGFVs partly on the **fiscal capacity of local governments**.
- Land revenues became common collateral.

b. Bundled Loans & Urbanization Finance

- CDB pioneered bundled loans to finance entire infrastructure packages.
- Enabled rapid urbanization and industrial upgrading.

c. Alternative Instruments

- Government Procurement of Services (GPoS)
- Public–Private Partnerships (PPP)
- Local government bonds (major institutional reform)

These innovations created a **nationwide infrastructure-financing market**, shifting from administrative credit allocation to competitive, market-based financing.

China's Overseas Development Finance

Chen emphasizes that China's overseas finance differs from Western DAC donors:

a. Not primarily concessional

- Over 90% of China Exim loans are non-concessional.
- Policy banks support commercially oriented projects in low-income countries.

b. Tied to Chinese firms

- Grants, interest-free loans, and concessional loans are 100% tied to Chinese contractors.

c. Filling the "development gap"

China finances projects in regions Western lenders avoid, often enabling host governments to **financialize future receivables** (e.g., resource-backed loans).

d. Regulatory fragmentation

Multiple agencies—NDRC, MOFCOM, embassies, Sinosure—shape outward investment, but implementation depends on banks and firms, not ministries.

State Fragmentation and the "Shareholding State"

Chen highlights bureaucratic competition:

- MOF, PBoC, SAFE, and sovereign funds all compete for influence.
- Policy banks have multiple state shareholders (MOF, Central Huijin, SAFE subsidiaries).

This fragmentation does not weaken state capacity; instead, it creates a polycentric but coordinated system of capital mobilization.

. Liu: Sovereign Leveraged Funds (SLFs) as Capital Mobilizers

SLFs as Financial and Political Engineering

Liu argues that China's sovereign funds—CIC, Central Huijin, SAFE funds, Silk Road Fund—are **sovereign leveraged funds**, created through:

- **Explicit leverage**: issuing government bonds to buy FX reserves (e.g., CIC's creation).
- **Implicit leverage**: reallocating low-risk reserves into high-risk investments (SAFE funds).

These funds expand the state's balance sheet and convert foreign exchange reserves into strategic capital.

Origins: Crisis, NPLs, and Recapitalization

- The 1997 Asian financial crisis and China's NPL crisis prompted the creation of Central Huijin (2003).
- Huijin recapitalized banks **using FX reserves, bypassing legal restrictions on PBoC ownership.**
- **This established the model of using reserves for domestic financial reform.**

CIC: From Sterilization Dilemma to Global Investor

CIC was created in 2007 to:

- relieve pressure from sterilization operations,
- diversify reserves,
- pursue higher returns and strategic investments.

Key features:

- Funded by MoF bond issuance (explicit leverage).
- Suffered early losses due to USD depreciation and currency mismatch.
- Later evolved into a **troika**: Central Huijin (domestic), CIC International (portfolio), CIC Capital (direct investment).

CIC became a major investor in:

- global natural resources,
- overseas infrastructure,
- Chinese tech firms (SMIC, AI startups),
- BRI-related assets.

SAFE: Shadow Reserves and Off-Balance-Sheet Power

SAFE operates a network of opaque investment vehicles:

- "Four Golden Flowers" (Hong Kong, Singapore, London, New York)
- Buttonwood Investment Platform
- SAFE Co-Financing Office (entrusted loans)

Functions:

- provide cheap FX loans to Chinese firms going abroad,
- stabilize China's stock market,
- capitalize policy banks and the Silk Road Fund,
- support BRI projects.

SAFE's undisclosed funds constitute shadow foreign exchange reserves.

Silk Road Fund (SRF): Dedicated BRI Vehicle

- Majority-owned by SAFE.
- Functions as a long-term private equity investor.
- Finances pipelines, ports, and strategic infrastructure.
- Promotes RMB internationalization through cross-border settlement.

SLFs as Geoeconomic Tools

Liu argues SLFs:

- act as quasi-ministries,
- enable China to bypass Western scrutiny by partnering with foreign sovereign funds,
- support SOEs' overseas acquisitions,
- advance industrial policy (Made in China 2025, AI plans),
- secure strategic resources (lithium, oil, minerals).

They transform China into a **"shareholder state"** with global reach.

Integrated Analysis: How Chen and Liu Fit Together

. Two Sides of the Same System

Chen focuses on **policy banks**; Liu on **sovereign funds**. Together they form a unified system:

Function	Policy Banks (Chen)	Sovereign Funds (Liu)
Capital Source	Domestic savings, sovereign guarantees	FX reserves, leverage
Instruments	Loans, bonds, LGFVs, PPPs	Equity, entrusted loans, PE-style funds
Orientation	Development finance (domestic + overseas)	Strategic investment (global + domestic)
Governance	Fragmented bureaucratic oversight	Party-controlled investment arms
Role	Infrastructure & industrial finance	Resource acquisition, tech upgrading, BRI support

Both rely on **financialization of state assets** rather than fiscal spending.

China's Model vs. Western Models

- Western DAC donors rely on fiscal transfers and concessionality.
- China relies on **commercial loans**, **state guarantees**, and **leveraged funds**.
- Western export credit rules (OECD Arrangement) are challenged by China's state-backed banks.
- China's approach has pushed OECD donors to adopt new frameworks (e.g., TOSSD, private capital mobilization).

Bureaucratic Competition as a Feature, Not a Bug

Both authors show:

- MOF, PBoC, SAFE, CIC, CDB, Exim, SASAC all compete.
- But competition produces innovation, not paralysis.
- The Party's central leadership sets strategic direction (BRI, tech upgrading, financial security).

This creates a **fragmented but coordinated financial state**.

Financialization of State Policy

Both source texts:

- The state increasingly uses **capital markets**, **equity stakes**, **bond issuance**, and **leveraged funds** to pursue policy goals.
- Administrative directives are replaced by **market-facing state entities**.

This is a shift from: **"state allocates credit" → "state leverages capital to shape markets."**

Conclusion: China combines Imperium and Dominium through State Ownership and Control of the Financial System

The combined insights of Chen and Liu reveal a sophisticated, multi-layered system of Chinese state finance that:

- **mobilizes domestic savings and foreign exchange reserves,**
- **uses sovereign guarantees and leverage to expand capital supply,**
- supports both domestic development and global expansion,
- advances industrial policy and geopolitical strategy,
- and reshapes global norms of development finance.

China's model is not simply "state capitalism" or "developmental state." It is a financialized Party-State, where policy banks and sovereign leveraged funds operate as capital mobilizers in the Gerschenkronian sense—scaled up to the level of a global power.