The Factional Politics of Exchange Rate in China

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Abstract

This paper tries to explain the change of national monetary policies choices in authoritarian regimes. It argues that the monetary policy outcomes in authoritarian regimes could be explained by the strategic interactions between political factions. Since exchange rate policy can generate a redistributional effect, the authoritarian leader has incentives to use the policy to fortify his faction and weaken his challengers’ economic coalition bases. The monetary policy outcomes will depend on the degree that the challengers can block the policy. This paper uses RMB appreciation during 2003 to 2010 as a case to illustrate the factional model. This paper will use Time Series Cross-Section analysis and game theory to analyze the factional data and economic data during 2003-2013. The results show that the economic redistribution effect of RMB appreciation would benefit the political leader’s faction and weaken his challenger’s faction in provinces, and the level of the RMB appreciation would depend on the factions’ strategic interactions in the central level.
Introduction

Previous studies from International Political Economy have tried to explain national monetary policy choices, which include the exchange rate regime and exchange rate level, by the effects of regime type and interest groups. However, the RMB appreciation since 2005 (Graph 1) is still a puzzle that cannot be explained using prior models, since the regime type for China is stable and interest groups’ lobbying lags.

Graph 1 RMB-dollar Exchange Rate 1995-2014

RMB-dollar exchange rate, 1995–2014

Source: XRATES
This paper examines the rationale, timing and domestic political effects of RMB appreciation from 2005 to 2010. Based on the factional approach, this article argues authoritarian regimes’ economic policy outcomes can be explained by the factional variables. Since exchange rate policy can generate a redistributitional effect, the authoritarian leader has an incentive to use it to fortify his faction and weaken his challengers’ faction. I apply this argument in the case of China. This paper avers that RMB appreciation was not only influenced by international pressures but also driven by factional struggles. Hu Jintao, the President of the People's Republic of China and the leader of Tuanpai, had incentive to weaken the influence of the former leader Jiang Zemin’s faction through RMB appreciation in order to remove it gradually from the Central Politburo of the Communist Party of China and the local provinces. However, since Jiang had a dominant strategy to maintain their political power through blocking RMB appreciation, the level of RMB appreciation depends on how the payoff was changed.

Based on a time series cross-sectional dataset with annual observation of 31 provinces between 2003 and 2010, my empirical analysis buttresses my argument. The data shows that the redistributing political outcome of RMB appreciation is the decline of Jiang’s faction in the Central Politburo. I also use game theory to illustrate how the level of RMB appreciation would depend on the factions’ strategic interactions at the central level.

This paper includes three parts. First, I will review the exiting explanations of national monetary policy choices and discuss their limitations in the case of China. Secondly, I will introduce assumptions and mechanisms of the factional model. Finally, I will use the case of China to test hypotheses from the factional model.
Exiting Approaches and China Puzzles

Economists explain the variation in these policy choices through the trilemma of international macroeconomics, which means the three policy goals--a fixed exchange rate, international capital mobility, and monetary policy autonomy—cannot be reached at once. The policy maker must choose to drop one of the three. From the economic perspective, the main driver of RMB appreciation is the huge cost of controlling inflationary pressure (Freeman & Yuan 2014). Based on the framework of the trilemma of international macroeconomics, China chooses the soft peg to the dollar and monetary policy autonomy, while maintaining capital controls. However, since China enjoys a huge trade surplus, it needs to increase money supply through purchasing the U.S. dollars circulated in the system in order to maintain the soft peg to the dollar. Although the People's Bank of China (PBOC) could use sterilization methods to absorb excess RMB, the net indebtedness of the PBOC increased when the PBOC used RMB to purchase U.S. Treasury Bills, which have lower rates of return than the interest rate the PBOC paid on its liabilities (Freeman & Yuan 2014). In the long term, this cost is unsustainable. However, since the theories of the optimal national exchange rate policy are still debatable among economists, the puzzle related to whether the RMB appreciation is totally based on the economic logic of cost and benefit is beyond the scope of this paper.

How policy makers choose the levels and regimes of the exchange rate has also become an important issue for political scientists, because these policy selections have domestic distributional implications for different sociopolitical actors; thus, the exchange rate policy is as much a political decision as an economic one for policy makers. The level
and regimes of the exchange rate could affect purchasing power, inflation, growth rates, and price levels, and these effects could create both winners and losers (Frieden, 1994). Broadly speaking, internationally oriented economic groups (i.e., producers of exportables, foreign direct and portfolio investors, and international merchants) should favor fixed exchange rates, since currency volatility makes their business riskier and more costly. By contrast, the nontradables sector and import-competing producers of tradable goods prefer floating rates, because they need national autonomy to deal with domestic macroeconomic conditions. Tradables producers prefer a relatively depreciated currency, because weak currency makes their products relatively cheap compared to foreign goods and increases their competitiveness. National residents and international investors prefer a relatively appreciated currency since this gives them greater purchasing power. Producers of non-tradable goods also favor strong currency because it raises the price of their products relative to tradable goods in the home market.

To explain the formation of exchange rate policy, scholars already highlight the impacts of regime types and interest groups (Broz & Frieden, 2001). The institutional approach focuses on how institutions shape the incentives of politicians to adopt specific exchange rate regimes. By analyzing the panel data of 109 countries from 1973-95, Broz (2002) argues that autocratic governments prefer fixed exchange rates, since it can represent a commitment to establish low inflation credentials. Alesina and Wagner (2006) also used large-N data and found that more democratic regimes are associated with less de facto exchange rate fixity. However, their model cannot explain the RMB appreciation in China, since their dependent variable mainly focuses on the exchange rate regime and China’s Polity score, their independent variable has been invariable since 1978. In contrast to the
above-mentioned studies, Steinberg and Malhotra (2014) adopt authoritarian regime type as the independent variable, and they substantiated that civilian dictatorships, as China is categorized, are no more likely than democracies to fix their exchange rates. Nevertheless, this model cannot explain the timing of RMB appreciation, since China’s authoritarian regime classification score is also unvarying in their datasets.

The interest group approach is another paradigm, and it argues that the choice of the level and regime is largely determined by the preferences and capabilities of economic actors. Steinberg and Shih (2012) have found that interest groups had lobbying ability to block the RMB appreciation in the middle of 2008. However, this cannot explain why central officials opposed RMB appreciation before any lobbying occurred.

**Factional approach**

This article argues that a factional approach could prove a better framework for understanding the formation of exchange rate policy in China. A faction can be defined as a personal network of reciprocity that seeks to preserve and expand the power of the patron (Shih 2008). According to Nathan and Tsai’s typology, factions are based on the exchange of private goods through secret noded communications (Nathan & Tsai 1995).

The factional approach assumes that political leaders’ predominant concern is to maximize their political power and to prevent being replaced by their political challengers (Acemoglu & Robinson 2006; Kinne 2005). To reach these goals, political leaders have inducement to organize political factions. When a political leader is backed up by a stronger faction, he or she has more bargaining power in confrontations with challengers. The
political actors with more bargaining power find it easier to reach higher payoff in strategic interactions with their challengers.

In order to enjoy the benefits of factions, political leaders, however, need to use policies to distribute private goods to their factions in order to gain loyalty (Siverson, Morrow, Bueno, Smith 2003). Since exchange rate policy can generate a redistributional effect, the authoritarian leader has incentives to use the policy to fortify his faction and weaken his challengers’ economic coalition bases.

In short, the factional approach is different from the interest group approach since it emphasizes how the factions maximize their own political power, rather than how economic actors maximize impersonal economic interests. The factional approach is also slightly different from the selectorate theory, as it not only accentuates the number of factional bases, but it also underscores the bargaining between dictator and challenger.

In the case of China, economists have found that real depreciation may have stimulated coastal advantages, leading to higher economic growth in coastal provinces than in inland provinces; meanwhile, real appreciation has probably exerted negative effects on the coastal advantages, and may have slowed down growth more in coastal than in inland provinces (Hua 2012). Consequently, the real depreciation of the RMB may have contributed to an increased gap in economic growth between the two categories of provinces, while real appreciation may have slowed down real GDP per capita divergence between the two categories of provinces (Hua 2012).

Several economical researchers have found that RMB appreciation dampens export growth (Ahmed, 2011). The data of export growth at the local level also shows that export growth in coastal provinces has declined since 2005 and since 2010 (Graph 2). Although
the huge decline during 2008 to 2009 might have been caused by the global economic crisis, the declines since 2005 and 2010 might be more related to RMB appreciation. On the other hand, the pattern of decline is not explicit in inland provinces (Graph 3). The data shows the economic redistribution effect on export growth is also different between coastal provinces and inland provinces. RMB appreciation might have caused more negative economic impacts on export growth in coastal provinces than inland provinces.

**Graph 2 Export Growth in Coastal Provinces**

![Export Growth in Coastal Provinces](image)

Source: National Bureau of Statistics of China
In China, a factional exchange exists between the central government and local governments. This feature of markets preserving federalism in economic reform enables rival power centers (Montinola, Qian & Weingast 1995), yet the central government still has the power to appoint and dismiss provincial governors (Blanchard & Shleifer 2000; Shirk 1993, p.149). The most powerful offices in the CC are often controlled by the dominant faction, and the faction enjoys enormous agenda-setting power in Politburo meetings (Shih 2008). However, there are competitions in the party. The dominant faction encounters political attacks by rival factions, especially when a major policy failure occurs (Shih 2008). To maintain political power, factions often have an exchange relationship between central leaders, provincial leadership and ministerial officials. Central leaders have incentives to
look for support from the provincial leadership and ministerial officials in order to acquire valuable resources for political struggles (Shirk 1993, p. 150). The provincial leaders and ministerial officials also have incentives to provide resources to central leaders, because they may gain lateral or vertical promotions, preferential allocation of financial resources and nonmarket rent, control over policies through the faction system, and protection from purges or corruption investigations (Shih 2008). Scholars have found that factional ties with various top leaders are a relevant factor which affects local officials’ ranking in the party hierarchy. Senior party leaders can use promotion within institutions to cultivate factions (Shih, Adolph & Liu 2012). The factional exchange relationship can be relatively stable because it is difficult for challengers to make credible commitments to defectors that they can gain more benefits from challengers’ factions (Siverson, Morrow, Bueno de Mesquita & Smith 2003).

Based on the economic redistribution effect of RMB appreciation and the exchange relationship in Chinese factions, the factional approach generates the following hypothesis. (1) The economic redistribution effect of RMB appreciation would benefit the political leader’s faction and weaken his challenger’s faction in the provinces. (2) Since RMB appreciation will generate a political redistribution effect, the level of RMB appreciation becomes a political issue. Monetary policy outcomes will depend on the factional balance at the central level.

**Empirical Tests**

*Data & Methods*
To test my hypotheses, I constructed a time series cross-section dataset that includes data on real exchange rate, central and local factions, and other variables. The data includes data on 31 provinces over the period of 2003-2010. I selected 2003 as the beginning since it was the year that Hu Jintao became the new political leader of the CCP. It is an appropriate starting point to observe factional interactions.

My two dependent variables are the local factions and real exchange rate levels in the provinces. The real exchange rate level in the provinces is calculated by the national real exchange rate multiplied by the ratio of average of provincial CPI to specific provincial CPI, and the data of CPI comes from the National Bureau of Statistics of China.

I measure a LOCAL FACTION by collecting the factional data of the Provincial Committee Secretary. I identify the factional connection of the Provincial Committee Secretary by checking (1) whether the provincial party secretary and Jiang Zemin were born in the same province, attended the same university or worked in the same unit within three administrative steps of each other (Shih 2004); (2) whether the provincial party secretary was promoted by Jiang Zemin; (3) whether the provincial party secretary was promoted by Hu Jintao; (4) whether the provincial party secretary was a member of the China Youth League; and, (5) whether the provincial party secretary and Hu Jintao were born in the same province, attended the same university or worked in the same unit within three administrative steps of each other. If the official possesses features (1) and (2), I code the person as Jiang’s faction, which is one; if the official possesses feature (3), (4) and (5), I code the person as Hu’s faction, which is zero. The sources of data mainly come from newspapers, books, and Chinese Political Elites dataset (http://cped.nccu.edu.tw/).

My two independent variables are the national real exchange rate level and the
The national real exchange rate is calculated as the nominal effective exchange rate (a measure of the value of a currency against a weighted average of several foreign currencies), divided by a price deflator or index of costs, and the data comes from the World Bank. The central faction is measured by two variables: TCENTRAL and JCENTRAL. TCENTRAL measures the seats of Tuanpai, Hu’s faction, in the Central Politburo; JCENTRAL measures the seats of Jiang’s faction in the Central Politburo. I use the same method in the local factions to identify the central officials’ factional connections. The two variables are continuous variables which present the number of seats in the Central Politburo for each faction.

Several control variables that may affect the real exchange rate levels in provinces and local factions are included in my statistical model. INFLATION is measured by the consumer price index, and the data is from the IMF. LOCAL TRADE OPENNESS is measured by the difference between local exports and local imports, divided by local GDP. The size of the local economy is measured by LOCAL GDP. The economic data in the provinces comes from the National Bureau of Statistics of China.

**Empirical results**

The results presented in Table 1 corroborate my argument that RMB appreciation benefits the political leader’s faction and weakens his challenger’s faction in the provinces. Since the local faction is a binary variable, I estimate the model using a logit regression. Model 2 reveals that the national real exchange rate has significant negative effect on the survival of Jiang’s faction at the 0.01 level. The negative coefficient of national real
exchange rate denotes that RMB appreciation has a political redistributional effect on factional politics. In other words, Hu might use the RMB appreciation to weaken Jiang’s faction at the provincial level.

Table 1: The Determinants of Local Factions

<table>
<thead>
<tr>
<th>VARIABLES</th>
<th>(1)</th>
<th>(2)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Local Faction</td>
<td>Local Faction</td>
<td>-0.069696***</td>
</tr>
<tr>
<td>National Real Exchange Rate</td>
<td></td>
<td>(0.026)</td>
</tr>
<tr>
<td>Local GDP</td>
<td>-0.000120***</td>
<td>-0.000039</td>
</tr>
<tr>
<td>Inflation</td>
<td>0.011539</td>
<td>-0.002557</td>
</tr>
<tr>
<td>Local Trade Openness</td>
<td>0.000271</td>
<td>0.000133</td>
</tr>
<tr>
<td>Constant</td>
<td>(0.000)</td>
<td>(0.000)</td>
</tr>
<tr>
<td>Observations</td>
<td>341</td>
<td>341</td>
</tr>
<tr>
<td>Number of ID</td>
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<td>31</td>
</tr>
<tr>
<td>chi2</td>
<td>20.33</td>
<td>28.94</td>
</tr>
<tr>
<td>rho</td>
<td>0.775</td>
<td>0.719</td>
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</table>

**NOTE:** Standard errors in parentheses. *** p<0.01, ** p<0.05, * p<0.1

Table 2 presents my analysis of the effects of central factions on the exchange rate level in provinces. The model is estimated using ordinary least squares and panel-corrected standard errors (PCSE) to deal with the problems of panel heteroskedasticity and contemporaneous correlation. I also estimate the AR1 process in the PCSE model. The result supports my hypothesis that the level of RMB appreciation would depend on the
factional balance in the central level. Model 2 shows \( T_{\text{central}} \) has significant positive effect on the local real exchange rate at the 0.01 level, while \( J_{\text{central}} \) does not have significant impact on the local real exchange rate. This suggests that RMB appreciation is associated with the rise of Hu’s faction at the central level. In other words, when Hu’s faction becomes stronger in the Central Politburo, it becomes easier for him to appreciate RMB.

**Table 2: The Determinants of Local Real Exchange Rate**

<table>
<thead>
<tr>
<th>VARIABLES</th>
<th>(1) Local Real Exchange Rate</th>
<th>(2) Local Real Exchange Rate</th>
</tr>
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<tbody>
<tr>
<td>( T_{\text{central}} )</td>
<td>4.013749***</td>
<td>4.013749***</td>
</tr>
<tr>
<td></td>
<td>(1.033)</td>
<td>(1.033)</td>
</tr>
<tr>
<td>( J_{\text{central}} )</td>
<td>1.503176</td>
<td>1.503176</td>
</tr>
<tr>
<td></td>
<td>(0.916)</td>
<td>(0.916)</td>
</tr>
<tr>
<td>Local GDP</td>
<td>0.000958***</td>
<td>0.000048</td>
</tr>
<tr>
<td></td>
<td>(0.000)</td>
<td>(0.000)</td>
</tr>
<tr>
<td>Inflation</td>
<td>-0.300643</td>
<td>-0.551157</td>
</tr>
<tr>
<td></td>
<td>(0.327)</td>
<td>(0.589)</td>
</tr>
<tr>
<td>Local Trade Openness</td>
<td>-0.000115</td>
<td>-0.000269***</td>
</tr>
<tr>
<td></td>
<td>(0.000)</td>
<td>(0.000)</td>
</tr>
<tr>
<td>Constant</td>
<td>88.851401***</td>
<td>48.751537**</td>
</tr>
<tr>
<td></td>
<td>(8.652)</td>
<td>(19.049)</td>
</tr>
<tr>
<td>Observations</td>
<td>341</td>
<td>341</td>
</tr>
<tr>
<td>R-squared</td>
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<td>0.835</td>
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<tr>
<td>chi2</td>
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<tr>
<td>r2</td>
<td>0.620</td>
<td>0.835</td>
</tr>
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</table>

**NOTE:** Standard errors in parentheses. *** p<0.01, ** p<0.05, * p<0.1
Illustrating the game of factional struggle in China

To apply game theory in the case of exchange rate policy in China, I will first describe the preferences of main actors Hu Jintao and his challengers. Secondly, I will formalize the strategic interaction between Hu Jintao and his challengers. Finally, I will illustrate the policy process to explain the timing of policy changes.

*Hu Jintao’s political and economic preferences*

Hu Jintao’s leadership was carefully choreographed, but it was fraught with potential risks from the divided factions in the seemingly unified CCP (Brown, 2012, p.27). Hu Jintao’s era began with rival factions’ constraints. To protect his legacy of “Three Representative,” the former leader Jiang Zemin secured his factions in key positions on the 2002 Politburo Standing Committee. For instance, Zeng Qinghong, Wu Bangguo, Huang Ju and Li Changchun still played gatekeepers in the new Politburo. Jiang also maintained a position as head of the Central Military Commission (CMC) till 2004 (Brown, 2012).

Being aware of this situation, Hu Jintao adopted a self-effacing collective leadership mode from his first year in power, and he patiently built up his own political faction, which was named Tuanpai, in the China Youth League (Brown, 2012). In 2007, Hu successfully brought Li Yuanchao, Wang Qishan and Wang Yang into the Politburo after the 17th CCP Congress.

Hu Jintao also tried to weaken Jiang’s faction by removing his factional followers from key positions. For example, Zhang Wenkang, the Minister of Health and Jiang’s follower, was fired since he suppressed crucial information related to cases of the disease
during the spread of SARS in April 2003 (Bo 2010). The case of Chen Liangyu, who was closely associated with Jiang Zemin, also illustrates the point. Chen and his top aides were accused of the misappropriation of more than USD 474 million of the city's pension funds to local real estate developers and other businesses, and Chen was detained in September 2006 (Bo 2010).

Hu-Wen leadership’s economic preference is to rebalance the Chinese economy away from investment- and export-driven growth toward a domestic consumption-driven model. After they came into office, the government started to draft a plan for income distribution reform aimed at helping low income groups in 2004, eliminated agricultural taxes for farmers in 2006, raised pensions for enterprise employees by 10 percent a year, expanded the scope and depth of welfare programs, and increased minimum wage three times, by an average of 13 percent each time (Wang, 2014). Moreover, the 12th Five Year Plan over 2010 to 2011 made it clear that Hu’s economic preference was no longer growth alone.

Since 2003, President Hu Jintao and Premier Wen Jiabao tried to promote exchange rate appreciation in order to rebalance the economy. This policy was aimed at achieving four political and economic goals. First, the beneficiaries of this policy would be nontradable industries and local consumers because foreign goods would become cheaper. Secondly, this policy would also have redistributional effects that benefitted inland provinces and the poor more than businesses and the coastal region. Thirdly, the change from a fixed and undervalued exchange rate toward flexible exchange rates could reduce the pressure of inflation (Freeman & Yuan 2014). Finally, RMB appreciation could reduce international pressure from the United States and G7 countries and prevent a disruption in trade
relationships with these countries (Foot & Walter 2011, p.119). These four goals were important for Hu and Wen, since they would enhance the legitimacy of their governance and the capability of political survival through increasing domestic supporters, reducing the chance of foreign interventions, and using international pressure to promote domestic reforms.

*Opponents’ preferences*

The major opponents of the appreciation of RMB are tradable firms, since their export products would become more expensive on the world market, weakening their external competitiveness and potentially reducing profits. For example, a survey in July 2008 indicated that 41% of 170 exporters viewed exchange rate policy as the most substantial problem for their businesses (Steinberg & Shih 2012).

The tradable industries are the most powerful lobbyists in China because of their size. Together, they produced more than one third of Chinese GDP in 2005, were bigger than the nontradable industries, and could transform their economic advantage into a political advantage (Steinberg & Shih 2012). Through the ties to politicians who sit on the Politburo Standing Committee (PBSC), lower-level bureaucrats and local politicians who participated in exchange rate policy making, these firms have their preferences taken into consideration in the policy-making process. For instance, in 2008, tradable industries started to lobby government officials in Zhejiang, the Chinese Ministry of Commerce (MOC) and other politicians at the top level of government (Steinberg & Shih 2012).

The Chinese Ministry of Commerce is the major governmental agency that opposes the appreciation of RMB. The MOC is also an institution that has been controlled by Jiang’s
faction for a long time. For example, the Ministers of Commerce from 2003 to 2013—Fu-Yuan Lu, Bo Xilai and Chen Deming—are all Jiang’s followers. The MOC could be a channel for Jiang’s faction to receive private goods from export sectors, and the private goods could be the resources for Jiang’s faction to maintain their political survival. Through the intermediation of provincial and local Chambers of Commerce in coastal cities and provinces, the MOC and the tradable industries could exchange resources and establish a political coalition.

The game

The game simplifies the main actors in the policy process of exchange rate as two main actors, Hu and Jiang, since this game assumes factional leaders have the ultimate power of strategic decisions. The strategic options for Hu are to appreciate RMB (Y) or not (N), and the strategic options for Jiang are to block the appreciation (B) policy or not (N).

Graph 4 The game between Hu and Jiang in extensive form
In this game, the best situation for Hu and the worst situation for Jiang is when Hu decides to appreciate RMB and Jiang does not block the policy. In this situation, Hu can decide the level of RMB appreciation which benefits his faction most and weakens Jiang’s faction most. I model this payoff as 1 for Hu and -1 for Jiang. On the other hand, the best situation for Jiang and the worst situation for Hu is when Hu does not appreciate RMB and Jiang does not block the policy. In this situation, Jiang’s faction can continue to benefit from Jiang’s policy legacy of undervalued RMB, and Hu’s faction cannot get more private goods. I model this payoff as -1 for Hu and 1 for Jiang.

The game assumes a parameter K, which is between one and negative one, to measure the challenger’s veto power. I assume that the K could be affected by the number for each factions in the Central Politburo and local provinces, faction’s abilities to affect the military, and the degree of international pressures and inflationary pressure. In the case of China, the K would increase when Jiang’s faction occupied more central and local positions, when it has more abilities to control the military, and when international pressure and inflationary pressure is low.

If the K is bigger than zero and smaller than 1, Jiang will have a dominant strategy of blocking the policy and Hu will have a dominant strategy of stopping RMB appreciation. The Nash Equilibrium will be (K, -K). If the K is bigger than negative one and smaller or equal to zero, Jiang will still have a dominant strategy of blocking the policy but Hu will have a dominant strategy of appreciating RMB. The Nash Equilibrium will be (-K, K).

Policy process
The first step in China’s currency reform was announced by Chinese Premier Wen Jiabao in July 2005. The Chinese exchange regime started to move toward a managed regime that would allow the RMB to float against a basket of currencies within a certain range. Hu had a dominant strategy of appreciating RMB at that time. Although Hu’s faction was still not strong enough, there were several factors decreasing the value of K. First, under the pressure of factional competition, Hu needed to use RMB appreciation to weaken Jiang’s faction gradually. Secondly, the risk of being replaced by Hu reduced during this time because he became the head of the Central Military Commission (CMC) beginning in 2004. Third, the rapid depreciation of U.S. dollar became an external threat since it increased inflationary pressure in China, and inflation threatened Hu’s political survival. Jiang always had a dominant strategy of blocking the policy. Hence, the policy outcome of PBOC’s project of appreciation was opposed by government officials of Jiang’s faction, such as Bo Xilai, the Minister of Commerce. In the end, the policy outcome was that two factions compromised on the slight revaluation of RMB by 2.1%. Jiang’s faction accepted this outcome possibly since China’s exchange rate actually depreciated in real effective terms (Graph 5).

Graph 5 The Evolution of Nominal and Real Effective Exchange Rates in China

NB: A rise of the curb is appreciation of renminbi and a fall is depreciation.
In late 2007, Hu and Wen decided to speed up the rate of appreciation, which appreciated 8.2% during November 2007 and June 2008 (Steinberg & Shih 2012). Moreover, Hu and Wen also renounced several policies that reduced exporter profits, such as cutting the export tax and releasing a new labor law and stricter environmental regulations (Steinberg & Shih 2012). These further reforms could be explained by factional balance. Hu and Wen’s faction had become stronger at the local level (Graph 6&7). After the 17th CCP Congress in October 2007, Hu’s faction also had more seats in the Central Politburo of the Communist Party of China (Graph 6). These conditions decreased the value of K, and made RMB appreciation the dominant strategy for Hu.

**Graph 6 Number of Provincial Committee Secretaries in Coastal Provinces**

![Graph showing the number of provincial committee secretaries in coastal provinces](image)
This wave of RMB appreciation stopped in July 2008. Hu and Wen stopped the reform, possibly because the value of K increased. There are several reasons that might explain this change. First, a new anti-revaluation coalition was formed by the MOC, exporters and local politicians in early 2008 (Steinberg & Shih 2012). Jiang’s faction was the main organizer of this coalition. This coalition actively made lobbying efforts on the Standing Committee, the State Council and local government, and it successfully created
public pressure on Hu and Wen’s leadership. Secondly, Jiang’s faction in the military had serious conflicts with Hu during the Sichuan earthquake relief work in May 2008. Jiang’s faction in the military, including people such as Xu Caihou and Guo Boxiong, publicly challenged Hu’s decision of allowing Japanese military planes to enter the disaster area for relief work. Under pressure from the military, Hu canceled his decision on the relief project. This event indicates that Hu could not totally control the military in practice. Finally, Hu accepted stopping appreciation, possibly because the real effective exchange rate would continue to rise (Graph 5).

In June 2010, the PBOC announced that RMB appreciation would be restarted because the value of K decreased again. External pressure is one of the factors that caused this wave of appreciation. Since 2009, U.S. President Obama started to publicly ask China for revaluation of RMB. The pressure from the U.S. continued to rise in January and March 2010. The IMF and World Bank also suggested RMB appreciation in March 2010. Although Premier Wen refused to acknowledge publicly the undervaluation of RMB, he finally accepted making the exchange rate more flexible in order to prevent a trade and currency war with the United States. Another reason was factional politics. During this time, Hu’s faction in the military and local provinces had become stronger; thus, the risk of being replaced for Hu decreased. To weaken Jiang’s faction for the 18th CCP Congress in 2012, Hu had incentive to launch RMB appreciation again.

**Conclusion**

Why has the Chinese government adopted RMB appreciation since 2005? This paper
argues that the level of RMB appreciation is driven by factional strategic interactions. The empirical analysis supports that the level of exchange rate is associated with factional variables.

My finding contributes an alternative political-economy mechanism which could explain the variation of authoritarian economic policies. The data shows that the change of exchange rate polices in China is consistent with the change of distribution of factional power. RMB appreciation from 2005 to 2008, and appreciation since 2010, accompany the rise of Hu’s faction and the decline of Jiang’s faction at both the central and local levels. This finding preliminarily supports the factional approach, which argues that the changes in national monetary policy choices depend on the political elites’ calculation of economic resources for their faction’s political survival.

Reference


Broz, J. L. (2002). Political system transparency and monetary commitment


