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An Unlikely Champion of Global Finance: Why Is China Exceeding International Banking Standards?

Peter KNAACK

Abstract: As a G20 member, China has been engaged in financial reform since the end of the global financial crisis. A core piece of this reform is Basel III, the new prudential standard issued by the Basel Committee. Rather than being merely compliant, China's banking regulation is stricter than the global standard and being implemented ahead of the international timetable. Why is China voluntarily subjecting itself to tougher regulatory standards than the rest of the world? This article shows that low adjustment costs, factional politics, and, above all, an unusual alignment of domestic interests in the quest for international reputation are driving this phenomenon. The troubled institutional history of China's financial system motivates all relevant stakeholders to seek external validation in order to address a credibility gap abroad, albeit for different reasons. The article examines the power of reputation as a driver of regulatory positioning in the context of China's integration into international financial institutions.

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Keywords: China, financial regulation, Basel III, global economic governance, government networks, reputation

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Introduction

China's rise in recent years has triggered a lively debate on the impact of its emergence as a major power in the international system. Largely ostracised in the first post-war decades until the West changed course in the 1970s, the People's Republic is a relative newcomer to the institutions of global economic governance. Its integration into the global trade regime at the turn of the century has received much scholarly attention. In the realm of global financial governance, however, China's integration as a key stakeholder is more recent and less understood.

In the wake of the global financial crisis, China gained access to the Basel Committee and other global standard-setting bodies, along with all other developing country members of the Group of 20 (G20). Drawing lessons from the crisis, the Basel Committee developed a new global prudential banking standard, Basel III. All member countries are expected to comply with the new standard, even though implementation entails significant adjustment costs for both banks and regulatory agencies. Basel III implementation in China demands attention: a new set of domestic prudential banking rules does not merely comply with the Basel regulation; instead, it stipulates capital requirements for banks that are more stringent than the global standard, encompasses a wider range of rules, and sets out a faster implementation schedule. China is thus exceeding Basel III, a practice that is called alternatively super-equivalence, over-compliance, or gold-plating, each with its own connotations.

Why is China, an emerging market economy with a largely underdeveloped financial system and a per capita income much below the OECD average, voluntarily subjecting itself to tougher financial standards than the rest of the world? This article presents two answers to this question. First, it situates prudential banking regulation in a context of low adjustment costs and a domestic factional struggle over credit growth. Over-compliance with Basel III helps the technocratic faction of Chinese policymakers reassert control over the banking system after the massive expansion of policy lending in the wake of the global financial crisis. Second, it argues that key stakeholders in China seek reputation to overcome an international credibility gap in financial prudential supervision. The troubled institutional history of China's financial system motivates relevant stakeholders, regulators, and the industry to seek external validation of soundness and credibil-

ity, albeit for different reasons. Specifically, banks need reputation to expand abroad, and regulators need reputation to enhance their negotiating position both internationally and domestically. Thus, in the search for international reputation, the interests of banks and regulators are aligned. It is this peculiar convergence of outward-oriented incentives on both the state and industry side that helps explain why China decided to over-comply with Basel III banking standards.

The remainder of this article[1] starts with a review of the key debate on China's position in the political economy of global financial governance. It then draws on the literature on policy diffusion, epistemic communities, and government networks to identify the conditions of reputation as a driver of compliance in global financial standard-setting bodies. An introduction to the Basel Accords on banking regulation is followed by a brief history of China's development in this area. As a consequence of financial reform in the early 2000s and the privileged position of banks in the domestic system of financial repression, adjustment costs for adherence to Basel III are relatively low. The article then presents two complementary explanations for the country's decision to over-comply with Basel III standards. First, in the wake of the massive credit expansion triggered by the 2008/2009 stimulus programme, the technocratic faction of China's policy-making elite can use gold-plated Basel III standards as an instrument to reign in the generalist faction, lock in banking reform, and control future credit growth. Second, because China's banks lack a track record as well-governed corporations in the marketplace, they need to rely on international standards as the reputational basis for future regional and global expansion. Mere compliance with Basel III would be insufficient to overcome the credibility gap that Chinese banks are facing abroad. In addition, promotion of and adherence to strict financial standards can be an instrument for Chinese regulators to attain status and prestige both in international regulatory bodies and at home. A concluding section considers caveats of the argument presented and avenues for further research.

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China in International Financial Institutions

China is a latecomer to the liberal economic world order. It shares a state capitalist model with other East Asian late developers that combines bottom-up entrepreneurial private capital accumulation with state control over strategic industries, in particular finance. At the same time, Sino-capitalism is different in that it has emerged in a highly globalised environment. China has absorbed Western liberal institutions more profoundly than its East Asian peers did at comparable development stages (Callahan 2015; McNally 2012; Otero-Iglesias and Vermeiren 2015). The conditions of World Trade Organization (WTO) accession in 2001 and China's near-perfect compliance record with decisions made by the WTO's Dispute Settlement Body (DSB) since then are telling examples in the trade regime (Zhang and Li 2014). In the world of global finance, much scholarly work to date has focused on the country's positioning in the Bretton Woods institutions whereas questions of compliance with global financial standards have received little attention.

The rules that govern global finance are negotiated in global standard-setting bodies such as the Basel Committee and the International Organization of Securities Commissions. Created in the 1970s and 1980s as government networks, these organisations exist outside the purview of international public law and their decisions are not legally binding. Instead, member agencies agree on a global standard by consensus and then proceed with domestic implementation unilaterally (Slaughter 2004). Until the global financial crisis, financial standard-setting bodies were rather exclusive clubs, confined to regulators from advanced economies. Even in the wake of the crisis, leading powers successfully resisted attempts to make the United Nations a relevant forum for global economic issues (Knaack and Katada 2013). Nevertheless, they widened the perimeter of involved stakeholders, granting membership in financial standard-setting bodies to all G20 nations, including developing countries such as China and India (Kahler 2013). Thus, the current agreement on prudential banking supervision (Basel III) was the first global financial standard developed with China at the negotiation table. Over the last eight years, Chinese regulators have participated in trans-governmental deliberations, but analysts who expected that Beijing would exert influence or resist the global standard-setting process were proven wrong.

This is because participation is not synonymous with influence. The literature on the political economy of global regulatory governance identifies two sources of power: market size and expertise. In the field of financial regulation in particular, scholars have highlighted the leading role of dominant financial centres in global standard setting (Simmons 2001; Oatley and Nabors 1998; Posner 2009; Singer 2007). Drezner (2007, 2010) argues that market size determines the balance between rewards and costs of adjustment and thus the state incentive to engage in global harmonisation of regulatory standards. In his eyes, China has already become a great power whose economic interests diverge clearly from those of the developed core countries. As a consequence, the likely outcomes of current global regulatory reform are either rival standards, where the great powers each promote their own regulatory settings, or sham standards, which are promoted by international institutions but lack enforcement. There is indeed evidence that Chinese authorities have sought to influence international standard setting in non-financial sectors by leveraging the size of China's domestic market (Bach, Newman, and Weber 2006).

A second approach to global regulatory politics builds on historical institutionalism to highlight the importance of regulatory capacity and expertise (Bach and Newman 2007). According to this perspective, economies with a longer track record of supervision and a more complex regulatory architecture are expected to lead global regulatory deliberations, thus wielding significant influence over the standard-setting process (Baker 2009; Farrell and Newman 2010; Raustiala 2002; Slaughter 2004; Tsingou 2010).

As Kempthorne (2015) rightly points out, in the realm of financial regulation China currently commands neither of these sources of power enough to be considered a leading jurisdiction. The small size and low degree of cross-border interconnectedness of China's financial market stands in stark contrast to its position in the global trade system. And China's financial supervisors have not yet accumulated regulatory experience and capacity equivalent to that of their colleagues from advanced economies (Walter 2016). As a consequence, and contrary to expectations that the inclusion of emerging market economies would lead to tension in global financial governance, the newcomers have largely supported the post-crisis regulatory reform agenda (Kahler 2013; Ren 2012; Véron 2016).

This article draws two lessons from current scholarship in this field. First, it acknowledges the relevance of key structural and institutional features for the Chinese case. Market size and the uneven distribution of cross-border banking activity matter. As long as the epicentre of global financial markets continues to be the United States and Western Europe, we cannot expect China to rise from rule-taker to first mover. Moreover, this study concurs with Drezner's claim that market size and adjustment costs interact to condition the domestic political economy of standards adoption. As this article will demonstrate, the fortunate financial position of Chinese banks at the time when Basel III was issued meant they were facing relatively negligible adjustment costs. These structural and institutional features provide the context for an analysis of the interaction of domestic key players that owes much to historical-institutionalist scholarship. This article will argue that Basel III was of instrumental value in a domestic struggle between two factions in China's financial and economic policy establishment.

Second, the Chinese case also reveals a lacuna in the state of the art in international regulatory politics. While the theoretical approaches discussed above provide inferential leverage to explain China's lack of resistance to regulatory harmonisation, they do not contemplate the possibility of China exceeding global regulatory standards. This is because the power of reputation has not received enough attention in this debate.

Reputation in Global Financial Regulation

Any reductionist approach that conceives of state behaviour as merely a function of domestic variables ignores a key element of international relations: governments respond to inputs from abroad, learn from each other, and continuously negotiate the rules that undergird the international system (Oatley 2011; Buzan 2004; Meyer et al. 1997). The diffusion of policies across borders can be driven by economic competition, promotion by dominant actors, learning, or social emulation. These four channels of policy diffusion often overlap in the empirical world (Brooks and Kurtz 2012; Elkins and Simmons 2005; Linos 2011; Simmons, Dobbin, and Garrett 2008; Weyland 2007). The social aspects of policy diffusion – that is, learning and emulation – are particularly pronounced in areas where policymakers are able to

interact frequently as members of the same international organisation, government network, or epistemic community (Bearce and Bondanella 2007; Bach and Newman 2010; Chwieroth 2007; Gandrud 2013; Cao 2012). Newcomers are especially susceptible to socialisation influences, at both the individual and the state level (Johnston 2008).

A key driver of policy emulation within such organisations is the search for reputation – that is, peer recognition and status (Simmons, Dobbin, and Garrett 2008; Meseguer and Gilardi 2009). The domestic implementation of a global standard promises to endow a jurisdiction with a certain degree of such recognition. But reputational benefits do not end here. Issuing regulation that is super-equivalent to the standards that carry global legitimacy provides states with more reputation than mere implementation does. Such over-compliance has both tangible and intangible benefits, and policymakers are aware of both.

In the realm of banking regulation, the tangible benefits of reputation are especially pronounced. Simmons (2001) points out that capital adequacy rules provide market participants with information about the soundness of a financial institution. Investors and shareholders reward companies that comply (or over-comply) with regulatory standards, and investment analysts and rating agencies provide better risk assessments for them. Risk is factored into the price of capital in financial markets, and therefore financial institutions that adhere to prudential standards enjoy access to cheaper capital (Brummer 2010).

In addition, the reputation derived from compliance with banking standards may be an essential requirement for banks from emerging market economies to expand overseas. When regulators from Basel Committee member states receive requests from banks headquartered in non-Basel countries to enter their domestic market, they are explicitly required to review the regulatory regime of the home-country supervisor. Only if and when the regulator deems prudential regulation equivalent will he or she grant the licence for the applicant bank to operate in his or her jurisdiction. This reputational mechanism has been found to play a decisive role in the adoption of Basel I standards (Ho 2002; Chey 2007; Alexander, Dhumale, and Eatwell 2006). The situation is unlikely to be different for the current set of

Basel standards. In a speech on the reasons for India's Basel implementation, the executive director of the Reserve Bank of India stated:

> The "perception" of a lower-standard regulatory regime will put Indian banks at a disadvantage in global competition, especially because the implementation of Basel III is subject to a "peer group" review whose findings will be in the public domain. (Vishwanathan 2015: 2)

To date, India and China are the only developing countries that have "gold-plated" Basel III – that is, they decided to issue prudential banking rules that are stricter than the global standard (IMF 2014; Reserve Bank of India 2014; Sekine 2011; Walter 2014). The political economy of India's decision to issue super-equivalent regulation is beyond the scope of this research, although it certainly merits scholarly attention. Regarding China, this article argues that over-compliance with Basel III was necessary to address a credibility gap abroad. For reasons that the following sections will identify, mere compliance with the global standard likely would not have endowed Chinese banks and their regulators with enough reputation among their peers in global finance. This causal mechanism operates at the international level, but it cannot be isolated from the domestic political economy of banking. As this article will show, strict implementation of Basel III took place in the context of a domestic factional struggle over credit expansion in the wake of the crisis.

The arguments developed in this article rely on two main sources of information. The first is extensive archival research that includes public reports by national and global regulatory agencies and the financial press. Furthermore, the article benefits from access to internal journals published by the State Council Development Research Center and the Central Bank's Research Institute that reveal internal discussions among Chinese policymakers. Second, the findings from archival research were corroborated in on-site interviews with 12 financial regulators in China, Hong Kong SAR, the United States, and the European Union between 2012 and 2015.

The Basel Accords

Facing serious disturbances in the international currency and banking markets, financial supervisors and central bankers from 10 developed economies (the so-called G10) met in the Swiss town of Basel in

1974. They agreed to establish a committee in order to institutionalise transnational cooperation in the field of banking supervision, thereby creating one of the first government networks (Slaughter 2004). The Basel Committee published its first Accord in 1988 and released Basel II in 2004. In the wake of the 2007–2009 financial turmoil, the G20 mandated the Basel Committee to build on the lessons learned from the crisis to establish a new set of regulatory standards.

The Basel III capital requirements, finalised in 2010, are more comprehensive and stricter than their predecessors. In addition to a wider definition of assets and a more stringent one of capital, Basel III raises the minimum standards for capital as a percentage of risk-weighted assets. Banks must hold highly loss-absorbing (Common Equity Tier 1) capital equivalent to 7 per cent of risk-weighted assets, up from 2 per cent under Basel II. This risk-based capital measure is complemented by a new leverage ratio that requires banks to hold Tier 1 capital equivalent to 3 per cent of total unweighted assets (BCBS 2011; BIS 2012).

China and Basel III

China was largely isolated from the global economy until the late 1970s. After three decades of Maoist planned economy and a decade of Cultural Revolution, the flow of capital was almost completely under the direct control of the central government, and banks merely served as accounting institutions. In October 1979, one year after embarking on the path of economic reform, Deng Xiaoping declared that "we must turn the banks into real banks" (Qiao, Su, and Zhang 2010: 73). When the first Basel Accord was released in 1988, China's financial system barely had "real banks," and the central bank had existed for a mere four years. A commercial banking law was not in place until 1995. It is thus not surprising that domestic authorities did not engage with Basel standards until 2003. One of the first acts of the China Banking Regulatory Commission (CBRC), created in 2003, was to implement Basel I standards domestically (Rana 2012). As for Basel II, a CBRC statement from 2007 reads:

> Obviously, it is a gradual and long-term course to meet all the standards; therefore, banks must, based on their own situation, make an overall plan and gradually meet the Basel II standards in a phased, well-sequenced manner. (CBRC 2007)

Since China joined the Basel Committee in 2009 it has changed its position significantly. The country is evolving from laggard to *primus inter pares* in financial regulation. China's new banking standards are not only stricter than Basel III, they were implemented ahead of the internationally agreed schedule.

In October 2009, the CBRC published a notification entitled "On improving the commercial bank capital replenishment mechanism," preparing banks for recapitalisation in line with expected higher capital requirements. In June 2011, half a year after the Basel III standards were published, the CBRC released the "Commercial Bank Leverage Ratio Management Method." After circulating consultation papers in April 2012, the CBRC followed up with the "Capital Rules for Commercial Banks," approved by the State Council in June 2012. All relevant rules for the domestic implementation of Basel III were thus published ahead of the Financial Stability Board (FSB)-mandated deadline of end of 2012 (State Council Development Research Center 2013e).

A striking feature of China's implementation of Basel III is that the domestic rules are stricter than the international standards in several categories. The following three super-equivalent rules stand out: (1) Basel III raised the common equity capital ratio from 2 per cent to 7 per cent, but China's minimum ratio is set at 7.5 per cent. Domestic systemically important banks (D-SIB) face a capital requirement of 8.5 per cent. (2) Chinese authorities require a leverage ratio that is one percentage point higher than the international standard. (3) China's regulators do not impose a fixed provisions rate or coverage rate on banks. However, they promote a model of dynamic provisions regulation with the goal of loan-loss provisions equal to 2.5 per cent of total loans, and a 150 per cent coverage rate of these loans. By contrast, Basel III refrains from setting any specific standard in this area. Instead, the Basel Committee merely states that it is "addressing incentives to stronger provisioning in the regulatory capital framework" (BCBS 2011: 6).

The Basel Committee's new peer-review programme examined China's implementation of Basel III in 2013. The committee gave Chinese regulators the best possible overall grade of "compliant" and duly noted a total of 17 points where China is gold-plating Basel III standards (BCBS 2013b). Even this long list is incomplete, because it

fails to incorporate the above-mentioned leverage ratio and provisioning rules.

Table 1. Basel Standards and Domestic Implementation in China (Selection)

Regulatory Standard	Basel II	Basel III	China
Common Equity Tier 1 Ratio	2	7	7.5
Leverage Ratio	n/a	3	4
Provisions Rate	n/a	n/a	2.5%
Provisions Coverage Rate	n/a	n/a	150%

Source: People's Bank of China Research Institute 2012b.

In addition to stricter regulatory standards, China also committed to a tighter implementation schedule. Basel III is scheduled to be gradually phased in between the beginning of 2013 and the end of 2018. Beijing originally envisioned the phase-in to start a year ahead of every other country, in 2012, but later recognised that this was overly ambitious (Rabinovitch 2012). Nevertheless, the Chinese schedule stipulates full compliance by the end of 2016, two years before the global deadline. Beijing further beat the international standard setters by implementing the 4 per cent leverage ratio in 2012 (BCBS 2013a; BIS and BCBS 2013; PBOC Research Institute 2012b).

However, China is not the only country that is gold-plating Basel standards. Currently, nine jurisdictions have issued rules that exceed Basel III, including Sweden, Hong Kong, Singapore, and the heartland of banking, which applies a so-called "Swiss Finish." Almost all of them are high-income countries with fully developed financial markets that can rather easily afford gold-plating. Besides China, India is the only exception to this pattern.

In sum, China is establishing a system of prudential banking regulation that is stricter than the international standards, and it is implementing it faster than anybody else. Why is China, an emerging market economy with a per capita income much below the OECD average and a largely underdeveloped financial system, voluntarily subjecting itself to tougher financial standards than the rest of the world?

The remainder of this article presents two answers to this question. It shows that a domestic factional struggle over credit expansion

and the perceived need to overcome an international credibility gap are driving China's efforts to exceed global banking standards.

The Context: Low Adjustment Costs for Banks

Adherence to stricter capital adequacy requirements entails costs for banks, and in the case of Basel III, these costs might be considerable. The Institute of International Finance (IIF), a bank lobby organisation, produced a study showing that the implementation of Basel III would strangulate credit expansion, thus slowing global GDP growth by more than three percentage points (IIF 2011). Recently, the assumptions underlying this and similar studies have been fundamentally questioned by Admati and Hellwig (2013; Modigliani and Miller 1958). In principle there is no risk-adjusted cost difference between equity and debt financing for any firm, but the authors themselves recognise that subsidies, signalling effects, and "market imperfections" mean that meeting higher capital requirements is a costly endeavour for financial firms. Similarly, econometric studies undertaken by regulatory agencies and a variety of scholars indicate that even though the estimates of the bank lobby are exaggerated, higher capital requirements will indeed raise the cost of lending as banks pass on higher financing costs to their clients (Allen et al. 2012; BCBS 2010; Elliott 2009; Kashyap, Stein, and Hanson 2010).

While higher capital requirements affect banks in all jurisdictions, some are harder hit than others. In comparison to their Western competitors, China's banks have a balance-sheet composition and income structure that greatly reduces their adjustment costs at this point in time.

Since its re-emergence in the 1980s, China's financial system has withstood two crises. The reform process that took place in the period between those two crises helps explain why China's banks today are in a different position than their Western competitors. The Asian Financial Crisis of 1997 revealed that years of "policy lending" and "relationship lending" had led to the accumulation of massive amounts of non-performing loans (NPL) on the banks' balance sheets (Goodstadt 2011; Zhou 2007). In response, state authorities had to prop up banks with considerable capital injections twice, in 1998 and 2003 (Walter and Howie 2011; Yi 2009).

In addition to these measures, the authorities promoted corporate governance reform of the state-owned banks and prepared them for listing on the stock market. The four big banks went public in 2005, 2006, and 2010, raising between 13 and 22 billion dollars each for a total of USD 74 billion on the stock markets of Shanghai and Hong Kong (Borst 2013). Thus, the structure and timing of domestic banking reform left China's big banks flush with capital as the global financial crisis approached (Ba 2010; Qiao, Su, and Zhang 2010).

According to the IMF's Financial System Stability Assessment, Tier 1 capital as a percentage of risk-weighted assets for China's biggest 17 banks increased from 6 per cent in 2007 to 9.6 per cent in 2010, with an equity-to-asset ratio of 6 per cent, which exceeded both Basel and gold-plated Chinese leverage ratio standards. Furthermore, loan-loss provisions jumped from 118 per cent of non-performing loans in 2008 to 218 per cent in 2010 (IMF 2011). Whereas Western banks have pressured regulators to grant them a transition phase until the end of 2018, China's banks had already met all Basel III capital requirements by September 2012 (OECD 2013; Zou 2013).

In addition to state-sponsored recapitalisation and market-driven equity capital flows, China's big banks benefit from their position in the domestic market, which guarantees a substantial net interest gap profit (Berger, Hasan, and Zhou 2010). Chinese authorities have established a system of financial repression that involves fixing the rates at which banks lend and take deposits, having provided domestic banks with an interest spread between 2.5 and 3.5 percentage points until 2009 and between 2 and 2.5 since then, whereas banks in the rest of the world must deal with a much less comfortable margin of approximately 1.45 on average (BIS 2012; PBOC Research Institute 2012a, 2012c; Qiao, Su, and Zhang 2010).

The Banker magazine revealed in its June 2013 report that the Industrial and Commercial Bank of China (ICBC) has become the world's biggest bank in terms of Tier 1 capital, making it the first Chinese bank ever to gain that status. Furthermore, with double-digit net profit growth rates, China's big four banks ranked among the top 15 in profit as early as 2009. By 2013 they occupied the first four places in the profit ranking, accounting for about one-third of the world's banking profits (*The Banker* 2013). Over the last half-decade, Chinese banks have been the only ones that have moved upwards in

the top-10 rankings, replacing Western banks such as JP Morgan Chase and Bank of America (Alexander 2014).

Having weathered the global financial crisis without major losses, and being backed by a domestic financial arrangement that ensures substantial profits in an overall environment of continued economic expansion, China's banks are in a good position to incur the adjustment costs of adherence to Basel III standards. However, favourable conditions in China's banking system merely represent an enabling factor for the country's adherence to global prudential banking standards. In a country where domestic banks have a joint market share of almost 98 per cent, and where the major financial firms continue to be majority-owned by the state, dissenting voices are few. The commanding powers of the party-state obviate the kind of contentious or consultative relationship with the banking sector that plays a key role in financial regulatory policymaking in pluralist democracies. But it would be wrong to conceive of the Chinese state as a monolithic entity, as the following section will show.

Table 2. Global Bank Ranking by Tier 1 Capital

	2012	2013	2014	2015
1	BofA	ICBC	ICBC	ICBC
2	JP Morgan	JP Morgan	CCB	CCB
3	ICBC	BofA	JP Morgan	JP Morgan
4	HSBC	HSBC	BofA	BoC
5	Citigroup	CCB	HSBC	BofA
6	CCB	Citigroup	Citigroup	ABC
7	Mitsubishi	Mitsubishi	BoC	Citigroup
8	Wells Fargo	Wells Fargo	Wells Fargo	Wells Fargo
9	BoC	BoC	ABC	HSBC
10	ABC	ABC	Mitsubishi	Mitsubishi

Source: *The Banker* 2013.

Note: ICBC – Industrial and Commercial Bank of China
CCB – China Construction Bank
BoC – Bank of China
ABC – Agricultural Bank of China

Factions and Finance in Post-Crisis China

In order to understand the domestic political economy of financial policymaking in China, with its dense web of interdependency between state and party as well as private firms and public authorities, one must go beyond the Western prism of interest group politics. Shih (2008) introduces the notion of cyclical factional politics to provide a convincing explanation of financial sector development in China up until the global financial crisis. Over the last decades of reform and opening, a generalist faction interested in maximising local growth through accelerated lending and investment has struggled with a technocratic faction that prioritises monetary and macroeconomic stability.

The banking sector is at the centre of this battlefield of factional politics. Large banks not only play an essential role in the central bank's exchange rate and macroeconomic management system, they have also been, at least until recently, the main source of capital for local investment. Throughout the early 2000s the technocratic faction can be credited with reforming state-owned banks, improving loan quality, and addressing inflationary pressures in a period of large balance-of-payment imbalances. Unlike its peers in advanced capitalist economies, the Chinese central bank has made use of prudential banking instruments to achieve these macroeconomic goals. It is in this context that Basel III emerges as another convenient instrument in the hands of the technocratic faction.

Although it might be tempting to regard China's development success as the consequence of a singular export-led growth model, in reality policymakers have constantly changed and adjusted macroeconomic management in a trial-and-error fashion (Wu and Ma 2013). Until the late 1990s, China's foreign exchange reserves were low, the current account was relatively balanced, and it can be argued that the value of the *renminbi* was close to market equilibrium. It was only after the Asian Financial Crisis that policymakers adopted a macroeconomic management model that combined export promotion with foreign exchange reserve accumulation as a self-insurance policy against external shocks (Chin 2010; Lardy 2013; State Council Development Research Center 2013d).

China's current account surplus rose from 1.3 per cent of GDP in 2001 to over 10 per cent in 2007, and its capital account also registered a constant surplus throughout the first decade of the 2000s. The

consequence of this inflow of capital, according to the Balassa–Samuelson effect, is either nominal currency appreciation or inflation, both of which are highly undesirable for the authorities. Because China adopted a fixed exchange rate from 1998 to 2004 and let the *renminbi* appreciate only slowly before and after the global financial crisis, fighting inflation by controlling money supply growth has become a formidable task for the authorities.

The People's Bank of China (PBOC) adopted two methods to sterilise capital inflows: First, it issued bonds (CNY 4 trillion outstanding in 2010) that domestic commercial banks would be obliged to buy in significant quantities. Second, it raised the portion of deposits that commercial banks must retain at the central bank. The required reserve ratio (RRR) rose from 6 per cent in September 2003 to 15 per cent by the end of 2008 (China Finance 40 n.d.; Lardy 2013). This approach stands in stark contrast to the constant and low or even non-existent RRR in most Western countries to date. In sum, banks were an essential wheel in the macroeconomic management mechanism of the technocratic faction, and prudential banking measures were part of its regulatory arsenal.

The global financial crisis altered this situation drastically. Chinese banks were not affected directly because of their limited exposure to Western financial markets. However, China's CNY 4 trillion (USD 586 billion) stimulus programme was channelled largely through the domestic banking system. In 2009, the total amount of outstanding renminbi loans expanded by 33 per cent and China's credit-to-GDP ratio jumped from 197 per cent to 229 per cent (IMF 2011; PBOC Research Institute 2013b; State Council Development Research Center 2013b). Observers qualified this move as a takeover by the generalist faction and a return to the policy-lending practices of the 1990s (Borst and Lardy 2015; Goodstadt 2011). Faced with the threat of a sharp economic contraction and the subsequent expected rise in unemployment and social unrest, the Communist Party opted for aggressive credit expansion even though this meant undoing years of improvement in domestic lending practices.

That China sailed through the global financial crisis at an almost unabated speed of economic expansion was considered a success by policymakers in Beijing and abroad, but the technocratic faction had to reassert power in order to address the repercussions of the stimulus programme. Fearing an overheating of the economy, it used all

available instruments to curb further credit growth. The Central Bank raised the RRR six times between 2010 and June 2011, up to an all-time high of 21.5 per cent for major Chinese banks in June 2011. This measure has significantly reduced the available capital that banks can transform into loans. Clearly, Chinese authorities use prudential regulatory tools not merely to enhance the stability of the financial system but also for purposes of macroeconomic management (PBOC Research Institute 2012a; Zhang 2012).

It is in this context that Basel III emerges as a desirable policy instrument. Adherence and even over-compliance with the new global standard enables the technocratic faction to lock in an important piece of prudential banking reform (Walter 2010). It also enables it to limit further credit expansion. Andrew Walter notes:

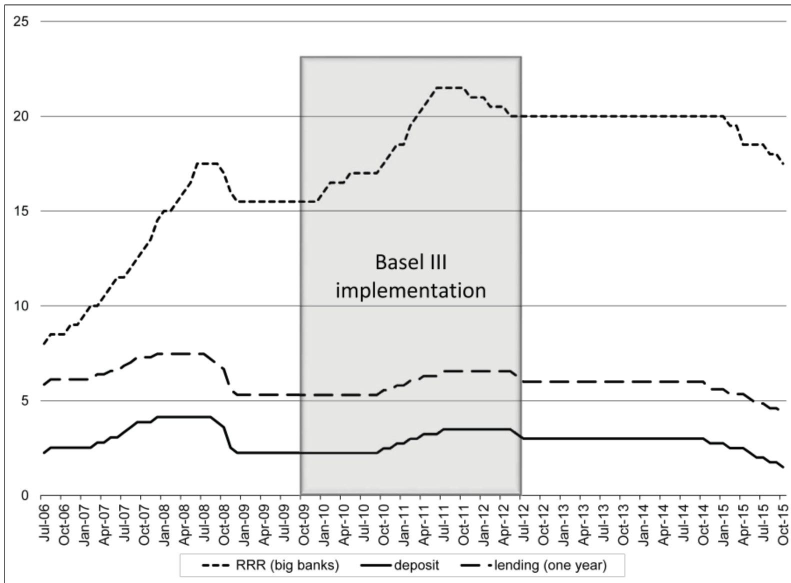
> Modest medium-term over-compliance with Basel capital standards can be justified as necessary compensations for the potentially damaging domestic consequences of the post-GFC credit boom. (Walter 2014: 30)

The external scrutiny provided by the Basel Committee's peer-review process is expected to insulate China's banks from political pressures for further reversion to policy lending in the event of a future crisis (Ju and Lo 2012). This is especially relevant under China's "dependent regulatory state model" (Yazar 2015), where financial supervisors are constrained by the political objectives of the Chinese Communist Party. Nölke expands upon this point, arguing that mock implementation of Basel III is meant to appease the generalist faction (Nölke 2015). His assertion of mock implementation, however, is based more on suspicion than evidence, highlighting the relevance of the credibility gap China's financial policymakers are facing abroad (see below).

Both the PBOC and the State Council continue to favour a gradual liberalisation of the capital account, but the authorities are concerned that further opening and reform will increase risk and volatility in domestic financial markets (*Xinhua* 2013). Local experiments in financial liberalisation, namely in the south-eastern city of Wenzhou, were shelved when they threatened to jeopardise social and political stability (Zeng 2015). Similarly, the stock market bubble and bust in 2015 challenged the authority and expertise of Beijing's financial policymakers. A gradual, experimentalist approach has been widely celebrated as a key ingredient of China's reform success, but it

faces structural obstacles in the area of financial liberalisation. The banking system, state-owned enterprises in key economic sectors, land management, and local government financing are entangled in a complex web of interdependence, especially in post-crisis China (Breslin 2014). Research has shown that local governments weigh political incentives against economic ones when determining how closely to follow Beijing's orders in the implementation of regulatory policies (Van Aken and Lewis 2015). In the area of financial liberalisation, the repercussions of sub-standard implementation of national policies for national social and political stability are especially worrisome.

Figure 1. Interest Rates and Required Reserve Ratio for Commercial Banks in China (in %)



Source: CBRC 2007.

In the face of these challenges, several internal documents highlight the importance of prudential supervisory instruments as a means of stabilising the economy (PBOC Research Institute 2012a, 2012c; State Council Development Research Center 2013b, 2013d). Basel III

imposes limits on assets relative to equity on a bank's balance sheet. As a complement to the loan-to-deposit and reserve requirement ratios that regulate the relationship between bank assets and liabilities, Basel III serves as an instrument for both microprudential and macroeconomic management purposes in the hands of China's technocratic faction of policymakers.

Stringent prudential regulation and financial repression does not come without unintended side effects, however. China is facing what Goodhart (2008) calls a "boundary problem." Any tightening of prudential requirements generates incentives to shift financial activities outside the regulatory perimeter to areas where regulation and supervision are weakest (IMF 2014).

In an environment where depositors lack profitable investment opportunities and where small and medium businesses face severe credit constraints, the shadow banking system is burgeoning. Chinese households use wealth management products (WMP) increasingly as deposit substitutes, and corporate savings enter the financial market through a variety of trust products and other, even less transparent instruments. Data from the PBOC shows that shadow banking accounts for 30 per cent of the CNY 17.3 trillion in credit issued in 2013, up from 23 per cent in the previous year (Mitchell 2014). This massive credit expansion outside of regulatory control poses a challenge for both the central bank's monetary policy and its financial stability objectives, as even top-level policymakers have recently admitted publicly (Bloomberg 2014; Zhang 2014). It does not affect compliance with Basel III, because the perimeter of Basel regulations is restricted to the formal banking sector. Nevertheless, the growth of the shadow banking sector shows that even gold-plated Basel III regulations cannot ensure – and may even be counterproductive for – monetary and financial stability (IMF 2016).

Reputation and the Credibility Gap

The reputational benefits of banking regulation were not a concern for China's policymakers as long as the country's financial system developed in an environment of sheltered autarky. In state-permeated capitalism in general and China's system of financial repression in particular, banks are not designed to maximise profits or allocative efficiency; rather, they serve as infrastructure to channel capital to

productive purposes in line with the government's development plan (Gruin 2013; Nölke 2015).

China's banks have grown fast in this comfortable domestic environment but have rarely expanded beyond the borders of the mainland and Hong Kong (Weinland 2015). In order to successfully compete in the financial sector abroad, Chinese banks need to rely on reputation. Their subsidiaries overseas need to attract deposits and secure cheap wholesale financing in capital markets, both of which require investor confidence. More fundamentally, they need to obtain a charter in order to operate in foreign jurisdictions. But how can Chinese banks build this reputation?

Relying on its historical track record is not an option for Chinese banks, for two reasons: First, even though some Chinese banks were established as far back as 100 years ago, they ceased operating as companies under the planned economy of the People's Republic. Only after Deng's call to turn them back "into real banks" did China's banks resume operations, and even then financial intermediation was subject to heavy state intervention until the commercial bank law of 1995 was passed. In other words, most Chinese banks have less than 30 years of a track record. Second, to further complicate things, this track record is everything but confidence-inspiring. Due to low-quality corporate governance, backwards risk management, and widespread relationship and policy lending, big state-owned banks reached the point of technical bankruptcy in 1998 and again in 2003. Both times, banks had to be bailed out and undergo restructuring under the supervision of state authorities. The latest recapitalisation of a bank using foreign exchange reserves occurred as recently as 2008 (IMF 2011). Foreign observers who believed that banks had gained some autonomy from the state were disappointed by the massive loan expansion under the 2009 stimulus package (Borst and Lardy 2015; Goodstadt 2011).

Adherence to purely domestic regulatory standards would not inspire investor confidence either. For example, Chinese regulators introduced a three-tiered system to measure non-performing loans (NPL) in 1995 that fell short of international standards. Even though the PBOC overhauled the loan classification system in 2002, suspicion among foreign regulators and market participants has not subsided (Borst 2013). Moreover, domestic prudential supervision lacks credibility because the state has a double role as a regulator of the

banks on the one side, and as the majority shareholder on the other. Under these circumstances, verifiable adherence to international prudential banking standards serves as one of the few sources of reputation available to Chinese banks.

In a recent interview, a US banking regulator explained the reasoning behind China's external credibility gap:

> It's very hard to compare China to other economies because there's so many of their firms that, still, if they're not state-owned, they're very closely owned by the state. I don't think that there is a high degree of confidence in the data from China. I don't think you can believe their non-performing numbers are as good as they say they are. I don't have any personal experience, but I don't know of anyone who doesn't view Chinese data with a great degree of scepticism. (Anonymous 1 2014)

This lack of confidence poses a real obstacle for the expansion of Chinese banks in the United States and other developed countries. Asked about the relationship with US banking authorities, a Chinese regulator states:

> When the Chinese banks would want to open a branch in the States, for quite a long time the US regulators didn't agree, saying that you have a poor regulation. […] We negotiate with the Federal Reserve to push them open to Chinese banks. (Anonymous 2 2013)

A survey conducted by Cai and Wheale (2007) shows that reputational concerns are indeed among the reasons why Chinese bank managers worked towards compliance with Basel II before 2008. Ironically, the series of bank failures at the heart of the global financial crisis exposed the inadequacy of these standards. However, the Basel Committee made considerable efforts to incorporate lessons learned from the crisis in its overhaul of global banking standards. The new Basel III standards with tougher requirements and a more rigorous peer-review mechanism serve as a quality seal for Chinese banks that no domestic institution could provide.

This article is unable to provide an objective assessment of the capability of Chinese financial stakeholders to "cook the books" in order to avoid domestic or transnational scrutiny. But in this context of uncertainty, mere compliance with Basel III is arguably not enough to address the credibility gap. By over-complying with the new global standards, Chinese banks can expect to overcome resistance by for-

eign regulators. Furthermore, banks that are able to fulfil or even exceed Basel requirements can count on favourable treatment in international capital markets. Therefore, the adjustment costs of adherence to Basel III are outweighed by the benefits these standards confer to China's major banks as they pursue outward expansion in the future.

China's biggest commercial bank, ICBC, may be most suited to illustrate this phenomenon. The bank took some preliminary steps overseas by acquiring minority stakes in Standard Bank (South Africa) in 2007 and ACL Bank (Thailand) in 2009, and by buying the broker-dealer operations of Fortis Securities in the United States one year later. More recently, ICBC purchased majority shares of banks in Canada in 2010 and Argentina in 2012 and converted them into its first foreign subsidiaries (Berger, Hasan, and Zhou 2010; Martin 2014). A bid to take over the US branches of the Hong Kong-based Bank of East Asia in 2011, however, was blocked by the Federal Reserve on the basis of prudential regulatory concerns (Thomas and Guerrera 2011). In the summer of 2012, however, at a time when the CBRC issued super-equivalent Basel III standards and three years after China joined the Basel Committee, US regulators revised their decision and authorised ICBC's acquisition. Since then, the bank has operated a subsidiary insured by the Federal Deposit Insurance Corporation (FDIC) in the United States under a federal charter. ICBC's regulatory reports to the US authorities highlight the growing stock of Tier 1 capital in accordance with the Basel III specifications issued by the CBRC (ICBC 2013, 2014).

In terms of international presence, ICBC is the most advanced of China's commercial banks. Its peers can be expected to follow in the upcoming years. Over the last decade, Beijing has made important steps in extending foreign loans and other "financial inducements" (Wu and Wei 2014) abroad, but the channels of cross-border financial expansion were policy banks and sovereign wealth funds, not the commercial banks (Mattlin and Nojonen 2015). At a time when rising unit labour costs are pushing Chinese companies to venture abroad and gradual capital account liberalisation is providing Chinese households with a growing range of offshore investment opportunities, commercial banks have every incentive to accumulate international experience and expand their financial services across borders.

But over-compliance with Basel III not only provides China's commercial banks with a credible external quality seal, it also helps regulators attain prestige in a major financial standard-setting body. In 2008, G8 leaders decided to incorporate emerging market economies into the exclusive clubs of global financial governance. They elevated the G20 to the prime forum to coordinate responses to the global financial crisis, and extended membership to the Financial Stability Board, the Basel Committee, and other government networks to selected developing countries, including China (Collins and Gottwald 2014). Leading Chinese policy figures welcomed this development, emphasising that in order to protect its domestic interests, China must have a voice in the international financial market and the supervisory bodies that regulate it (State Council Development Research Center 2013d, 2013c; Yi 2009; Zhou 2012).

In the wake of the crisis, China has called for and achieved some degree of governance reform in the IMF and the World Bank in order to give a greater voice to itself and other emerging economies (Ferdinand and Wang 2013; Wade 2011). The politics of influence in transnational government networks, however, are more complicated than those of the big international financial institutions. In principle, all members of standard-setting bodies such as the Basel Committee on Banking Supervision (BCBS) are on equal standing, and decisions are made by consensus. In the absence of formal voting shares, voice is bestowed upon member countries according to their market size and legitimacy. The precondition for legitimacy, in turn, is compliance with the financial standards promoted by the government network itself. Because China's share of global financial markets is still negligible (Hong Kong is a separate member of the standard-setting bodies), legitimacy through compliance – or, in fact, over-compliance – is the only way for China to attain a voice in these government networks.

Beijing's intentions to engage in gold-plating Basel in order to become a respected stakeholder in the international regulatory community do not go unnoticed. A regulator from Hong Kong states:

> China is keen on innovating domestic standards up to international standards at a fast pace in order to catch up with the international development. […] I think they have a case to be keen on implementing those international standards domestically to be treated more seriously than other developing jurisdictions in order

> to gain [a position for] the country as a major player in international forums. (Anonymous 3 2013)

As mentioned above, China's banks suffer from a reputational deficit due to a short and less-than-stellar track record. The same can be said for China's regulatory authorities. Especially in the realm of financial regulation, China is a latecomer in institutional development (Brehm 2008; He 2013; Heilmann 2005; Pearson 2007). Hence, over-compliance with a global standard is a costly but necessary signal to China's peers in the global regulatory community. When asked about the main motivation for the massive regulatory upgrade that gold-plating Basel III implies, a Chinese regulator responded: "It's international. Well, you see the foreign regulators went kind of, 'Okay, the Chinese regulators really made a lot of progress.'" (Anonymous 2 2013).

It is important to recognise, though, that the phenomenon described above does not extend to all areas of financial regulatory reform. The initiative by the G20 and the FSB (2011) to bring the shadow banking system under regulatory control, for example, has not been received by Beijing with enthusiasm. Chinese scholars and policymakers have made an effort to show why international efforts to strengthen regulation are not compatible with the domestic situation (Chinese Academy of Social Sciences 2013; State Council Development Research Center 2013a; Zeng 2013). A thorough examination of the sectoral differences in Chinese financial regulatory convergence with international standards is beyond the scope of this article, but a preliminary analysis indicates that the costs of adjustment would be high for China and the benefits to the country's external reputation low. This incentive structure is likely to give veto players in the domestic political economy the upper hand over change agents. Therefore, even though the dramatic expansion of the shadow banking system in China interferes with conventional macroeconomic policy (PBOC Research Institute 2012d, 2013b, 2013a), we are unlikely to see China gold-plating the emerging international standards of shadow banking regulation.

Conclusion

China's current behaviour in the realm of banking regulation provides only one data point, which is insufficient to validate or disprove any theory of global regulatory politics. Nevertheless, the case of Basel III

implementation in China can help us to assess the strengths and weaknesses of salient theories in the current literature.

As the above study shows, Drezner's (2007) point about the importance of adjustment costs to global regulation is well taken. Because of the timing and scope of domestic banking reform, Chinese banks face much lower adjustment costs.

At the same time, the Chinese example shows how difficult it is to establish a direct causal link between market size and the balance between adjustment costs and benefits. Drezner (2010) predicted that China as a major power would lack the incentive to converge with international regulatory standards, yet in the case of Basel III China is making more of an effort to comply and over-comply than most other jurisdictions.

What historical institutionalists can take from the Chinese case is not only support for their arguments, but also rich material for further theory development. Several of the reasons why adjustment costs for Chinese banks are relatively low are clearly linked to the domestic institutional arrangement. Established commercial banks in China could count on a privileged source of income and thrive in a protected environment that has been created by public authorities.

Above all, this study highlights the importance of reputation as a driving force. More than merely an auxiliary to socialisation that is embedded in what constructivists call the logic of appropriateness, reputation is an asset with clear economic benefits, at least in the world of financial regulation. Kahler (2013) correctly points out that the capabilities of rising powers in the ongoing bargain with incumbents rest not only on market size but also on a credible commitment to predominant liberal standards.

In China's case, banks need reputation to expand abroad, and regulators need reputation in order to enhance their negotiating position both internationally and domestically. Thus, in the search for international reputation, the interests of banks and regulators are aligned. In addition, global banking standards represent an important opportunity for the technocratic faction of China's policymaking elite to lock in and insulate prudential banking reform from reversion due to political pressures. It is this peculiar convergence of outward-oriented incentives and domestic conditions on both the state and industry side that helps explain why China is in the process of gold-plating Basel III banking standards.

An important limitation of this study is that it cannot make inferences regarding the stability of the Chinese financial system. The reason is not that China would emulate its neighbours' exercise in "mock compliance" with global financial standards (Walter 2008). Enhanced peer-review mechanisms under the auspices of the G20 and the IMF reduce the room to manoeuvre in terms of domestic regulatory finagling. Moreover, China's accounting standards have substantially converged with International Financial Reporting Standards (IFRS) and International Standards on Auditing since 2005, and all stock-listed companies have to meet international accounting and auditing requirements, even though compliance rates have risen only in the last few years (IMF 2011; Taplin, Zhao, and Brown 2014).

Rather, the reason inferences regarding financial stability cannot be made is that the new global regulatory standards themselves may be of limited effectiveness. Believing that compliance with or even gold-plating of Basel III will protect China from the next financial crisis may be just as naïve as thinking the same of Basel II in the United Kingdom in 2007. Even though the Chinese financial system withstood a series of stress-test simulations as part of the 2011 Financial System Stability Assessment, the country is facing massive challenges that range from reducing local government debt (Shih 2008) to internal rebalancing after years of debt-fuelled overinvestment (Pettis 2013). Basel III does not effectively address these vulnerabilities, and a conservative implementation of its standards might even have the perverse effect of contributing to the concentration of systemic risk outside of its regulatory perimeter, in the shadow banking sector (Elliott and Qiao 2015). The next steps of market-oriented reform and opening to global capital flows are leading China's policymakers into unchartered and risky territory where a Basel gold-plate cannot guarantee protection, no matter what karat.

Further research might look beyond the realm of financial regulation to discover the conditions under which emerging powers such as China exceed global standards. Ren (2012) argues that China is taking conscious steps to signal a non-revisionist stance in the G20 while pushing for reform within the existing order. Over-compliance with global standards might also endow rising powers with reputational benefits in areas other than trade and finance. China's significant contribution to peacekeeping troops under the aegis of the United Nations might be a case in point (Huang 2011). A cross-sectoral

integration of research is needed to develop a theoretically rooted and empirically sound understanding of China's integration into the liberal world order.

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ICBC see Industrial and Commercial Bank of China

IIF see Institute of International Finance

IMF see International Monetary Fund

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Contents

Editorial

- Kerry BROWN and Georg STRÜVER
  Editorial 3

Research Articles

- Julia Kirch KIRKEGAARD
  Tackling Chinese Upgrading Through Experimentalism and Pragmatism: The Case of China's Wind Turbine Industry 7
- **Peter KNAACK**
  An Unlikely Champion of Global Finance: Why Is China Exceeding International Banking Standards? 41
- Ane BISLEV
  Student-to-Student Diplomacy: Chinese International Students as a Soft-Power Tool 81
- Camilla T. N. SØRENSEN
  Constraints on the Soft Power Efforts of Authoritarian States: The Case of the 2015 Military Parade in Beijing 111

Analyses

- Karin BUHMANN
  Chinese Human Rights Guidance on Minerals Sourcing: Building Soft Power 135
- Hannah POSTEL
  Moving Beyond "China in Africa": Insights from Zambian Immigration Data 155

Contributors 175