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The role of China in the international financial system

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Abstract

China's interaction with the international financial system is driven by its growing economic importance in the world. However, China's financial influence has been much under-presented compared with its economic power. This mismatch provides an opportunity for China to promote greater inclusiveness and better balance of power in global financial governance. The accelerated financial opening-up, exchange-rate flexibility, and deepened domestic reform also nourished the ambition of internationalization of the renminbi that would have impact on the global reserve currency system. This paper investigates the motivations behind China's engagements with the international financial system, the approaches China adopted to achieve its goals, and the key domestic policies required for China to gain more weight in the global financial market.

Keywords: international financial system, renminbi, capital account liberalization, exchange rate

JEL classification: F33, F02, E60

I. Introduction

Since the reform and opening up in 1978, China has emerged as the second largest economy, and the largest trade nation in the world. China's deep integration into the world economy and its creditor position are seen as symbols for this influential player entering the global financial system. However, China doesn't seem to have the equivalent bargaining power. While China's dual status as both of systemic importance and as a developing country raises the debate on whether China fits into the traditional norms and rule-based system, China has to meet the requirements as a responsible stakeholder in international financial institutions as well as to adjust its domestic policies in order to be recognized as a key international player.

China's engagement in the international financial system is also motivated by the financial crises in the past decades. Particularly, the outbreak of the Asian financial crisis in 1997–8 changed China's view of its financial influence in Asia. It was the first time that China realized that its currency's non-devaluation actually had a stabilizing effect in the region. The global financial crisis in 2008 created cooperation momentum worldwide to safeguard global financial stability and to reform the Bretton Woods institutions, such as the International Monetary Fund (IMF) and the World Bank. China happened to be in the position that its economy was deeply integrated with the world through trade, investment, and global value chains (GVCs) after its entry into the World Trade Organization (WTO). The country took the opportunity to familiarize itself with global standards, rule of games, and best practice, and realized the importance of bargaining power in the global market. Through the crises, China saw itself to be large, responsible, and capable, and was ready to join other key countries in the reform of the international financial system.

China provides financial contributions and promotes reform necessary for a balanced power in the existing institutions. For instance, China joined quota reforms of the IMF and the World Bank. The renminbi has been included

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in the IMF's special drawing rights (SDR) since October 2016, a milestone for both the currency's international role and for the diversification of reserve currency system in response to changing economic and financial strength of the member countries of the IMF. Furthermore, China initiated new multilateral financial institutions—the Asian Investment Infrastructure Bank (AIIB), and jointly set up the New Development Bank (NDB) with BRICS countries (Brazil, Russia, India, China, and South Africa). The new institutions aim to supplement the existing multilateral financial institutions and, hopefully, narrow the supply gap of global public goods by providing additional ones.

More specifically, China decided to enhance the international role of the renminbi. Supported by the continuous capital account liberalization, domestic financial reform, and the policies to encourage cross-border settlement, the international use of the renminbi has expanded gradually in the past two decades. While the international role of the renminbi is still very limited, the ambition to make the currency internationally acceptable has more implications besides its actual use, in the sense that it requires a set of conditions that the currency has to meet. For China, the strategy of promoting internationalization of the renminbi also serves an additional purpose, namely inviting external pressure for domestic reform. This 'forcing force' approach was successful in the case of China's WTO entry. However, the policy-makers have to face the trade-offs between financial openness and stability, and try to increase the flexibility of the exchange rate to manage the difficulty of policy choices. Furthermore, amid the rise of anti-globalization and decoupling, China's domestic dynamic, such as the adoption of the 'dual circulation' strategy and the commitment to a high quality of economic openness, will determine how and the extent to which China continues interacting with the world financially.

The paper is organized as follows. Following the introduction, section II analyses the motivations behind China's engagement with the international financial system. Section III investigates how China participated in the reform of global financial institutions by establishing the new ones. Section IV explains the currency influence with focuses on the key aspects of the internationalization of the renminbi. Section V elaborates on China's financial openness and exchange-rate flexibility, the key requirements for China's global financial role, with evolutional details, and how the policy-makers managed policy trade-off. Section VI is the conclusion.

II. China's evolving economic position in the world

China is a super-power in terms of economic size. And yet, measured by GDP per capita, China is still a developing country. China is also one of the major creditors with its high domestic savings rate and the subsequent persisting surplus of the current account. How does this position affect China's role in the international financial system? Why are the past two crises, the Asian financial crisis in 1997–8 and the global financial crisis in 2008, relevant for China's perception of its financial and currency influence?

(i) A systemically important economy

China's world trade share was less than 1 per cent in the 1970s. However, China's entry into the WTO in 2001 was the demarcating point for the country to join the international labour division. The Chinese government has made a series of reform commitments in order to meet the requirement for WTO membership, such as to reduce tariff rates and eliminate non-tariff barriers, permit foreign companies to participate in restricted industries, open China's insurance market, and allow foreign banks to access the renminbi business, etc. Since then, China has actively interacted with the world through its rapid economic growth, integration into the GVCs, and expansion of trade and investment. In 2008, China took the world trade share by 9 per cent, surpassing Germany (8.9 per cent) and the US (8.1 per cent), and became the largest trading nation in the world amounting to 21.6 per cent of the world total in 2021. In terms of nominal GDP, China emerged from a low place, gradually surpassing the UK, Germany, and Japan, and the gap with the US has narrowed since 2010. Over the past two decades, China has become the powerhouse in most sectors of global production. The rise of such a status has also caused concerns about the role of the state, export measures, and intellectual property rights, etc. (Nicita and Razo, 2021).

Over time, as China's economic size and its trade linkage with the rest of the world increased, China's economic influence grew as well. In 2011, the IMF included China as a systemic economy in addition to the Euro Area, Japan, the United Kingdom, and the United States (IMF, 2011).[1] This consideration is based on the fact that the Chinese economy has the ability to transmit real economic shocks to the world. While China's key partners benefit from China's economic growth, they also face the impacts of the possible slowdown of China's growth, fluctuations of the renminbi exchange rate, accumulation of foreign exchange reserves, and the openness of the capital account. In particular, as China's economy has integrated more closely with countries in Asia, China's economic impact is

[1] The classification is based on the fact that all five economies articulate the concerns of partner countries, quantify the external effects, and foster multilateral dialogue, although each is systemic in its own way, according to IMF (2011).

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larger in Asia than in other regions. Some early evidence showed that, in the period of post-global financial crisis, 1 per cent slowdown in China's growth resulted in 0.15–0.30 per cent decline in growth for the other Asian economies (Salgado, 2016). The most recent evidence indicated that while China's slowdown in the wave of the outbreak of Covid-19 caused global repercussions, the ripple effects were more evident in ASEAN countries (AMRO, 2022). For instance, considering the upstream and downstream links and the importance of property investment as a share of total GDP in the region, a 1 per cent decline in China's output over a year would lead to an average 0.8 per cent decline in the output in the ASEAN five countries (Singapore, Indonesia, Malaysia, Thailand, and the Philippines), Japan, and Korea (Del Rosario and Vu, 2020).

However, China's GDP per capita, an indicator implying low productivity measured by GDP per workforce, is much lower than that in many other advanced economies. Even at the peak of $10,434.8 in 2020, China's GDP per capita was only equivalent to 72.7 per cent of the world average, 16.5 per cent of the US, 24.5 per cent of the UK, 22.6 per cent of Germany, and 26 per cent of Japan. With a relative lower GDP per capita, China remains a developing country in the phase where individuals' income must grow faster so that it can be parallel to the growth of the nation's wealth. More importantly, like many other developing countries, China faces the vulnerabilities in the domestic financial market and a need for protection of domestic infant sectors.

China's dual status as both of systemic importance and a developing economy raised concerns about China's attitudes towards the existing global institutions and established international norms.[2] While it is understandable that China carefully defines itself as a developing country, China has been reluctant to take on the same responsibilities of rich countries (Dollar, 2020). Some believe that, as China is expected to demand more influence in the international system, like any powerful country, China's leaders are likely to use the country's growing influence to shape the rules to serve their interests and to circumvent those rules that do not (Mazarr *et al*., 2018). Although China's economic performance is based on a different economic and political model, the Bretton Woods Institutions need to be reformed to achieve a balanced power as the world cannot function without China (Subacchi, 2022). In fact, the Chinese policy-makers realize that the country has to meet the requirements to achieve a larger share in the international arena alongside the established partners. The country's dual positions simply reflect the need to legitimatize the rights of emerging and developing countries as a whole, if the world expects diversified actors on global stages.

(ii) A creditor in global imbalance

China has another prominent status in the world economy in that the country is one of the major creditors to the world. The country's net international investment position (NIIP) was at $276.4 billion in 2004. It jumped to $1.5 trillion in 2008, and stood at $1.98 trillion in 2021 (Figure 1). This position is the result of the country's high gross savings rate at 54 per cent on annual average over the past two decades.

As a creditor, China financed the world through accumulation of foreign exchange reserves and current account surplus. Some argued that China has been in the situation where a poor country financed the rich ones, and failed

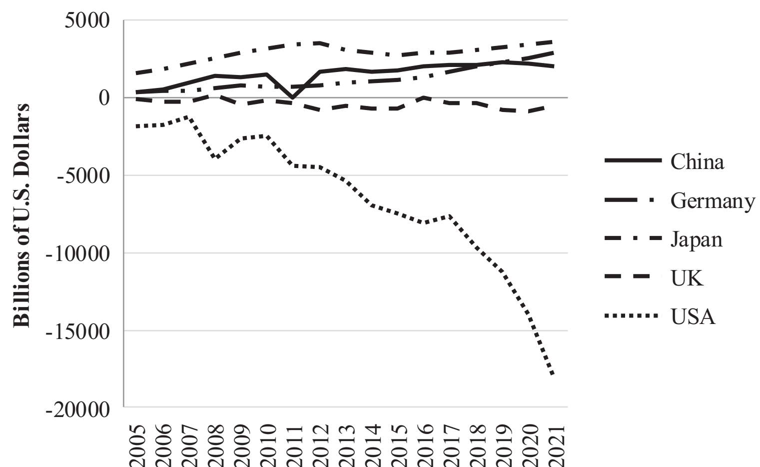

Figure 1: Net international investment position. *Source*: International Financial Statistics.

[2] The term 'dual status' refers to China's unique position of strength in economic size and weakness in the level of economic development.

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to transform its domestic savings into investment (Yu, 2008). In fact, China fits the argument of 'conflicted virtue' in which a country with a 'virtue' characterized by a high savings rate has to run a current account surplus and accumulate foreign reserves for fear of losing competitiveness.[3]

China's external position is affected by choices of domestic policy. It also makes China a part of the formation of global imbalance. The arguments of 'saving glut' believe the countries with high savings rates to be responsible for the decline of the long-term interest rates and low borrowing costs (Bernanke, 2005). However, it is reasonable to argue that, following this chain of thoughts, it is low savings rates in deficit countries that cause the consumers to borrow beyond limits. The discussions about the role of China in global imbalance before the global financial crisis in 2008 were much related to China's exchange rate policy and economic growth model that was highly reliant on export and investment. In particular, throughout the period of 2009–14, China ran a large trade surplus and accumulated massive foreign reserves—the amount increased from $191.4 billion to $384.3 billion over the 5 years (Figure 2). The renminbi was also undervalued in real terms because of the central bank's heavy intervention. Facing criticisms that China's exchange rate policy caused large misalignment and a distortion of market principles, China was reluctant to adjust its policy, given that the exchange rate policy aimed to support an export-led growth model. However, China soon realized that the rigidity of the renminbi's exchange rate was responsible for external imbalance. It also worsened domestic imbalance, because domestic resources were continuously channelled to the manufacturing sector and caused the problem of overcapacity where production is in excess of market demand. The subsequent rebalancing after the crisis and a series of domestic market- driven reforms, including more flexibility of the renminbi's exchange rate formation, further consolidated China's external position—a creditor intending to raise its voice and monetary influence in the international financial system.

(iii) Two crises shaping China's perception of its role

The Asian financial crisis in 1997–8 caused severe economic and financial damage to Asian economies. However, China was an exception because of its strict capital control and limited external exposure during that time. China's relatively stable position played a positive role during the crisis. In particular, when Hong Kong's currency board system faced speculative attacks in 1998, Premier Zhu Rongji expressed full support at any costs from the central government. He also promised to keep the value of the renminbi stable, although devaluation was obviously beneficial for China's exports during the time (Zhu, 2011). The decision to stabilize the renminbi was a political one. The policy-makers did not intend to use this crisis as an opportunity to increase the renminbi's role in Asia. However, in reflecting on the crisis, the policy-makers realized that the country's currency policy could have regional influence, and in times of crisis, a stable renminbi performed as a stabilizing factor and helped other economies rebuild confidence against the pressure of foreign exchange market turbulence.

The global financial crisis in 2008 brought negative impact on China's trade and investment, which led the policy-makers to adopt massive fiscal stimulus and a comprehensive reform agenda. China also faced the challenge

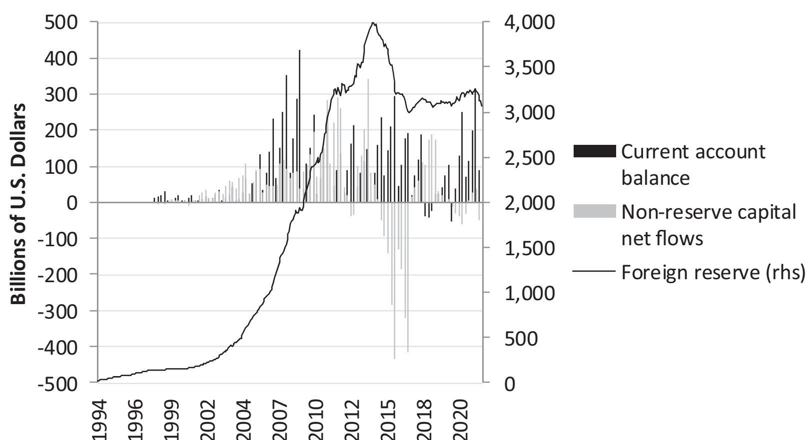

Figure 2: China's external sector (January 1994–June 2022). *Source*: Wind.

[3] The concept of 'conflicted virtue' mentioned by McKinnon and Schnabl (2004) indicates the situation that when a creditor country cannot use its own currency internationally, it has the tendency to peg its currency to the key currency, i.e. the US dollar, to maintain competitiveness in trade. While the 'conflicted virtue' is applied to creditor countries, the 'original sin', coined by Eichengreen and Hausmann (1999) suits the situation in which a debtor country subject to double mismatch of currency and maturity cannot borrow in its own currencies abroad.

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of managing its accumulative foreign reserves resulting from a current account surplus. In fact, in late 2008, when the economy was in sharp downturn, the Chinese government faced domestic pressure to use foreign exchange reserves in profitable ways rather than to recycle domestic savings into dollar assets that are subject to the volatility of the dollar exchange rate.

Such concern coincided with the discussions to reflect the function of the international monetary and financial system. It is reasonable to argue that a typical 'central-periphery' system, with the US dollar and a few other key currencies issued by advanced economies in the centre and the other currencies in the periphery, means overall stability given the lack of institutionalized global currency arrangement. However, there is also inherent cooperation failure due to the asymmetric problem between the key currency-issuing countries and the countries that are the major source of demand for the key currency assets (Obstfeld, 2011). Since the dollar is a global currency and the US is not obliged to maintain the stability of the dollar exchange rate, the periphery countries continuously face an asymmetric effect of policy decisions. For instance, the monetary authorities in countries that have voluntarily pegged their currencies to the dollar face two choices: either to keep the dollar peg to maintain competitiveness while closely following the Fed and accepting the pass-through of US monetary policy, or to intervene in the foreign exchange markets to passively accumulate more dollar reserves. The countries that have to accumulate dollar reserves would face what Krugman (2009) described as 'the dollar trap'.[4]

Overall, the past two financial crises have helped China realize that policy spillovers can present in two ways. China's economic and financial shocks to the world can be significantly important. At the same time, China also exposes itself to potential 'spillback' effects from the world. Such interaction is the root rationale for China to actively engage in policy dialogues and cooperation at both regional and global levels.

III. Institutional engagement

China's participation in the international financial institutions is based on the Chinese view that global governance faces the gaps in supply and it is a mutual responsibility to narrow the gaps by updating the old institutions and/or providing new supply.[5] China joined reforms, such as the quota reform in the IMF and World Bank. However, China's share of quotas in the IMF and the World Bank was not increased in a way consistent with the growth in the size of the Chinese economy. This seems to have been one of the reasons which propelled the China towards creating new multilateral financial institutions.

(i) Creating new multilateral financial institutions

The AIIB was founded by 57 countries and came into operation in January 2016. It is the first multilateral development bank that China initiated. Like many other development banks, the AIIB is designed to utilize the resources to finance development, and supplement private investment when private capital is not available on reasonable terms and conditions. The AIIB also injected new ideas into its governance by introducing a non-resident Board of Directors. Jin Liqun, the president of the bank, put forward a philosophy of 'lean, clean and green' to show the bank's modest ambition and high standards in its operation. He also made it clear that although China is the largest shareholder of the bank, it is only one shareholder and the bank would not do anything to interfere in political affairs (Anderlini, 2016).

The intention of the establishment of the AIIB is to meet the shortfall of infrastructure investment in developing Asia. However, in the early phase of its establishment, the bank faced backlash from scepticism, such as regarding China's motivations, its relationship with the existing multilateral development banks (MDBs), and issues related to its transparency, standards, and governance, etc. After several years of operation, the scepticism faded away. Its membership expanded to 103 economies worldwide, although some major economies still do not participate.

The NDB was proposed jointly by the leaders from China, Russia, Brazil, India, and South Africa during the fourth BRICS Summit in New Delhi in 2012. The NDB came to be fully operational in February 2016, with equal shares among founding members. Within the NDB, the contingent reserve arrangement (CRA) is set to provide liquidity and precautionary instruments for the member countries under actual or potential short-term balance-of-payments pressure.

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[4] 'Dollar trap' is mentioned by Krugman (2009). He described the situation where China's hoard of dollar-denominated assets resulted from renminbi's dollar peg faced the problem that any future fall in the dollar would mean a big capital loss for China.

[5] On 14 May 2017, President Xi Jinping mentioned the three major 'deficits' in his keynote speech at the opening ceremony of the Belt and Road Initiative Forum for International Cooperation: 'peace deficit, development deficit and governance deficit'. By 'governance deficit', he meant that the world order faces a shortage of public goods providers. For more details, see: http://china.cnr.cn/gdgg/20170514/t20170514_523753936.shtml.

The NDB is the first of its kind set up by a group of middle-income emerging economies aimed to strengthen financial cooperation. Since its establishment, the new bank has kept a low profile. The CRA is regarded as a supplement to the IMF and other regional liquidity supporting arrangements, reflected by its IMF-linked portion that consists of 70 per cent of the maximum access. The remaining 30 per cent is the de-linked portion of the maximum access for each member. Since its launch, the CRA has never been activated. This is perhaps partly due to its linked portion that is subject to the IMF conditionality, as well as tothe member countries not having been in the need of short-term liquidity assistance. Furthermore, the limitation of its operation also lies in the fact that the BRICS countries are fundamentally a loose group of countries that share common interests in certain areas, but countries follow different rules (Zhao, 2014). A political element is also part of the consideration of the financial function of the bank, as the BRICS want to make sure that they never attempt to make the group into a security framework.

(ii) Regional effort: Chiang Mai Initiative Multilateralization

China's participation in Asian financial cooperation was inspired by the regional consensus on managing contagion effects after the Asian financial crisis in 1997–8. Japan put forward the Asian Monetary Fund (AMF) in 1997. China was muted about the idea, partly influenced by the US and partly because China was unprepared for a regional monetary fund at that time (Gao, 2022). However, given the country's increasing integration with the region, and the the contagious nature of a capital account crisis, China decided to join in another collective effort with Japan, Korea, and ASEAN ten countries (ASEAN+3).

In May 2000, the finance ministers from the 13 countries established the Chiang Mai Initiative (CMI). The CMI is designed with a clear mandate to provide liquidity support to member countries as well as to supplement to the IMF. Since its launch, the CMI has evolved to be a disciplined framework with a collective activation and decision-making process, an integrated surveillance approach, the ear-marked foreign reserve pooling, and eventually the multilateralization of the bilateral swap arrangements (BSAs). The milestone was that the Chiang Mai Initiative Multilateralization (CMIM) agreement came into effect in March 2010. In 2014, the size of CMIM expanded from $120 billion to $240 billion. China (including HKSAR) and Japan committed $76.8 billion each, together with Korea's contribution of $38.4 billion and ASEAN countries' total of $48 billion. In 2011, establishment of the ASEAN+3 Macroeconomic Research Office (AMRO), a surveillance institution under the CMIM framework, was another milestone for regional institutionalized financial cooperation.

The relationship between the CMIM and the IMF has been one of the most debated issues since the establishment. The CMIM is not a fund because it does not have paid-in capital. However, the CMIM cuts across some of the core functions of the IMF, especially with respect to developing its own regional policy dialogue and economic surveillance. The focal issue is the linkage of the CMIM loans to the IMF conditionality. In principle, the IMF conditionality is set of requirements for recipients to carry out policy adjustments and macroeconomic structural reforms, and is used as specific tools to monitor progress toward goals outlined by the country in cooperation with the IMF. In practice, the activation of the CMIM loans linked to the IMF conditionality in a certain proportion pushes the CMIM into an awkward situation: the linkage is to ensure the loans are utilized effectively; the reliance on the IMF, however, runs counter to the original purpose of CMIM. The lack of an in-house conditionality mechanism within the CMIM is also the key reason that leads to the IMF linkage as a condition for full access to CMIM resources. The proportion was initially set at 90 per cent. In May 2005, the member countries decided to reduce the linkage to 80 per cent. After a decisive reduction in 2020, the proportion stands at 60 per cent.[6] The key argument for demolishing the link is related to the bitter memory of the countries in crisis in 1997–8—the IMF provided loans to crisis-hit countries under strict conditions of policy adjustments, such as, to tighten macroeconomic policy and further liberalize the capital account, which apparently worsened the problems in the recipient countries during the crisis. The IMF linkage of the CMIM also limits the actual size of the CMIM. However, it is reasonable to believe that it is necessary to protect donors' interests and avoid moral hazard through this link unless the CMIM has its own comprehensive surveillance.

The CMIM's role in the regional financial safety net was further improved in 2020. In June, the member countries amended the CMIM Agreement and the Operational Guidelines and decided to increase the flexibility of the financing period of the IMF-linked portion of the CMIM, introduce an overarching legal base for conditionality,

[6] The proportion of linkage with the IMF conditionality means that when a CMIM member obtains loans from the CMIM, 60 per cent of the loan access is activated under the IMF framework that donors would assess the economic and financial situation of recipients and observe the recipients' macroeconomic policy implementation (Han, 2021).

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and address legal issues. Those amendments aim to strengthen the regional line of defence in the Global Financial Safety Net (GFSN) as well as to keep consistency with the IMF.[7]

Although the CMIM has never been activated, the ASEAN+3 countries have greater buffers if they are in need of support. From the Chinese perspective, the regional integration through trade, investment, and supply chain production is in real need of financial cooperation. It is an inseparable part of China's engagement in multilateral financial institutions and arrangements. From China's perspective, Asian regionalism does not necessarily lead to an exclusive bloc because Asia is diverse in trade and economic structure as well as political regimes.

IV. Currency influence

In reflection of the pitfalls of the international monetary system, the Chinese central bank governor Zhou Xiaochuan proposed 'super-sovereign reserve currency' (Zhou, 2009). He criticized the fundamental flaws of a single currency dominating system and suggested delinking global financial stability from one country's balance of payments. This idea is regarded as a theoretical thought to design an ideal system where the 'Triffin Dilemma', an inherent problem in a national currency also serving as an international currency, could be avoided. Zhou's proposal also reflected that China as the major growth engine of the world economy was frustrated with its potential capital loss of massive foreign exchange reserves (Gao and Yu, 2011). One way to avoid capital loss is to increase the influence of its own currency. The rationales are also from the benefit of risk reduction associated with the exchange rate, strength of Chinese financial institutions, and narrowing the gaps between China's trade share and currency invoicing (Gao, 2018). In particular, the renminbi internationalization serves as a policy objective which could only be achieved through China's continuous efforts at liberalizing its financial system and pursuing domestic reforms. In fact, following remarkable achievements of financial opening and reform of exchange rate flexibility, the renminbi officially joined the IMF's SDR basket currency in 2016, a milestone for the renminbi's status as an international reserve currency.

(i) As a trading currency

Choice of trading currency is a market decision and driven by several factors including trade relations, currency transactional cost, and degree of the market liquidity, etc. Recent literature has highlighted the phenomenon of dollar dominance. For example, Gopinath *et al.* (2020) provided the evidence of the dollar playing a dominant role in trade pricing through the existence of the paradigm of dominant currency pricing (DCP). Gagnon and Sarsenbayev (2021) found that the DCP is present in small size economies. Bruno and Shin (2020) implied the prominent role of the dollar in trade and provided evidence that the change of dollar credit condition could have an impact on trade volume through wholesale dollar-funded banks and through GVCs. The reasons for the dollar dominance may vary, depending on the perspectives of different studies. For example, Farhi and Maggiori (2017) referred excessive issuance of reserve currency to the safety premium that the issuing country enjoyed. Eichengreen (2011) provided an historical angle to examine the network externality of how the US dollar maintained its role as a key currency for so long. Beyond trade, some earlier studies found that the dollar's role as a country's monetary anchor has been strengthened since 1946 (Ilzetzki *et al.*, 2017).

The renminbi is not a key trading currency. According to SWIFT, the renminbi's share in international payment was only 2.5 per cent, while the shares of the US dollar and euro were 39.4 and 38.4 per cent, respectively in January 2022. In the global foreign exchange market, the share of renminbi in total transactions was only 4.3 per cent (net-net base), much lower than the dollar's share of 88.3 per cent and the euro's share of 32.3 per cent, according to BIS Triennial Central Bank Survey of Foreign Exchange and Over-the-counter (OTC) Derivatives Markets in 2019.

However, the renminbi's role in cross-border settlement is phenomenal. The cross-border renminbi settlement in trade was only 3 billion yuan (equivalent to $0.45 billion) in 2009. It increased to 6.77 trillion yuan ($1.01 trillion) at the end of 2020 (Figure 3). In terms of cross-border renminbi in capital flows, the size of the settlement is even more dramatic. It increased from 284 million yuan ($42.47 million) a decade ago, to 21.61 billion yuan ($3.23 trillion) at the end of 2020. This change of size exhibited high correlation with the relaxation of policy restrictions. For example, in 2018, China stepped up the pace of capital account openness by relaxing policy restrictions in

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[7] The GFSN is a loose network of various sources of financial support aimed to secure global financial stability through a multi-layered set of instruments and institutions (Gallagher *et al.*, 2020). Normally, it includes: a nation's foreign exchange reserve as a self-insurance; the central banks' bilateral swap lines are the second defence line; the regional financing arrangements (RFAs), such as the CMIM, European Stability Mechanism (ESM), Latin American Reserve Fund (FLAR), and the Arab Monetary Fund (AMF), etc., serve as instruments for groups of countries. The IMF with its universal funding source and wider risk-sharing is the centre of the GFSN.

equity and bond markets. As a result, the volume of renminbi settlement through capital account increased sharply. In particular, China took measured monetary policy in response to the outbreak of Covid-19 in 2020 and 2021. Such policy widened interest rate differential with the US, and created incentives for debt securities (equity and bond) investment by offering higher returns.

The exchange rate of the renminbi is a key factor affecting the market preference for the currency. This was particularly evident in August 2015 when the People's Bank of China (PBC) adopted a short-lived free floating exchange rate policy. Both onshore and offshore renminbi markets experienced a sharp depreciation before the PBC resumed market intervention and implemented tightening restrictions on capital flows. As a result, the renminbi settlement in both trade and investment declined. It is reasonable for the market to follow the currency valuation. However, the highly correlated currency value with the demand for the currency results in two problems. One is that, during the time of currency appreciation, companies are more willing to hold renminbi assets than renminbi liabilities. Subsequently, the use of the renminbi in exports far exceeds the use in imports. This also implies that the renminbi is far from being a safe-haven currency that is supported by a number of factors, such as sufficient liquidity and a good hedge in the conditions of financial stress (Cheng *et al*., 2021).

(ii) Yuan bloc?

Building a yuan bloc in Asia was never a part of China's policy intentions. However, due to the close economic links, China's exchange rate policy has begun to exhibit regional effects. For instance, the stability of the renminbi in the onset of the Asian financial crisis in 1998 played a role of an anchor for Asian crisis-hit currencies. The potential need for a high level of regional currency arrangement in the aftermath of the Asian financial crisis also provided an opportunity for China to join Japan, Korea, and other regional partners to build up buffers against excessive currency movement through a set of proposals, such as the discussions on the possible forms of G-3 Basket proposed by Ito *et al*. (1998) and the Asian Monetary Unit (AMU) raised by Ogawa and Shimizu (2005). Those proposals were inspired by the experiences of the European monetary integration. Unfortunately, they remain on the drawing board because of the lack of political consensus to envision the future of the roadmap for Asian financial cooperation among the countries concerned. As a regional collective currency arrangement was off the table, China began looking at the potential use of the renminbi through trade and investment relations in Asia.

In the early 2000s, the renminbi has been already accepted by neighbouring countries and regions through their frequent border trade and personal exchanges with China. The overseas circulation of the renminbi in the early phase was purely market-driven, because the usage the currency was simply due to close economic ties. As China continued to expand its regional economic influence, the growing trade and investment in the region has created the real need for renminbi in transactions. For instance, Gao and Li (2020) found that the renminbi exerted significant impact on the volume of intermediate goods that China exported to Asian Belt and Road Initiative (BRI) countries due to China's important position in global value chains. This reflected the fact that the growing cross-border network of production has been part of the formation of GVCs in Asia where China's trade with ASEAN countries has been dominated by intermediate goods. Some other evidence also suggested a regional approach for renminbi

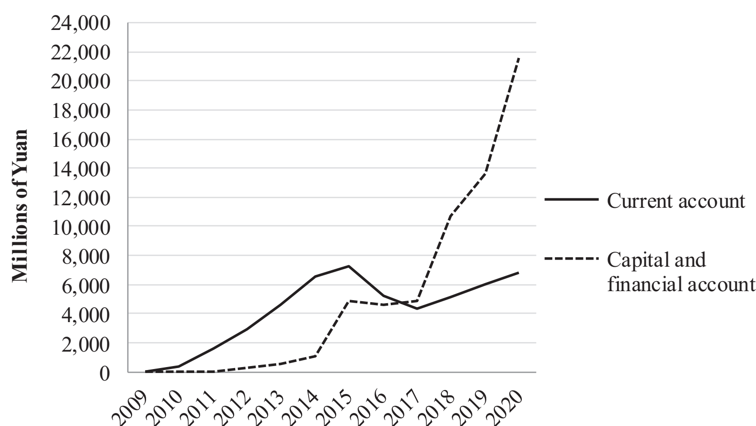

Figure 3: Cross-border renminbi settlement. *Note*: Data for capital and financial account include FDI only for 2012–14. *Source*: People's Bank of China.

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internationalization based on the renminbi denomination of financial assets (Park, 2010). McCauley and Shu (2016) considered trade links and the business cycle and assessed the influence of renminbi movements on Asian and non-Asian currencies, suggesting the existence of a north-east Asian renminbi zone since 2017. Although the increasing role of the renminbi has been recognized, the US dollar remains the dominant currency in Asia.

The renminbi's regional use has also been boosted by reduction of the currency's transaction cost. The Chinese authority prioritizes the renminbi clearing system as a means to facilitate smooth transactions of the currency. First, they authorized numerous Chinese clearing banks to conduct renminbi payment in offshore centres. Then, they launched the Cross-border Interbank Payment System (CIPS) to build an onshore payment infrastructure in October 2015. This system is based on real-time settlement to support renminbi payment businesses such as remittance, trade, investment, and financing. The operation of CIPS remains limited in terms of scope of participants and areas. However, as far as the geographic coverage is concerned, the major clients come from Asia, reflecting the fact that a low cost of renminbi transactions is beneficial for the partners in the region. According to CIPS statistics, as of the end of 2020, CIPS has covered 99 countries and regions, among which all the ASEAN countries have joined the system and 876 participants directly and indirectly come from Asia.

The renminbi's regional role is part of the efforts as Asian countries are looking for more use of local currencies in their trade and financial transactions. In Asia, 89 per cent of trade exports and 77 per cent of trade imports are denominated in the US dollars (ADB, 2021). Although trade and financial ties do not necessarily increase the local use of the currencies, promoting the use of local currencies had become one of the approaches to achieve close regional cooperation. One example is that the ASEAN+3 decided officially to include the renminbi, yen, and other local currencies as liquidity supporting currency in addition to the US dollar under the CMIM framework. In fact, Asia countries are supportive of the development of local currency bond markets and see the potential need for the use of local currencies.

(iii) PBC's renminbi swap arrangements

The PBC's renminbi swap lines played an important role in the renminbi internationalization at an early stage. In December 2008, the PBC and the Bank of Korea (BOK) signed a swap line with 180 billion yuan or 38 trillion won, in response to the liquidity problem facing the Korean banks. This is the first contract of its kind between the PBC and other monetary authorities. By the end of 2021, the PBC has signed 40 swap lines with total amount of 3,838.7 billion yuan (including the extended and enlarged ones).

The motivations of those swap lines have attracted much attention. As the renminbi is not a fully convertible currency, the traditional function of currency swap lines, such as providing liquidity support, is symbolic in the case of the renminbi. It is also true that when countries have liquidity problems in the balance of payments, they often experience a shortage of the US dollar. This is probably the reason why most of the renminbi swaps are rarely activated. On the other hand, however, the PBC's swap lines do help build confidence by sending a positive signal to the market through central banks' cooperation. In doing so, those swap lines have effectively become an important part of the GFSN to safeguard regional and global financial stability.

The PBC's swap lines have an additional purpose. That is to boost the use of renminbi in bilateral trade and investment by way of cooperation between the PBC and other monetary authorities. This purpose is explicitly stated in the PBC's official announcements. By using those officially arranged swap lines to boost demand for the renminbi, the PBC has effectively incorporated the swap lines into a broader purpose of renminbi internationalization. One example is the swap line signed between the PBC and Turkey's central bank in 2019. During the Covid-19 crisis, Turkey's central bank allowed its firms to settle their payment of Chinese imports using renminbi under the currency swap agreement with the PBC.

(iv) Digital push?

China's digital renminbi (e-CNY) is one of the most advanced forms of Central Bank Digital Currency (CBDC) in major economies. According to PBC (2021), the e-CNY, defined as the digital version of fiat currency issued by the PBC and operated by authorized operators, is a value-based, quasi-account-based and account-based hybrid payment instrument, with legal tender status and loosely-coupled account linkage. The e-CNY is designed to be equivalent to M0, thereby coexist with physical cash. It is mainly used for retail transactions in domestic payments. Cross-border transaction is very limited and only carried out through the testing practice.

A digital renminbi can certainly facilitate foreign exchange payments. For example, it makes direct exchange easier and cheaper since China and its trading partners can use their own currencies rather than a third-party currency. But it is not yet a game changer. Cross-border payments still face issues—such as monetary sovereignty and regulatory requirements—and raise challenges for monetary authorities in managing cross-border capital flows.

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Increasing foreign users' willingness to adopt a new digital currency is even more challenging because such a decision goes beyond economic rationales to factors such as trust and data protection.

However, the PBC does not rule out the possibility of the applicability of e-CNY in cross-border use based on domestic practice and international demand, in line with the principles of compliance, interoperability, and no disruption. The PBC also wants to take advantage as the first mover of CBDC in setting standards and a regulatory framework through international collaborations with other central banks, monetary authorities, and international financial institutions, such as through the Multiple CBDC (m-CBDC) Bridge with the Central Bank of United Arab Emirates, Bank of Thailand, and Hong Kong Monetary Authority (HKMA), and participate in the BIS Innovation Hub. In spite of the slow pace in cross-border use of CBDC, China will continue to improve e-CNY and to participate in international cooperation.

V. Managing financial opening and stability

Capital account liberalization and exchange rate flexibility are the key requirements for China to be able to play a bigger role in the international financial system. However, China was very cautious in relaxing foreign exchange restrictions in the capital account transactions. China also adopted a general principle of 'crossing the river by feeling the stones' and delivered simple guidelines without a timetable on currency convertibility under capital account transactions. In times of increasing volatility, the PBC has to manage the trade-off between financial opening and stability.

(i) Opening the capital account

In December 1996, China accepted Article VIII of IMF's Articles of Agreement that set out legal obligations to liberalize current payments and lifted foreign exchange restrictions on current account transactions. The outbreak of the Asian financial crisis in 1997–8 interrupted the subsequent liberalization of China's capital account. In particular, China learned lessons from the crisis that a full convertibility cannot be sustainable without flexible exchange rate regime.

Another factor that prohibited China from adopting a radical approach to financial opening was its underdeveloped financial market. China's securities market was completely closed until 1991 when Shanghai Stock Exchange (SHSE) and Shenzhen Stock Exchange (SZSE) began to offer B shares, providing foreign investors a legal channel to invest in China's equity markets. The domestic financial system was also dominated by state-owned banks with state-guarantee and lack of foreign competition. In 2002, China introduced the Qualified Foreign Institutional Investors (QFII) programme, allowing non-resident institutions to invest in China's capital market. In 2007, China introduced the Qualified Domestic Institutional Investors (QDII) programme, allowing domestic institutional investors to invest in overseas markets. A major breakthrough was in November 2013 when the Third Plenary Session of the 18th CPC Central Committee decided to define the goal of building a modern market system. The ambitious reforms included promoting privately funded small and medium banks, setting up a registration-based stock issuance system, liberalizing interest rate and conducting market-oriented exchange rate formation. These measures gave more space for accelerating financial openness and currency convertibility. In May 2016, the PBC rolled out macro-prudential management nationwide, based on the experiment of relaxed foreign exchange controls in the Shanghai Free Trade Zone (SFTZ). In the meantime, China continued to open up its interbank market and set up more channels for foreign capital through Shanghai-Hong Kong connect, Shenzhen-Hong Kong connect, and Mainland-HK Bond Connect.

Starting from April 2018, US–China tension extended from trade, currency, and technology to financial areas. Against the worsening environment, China continued its financial opening-up. China decided to allow foreign ownership to enter the domestic market a year earlier than it planned. The quota requirements for QFII and QDII were abandoned. While accelerating capital account liberalization, the threat of de-coupling with the US and the rise of geopolitical tension brings both risks and uncertainties.

(ii) Managing capital flows

China experienced stable capital flows because direct investment dominated the flow pattern before 2008. However, as China decided to open the capital account at a faster pace, it also created substantially large two-way portfolio flows because they are more pro-cyclical. Especially, the net capital flows have been correlated with policy steps of opening in the last decade. For example, when China began accelerating capital account convertibility in 2012, the net capital outflows increased sharply (Figure 4). In late 2015, the PBC adopted a short-lived free float exchange rate policy. It created massive capital outflows. The policy-makers had to tighten bureaucratic scrutiny on

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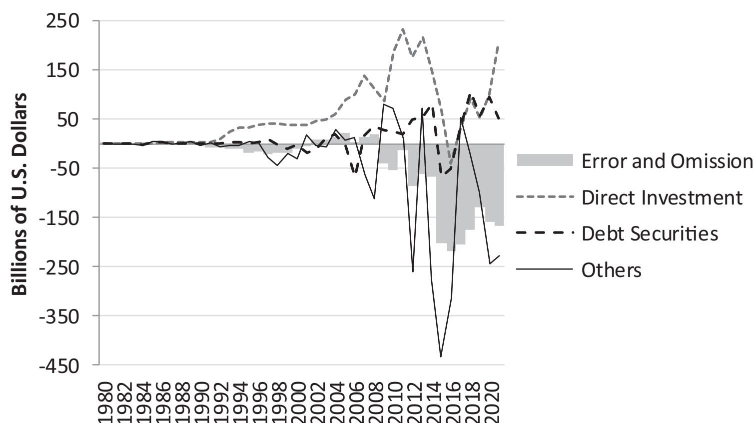

Figure 4: China's net capital flows (yearly, 1980–2021). *Source*: Wind.

cross-border capital flows in order to avoid the worst spiral of capital outflows and devaluation of the currency. The sudden reversal of capital flow management raised concerns about the continuity of China's financial opening policy.

The PBC also faced the problem of limited effectiveness of capital control. For example, the loopholes, judged by 'error and omission' in the balance of payments, turn out to be larger during the time that the net outflow hikes. Anther evidence is that, the size of 'others' in the balance of payments is highly correlated with outflows, indicating that residents prefer to increase overseas money and deposit holding through activities of Chinese business. Domestic banks also increase loans to their subsidiaries overseas during the time of massive capital outflows.

Facing the increasing challenges to financial stability, China tried to improve financial regulatory policies by adopting an international framework. In particular, China strengthened macroprudential policy tools following the guidelines provided by the IMF, Financial Stability Board (FSB), and BIS (IMF–FSB–BIS, 2016). Like many other emerging economies, China continuously faces the difficulty of keeping capital account opening while maintaining financial stability. With a set of macroprudential tools in hand, the Chinese policy-makers see capital control as the last resort in extreme conditions and only usable on a temporary basis.

The change of regulatory environment also affects China's financial flows. Starting from the Trump presidency, the US tightened the Chinese listing in the US stock market in the name of accounting standards and national security. In fear of being delisted, many Chinese companies considered shifting their listings to the Stock Exchange of Hong Kong (SEHK) where international investors are able to invest. Domestically, starting in 2021, the regulatory principle has changed to be less tolerant of the expansion of giant private tech companies traded in the stock market. The tightened regulation also triggered massive loss of stock value of those companies. Those policy moves raised concerns about how far China's financial openness would go.

(iii) Exchange rate flexibility

The renminbi exchange rate was first officially defined as a managed floating one in 1994, when a dual currency system ended. However, the renminbi was still pegged to the dollar, which was a match with the export-oriented growth strategy during the 1990s and the early 2000s. As a result of the renminbi's dollar peg and a surge of current account surplus, the renminbi exhibited large appreciation in nominal terms from 2004 to 2008 (Figure 5). However, the PBC soon realized that the misalignment of the renminbi was a distortion for resource allocation. As both external and internal imbalances became unsustainable, it was clear that a more flexible exchange rate regime could help this rebalancing smoothly. From 2012 to 2014, the PBC relaxed the trading bands of the renminbi several times in order to allow the exchange rate fluctuation to be driven by market forces. Arbitrage activities also increased because the renminbi spot exchange rate, the CNH, was introduced in Hong Kong in June 2011.

The most stunning move was that the PBC decided to stop intervening in the exchange rate of the renminbi on 11 August 2015. This decision coincided with the IMF's SDR review. As the renminbi's inclusion was under consideration, a flexible exchange rate was part of the deal, albeit an implicit requirement. In the hope of the renminbi's inclusion, the PBC had reasons to let the exchange rate float. However, a proper action was implemented at a wrong time, as the Fed began to increase the Federal Funds rate around mid-2015. It was also the time when the

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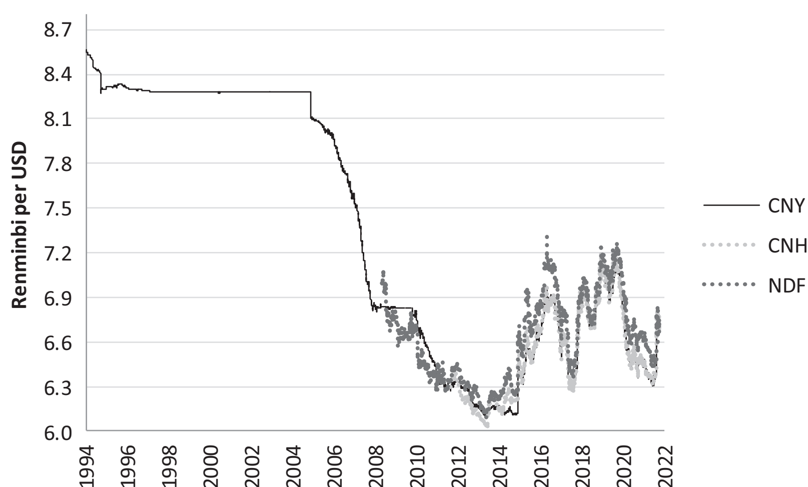

Figure 5: The renminbi exchange rates (daily, 31 August 1994–28 June 2022). *Note*: CNY = onshore Chinese yuan; CNH = offshore Chinese yuan; NDF = non-deliverable forward. *Source*: Wind.

capital account was opening up at a fast pace. A flexible exchange rate was supposed to perform as a buffer against external shocks and, at the same time, allow freer capital flows with fewer capital controls. However, market reaction was contrary to what the central bank wished for. As a result, the renminbi depreciated by 4.7 per cent in one day, creating further depreciation expectations as well as rapid capital outflows. The offshore non-deliverable forward (NDF) and offshore Chinese yuan (CNH) went higher, indicating a strong depreciation pressure on onshore Chinese yuan (CNY). In order to stabilize the foreign exchange market, the central bank adopted the traditional measure of injecting foreign exchange reserves and tightened capital flow management on cross-border capital flows.

In December 2015, the PBC changed the exchange rate formula by introducing a weighted currencies basket—China Foreign Exchange Trade System (CFETS) index, aimed to let the currency value reflect the relation with China's major trade partners. Another change of the exchange rate formula is that the central banks added a counter-cyclical factor. Such inclusion received criticisms because the operation of this factor lacks transparency and is against market principles. It is noticeable that the counter-cyclical factor is not a permanent variable in the formula. It was first adopted in June 2017. Then in January 2018 the PBC removed it when the market was stabilized. In August 2018, the central bank re-added it into the equation as trade war between China and US escalated. In face of irrational expectation and herd effect dominating the market, the counter-cyclical factor is a useful tool for the central bank to prevent excessive volatility without using extreme measures of capital control.

Like many other central banks, the PBC constantly faces trade-off between stability and flexibility. Theoretically, the relation between the stability of exchange rate, monetary policy autonomy, and free capital flows has been a never-ending debate. For the Chinese policy-makers, a middle solution is always practically possible. As Yi and Tang (2001) found, the development of derivatives markets for hedging activities played an important role in this trilemma: the more sophisticated the market was, the more likely the triangle held. Nevertheless, over time, a flexible exchange rate has been proved to be a reasonable choice if China wants to maintain its monetary policy autonomy in the condition of an open capital account.

VI. Conclusion

The international financial system has undergone profound changes since the collapse of the Bretton Woods system. In particular, China's rise has put forward new requirements for the reform of the Bretton Woods institutions founded in 1944. In the meantime, China has also adjusted its policies in order to meet the conditions for being a significant player.

One of the key factors to determine China's future role is its attitude to multilateralism. In principle, a multilateral approach is still the main channel for China to be engaged in international cooperation. China as a past beneficiary and a contributor to globalization has no reason to withdraw from the multilateral international financial system, even though multilateralism faces backlash. Furthermore, China sees the existence of global governance

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gaps in international institutions as an opportunity to improve the genuineness of multilateralism. By genuineness, it requires inclusive membership, fair representation, and governance reform. Such a request, however, would face more resistance in a fragmented world where political elements hijack economic decisions. The eruption of the Russia–Ukraine crisis escalates geopolitical tension, making financial integration vulnerable to being used as a tool of financial weapon.

China's domestic development is also crucial in determining its role on the global stage. China's past economic achievement is the result of ambitious market-oriented reform and continuous openness of the economy. After decades of high growth, China now faces new challenges like demographic change and the much needed factor market reform. China's recent adoption of 'dual-circulation' economic strategy came at a time when the Chinese economy faced great downturn and dramatic changes of international economic and geopolitical environment. The 'dual-circulation' will allow domestic investment and consumption to drive growth, while the external sector continues to be engaged with the global markets. There are concerns that China would become more self-sufficient and inward-looking if it emphasized domestic economic resilience and put national security as a policy priority. The concerns come from the fact that the de-coupling happens in circumstances where globalization retreats and protectionism is on the rise. China's de-coupling could further heighten the trend of global disintegration. However, the new leadership also reiterated that China would continue 'high-quality' openness and promised to open more services sectors and improve legal systems and international standards. In fact, the 'high-quality' openness strategy is regarded as a counter-measurement against uncertainties of China–US decoupling. For instance, in the financial area, only continuous openness could help to deepen and broaden the domestic market as well as make the renminbi more accessible and usable for foreign investors. De-coupling is not China's choice, as long as efficiency remains the key factor for better resource allocation. China would suffer tremendous loss if its economy and financial system were cut off from the world.

The outbreak of the Covid-19 pandemic brought catastrophic impact on human livelihoods as well as unprecedented damage to the world economy. The Russia–Ukraine crisis could have far-reaching implications for the changing world order. China happens to be in the position where its global influence resides on the size of the economy and its economic interconnection with the world. While China's domestic economic and political path is the key for the country to fit its role in the current rule-based global order, the world financial architecture also needs to be improved so that it becomes more responsive to common challenges, such as climate change, technology transformation, development sustainability, and financial stability. China's continuous engagement and cooperation with the established players in the world will be a great contribution for a better and stronger international financial system in the future.

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