China's Rise in the International Financial System: Progress and Limitations*

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China has been one of the biggest economic entities in the world for the last two decades. Its GDP now ranks second, only after the United States (and first by purchasing power parity). However, China's role in the international financial system has only become prominent in the last few years. While the world has been getting familiar with China's rapidly growing economy, its status as a manufacturing powerhouse, a trading juggernaut, and a huge consumer market for some time, it is just beginning to take note of China's role in the international financial market and global financial governance.

This article examines three aspects of the rise of China in the

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international financial system – its emergence as a net international creditor, the internationalization of the Chinese currency, and China's role in the creation of new international financial institutions. It shows China's growing prominence in the international financial system, but also makes clear the limitations of China's influence.

I. China as a Net International Creditor

A net international creditor is a country whose total external assets exceed its total external liabilities. Whether a country is a net creditor or a net debtor is reflected in its net international investment position (NIIP). Measuring the difference between a country's gross external assets and liabilities, NIIP compares the country's financial claims on residents in the rest of the world with the rest of the world's financial claims on domestic residents. Since 2004, the first year such data were released by the Chinese government, China's NIIP has been positive. The ratio of China's NIIP to its economy peaked just under 35 percent in 2007. In 2015 China's net foreign assets amounted to $1.6 trillion or about 15 percent of its GDP. This contrasts markedly with the situation in the United States, whose NIIP has been negative since the late 1990s. In 2015, US net foreign liabilities reached $7.36 trillion or about 41 percent of its GDP.

Some observers see these indicators as epitomizing China's increasing dominance in the world economy and the relative decline of the United States. History offers some support for this view. For example, the changing power balance between Britain and the United States during the twentieth century was in part manifested in their respective trajectories in terms of their NIIP. Britain changed from an international creditor to an international debtor as the United States moved in the opposite direction. This was part of the hegemonic transition from one to the other. Arvind Subramanian captures this development with a recounting of the US power play over Britain during the 1956 Suez crisis.[1] He suggests that China's rise as an international creditor will give it similar leverage over the United States (and others) in the not-too-distant future.

The emergence of China as a net international creditor has been a new and remarkable development. It has largely resulted from China's strong exports and consistent current account surplus. In addition, for years China ran a (non-official) capital account surplus. China's large official foreign reserves, peaking at $4 trillion in 2014, mirrors the sum of its current account and (non-official) capital account surpluses.

Has China gained substantial power and financial benefits as a result of its net creditor status? We look into the power question first. Here it is useful to remember Benjamin Jerry Cohen's analysis of monetary power.[2] According to Cohen, international monetary power has two dimensions – power as autonomy and power as influence. A country is powerful in the *autonomy* sense if it is able to resist outside pressure and operate independently. A country is powerful in the *influence* sense if it is able to make others do what it wants them to do. China's net international creditor status, manifested in its large foreign reserves, has provided it with an important financial safety net against the threat of international financial crises. In doing so, it helps insulate China from political pressure from outsiders whose assistance it might need in such crises. In other words, being a net international creditor has enhanced China's ability to stay independent and carry out its own policy preferences. In this sense, it has increased China's power.

On the other hand, China's favorable NIIP position has not necessarily increased its international influence. To understand this issue, it is important to look at China's NIIP in greater detail. Large portions of China's foreign assets are US assets, especially US treasury bonds. To a significant degree, China's net creditor position reflects its claims on the United States, especially its lending to the US government. China's choice in this regard reflects the dominant position of the United States within the international financial system.

Some observers worry that China's massive holding of US debt gives it leverage over the United States.[3] Anecdotal evidence suggests that China may have indeed tried to exploit this purported financial leverage. According to diplomatic cables released by WikiLeaks, for instance, following the outbreak of the global financial crisis, China pressed US regulators to accelerate the approval of its US$1.2

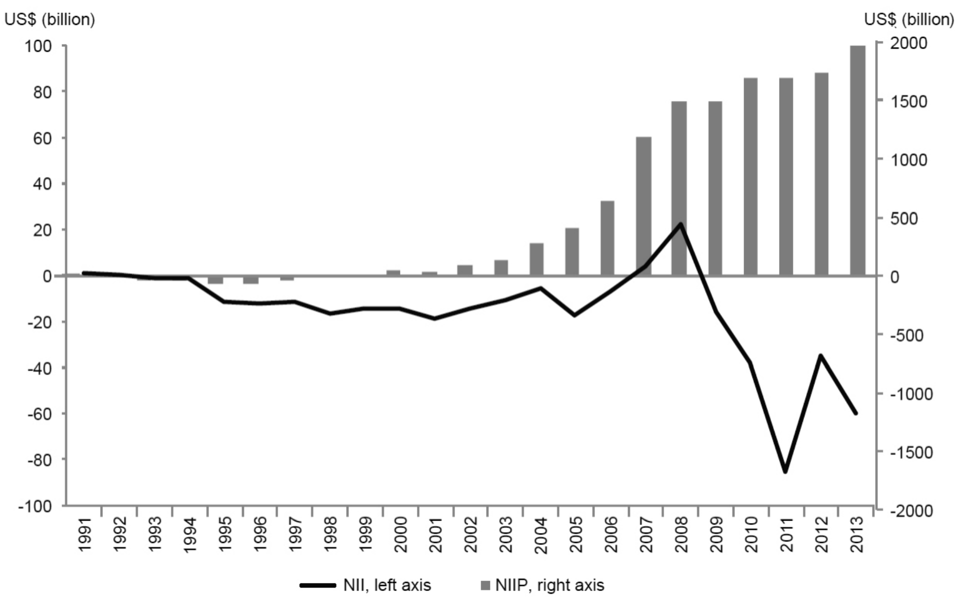
billion equity investment in Morgan Stanley. Although US officials did not respond to the request openly, China's purchase of Morgan Stanley shares was announced quickly, suggesting the plausibility of Chinese leverage.[4]

Beyond individual deals, China may have tried to use its creditor position to gain policy influence. For instance, at the height of the global financial crisis, the Chinese government expressed serious concern over the safety of its Fannie Mae and Freddie Mac debt holdings. China (along with Russia) tried to pressure the US government into guaranteeing this agency debt, backing it with the full faith and credit of the US government. The United States opted only for conservatorship, something it would have done without any prodding from the creditors of these government-sponsored organizations.[5] After the global financial crisis, Chinese government officials intensified their criticism of loose monetary policy in the United States, decrying its depressive impact on the renminbi (RMB) value of Chinese-held US dollar-denominated assets.[6] While the short-term fiscal outlook in the United States has since improved owing to the economic recovery, little has changed on the long-term entitlement front where the debt trajectory remains unsustainable. It does not seem that China has exerted a material impact on US policy in this regard.

A key leverage China presumably has over the US is a threat to significantly diversify the composition of its foreign exchange holdings away from Treasuries and US dollar holdings. However, the periodic suggestions or speculation that the Chinese would do so are not credible. Given the continued dominance of the US dollar in the international monetary system and the depth and safety of the US financial market, there are no real alternatives for China to transfer its US assets to *en masse*. This is a form of structural financial power derived from the making or manipulation of the rules of game or otherwise shaping the environment in which others have to operate.[7]

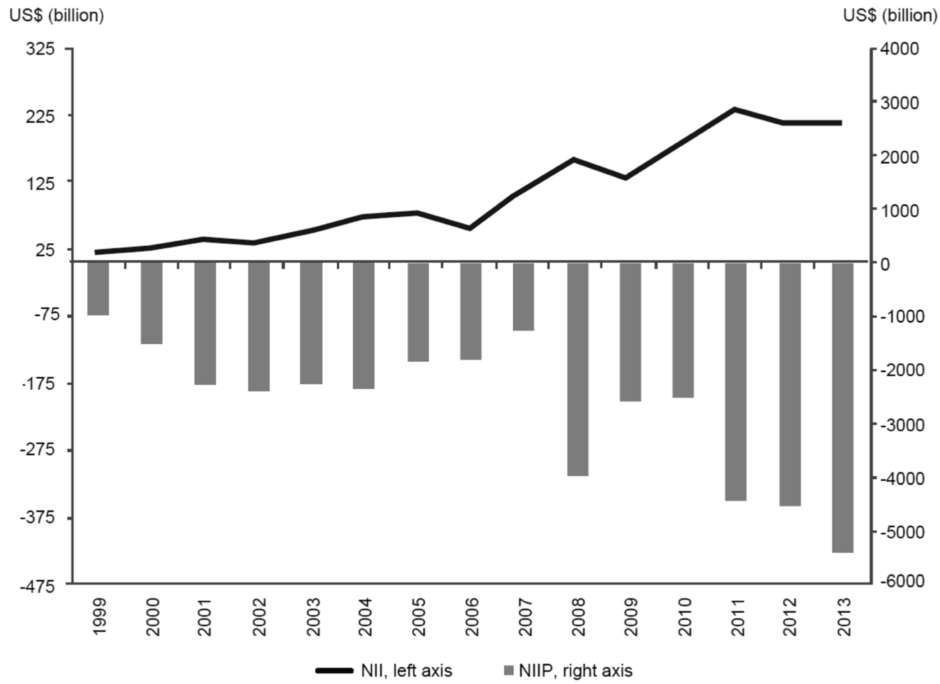
If China's net creditor status has not given it much influence, has it brought financial gains? One would assume that a country with more foreign assets than foreign liabilities should enjoy net investment income (NII). However, although China has been a leading net creditor, its recent annual flows of NII have been negative. As figure 1 indicates, NII was in balance during the early 1990s, but declined moderately in 1995, mirroring a modest net debtor position at the time. From 1997, however, as NIIP began its steady ascent, NII remained moderately negative until 2005. During 2006-2008, China experienced a sharp improvement in NII, briefly entering positive territory in the run-up to the global financial crisis, before plummeting by some US$100 billion during 2008-2011. By 2013, China's NII had rebounded somewhat, but remained at negative US$60 billion, in stark contrast to a positive NIIP of virtually US$2 trillion.

Figure 1: China's Net Foreign Assets and Net Investment Income Flows, 1991-2012



Source: People's Bank of China, State Administration of Foreign Exchange, and Rhodium Group; historical data before 2004 based on the Global Wealth dataset by Lane and Milesi-Ferretti. Data provided by Rhodium Group; version of figure appeared in T. Hanemann, "China's International Investment Position: 2014 Update", 2014, available at: http://rhg.com/notes/chinas-international-investment-position-2014-update.

Figure 2: Net Foreign Assets and Net Investment Income Flows of the United States, 1999-2013



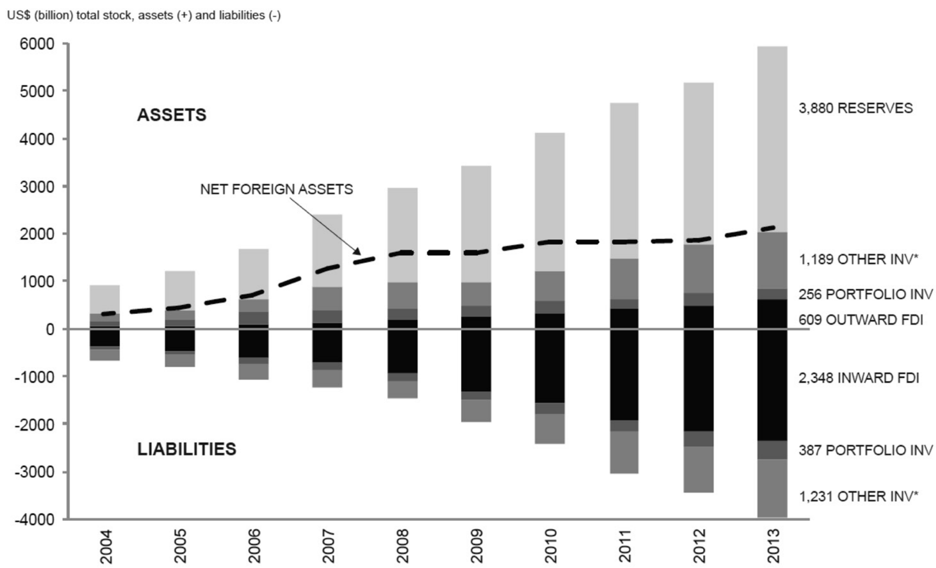
Source: US Bureau of Economic Analysis, "Table 1.2. U.S. Net International Investment Position at the End of the Period, Expanded Detail", 2015, available at: www.bea.gov/iTable/iTable.cfm?ReqID=62&step=1#reqid=62&step=6&isuri=1&26210=5&6200=144.

The US experience contrasts markedly with that of China. Owing to sustained current account deficits since the early 1980s, US NIIP has steadily descended into increasingly negative territory. Ironically as the United States transitioned from a large net creditor to a large net debtor, over the entire period it has managed to maintain a positive balance on NII (see figure 2). By the end of 2013, US NII remained at 1.2 percent of GDP.

To understand the paradox of China's negative annual NII despite a sizeable, positive NIIP, one has to look into the composition of China's international investment position. As figure 3 illustrates, by far the biggest portion of China's external assets consists of official foreign reserves, which have been heavily invested in low-yielding

US government bonds. On the other hand, a significant part of China's external liabilities is inward foreign direct investment (FDI) made by foreign investors, which has produced relatively high returns. Although Chinese policymakers and analysts are keenly aware of the disappointing financial outcomes of this pattern, it has persisted because of the structural power of the United States in international finance noted above.

Figure 3: China's International Investment Position, 2004-2013



Source: People's Bank of China, State Administration of Foreign Exchange, and Rhodium Group. Data provided by Rhodium Group; version of figure appeared in Thilo Hanemann, "China's International Investment Position: 2014 Update", 2014, available at: http://rhg.com/notes/chinas-international-investment-position-2014-update.

To summarize, China's emergence as a net international creditor has given the country more autonomy than before, but it has not led to a significant increase in the country's international influence. Ironically, despite its significant amount of net foreign assets, China has gained few financial benefits. The critical factor underlying this situation is the enduring structural power of the United States in global finance.

II. The Internationalization of the Chinese Currency

Another important aspect of China's rise in the international financial system is the wider use of the Chinese currency. The Chinese government began to push for the internationalization of the RMB in 2009. For the first couple of years, this involved the use of RMB in bilateral trade settlement. Later, the Chinese government allowed RMB-denominated foreign indirect investment in and out of China and fostered an offshore RMB-denominated bond market. In addition, China has signed a growing number of currency swap agreements, providing foreign central banks with RMB, and permitted the trading of RMB directly with other currencies without going through the US dollar.[8]

The international use of the RMB has progressed rapidly in recent years, but the internationalization of the Chinese currency is far from complete. As Benjamin Jerry Cohen first conceptualized it over four decades ago, the roles of an international currency can be classified as three functions at two levels of analysis.[9] At the private level, an international currency can serve as a medium of exchange (as in foreign exchange trading and trade settlement), as a unit of account (as in trade invoicing) and as store of value (as in financial markets). An international currency can serve the same three functions at the official level. As a medium of exchange, it can be used to intervene in the foreign exchange market. As a unit of account, it can be an exchange rate anchor. As store of value, it can be held as a reserve currency. Table 1 summarizes these functions of an international currency.

Table 1: Functions of an International Currency

Function	Medium of Exchange	Unit of Account	Store of Value
Private level	Forex trading, trade settlement	Trade invoicing	Investment
Official level	Intervention currency	Exchange rate anchor	Reserve currency

Source: Based on B.J. Cohen, *The Future of Sterling as an International Currency*, London: Macmillan, 1971.

The international use of the RMB has made impressive inroads in the private sphere. According to data provided by the Society for Worldwide Interbank Financial Telecommunication, as of mid-2015, the RMB ranked second in international trade settlement, fourth in global payment and sixth in foreign exchange turnover.[10] However, these rankings may be overstating the role of the RMB. In international trade settlement, the RMB accounts for 9.1 percent of the total issuance of letters of credit, a long way behind the 80.1 percent for the US dollar.[11] In global payments, the RMB only makes up 2.79 percent of the total, similar to the yen (2.76 percent), and well behind the sterling (8.45 percent), the euro (27.20 percent) and the US dollar (44.82 percent).[12] In foreign exchange trading, the RMB accounts for 2.8 percent.[13] The international use of the RMB at the official level has been more limited. According to the IMF's latest report, in the first quarter of 2015, the US dollar and the euro account for 64 and 21 percent, respectively, of global official reserves, followed by the yen and the sterling at about four percent each, and then the Canadian dollar and the Australian dollar at about two percent each. The RMB, held by nearly 40 countries in their official reserves, accounts for about one percent of the global total.[14]

The Chinese government has been particularly interested in furthering the role of the RMB as an international reserve currency. The hope is that, once the RMB achieves the status of a major reserve currency, China will not have to hold massive foreign reserves in the form of dollar-denominated assets, which, as noted in the previous section, have incurred significant financial losses for China. China will also be able to lower the cost of borrowing, and reduce the transaction costs of trade and investment, as well as the exchange rate risks. Indeed, this is one of the main reasons why China has actively pursued the RMB's inclusion in the special drawing rights (SDR) basket of the IMF, which is made up by the US dollar, the Euro, the British pound, and the Japanese yen. Many Chinese officials and analysts believe that, once the IMF accepts the RMB as part of the SDR, it will greatly facilitate the transformation of the RMB into a major international reserve currency.

In late 2015, the IMF decided to accept the RMB as part of the

SDR basket. This was in some ways a political decision that reflected widely shared recognition of China's weight in the international financial system. However, this decision in itself does not make the Chinese currency a more important international reserve currency. Whether and how much a currency is held in reserves depends on a number of factors, including convertibility, credibility and liquidity. A recent study identifies 37 countries that have added the RMB to their official reserves since 2010. These "early adopters" are countries that share China's political preferences with regard to the international order.[15] Presumably, beyond these countries, others will base their decision about holding RMB in their reserves on more conventional criteria – convertibility, credibility and liquidity.

Thus far, the Chinese currency faces significant limitations along all these dimensions. First, with regard to convertibility of the RMB, in 2015 the governor of the People's Bank of China, Zhou Xiaochuan, stated, "According to the IMF's classification of capital account transactions, 35 out of the 40 items are fully or partly convertible in China, and only five items remain inconvertible. These five items mainly involve individual cross-border investment and the issuance of shares and other financial instruments by nonresidents on domestic markets. Therefore, China is not far from achieving its goal of RMB capital account convertibility."[16] However, a closer look at China's rules and policies shows that the convertibility is far more limited than it is described to be. Even as many channels are opened and expanded for capital flow, the Chinese government maintains control over them through licensing, quota allocation and other forms of intervention. China's capital account liberalization so far has been quite different from conventional understanding of the term.[17] With the slowdown of China's economic growth and the recent volatility in capital flow in and out of the country, the Chinese government is under increasing pressure to tighten its control of the capital market.

Second, with regard to credibility, historically, reserve currencies have been issued by democratic polities. For instance, behind the sterling and the dollar were British and American institutions characterized by transparency, checks and balances, and rule of law. Going further back in time, other international currencies, such as the Dutch guilder, the Genoese denaro and the Venetian ducat, came out of republics or self-governing communes.[18] If the RMB is to be an international reserve currency, people need to have a great deal of confidence in the institutions of China. They need assurance that, if they are to hold their wealth in the RMB, it is safe from the arbitrary action of the government and will be protected by an independent central bank and a competent judicial system. Thus far, China's institutional setup remains very different from these precedents. The tight grip of the government on the economy and the financial system, most recently highlighted by the heavy-handed intervention in the stock market from the summer of 2015 to early 2016, has not been conducive to confidence building.

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Third, with regard to liquidity, China is again in a position that is far from what is expected of a reserve currency issuer. For a country to provide liquidity to other countries using its own national currency, it has to have an overall balance of payments deficit. Since the mid-1990s, China has consistently run current account surpluses. Until recently, it has also maintained capital account surpluses. Given the unlikely prospect for China to run current account deficits in the foreseeable future, the alternative is for it to provide RMB liquidity to the rest of the world through capital account deficits. This might involve China's lending and investing abroad and providing aid using RMB. However, thus far, China's outgoing investment has been mostly conducted in US dollars. In other words, capital outflow from China has not yet become a major source of RMB liquidity. This is understandable given China's desire to diminish its massive foreign reserves held in dollar assets.[19] It is also likely the case that recipient countries prefer US dollars, which are more versatile than the RMB.

To summarize, the internationalization of the Chinese currency has come a long way, as symbolized by the RMB's inclusion in the SDR basket alongside four other major international reserve currencies. However, the RMB is still not a fully internationalized currency due to its limited convertibility, credibility and liquidity. Further progress on those fronts faces obstacles in China's economic and political system as well as the enduring dominance of the dollar in the international financial system.

III. Leading the Creation of New International Financial Institutions

Besides its rise as a net international creditor and the internationalization of its currency, a third dimension of China's increasingly prominent role in the international financial system is its new activism in global financial governance, in particular, the creation of new international financial institutions. In 2014, China joined other members of the BRICS countries – Brazil, Russia, India and South Africa – and established the New Development Bank (NDB) and the Contingent Reserve Arrangement (CRA). The NDB, with an initial subscribed capital of US$50 billion and authorized capital of US$100 billion, aims to mobilize resources to invest in infrastructure and sustainable development projects in BRICS countries and other developing countries. The CRA, with a reserve pool of US$100 billion, is designed to help BRICS members deal with short-term balance of payment pressures and reduce financial instability caused by liquidity problems. In 2015, China launched the Asian Infrastructure Investment Bank (AIIB) with dozens of other countries from various regions of the world. The AIIB has authorized capital of US$100 billion and focuses on supporting infrastructure development in Asia first and other areas later.

Engagement in international financial cooperation is not new to Chinese foreign economic policy. In 2000, China joined neighboring countries in launching the Chiang Mai Initiative (CMI), a series of bilateral currency swaps to provide support for countries faced with liquidity crises. China was also a major force behind the Asia Bond Market Initiative (ABMI) in 2002, which aimed to promote regional bond market development. Later, China played an important role in expanding the CMI, turning the bilateral swaps into multilateral arrangements known as Chiang Mai Initiative Multilateralization (CMIM). Today, CMIM is a regional pool of foreign reserves of US$240 billion. However, the establishment of the NDB, CRA and AIIB marks a new stage of Chinese financial activism. Compared with the earlier regional financial arrangements – the CMI, ABMI and CMIM – these institutions are far more China-centered and China-dominated. They are clear signs of China's desire and capacity to play a greater role in international financial governance.

The new international financial institutions have received intense scrutiny around the world. The establishment of the AIIB has been particularly controversial. In the weeks and months leading up to the founding of the bank, the US government actively sought to discourage other countries from joining. To the surprise of many, including China itself, following the United Kingdom many US allies rushed to become founding members of the AIIB. This was a major diplomatic fiasco for the United States and a moment of triumph for China. The official rationale for the US opposition to the new bank was that it may not follow good governance practices or international labor or environmental standards. But the unstated concern was really about China's challenge to the US-led international order. In early April 2015, following the avalanche of countries applying to join the AIIB despite US opposition, former US Treasury Secretary Larry Summers commented, "This past month may be remembered as the moment the United States lost its role as the underwriter of the global economic system."[20]

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Is China using these newly created financial institutions to challenge the international financial order established at Bretton Woods after World War II under US leadership? Chinese officials have gone out of their way to stress that China is not out to overturn the existing financial system and that these new financial institutions are meant to complement the existing institutions and fill a gap in providing global public goods. For instance, in April 2015 Chinese Premier Li Keqiang held an interview with the *Financial Times*, in which he strongly emphasized China's continued commitment to the existing global financial order, with special reference to the AIIB as a supplement to the current international financial system.[21]

The founding documents of the new institutions are quite consistent with this cooperative theme. According to the NDB's articles of agreement, "The Bank shall mobilize resources for infrastructure and sustainable development projects in BRICS and other emerging economies and developing countries, complementing the existing efforts of multilateral and regional financial institutions for global growth and development." Likewise, the articles of agreement of the AIIB state that it "will complement the existing multilateral development banks, to promote sustained and stable growth in Asia."

The limited ambition of these new financial institutions is in part due to the benefit China and other emerging economies have derived from the current international financial order. It is also in part due to their limited capabilities. As new multilateral development banks (MDBs), the NDB and the AIIB are ones that face various challenges, not the least of which is the ability to raise capital cheaply in the international capital market. The big three credit rating agencies – Moody's, Standard and Poor, and Fitch – are dominant players in evaluating the credit worthiness of borrowers in international capital markets. As a recent study reveals, their methodologies are problematic when it comes to evaluating the MDBs in that they underestimate those banks' financial strength. The methodologies seem to be particularly unfavorable to MDBs not led by Western industrialized countries, so much so that MDBs made up mostly of borrower countries can hardly ever obtain an AAA rating from these agencies, regardless of their record of repayment.[22]

For the NDB, among the member countries, only China has AA-rating, while all the others have ratings bordering or below investment grade. Compared with the NDB, the AIIB is in a more advantageous position in this regard. Its membership includes a large number of non-borrower countries from the global North, which will help it obtain a good credit rating. A recent study examines a variety of scenarios of the growth of equity and potential loan portfolio of the two new banks. It concludes that the NDB will grow its operations slowly, with a potential loan portfolio of about $25 to $30 billion after five years, increasing to $45 to 60 billion in ten years. Meanwhile, the AIIB's loan portfolio could reach 70-90 billion in five years and $120 billion by 2025 (Humphrey 2015). While the AIIB may rival the Asian Development Bank in a decade, the NDB's loan portfolio is likely to be quite a bit smaller (see table 2).

Table 2: New Financial Institutions in Comparative Perspective

Institution	**CMIM**	**CRA**	**IMF**
Total capital (US$ billion)	240	100	327 (quota) 515 (New Arrangements to Borrow)

Institution	**AIIB**	**NDB**	**World Bank**	**ADB**
Estimated loan portfolio in 2025 (US$ billion)	70-90	45-60	219.2	73.1

Sources: Official data from each organization, estimates by C. Humphrey, "Developmental revolution or Bretton Woods revisited? The prospects of the BRICS New Development Bank and the Asian Infrastructure Investment Bank", ODI Working Paper 418, 2015, available at: https://www.odi.org/sites/odi.org.uk/files/odi-assets/publications-opinion-files/9615.pdf.

Not surprisingly, the NDB and the AIIB find it helpful to collaborate with the Bretton Woods institutions. For example, several of the first projects picked by the AIIB are jointly funded with traditional development banks. One of them involves building a motor way in Pakistan, which is a project led by the ADB following ADB's rules and procedures. Another involves a road in Tajikistan and is a joint project with European Bank of Reconstruction and Development (EBRD). A third, a road project in Kazakhstan is co-financed with the World Bank and the EBRD.[23] In May 2016, the AIIB and the ADB signed a memorandum of understanding regarding jointly financing projects of sustainable development. At the same time, the AIIB and the World Bank signed their first co-financing framework agreement.

The CRA also shows limited capacity. Like the earlier-established CMIM, the CRA stipulates that 70 percent of its lending to countries with liquidity problems is linked to the IMF programs for those countries. A major reason is that the CRA does not have the technical capabilities to provide sophisticated macroeconomic surveillance, which the IMF has developed over decades under the rules and norms of the liberal financial order. It is telling that during the global financial crisis, the CMI/CMIM mechanism did not even use the 30 percent of its resources not linked to the IMF. Asian countries faced with liquidity crises sought assistance through bilateral swaps with the United States and other countries.[24] How independent and functional the CRA will be in the next financial crisis remains to be seen. Besides, in terms of scale, as table 2 indicates, the CMIM and the CRA are no match for the IMF.

To summarize, by playing a leading role in creating new international financial institutions, Chinas has demonstrated unprecedented activism in international financial governance. The NDR, CRA and AIIB have greatly enhanced China's profile in the international financial system, but so far they do not seem offer real alternatives to the Bretton Woods institutions. China is not using them to fundamentally change the rules of the game.

IV. Conclusion

The rise of China in international finance is becoming a widely recognized phenomenon. Its status as a net international creditor, as the issuer of an increasingly internationalized currency, and as a leader in new international financial institutions have all made China a prominent actor in the international financial system. But as this article shows, the China's financial power is more limited than it might seem, and its growth faces difficult obstacles.

A major constraint on China's financial power is the enduring structural power of the United States. For instance, the dominant role the dollar has played for decades and the depth and relative safety of the US financial market curtail China's policy influence on the United States despite their creditor-debtor relations and limits China's policy options despite its dissatisfaction with the poor returns on its investment in US government bonds. In addition, while China has led the creation of a number of new international financial institutions in the last few years, these institutions have limited capacity to challenge the existing institutions under the rules and norms of the US-dominated financial order.

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Another constraint on China's status in the international financial system lies in its domestic development. For example, further internationalization of the Chinese currency depends on greater convertibility, credibility and liquidity of the RMB. These in turn require major changes in China's financial system, its legal and political institutions, and its economic development model. The economic risks and political resistance involved make these reforms very difficult to proceed.

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