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CHINA AS A LEADING ECONOMIC POWER

COULD CHINA STABILISE THE GLOBAL ECONOMIC SYSTEM IN TIMES OF CRISIS?

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SUMMARY

This Working Paper ponders whether China could exercise a role in global economic governance in the foreseeable future in a similar way to other leading economic powers, especially the United States and previously the United Kingdom. Specifically, the paper asks whether China is able and willing to assume responsibility for the five stabilising functions that Charles Kindleberger envisioned for a leading economic power. The paper discusses each criterion in turn, providing a tentative qualitative assessment as to whether China is prepared to assume this responsibility in light of evidence from economic data and Chinese policy debates. Particular emphasis is placed on the domestic political constraints China faces in assuming these functions. The ensuing discussion indicates that China's importance for the global economy is more akin to that of the United States in some respects (e.g. as an import market and provider of long-term lending) than in others.

The paper concludes that the biggest stumbling block to China's ability to fulfil the stabilising functions is its ability to act as a lender of last resort. Currently, domestic financial stability and financial system risks take precedence over China's global economic governance role. Were a new global financial crisis to hit, China would not be able to fulfil the function of *the* lender of last resort for other countries. In particular, as long as China maintains tight capital controls and relatively closed financial markets, the United States will likely again be pushed to the centre of crisis management when the next crisis hits. The continuing dominance of the dollar and American financial markets in the global economic system ensures that, for the time being at least, the United States will remain the leading economic power by default.

INTRODUCTION

In a much-noted 1999 *Foreign Affairs* article, Gerald Segal, an old China hand, provocatively asked whether China 'mattered' to the world. Segal criticised Western observers for seeing China as much more important to the world than it actually was in light of the raw economic data (on GDP, trade, FDI, and so on). Segal claimed that China appeared to matter more than it actually did because of its adroitness in using 'theatrical power', and the West's dazzlement by it.[1] The timing of the article was rather ironic, as China began a historically rapid economic ascent right after its publication. Today, it is that same economic data that is lending the strongest support for assertions of China's looming economic dominance. Segal was clearly too pessimistic when it comes to China's economic growth potential and economic importance. Yet the deeper point that he made is still worth pondering. Do we afford China greater importance than it really warrants as a global economic power?

China's emergence as an economically dominant power has been so protracted and well advertised that it has become somewhat akin to the famous quip that 'the news of someone's death has been greatly exaggerated'. Commentators have talked of a 'Beijing consensus'[2] and a 'China model'[3]; about a G2 between the United States and China[4]; about China 'ruling the world'[5], or what it is like to 'live in the shadow of China's economic dominance'[6] for so long now that scholars, journalists and pundits have become hard-wired to look for signs of China's impending economic dominance in global economic governance as well.

The last two or three years have only served to confirm expectations. First, China's diligent efforts since the global financial crisis to promote its currency's wider international use culminated in the November 2015 announcement by the International Monetary Fund of the renminbi's inclusion in that most exclusive of international clubs – the Special Drawing Rights (SDR) currency basket. Hot on the heels of this decision, the US Congress ended its foot-dragging on ratification of the 2010 IMF reform package regarding the reallocation of quotas and voting rights that raised China's share of votes.

1 Gerald Segal, 'Does China matter?', *Foreign Affairs*, vol. 78, no. 5 (1999), pp. 24–36.

2 Joshua Cooper Ramo, 'The Beijing Consensus' The Foreign Policy Centre (2004), http://www.politicalchina.org/uploadfile/200909/20090918021638239.pdf, last accessed 2 June 2017; Li Xin, Kjeld Erik Brodsgaard and Michael Jacobsen, 'Redefining Beijing Consensus: ten economic principles', *China Economic Journal*, vol. 2, no. 3 (2010), pp. 297–311.

3 Barry Naughton, 'China's distinctive system: Can it be a model for others?, *Journal of Contemporary China*, vol. 19, no. 65 (2010), pp. 437–460; Matt Ferchen, 'Whose China Model is it anyway? The contentious search for a consensus', *Review of International Political Economy*, vol. 20, no. 2 (2013), pp. 390–420.

4 C. Fred Bergsten, 'A partnership of equals. How Washington should respond to China's economic challenge', *Foreign Affairs*, vol. 87, no. 4 (2008), pp. 57–69.

5 Martin Jacques, *When China Rules the World* (New York: Penguin Books, 2009).

6 Arvind Subramanian, *Eclipse. Living in the Shadow of China's Economic Dominance* (Washington: Peterson Institute for International Economics, 2011).

The Congress ratified this agreement on 18 December 2015. Then China successfully launched the Asian Infrastructure Investment Bank (AIIB), a new multilateral development bank that started operations on 16 January 2016.

This Working Paper ponders whether China is able, let alone willing, in the foreseeable future to exercise a role similar to that of previous leading economic powers, especially the United States and previously the United Kingdom.[7] As an analytical aid, I will use the famous criteria for a leading economic power promulgated by Charles Kindleberger – often called the father of hegemonic stability theory (HST), although Kindleberger never used the term himself, and even explicitly disavowed it.[8] First published in his classic book in 1973, Kindleberger maintained that a leading power in the global economic system has to assume responsibility for five 'stabilising functions'[9]:

1. maintaining a relatively open market for distress goods
2. providing counter-cyclical (stable) long-term lending
3. policing a relatively stable system of exchange rates
4. acting as a lender of last resort, namely providing liquidity in a financial crisis
5. ensuring the coordination of macroeconomic policies

Kindleberger developed the criteria in response to the major question of why the Great Depression that began in 1929 became so wide, deep and long. His answer revolved around British inability and American unwillingness to assume responsibility for stabilising the system by performing the five functions enumerated above. Whether or not the global economy needs such a leading power or hegemon has often been questioned.[10] Recent research has argued that it may not be necessary to have only one leading power as a 'stabiliser', as Kindleberger had argued, but rather that stabilising functions can also be shared between major economies. Norrlof and Reich tested Kindleberger's thesis in light of new evidence about three more recent economic crises (the 1997 Asian economic crisis, the Dotcom collapse in 2000–2002, and the Great Recession of 2007–09). The authors concluded that although Kindleberger's stabilising

7 Niall Ferguson, *Empire. How Britain Made the Modern World* (London, Penguin Books, 2004); Subramanian, Eclipse.

8 Robert Gilpin, *Global Political Economy. Understanding the International Economic Order* (Princeton and Oxford: Princeton University Press, 2001); Carla Norrlof and Simon Reich, 'American and Chinese leadership during the global financial crisis: Testing Kindleberger's stabilization functions', *International Area Studies Review*, vol. 18, no. 3 (2015), pp. 1–24.

9 Charles Kindleberger, *The World in Depression: 1929–1939* (University of California Press, 1986), p. 289.

10 E.g. Duncan Snidal, 'The limits of hegemonic stability theory', *International Organization*, vol. 39, no. 4 (1985), pp. 579–614.

functions may still be valid, then this stabilising role does not necessarily need to fall upon one country, but can indeed be shared.[11]

Norrlof and Reich may very well be correct in their line of thought, as the structures of the global economy have undergone profound changes since Kindleberger wrote his book (even more so compared to the 1930s). Yet arguably there are some distinct similarities between the time period that the global economy entered after the Great Recession in 2007, and the 1930s. Today, the old leading power (the United States) seems increasingly unwilling to play the role of stabiliser. For example, US Federal Reserve governors intermittently remind people that they are the central bank of the United States, not of the whole world, while Donald Trump's administration has been the aloof outlier among G20 countries on several global governance issues, rather than a proactive leader. The emerging power (China) may also be either unwilling or unable to shore up the global economic system in times of crisis.

Nevertheless, for the sake of argument and in order to bring China's strengths and weaknesses as a leading economic power into sharper relief, this paper gauges China's economic leadership potential through the original Kindleberger framework, which assumes that one leading power performs these functions. Accordingly, the paper asks *whether China today is able and willing to assume responsibility for the five stabilising functions*. I discuss each criterion in turn, providing a tentative qualitative assessment in light of evidence from economic data and Chinese policy debates. Particular emphasis will be placed on the domestic political constraints on China assuming these functions.

11 Norrlof and Reich, 'American and Chinese leadership during the global financial crisis'.

CHINA AS AN OPEN MARKET IN TIMES OF CRISIS

With the criterion of maintaining a relatively open market for distress goods, Kindleberger was essentially referring to upholding free trade principles in the face of economic recession. More specifically, adapting domestic resources to changes in productive capacities abroad and keeping the (domestic) import market open in periods of economic stress. Kindleberger juxtaposed Britain's tenacious clinging to free trade through several economic depressions in the late 19th century with the protectionist American Smoot-Hawley Tariff Act of 1930, which raised tariffs and is widely seen as exacerbating the Great Depression.[12]

Rhetorically, China's top leaders have recently shown a strong commitment to free trade, as exemplified in the Davos speech by Chinese President Xi Jinping, as well as on other occasions. Xi defended free trade and cautioned about protectionism by saying, "We must remain committed to developing global free trade and investment, promote trade and investment liberalization and facilitation through opening-up and say no to protectionism. Pursuing protectionism is like locking oneself in a dark room. While wind and rain may be kept outside, that dark room will also block light and air. No one will emerge as a winner in a trade war".[13]

On the one hand, it is only to be expected that Chinese leaders should take a positive view of open global markets. After all, purely in terms of numbers, China has been one of the main beneficiaries of world trade since its WTO accession in December 2001. In that same year, the value of China's exports were USD266.1 billion. By 2008, this figure had risen to USD1430.7 billion – a more than fivefold increase in just seven years. In 2015, the figure had ballooned to USD2281.9 billion, making China by far the world's biggest exporting economy. China's exports have thus increased almost tenfold in the space of one and a half decades. No other major economy has seen such a tremendous explosion in trade, and – apart from Germany and the Netherlands – few sizeable economies have produced such persistently high trade surpluses. In the decade through 2015, China's cumulative trade surplus reached an astonishing USD2.75 trillion. Furthermore, the trade surplus has been increasing rapidly. In 2015 alone, China recorded a surplus in excess of USD600 billion. This figure exceeds the total value of China's imports in 2004.[14]

However, on closer inspection, it is not self-evident that Chinese leaders should favour *free* trade in the strong sense of the term. Numerous observers have argued that China has effectively been running a modern version of a mercantilistic trade policy – being strongly in favour of market access for Chinese exporters, while at the

12 It should be noted that Kindleberger considered British adherence to free trade to have possibly been more due to cultural lag and the influence of Adam Smith's liberal ideas than any conscious concern for the wellbeing of the world economy. Kindleberger, *The World in Depression*, p. 291.

13 https://america.cgtn.com/2017/01/17/full-text-of-xi-jinping-keynote-at-the-world-economic-forum, last accessed 20 May 2017.

14 Figures extracted from World Integrated Trade Solutions (WITS), World Bank, http://wits.worldbank.org/, last accessed 20 May 2017.

same time restricting imports through a great number of market access restrictions.[15] As a consequence, apart from some raw materials producers and adjacent Asian economies, most other countries are running persistent and large trade deficits with China, including the United States and most of the EU. Over the past two years, surveys conducted by the American and European chambers of commerce in China have shown a deterioriating view of the Chinese business climate for foreign companies.[16] This state of affairs underlies the reluctance of the EU and the US in granting China the 'market economy' status that it so covets.

Above all, this particular Kindleberger criterion puts emphasis on absorbing the exports of other countries in times of crisis when trade declines. Whether China is both able and willing to do so is somewhat doubtful. In 2008, China saw a very rapid drop in its own trade. The Great Recession revealed China to be a highly integrated economy, given its central position in global production networks.[17] However, for all China's importance to the global economy, the country was very much on the receiving end of the trade collapse that followed the financial crisis, and initially not in a good position to pick up the slack for other economies as it was not the end-market for their products. Nevertheless, in November 2008 Chinese leaders launched a massive 4000 billion renminbi infrastructure stimulus package to combat the economic downturn. Lending spigots were also loosened. Countries that were reliant on Chinese demand saw their exports make a rapid recovery. This was to some extent replicated in 2016 when lending by Chinese financial institutions for infrastructure building again saw a big spike. Within a few months, the economic outlook had perked up in a number of countries reliant on Chinese demand, especially in Asia, but also in European countries like Germany and Finland, whose economies are relatively closely linked to the Chinese economy. The evidence for China's role as a major market absorbing imports in times of distress is mixed.

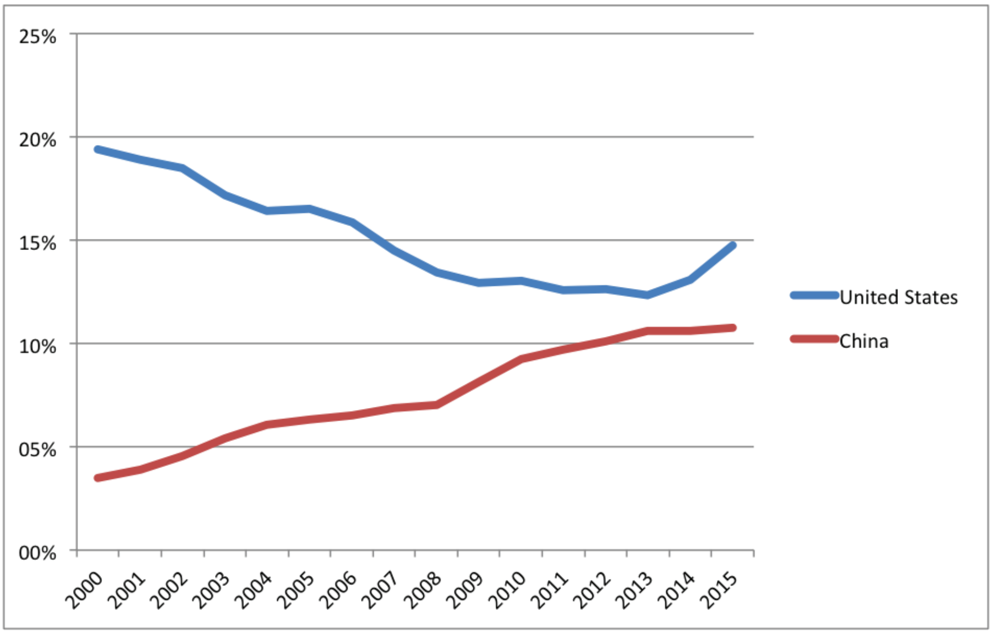
Chinese imports as a share of world imports have been on a long upward trajectory, reaching 10.8% in 2015. However, at 14.8%, the US import share is still substantially higher and has even increased in recent years, while the growth in China's ratio has levelled off (Figure 1).

Until recently, China itself has been quite reliant on external end-demand. When American and European demand wanes, the impact is quickly felt in China and in turn transmitted to all those economies that are reliant on exporting commodities and capital goods to the Chinese economy, such as Australia, Indonesia and Brazil, as well as all those economies producing intermediate products for re-export through (Mainland) China, such as Taiwan and South Korea. Consider the respective mix of American and

15 See e.g. Jonathan Holslag, 'China's new mercantilism in Central Africa', *African and Asian Studies*, vol. 5, iss. 2 (2006), pp. 133–169.

16 Business Confidence Survey 2017, European Chamber of Commerce in China, http://www.europeanchamber.com.cn/en/publications-business-confidence-survey, last accessed 2 June 2017. Business Climate Survey 2017, https://www.amchamchina.org/policy-advocacy/business-climate-survey/, last accessed 2 June 2017.

17 Mireya Solís, 'Global economic crisis: Boon or bust for East Asian trade integration?', *The Pacific Review*, vol. 24, no. 3 (2011), pp. 311–336.



Source: Calculated from World Bank WITS database figures, http://wits.worldbank.org.

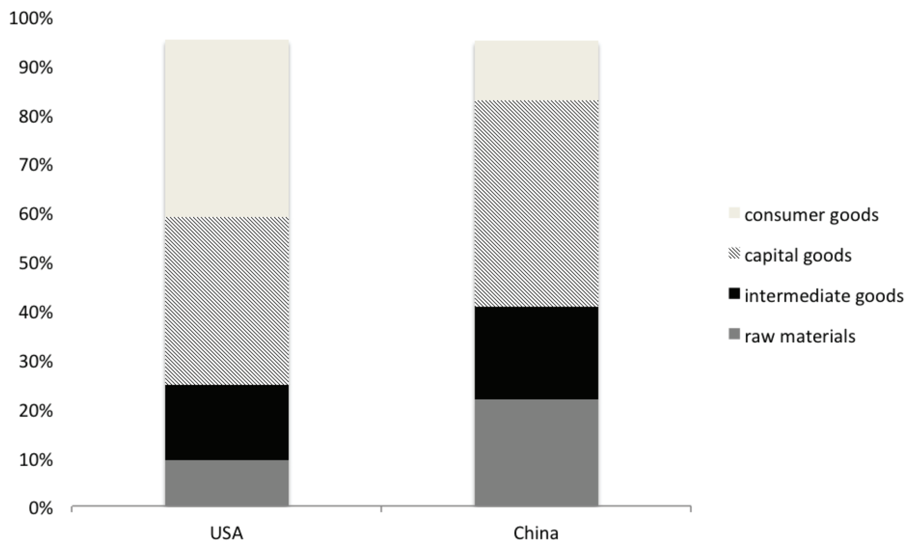
Figure 1. Import shares as a proportion of world imports.

Chinese imports by stages of processing (Figure 2). In 2015 the composition of Chinese imports showed that 21.8% consisted of raw materials, 42.1% of capital goods and 18.8% of intermediate goods, whereas only 12.2% were consumer goods. Contrast this with the share of consumer goods in the import composition of the United States, which is three times as high, whereas less than 10% of American imports are raw materials.

China is also in the process of transforming its economy into a more consumer-led and hi-tech one. The big question is whether this will mean more demand for producers of final goods in other economies. Given the strength of China's domestic producers in many industries, as well as the drive to localise high-end production (e.g. the China Manufacturing 2025 plan,[18] and recent rules on technology transfers), China is unlikely to surpass the United States in terms of end-demand for imported finished goods any time soon. On the contrary, current trends point to no major changes in the prevailing structure of imports in the foreseeable future. China continues to crave more raw materials and intermediate goods from abroad than it needs consumer goods.

Hence, more important than China's ability to absorb other countries' distress goods in times of economic crisis (as the biggest trading economy, it would certainly have the ability to do so) is the question of whether China is *willing* to assume responsibility for such a global function. This willingness hinges on whether Chinese leaders are

18 See e.g. http://www.europeanchamber.com.cn/en/china-manufacturing-2025, last accessed 2 June 2017.



Source: World Bank WITS database
http://wits.worldbank.org.

Figure 2. Comparing the import composition of the United States and China (2015).

comfortable with running large trade deficits. In recent economic crises, the US market has been of paramount importance to other economies, not simply because of its size *per se*, but also because the United States has been comfortable in running large trade deficits for a long time – admittedly partly as a consequence of the dominant role of the US dollar in the global economy. In contrast, while China's trade deficit has shrunk, the last time it ran an actual annual trade deficit was almost a quarter-century ago, in 1993.

CHINA AS A PROVIDER OF LONG-TERM LENDING

If China's recent historical record as an import market does not lend strong support to the country's willingness to perform the Kindleberger functions in times of crisis, there is a stronger case to be made for its function as an increasingly important provider of capital to the rest of the world. In the heyday of British and American economic dominance, both were major creditor countries and net exporters of capital to the rest of the world. In 1870, the UK's share of world net capital exports was 49.8%. This share reached an astonishing 55.8% in 1913, just before the long decline and unravelling of the British empire. Similarly, the US share of net capital exports was 34.0% in 1950 and still 17.1% in 1973, at the time when the Bretton Woods system unravelled. This stands in sharp contrast to the time period 1990–2010, when US net capital *imports* have represented more than half of the world total. By 2010, China's net capital exports had already reached 17.5%.[19] In the latest global economic crisis, the reversal of roles between the United States and China was evident. China's relative share of the world's capital exports jumped noticeably, beginning in 2007 at the start of the crisis, and peaking at over 40% in 2008.[20]

China's importance as a global provider of long-term lending has increased considerably in recent years, especially after the global financial crisis. The massive infrastructure financing package launched in late 2008 was mainly aimed at domestic economic goals. However, in a policy shift, Chinese policy banks, primarily the China Development Bank and the China Export-Import Bank, have in recent years begun to focus more of their lending efforts abroad.[21] As a consequence, China has emerged as a major source of external funding for a number of countries. For example, in Latin America in 2015, Chinese debt made up more than half of the total external debt of three countries: Venezuela (59.4%), Ecuador (60.7%), and Trinidad and Tobago (53.3%).[22] Similarly, in some African and South-East Asian countries, China has already emerged as the largest external lender (and investor). Countries such as Namibia, South Sudan, Zambia, Cambodia, Angola and Sri Lanka have become quite reliant on Chinese lending and investment.

Launching the Asian Infrastructure Investment Bank (AIIB) can be regarded as the latest and most significant way of institutionalising and multilateralising China's provision of long-term lending for infrastructure and development purposes outside of its borders. Since Xi Jinping emerged as the paramount leader, China has put considerably more effort into promoting multilateral financial institutions that it has initiated itself. First, the so-called New (formerly BRICS) Development Bank was established in July 2015.

19 Subramanian, *Eclipse*, p. 103.

20 Norrlof and Reich, 'American and Chinese leadership during the global financial crisis,' pp. 10–11.

21 Henry Sanderson and Michael Forsythe, *China's Superbank. Debt, Oil and Influence – How China Development Bank is Rewriting the Rules of Finance* (Singapore: John Wiley & Sons, 2013).

22 Harold Trinkunas, 'Renminbi Diplomacy? The Limits of China's Influence on Latin America's Domestic Politics. Order from Chaos: Foreign Policy in a Troubled World', *Geoeconomics and Global Issues*, no. 3, Brookings Institute, November 2016, p. 7, https://www.brookings.edu/wp-content/uploads/2016/11/renminbi-diplomacy_harold-trinkunas.pdf, last accessed 1 June 2017.

The Bank – headquartered in Shanghai – promises to pool the resources of China and other countries. The NDB will provide capital for development projects, as the World Bank does, and it also maintains contingent reserve arrangements, similar to the IMF. A pointed difference to the IMF is that the NDB adopts a 'one country, one vote, no vetoes' decision-making system, whereas the IMF decision-making structure resembles more of a corporate shareholder structure.

Compared to the NDB, however, China will be more influential in the Asian Infrastructure Investment Bank. It currently holds 26.1% of the votes and a position similar to that of the US in the IMF. Sensitive to criticism of dominance, Beijing has been keen to stress that it will not exercise its veto and that its vote share in the AIIB will gradually be diluted, as other countries join. Yet Beijing will face an uphill struggle to convince sceptics that the AIIB will not be indirectly dominated by China and used to further China's political and strategic objectives.

China's signature grand plan to guide its international provision of capital is the One Belt, One Road initiative launched by President Xi Jinping in September-October 2013. The 'OBOR' – sometimes referred to as the New Silk Road initiatives[23] – is an ambitious strategic plan that envisions greatly improving Eurasian connectivity, trade networks and cultural exchanges through two main components: a land-based Silk Road Economic Belt running through Central Asia to Western/Central Europe and a Maritime Silk Road around South-East Asia, South Asia and Eastern Africa through the Suez Canal to Western Europe.

The ambitious scope of the OBOR plan is breathtaking. OBOR is a sort of Marshall Plan on steroids for Eurasia – a 'Grand Plan' into which many other smaller economic plans and blueprints are integrated. Implementing the plan will require hundreds of billions of euros in infrastructure investment. A headline figure of USD900 billion has been mentioned in this connection. Yet, throughout its reform period, China has launched a number of other regional economic initiatives, typically involving promises of great infrastructure investment and loans. Much infrastructure has been built around the world with Chinese money and expertise, starting from the famous Tazara railroad that China built back in the early 1970s as a turnkey project. However, oftentimes the ambitious headline figures have not been realised, at least not to the extent that partner countries had hoped. The OBOR brings with it a great number of economic, political and geopolitical risks. A cautionary example concerns the tens of billions of dollars that China has lent to Venezuela – a country that is perennially teetering on the brink of default and socio-economic collapse. Similar problems are almost sure to crop up in many locations in conjunction with OBOR.

However, a more immediate problem is that launching OBOR gave the green light to Chinese enterprises, both state-owned and private, to raise massive amounts of borrowed funds in order to go on a global shopping spree, the likes of which the world has not seen since Japanese companies were 'buying up the world' in the late 1980s.

23 The Silk Road Plan broadly follows the original historical silk roads, although it should be noted that there was never just one dominant silk *road*, but rather a shifting pattern of trade routes, a trade network. In fact, the very term 'Silk Road' only came into being in 1877 when German geographer Ferdinand von Richthofen coined the German equivalent *Seidenstraße* (or *Seidenstraßen*) to describe the web of caravan routes and travel passages that linked China with the Eastern Mediterranean.

Chinese leaders have recently grown cautious of the risks associated with indiscriminate corporate borrowing and expansion, and sought to forcefully rein in some of the most aggressively expanding Chinese corporate conglomerates, for example by forbidding local lenders from funding their overseas acquisitions. Chinese leaders have been seeking to avoid repeating Japan's mistakes.[24] The Japanese experience is indeed sobering. Overborrowing by Japanese corporations destroyed their balance sheets and, as a corollary, also the banks' ability to lend for a long time. This was a major factor behind Japan's long-running balance-sheet recession and its 'lost decades'.[25] Michael Pettis has argued that a simple balance-sheet analysis of China's economy points to how Chinese debt dynamics have produced a similarly risky financial system, which practically ensures slower economic growth going forward, and great difficulties in 'rebalancing' such growth.[26]

24 See e.g. *Financial Times*, China tightens rules on state groups' foreign investments, https://www.ft.com/content/3251987c-7806-11e7-90c0-90a9d1bc9691, last accessed 4 August 2017; *Bloomberg*, China's fear of Japan-style economic bust drives crackdown on deals, says source, https://www.bloomberg.com/news/articles/2017-08-02/china-s-fear-of-becoming-japan-is-said-to-drive-deal-crackdown, last accessed 4 August 2017.

25 Richard C. Koo, *The Holy Grail of Macroeconomics. Lessons from Japan's Great Recession* (Singapore: John Wiley & Sons, 2009).

26 Michael Pettis, 'If we don't understand both sides of China's balance sheet, we understand neither'. Carnegie Endowment for International Peace, 1 September 2015, http://carnegieendowment.org/chinafinancialmarkets/61173, last accessed 4 August 2017.

CHINA AS A BACKER OF A STABLE SYSTEM OF EXCHANGE RATES

The Chinese currency, the renminbi, has been a source of considerable and sometimes acrimonious frictions in US-China trade relations. Although Washington has refrained from formally designating China as a currency manipulator, American leaders – most recently President Donald Trump – have habitually complained about the Chinese currency being substantially undervalued, giving Chinese exports a competitive edge.[27] Unsurprisingly, key Chinese central bank officials often talk of maintaining a stable exchange rate as an important goal of their monetary policy.

The Chinese currency fluctuates within a narrow daily band. However, a common view among observers is that government authorities periodically intervene in the exchange rate. In recent years, bouts of both rapid weakening and strengthening of the currency's value have occurred, often coming as a surprise to investors and observers, as the reasons for these moves are seldom thoroughly explained by the authorities. The currency band in conjunction with controls on the capital account also mean that, unlike the US dollar, the value of the renminbi is not freely determined by market flows.[28] In late May 2017, China's central bank added a new 'countercyclical' component to the determination of the renminbi's value that further reduces transparency and enhances administrative control over the exchange rate, leading market participants to refer to it as the 'X factor'.[29]

The currency criticism cuts both ways. During the global financial crisis, Chinese central bank officials were some of the most ardent critics of a dollar-centric global economy and the most enthusiastic proponents of reform of the global reserve currency system. In March 2009, Chinese central bank governor Zhou Xiaochuan argued in an article[30] posted on the People's Bank of China website that the world should gradually move away from dollar-centricity, and pondered options that included more extensive use of IMF Special Drawing Rights in the global financial system. One milestone was reached in late 2015 when the IMF decided to include the renminbi in its SDR currency basket. This was despite the IMF having earlier maintained that the Chinese currency was not yet ready

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27 In the context of the global imbalances underlined by the global economic crisis, the issue took on broader importance, with the IMF's managing director, Dominic Strauss-Kahn, even weighing in on the matter and urging the Chinese government to let the renminbi rise in value. *Financial Times*, IMF chief urges stronger renminbi for global balance, 16 November 2009, www.ft.com/cms/s/0/fb07a8ac-d254-11de-a0f0-00144feabdc0.html, last accessed 2 June 2017.

28 On the whole, the renminbi's exchange rate has been more stable than that of the US dollar, due in part to the dollar being far more widely used and thus subject to inflows and outflows, depending on the global economic situation. Norrlof and Reich, 'American and Chinese leadership during the global financial crisis', pp. 11–12.

29 *Caixin*, China tweaks yuan's fix to keep currency stable, www.caixinglobal.com/2017-05-27/101095772.html, last accessed 18 August 2017; *Business Times*, http://www.businesstimes.com.sg/banking-finance/markets-still-bewildered-after-china-central-bank-explains-yuan-x-factor, last accessed 18 August 2017.

30 Xiaochuan Zhou (2009) *Guanyu gaige guoji huobi tixi de sikao* [Reflections on reforming the international monetary system]. People's Bank of China, March 24.

to be included in the basket because of its formally still relatively tight controls on the capital account.[31] Following Zhou Xiaochuan's SDR 'trial balloon', China signed up to a multi-billion dollar IMF issue denoted in SDR, apparently in exchange for an increase in its IMF quota.

The Chinese authorities have been reluctant to relinquish control of the capital account. Article VIII of the IMF Articles of Agreement[32] is commonly regarded as providing the basis for capital account convertibility, although the IMF's mandate here is on a weaker footing than on the current account. Some prominent Chinese experts have, in fact, been highly critical of the IMF's earlier policy advocacy of capital account liberalisation.[33] In late 1996, China announced that it was going to comply with Article VIII of the IMF's Articles of Agreement and open up its current account. Making the Chinese currency convertible had been set as an eventual political goal as early as the third Central Committee plenary meeting of the Communist Party's 14th Party Congress in November 1993.[34] That meeting resolved to gradually make exchange rate fluctuations market-based and the currency gradually convertible. In practice, China has since 1996 essentially maintained a situation whereby its current account has been convertible, while there have still been plenty of restrictions placed on the capital account. How open or closed has China's capital account been? Determining the degree of openness is not an exact science, as different sources provide somewhat different assessments. One highly authoritative source, a research unit of the PRC State Administration for Foreign Exchange, provided the following breakdown by IMF categories in 2011 (Table 1).

With regard to capital account restrictions, China has been most open vis-à-vis foreign direct investments, and most restrictive towards non-residents acquiring or selling domestic financial assets and instruments. The Chinese government is constrained with regard to how much and how quickly it can liberalise the capital account. Lessons from the Asian financial crisis of 1997-98 are still vivid for many Chinese policymakers, who face a challenge in stemming the accumulation of dollars and hot money flows. Maintaining strong controls on capital account convertibility has been regarded as one of the primary means by which China managed to avoid the harmful effects of the Asian financial crisis. More recently, it insulated China against the worst effects of the 2008-09

31 Eswar Prasad and Lei Ye, 'The renminbi's role in the global monetary system', *IZA Discussion Paper* No. 6335, February 2012, https://www.econstor.eu/dspace/bitstream/10419/58835/1/715374338.pdf, last accessed 2 June 2017.

32 See IMF Articles of Agreement, www.imf.org/external/pubs/ft/aa/index.htm#a8s4, last accessed 2 June 2017.

33 For example, Yu Yongding, an influential Chinese economist and former advisor to the Chinese central bank argues that the IMF has 'pushed capital account liberalisation dogmatically' and it should adjust its policy position and play a more positive role in helping developing countries manage cross-border capital flows instead. Yongding Yu, 'The road map of the reform of the international monetary system' (2009), p. 3, www.un.org/ga/president/63/commission/roadmap_yongding, last accessed 2 June 2017.

34 *Zhonggong zhongyang guanyu jianli shehui zhuyi shichang jingji tizhi ruogan wenti de jueding* (CPC Central Committee decisions with regard to some issues related to the establishment of a socialist market economy system), www.china.com.cn/chinese/archive/131747.htm, last accessed 2 June 2017.

Table 1. China's capital account restrictions by IMF sub-categories.

Status	Number of items
Convertible	9
Basically convertible	13
Partially convertible	11
Non-convertible	10

Source: Guojia waihui guanliju Shanghai shi fenju ketizu (State Administration of Foreign Exchange Shanghai city branch research group), 'Renminbi guojihua yu waihui guanli tizhi gaige' (Renminbi internationalisation and reform of the foreign exchange system), Shanghai Jinrong (Shanghai Finance), No. 7 (2011), p. 29.

Note that there seems to be some variance in how Chinese sources classify the various components. Other sources provide a slightly different breakdown.

global financial crisis. Lifting controls on the capital account may exert added pressure on the renminbi to strengthen.

China faces considerable constraints in opening up its capital account and needs to protect its still underdeveloped domestic financial system. There is little doubt that the role of finance has risen in importance for the Chinese leadership. In terms of industrial development and manufacturing, China has already reached a relatively advanced level. However, the development of the Chinese financial system has lagged behind. Until recently, much of China's financial system was still underdeveloped or poorly functioning. For example, its domestic bond markets were practically non-existent in the early 2000s.[35] Similarly, the Chinese stock market is still commonly considered to be prone to speculative bubbles, as evidenced in the 2007 and 2015 rapid stock run-ups and busts. Not so long ago, Chinese interest rates were still administratively set and not reflective of true financial risks. Finally, the available investment options for Chinese domestic investors have been severely curtailed due to capital controls, which have prompted rolling bubbles in real estate and stocks, as well as large inflows to shady alternative financial products within the shadow finance sector, such as the highly-popular but inherently risky 'wealth management products' (WMPs).

The Chinese leadership is well aware that in order for the country's economy to continue developing, finance is a key area that needs to be reformed. Finance was a reform area singled out in an extensive and much-noted research report jointly produced by the

35 See e.g. Walter and Howie, *Red Capitalism*.

World Bank and the Development Research Center of China's State Council,[36] which supposedly had the backing of the Chinese Premier. In late 2013, the Chinese Communist Party's Central Committee publicised a 60-point extensive reform agenda for the coming years. Reforming China's domestic financial system has high priority on this agenda, including increasing the renminbi's international use, as well as opening and deepening domestic financial markets. Similarly, if China truly intends to challenge American economic dominance, finance is key. The increasing importance of finance is reflected in the current line-up of top leaders, who seized the levers of power in late 2012. While it used to be the case that top leaders were all engineers by education (and males in their 60s), the current leadership comprises several people who have studied various aspects of economics or finance.

36 www.worldbank.org/content/dam/Worldbank/document/China-2030-complete.pdf, last accessed 2 June 2017.

CHINA AS A LENDER OF LAST RESORT

Acting as a lender of last resort is the toughest test for China's ability and willingness to assume leadership in times of economic crisis. The ability to provide liquidity to other countries during financial market stress, namely to act as a global lender of last resort, has been seen by many observers besides Kindleberger as the ultimate criterion for a country to be in a leadership position. As part of its drive to internationalise the renminbi, China has ambitiously been building the global infrastructure and 'plumbing' for renminbi liquidity provision by concluding bilateral swap arrangements with a long list of central banks in other countries and territories.[37] China has also taken a very proactive role in boosting various multilateral liquidity arrangements, including through the IMF, within the multilateralised Chiang Mai Initiative (between Asian central banks) and in the NDB (among BRICS countries).[38]

Internationalising the renminbi emerged as a topical issue after the Chinese government made the currency's internationalisation and greater international use a stated policy goal in the 12th five-year plan.[39] A raft of government initiatives was launched to promote the political aim of making the Chinese currency viable and more widely used in the global monetary system.[40] China has, for example, gradually expanded possibilities for cross-border trade settlement in the Chinese currency, opened a renminbi-denominated bond market in Hong Kong ('dim sum bonds'), and announced a series of bilateral swap arrangements with other central banks using the renminbi as settlement currency, as well as established renminbi clearing centres in many financial centres. Beijing has also opened up the possibility to make direct overseas investments in the renminbi.

Among the conditions that economists regard as necessary for internationalising the renminbi are: promoting the usage of the currency in the pricing and counting of products and goods; liberalising and reforming the domestic financial system; developing the domestic money, bond and equity markets; creating liquid offshore bond markets; and promoting the renminbi as a regional trading currency in Asia. Above all, most economists would probably agree that unless China liberalises its capital account

37 Some of the first bilateral swap arrangements were concluded with South Korea, Hong Kong, Malaysia, Belarus, Indonesia, Argentina, Iceland, Singapore, New Zealand, Uzbekistan, Mongolia, Kazakhstan, Thailand, Pakistan and the UAE.

38 For a good recent paper covering China's liquidity provision, see Mikko Huotari and Sandra Heep (2016) 'Learning geoeconomics: China's experimental financial and monetary initiatives', *Asia Europe Journal*, vol. 14, iss. 2, pp. 153–171.

39 *Zhonggong zhongyang guanyu zhiding guomin jingji he shehui fazhan di shi er ge wu nian guihua de jianyi* (Recommendations by the CPC Central Committee on formulating the 12th five-year plan for national economic and social development), 2010.

40 For a comprehensive list of measures up until 2012, see Prasad and Ye, 'The renminbi's role in the global monetary system', pp. 42–54.

and makes the currency freely convertible, there is little prospect of truly making the Chinese renminbi a widely-used currency.[41]

Renminbi internationalisation met with some early success. Its use in global financial transactions has increased rapidly, albeit from a low base. In the most recent report on global foreign currency transactions by the Bank for International Settlements (BIS), published in April 2016, the renminbi's share of total OTC forex daily turnover had reached 4% – double the figure quoted in the previous report three years earlier (Table 2). Yet, by this measure the USD is still the dominant international currency. Almost 88% of forex instruments have the US dollar as one side of the transaction pair.

Table 2. Use of currencies in OTC foreign exchange instruments (as % of total).

US dollar	87.6%
Euro	31.4%
Japanese yen	21.6%
British pound	12.8%
Australian dollar	6.9%
Canadian dollar	5.1%
Swiss franc	4.8%
Chinese yuan (renminbi)	4.0%

Source: Bank for International Settlements, April 2016, https://www.bis.org/statistics/d11_1.pdf.

41 Rajiv Ranjan and Shri Anand Prakash, 'Internationalisation of Currency: The Case of the Indian Rupee and Chinese Renminbi,' *RBI Staff Studies* 3/2010, p. 12; Nicholas Lardy and Patrick Douglas, 'Capital account liberalization and the role of the renminbi', *Peterson Institute Working Paper Series*, WP 11–6, February 2011, pp. 1–17; Baogen Ding, 'Xin xingshi xia guanyu renminbi guojihua de sikao,' *Heilongjiang duiwai jingmao*, no. 5 (2009), pp. 20–22; Brendan Kelly, 'China's challenge to the International Monetary System', *Issues and Insights*, vol. 9, no. 11 (2009), *Pacific Forum*, CSIS, pp. 1–19.

Furthermore, the pace of the increase in the ratio has stalled of late, and even slightly declined. It is tempting to conclude that there are natural limits to how much genuine international demand there is for the renminbi, as long as China continues to maintain capital controls.

The Chinese policy debate is torn between the goal of internationalising the currency (and by extension increasing China's economic clout) and the need to maintain a stable financial system. A number of experts advocate maintaining some form of capital controls (e.g. administrative controls), even as the renminbi is internationalised and the economy gradually moves towards capital account convertibility.[42] Some foreign financial experts with long experience of operating within the Chinese financial system are even convinced that the Chinese political elite have no intention of genuinely opening up the financial system to international capital markets.[43] At the very least, China appears intent on maintaining some controls for the time being. This is, as several scholars have noted, uncharted territory. Internationally widely used currencies have, as a rule, become freely convertible before they became internationalised, and economic theory regards convertibility as a precondition for internationalisation.[44] There are some indications that China has been attempting the reverse, that is, attempting to make the currency internationally widely used prior to it becoming freely convertible.[45]

The way that China's government has gone about increasing the international use of its currency since the global financial crisis has, according to Christopher McNally, followed a pattern of combining China's vast entrepreneurial networks with state co-ordination, resulting in numerous bilateral international accords to increase the international use of the renminbi. The Chinese authorities have made active use of global financial channels, such as international financial centres and financial institutions, to create and absorb offshore pools of renminbi. However, they have continued to exercise active control over renminbi capital flows into and out of China. Essentially, renminbi internationalisation has duly followed the logic of a closed economic system with dual objectives. On the one hand, the government has aimed at maintaining control (a political objective) and, on the other hand, making it work, which is an economic objective.[46]

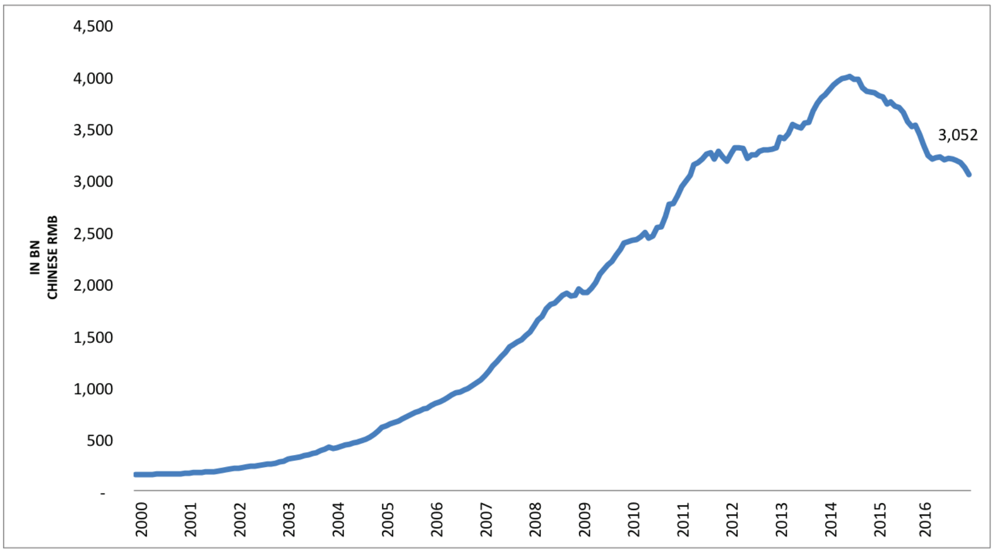
42 Prasad and Ye, 'The renminbi's role in the global monetary system'; Joseph Yam, 'A safe approach to convertibility for the renminbi', Working Paper no. 5 (2011), Hong Kong Institute for Global Economics and Finance, Chinese University of Hong Kong; François Godement et al. 'Redbacks for greenbacks: The internationalisation of the renminbi', China Analysis, European Council on Foreign Relations, November 2010, pp. 1–13.

43 Carl E. Walter and Fraser T. Howie, *Red Capitalism: The Fragile Financial Foundation of China's Extraordinary Rise* (Singapore: John Wiley & Sons, 2011).

44 Lardy and Douglas, 'Capital account liberalization and the role of the renminbi,' pp. 13–14; Paola Subacchi, '"One currency, two systems": China's renminbi strategy', *Chatham House Briefing Paper* IE BP 2010/01, October 2010, pp. 2–4.

45 Note that the IMF now considers the renminbi to be sufficiently freely convertible, despite its remaining capital controls.

46 Christopher A. McNally, 'Sino-capitalism: China's re-emergence and the international political economy', *World Politics*, vol. 64, no. 4 (2012), pp. 741–776.



Source: PRC State Administration for Foreign Exchange.

Figure 3. Development of China's currency reserves.

Since the mini stock market crash in 2015 and serious capital flight in 2016, Chinese leaders' actions have been sending mixed signals with regard to further liberalisation of the capital account. In early 2017, the Chinese authorities adopted a raft of strong measures that managed to stem the outflows that were having a major impact on China's vast currency reserves (Figure 3).

It is doubtful how much leeway remains for further increases in the renminbi's international use, as tight capital controls have not only been maintained, but even tightened again.

CHINA AS A CO-ORDINATOR OF MACROECONOMIC POLICIES

Coordinating international macroeconomic policies has been a key role for the United States in particular, and for the UK to a lesser extent before that. From the Bretton Woods conference in 1944, where several of the main post-war international financial institutions were designed in a process dominated by the United States,[47] through the G7 Plaza Accord in 1985, to the 2008 global financial crisis emergency measures, the United States has played a role that no other country has been able to play. China's role has grown steadily since the Asian financial crisis. In the 2008 global financial crisis, China joined the crisis-fighting efforts exerted by other governments and central banks, for example through liquidity provision and lowering interest rates. However, China's role was more complementary and peripheral, whereas the lead was taken by the United States in conjunction with other G7 countries.[48] Thus far, the world has yet to witness a global, or even regional, financial/economic crisis where China takes the decisive lead in international crisis-fighting efforts.

Since the global financial crisis, China's vote share and especially its informal importance within the IMF has increased.[49] However, arguably, China has played a more important role in the G20 setting, aided by its strong role within the BRICS cooperation framework, which has deepened and broadened greatly from a modest inception,[50] with China as the *de facto* economically dominant member, despite the strong commitment of BRICS countries to equality. For example, reform of the Bretton Woods institutions appeared on the G20 agenda during the Chinese chairmanship in the October 2005 meeting of finance ministers and central bank governors in China (Xianghe). After this meeting, the G20 issued a statement on reforming the Bretton Woods institutions. The two main substantive points of the statement were that quotas and representation should reflect changes in economic weight, and that the selection of senior management should be based on merit and ensure broad representation of all member countries.[51] Following this meeting, China and the other BRICS countries kept up the pressure on this issue within the G20 setting. BRICS summits have consistently called for greater voice and representativeness, both through a substantial shift in voting power and by diversifying personnel selection procedures in these organisations.[52] More recently, China hosted the 2016 G20 Summit in Hangzhou. This was only the second time that a G20 Summit had ever been held in an Asian country.

47 See Subramanian, *Eclipse*, pp. 16–17.

48 Norrlof and Reich, 'American and Chinese leadership during the global financial crisis'.

49 Qu Bo, 'Dynamic engagement: China's preference to the international monetary system,' Paper presented at the 2nd GLF Colloquium, 3 May 2010, Princeton University; Benjamin J. Cohen, '*The China Question', The Politics of China's Role in the International Monetary System* (Ithaca, NY: Cornell University Press, 2012).

50 Oliver Stuenkel, 'The financial crisis, contested legitimacy, and the genesis of intra-BRICS cooperation', *Global Governance* No. 19 (2013), pp. 611–630.

51 G20 Statement on Reforming Bretton Woods Institutions (2005).

52 Stephan Keukeleire et al., 'The EU Foreign Policy Towards the BRICS and Other Emerging Powers: Objectives and Strategies' (Brussels: The European Parliament, 2011).

Given the many ways in which China's relative importance in the global economy has grown over the past decade, the desire of the current White House incumbent Donald Trump to withdraw from or renegotiate a number of multilateral institutions and commitments, and the self-confidence and proactivity displayed by China's leader, Xi Jinping, it will be highly interesting to see whether China will be thrust into the centre of the action when the next financial crisis hits, as it inevitably will some day. China's President Xi Jinping addressed the global Davos Forum in early 2017 to great fanfare, as the first Chinese president ever to do so. To many observers, his articulate and strong defence of an open international economy appeared to signal the symbolic passing of the baton for the responsibility of maintaining the open global economy, especially as it was set against the backdrop of a new American presidential administration that seemed intent on withdrawing into economic nationalism, relative isolationism, and great ambivalence towards the benefits of an open economy.[53]

Clearly, China's profile in global economic governance during times of relative stability has been enhanced. However, whether other countries are willing to grant China a leading role in coordinating macroeconomic policy responses in times of financial and economic crises is still an open question. Whether the United States would be willing to cede its leading role in the global economy to China is also highly doubtful, regardless of Trump's 'America first' rhetoric.

53 Other observers perceptively noted that on numerous issues of international concern, China still tends to take a cautious and reactive stance, rather than true leadership. Thomas Kellogg, 'Xi's Davos speech: Is China the new champion for the liberal international order?', *The Diplomat* (2017), http://thediplomat.com/2017/01/xis-davos-speech-is-china-the-new-champion-for-the-liberal-international-order/, last accessed 20 May 2017.

A TENTATIVE ASSESSMENT OF CHINA'S ECONOMIC LEADERSHIP POTENTIAL

This Working Paper has delved into the question of whether China today is *able* and *willing* to assume responsibility for Charles Kindleberger's five stabilising functions in times of international financial or economic crisis. The paper briefly discussed each of Kindleberger's criteria, focusing in particular on the domestic political constraints on China assuming these functions. We can now provide a tentative qualitative assessment with regard to whether China is willing and able to assume this responsibility in light of the evidence discussed. Table 3 summarises this assessment. Caution should be exercised in reading the Table, however, as it is still preliminary and based on a qualitative evaluation.

The discussion in this paper indicates that China's importance for the global economy is much closer to that of the United States in some respects (e.g. as an import market and provider of long-term lending) than in others (especially as a lender of last resort). China today has a strong ability to provide both an open market in times of crisis and long-term lending to other countries. China is a major market for other countries, albeit skewed towards raw material and capital goods exporters, and less important than as an exporting powerhouse. Likewise, China has in recent years become a major international lender, and for some developing countries even emerged as their most important source of long-term international lending. This role is set to become stronger, more institutionalised and more multilateralised in the future with the growing role of the AIIB, the NDB and the One Belt, One Road initiative. With the very high-level political

Table 3. Qualitative assessment of China's ability and willingness to assume the Kindleberger functions in times of financial/economic crisis.

China as ...	willingness	ability
an open market in times of crisis	low	high
a provider of long-term lending	high	high
a backer of a stable system of exchange rates	moderate	moderate
a lender of last resort	moderate	low
a coordinator of macroeconomic policies	moderate	moderate

support for these policy intiatives, China has also shown strong willingness to assume the function of a major provider of international lending. The same cannot be said of its willingness to play the role of an open market in times of crisis, however. Given China's import structure, lingering mercantilist and protectionist impulses, as well as its policy drive to become a more high-tech and increasingly self-sufficient economy, one may doubt the country's *willingness* to assume the function of a market for distress goods in times of crisis.

As for the other three functions, both China's ability and willingness to perform them can be assessed as moderate. China has shown the willingness to back a stable system of exchange rates, both through its own monetary policy (in recent years), and in terms of support for such a system at the global level. China has gradually assumed a more important role in macroeconomic policy coordination, especially in the G20 and IMF settings, and also as a lender of last resort, at least with regard to the provision of renminbi liquidity, both in terms of a large network of bilateral swap agreements and regional/multilateral liquidity initiatives (Chiang Mai Initiative Multilateralisation, NDB).

It would seem that the biggest stumbling block for China's ability to perform the Kindleberger functions is its ability to act as a lender of last resort. Although the Chinese central bank actively pushed for capital account liberalisation and renminbi internationalisation previously, this effort has clearly been put on the back burner following the summer 2015 stock market crash and capital outflows, which saw China lose a quarter of its vast currency reserves in a little over a year. Further capital account liberalisation has been postponed, and new capital controls have been imposed through a raft of strong measures undertaken in late 2016 and early 2017 that targetted corporations, banks as well as individuals. Indications are that international renminbi usage has recently fallen as a consequence.

Instead of further opening up, China's leaders have recently put 'financial security' at the forefront of their concerns, conscious of the dangers that the country's unruly financial system poses, not just for economic, but also for political stability. For the time being at least, domestic financial stability – and by extension political stability – is taking precedence. As long as China maintains tight capital controls and has relatively closed financial markets, it will not be able to perform the function of *the* lender of last resort for other countries should a new global financial crisis hit. In fact, one of the most likely sources of a new financial crisis is China itself, and its murky and massive shadow banking sector in particular. Chances are that the United States will again be pushed to the centre of crisis management. In a crisis, people will still want to hold US dollars, not renminbi. The continuing dominance of the dollar and American financial markets in the global economic system ensures that for the time being the United States is still the leading economic power by default.