CHINA AND THE GLOBAL FINANCIAL ARCHITECTURE

Keeping Two Tracks on One Path

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THE INTERNATIONAL FINANCIAL ARCHITECTURE

The international financial architecture offers a framework for managing the global economy. It dates back to the Bretton Woods conference in 1944, where the International Monetary Fund (IMF) and the World Bank were created. Both institutions started their operations in 1946 and are based in Washington, D.C.

The international financial architecture is centred around providing two international public goods: a financial safety net and finance for development. Even though this system is imperfect, this architecture has been an important element of stability for the international financial system, providing "liquidity, confidence, and adjustment" (Machlup quoted in Temin and Vines, 2013: 112). Despite recurring economic crises and tensions, the world has remained remarkably open and peaceful.

The financial safety net has four primary components: the IMF, regional financial arrangements, bilateral financial arrangements, and national foreign exchange reserves. With 190 members, the IMF is the oldest, largest, and most important component. Members contribute a quota in return for financial support, and their voting shares are determined by quota size. Total financial resources amount to $1.4 trillion in quota subscriptions, but only 70 per cent of this is available for lending (approximately $1 trillion) (IMF, 2021). Whether these resources will be enough in the event of a major global financial crisis is an open question.

Regional multilateral financial arrangements further contribute to the global financial safety net. These include the Chiang Mai Initiative Multilateralization (CMIM), the European Financial Stability Facility (EFSF), and the BRICS[1] Contingent Reserve Arrangement (CRA), all of which have been established in recent years. However, their capacity to deploy financial resources is limited. The EFSF, for instance, is made up of contributions from the eurozone governments and has a maximum lending capacity of €500 billion. The CMIM's resources amount to $240 billion, 40 per cent of which can be deployed independently of the IMF. The CRA is even more limited as it provides liquidity through swap agreements for up to $100 billion; these swaps can be activated when all the BRICS countries are in agreement.

The other two components are the bilateral swap lines, established when two countries make an agreement to purchase currencies from each other in the event of a liquidity crisis, and the national foreign exchange reserves (not an easy course of action for low-income countries with limited export capacity).

Development finance hinges on the World Bank and the regional multilateral development banks (MDBs). These institutions focus on supplying financial resources to projects in areas such as infrastructure or health, which require long term investment commitments. The World Bank is the oldest, largest and perhaps the most important MDB. Following in its footsteps, four major regional MDBs emerged in the decades after its establishment: The Inter-American Development Bank (IDB), the African Development Bank (AfDB), the Asian Development Bank (ADB), and the European Bank for Reconstruction and Development (EBRD).

Other institutions and informal groups play a significant role in the international financial architecture. These include the United Nations (UN)[2] and the General Agreement on Tariffs and Trade (GATT)/World Trade Organisa-

1 The BRICS countries are Brazil, Russia, India, China and South Africa.

2 The IMF and the World Bank Group are specialised agencies of the UN system, meaning that they are autonomous institutions that work with the UN under negotiated agreements.

tion (WTO). The GATT was established in 1948 to liberalise international trade through the multilateral reduction of tariffs and other non-tariff barriers; it was replaced by the WTO in 1995.

Among the informal groups, **the Group of Twenty (G20)** and the Paris Club are worth mentioning here. The former **is an intergovernmental forum** representing the world's largest economies. It was founded in 1999 as a meeting of finance ministers and central bank governors in response to the decade's recurrent crises in emerging markets. The G20 aims to coordinate policies between its member countries to achieve economic stability and sustainable growth. After the global financial crisis, it was elevated to the premier international forum. By including the main emerging market economies in the post-crisis years, the G20 superseded the Group of Seven (G7).[3] The G20 doesn't have a permanent secretariat; instead the chair rotates annually among its members.

The Paris Club is an informal group of creditor nations. It was established in 1956 when Argentina agreed to meet its public creditors in Paris to find workable solutions to payment difficulties. Since then, the Paris Club has made 477 arrangements with 101 different debtor countries, treating a total of $612 billion in debt.[4] It has 22 permanent member countries[5]. The IMF, World Bank, Organisation for Economic Co-operation and Development (OECD), UN Conference on Trade and Development (UNCTAD), the European Commission, AfDB, ADB, EBRD, and IDB are observers and can attend the sessions.

The international financial architecture is not set in stone. The institutions have adapted over the years to reflect the changes in the world economy. Since the end of the Second World War, nothing has altered the dynamics of the world economy as much as the rapid growth and transformation of China's economy. This is challenging the international financial architecture in a number of ways. Three interrelated aspects of China's growth are notable here: the size of China's economy and financial sector in relation to the global financial safety net, its savings surplus, and its role as a lender.

China's financial system is now one of the largest in the world, with financial assets amounting to nearly 470 per cent of gross domestic product (GDP) (IMF, 2017). It has also become more complex and further integrated with the rest of the world through investment flows and direct lending. This has increased the risk of large external financing requirements and the transmission of shocks[6], as well as the requirement for more resources for the international financial safety net.

China's gross national savings amount to roughly 45 per cent of its GDP[7], one of the highest rates globally. Given the size of China's GDP ($14.7 trillion), these large savings have the potential to impact international financial stability should they flow abroad and create a large external imbalance.

China's role as a lender, arises from its savings and the gap between supply and demand for development finance regionally as well as globally. In Asia, for example, the gap in infrastructure investing between 2010 and 2020 was approximately $8 trillion, more than sixty times the amount given annually in development assistance (Bhattacharyay, 2010: 11). This investment gap has created the space for China to transition from being a borrower to a lender, and try its hand at development finance.

Two critical consequences for the future of the international financial architecture arise from these three aspects of China's growth. First, the sheer size and impact of China's economy and financial sector make clear the need for the governance reform of the IMF and the World Bank. China and the large developing countries, notably the other BRICS, should have quotas that reflect their economic weight. Quota reforms will increase the legitimacy and financial capacity of these institutions. Better governance and more resources for the multilateral institutions would improve cooperation in other areas such as trade, energy, climate, and global health.

The G20 has spearheaded the reform of the IMF and the World Bank, but reforms have been proceeding at a very slow pace. Take the example of IMF voting rights and quota allocations. In 2010, the G20 agreed to the 14th General Review of Quotas. As a quid pro quo, China increased its contribution to the IMF's emergency funds. This reform delivered a 100 per cent increase in total quotas and a major realignment of quota shares from the advanced European countries and Gulf States to emerging countries. China is now the third-largest member country in the IMF, and the four BRIC countries are all among the ten largest shareholders. However, the US Congress took five years to approve the Review, meaning that it only became effective in January 2016. The reform marginally increased China's representation in the IMF relative to its share of the global economy. Its voting share is 6.08 per cent, slightly lower than Japan's (6.14 per cent), but well below that of the US (16.50 per cent). Increasing China's quota requires other large countries, specifically the US,

3 The G7 became the Group of Eight (G8) in 1997 when Russia joined, but reverted back to the G7 in 2014 when Russia was suspended indefinitely after the annexation of Crimea.

4 As of January, 24 2022.

5 The Paris Club also has ad hoc participants (including China) which can actively participate in negotiation sessions subject to the agreement of the permanent members and the debtor country.

6 Arguably China has foreign exchange reserves that are larger than its short-term financing requirements; furthermore, it has ample fiscal space and substantial domestic buffers to fend off financial stability without relying on international support.

7 As of 2020.

Germany, France, and the UK, to reduce theirs. While it would be possible to expand the overall size of the existing institutions if all members were prepared to contribute in proportion to their actual quotas, a significant redistribution to increase China's share would be a zero-sum game.

The second consequence for the future of the international financial architecture, which arises from China's role as a lender, **is the fragmentation of the global financial safety net.** China is now in a position where it can engage in both bilateral and multilateral lending. This capacity as a lender and the slow pace of governance reform creates incentives for the Chinese leadership to consider other options, such as setting up a multi-tiered and multi-centred global governance system through the creation of new institutions and organisations that are more representative of the emerging markets and developing countries (Chin and Freeman, 2016: 17). However, the risk is that by spreading its financial wings too widely, China may fragment the global financial safety net, reducing its coverage, responsiveness, predictability, and leaving some countries exposed to systemic risks.

In recent years, **China has taken a multi-pronged and multi-layered approach to promoting a series of regional initiatives** that enhance cooperation among emerging market economies and within Asia. It has spearheaded the internationalisation of the renminbi, the Belt and Road Initiative (BRI), and the creation of the CMIM. It is also working collaboratively on regional economic issues within Asia-Pacific Economic Cooperation (APEC), ASEAN+6[8], and the East Asia Summit.

The most notable of these initiatives is the creation of two new regional MDBs, the Asian Infrastructure Investment Bank (AIIB) and the New Development Bank (NDB), both of which began operations in 2016. The AIIB was first announced by the Chinese government in 2013[9], resulting in the bank's 50 founding members signing the Articles of Agreement (the bank's charter) in June 2015. The NDB was jointly established by the BRICS countries. The plan for creating a development bank was discussed at the fourth BRICS Summit in New Delhi in 2012, and the bank's Articles of Agreement were signed at the sixth BRICS Summit in Fortaleza in 2014. Both banks stem from the idea that since developing countries are critically dependent on development finance, this cannot be left solely to the developed world. They also respond to the gap between demand and supply for infrastructure investment. Finally, they help China leave its own footprint on development finance and establish its reputation as a reliable player in the international order.

Box 1
China in the international financial architecture

- **China is a member and active participant of the international financial architecture**. It has been in the **IMF** since 1945, when it joined the **UN**, and has supported IMF lending initiatives through the years. However, China's share of the IMF quota and voting rights are outstanding issues. China is also an active supporter of the **CMIM**. China, Japan and South Korea are the largest contributors to the fund ($77 billion with 28.41 per cent of the voting share each). China is also the biggest contributor to the **BRICS CRA**, at $41 billion. China has 31 bilateral swap lines (as of 2020), totalling over $500 billion.

- China joined the **World Bank** in 1980 and is the second-largest cumulative borrower after India (having received $64.6 billion in total). It became a member of the **ADB** in 1986 and is the second-largest cumulative borrower after India (having received $41.5 billion in total) (Humphrey and Chen, 2021: 8). It joined the **AfDB**, **IDB**, and **EBRD** as a non-borrowing member in 1985, 2009, and 2016, respectively.

- As for the other institutions and informal groups, China became a member of the **WTO** in 2001, and joined the **G20** when it was established in 1999. China is **not a member of the Paris Club**, where it participates as a creditor on an ad hoc basis.*

* Two-thirds of Chinese debt restructurings have occurred independently of the Paris Club (Bon and Cheng, 2020).

BUILDING INSTITUTIONS

As the first MDBs established by China, the AIIB and NDB have sparked a debate over how they will fit into the existing international financial architecture – or if they were even intended to fit into it at all. Despite the diplomatic frictions that their creation caused, the two banks do complement the existing institutions, as neither represents a clear departure from the MDBs that came before them (Wang, 2019). Their governance and Articles of Agreement are modelled on the World Bank, with aspects adopted from regional MDBs such as the ADB. In the words of AIIB's Vice President of Policy and Strategy Danny Alexander, the "AIIB is firmly established as part of the family of multilateral development banks" (Center for Global Development, 2020: 6.27).

Like the World Bank, the new MDBs have a three-tiered system of governance with a board of governors, a board of directors, and a senior leadership team headed by a president. They both began their operations with $100 billion of total authorised capital. They can be categorised as medium-sized, smaller than the World Bank ($280 billion in capital) and the ADB ($153 billion) (Table 1).

The AIIB is the second-largest MDB after the World Bank by number of members. It had 103 members by

8 The group comprises the ten countries of the Association of Southeast Asian Nations (ASEAN) and six other countries in the Asia-Pacific region.

9 The idea for the AIIB originated from the Chinese think tank the China Center for International Economic Exchanges (CCIEE) in 2009 (Callaghan and Hubbard, 2016: 121).

Table 1
The World Bank, ADB, AIIB, and NDB – then and now

	World Bank	ADB	AIIB	NDB
Headquarters	Washington, D.C. United States	Manila The Philippines	Beijing China	Shanghai China
Operations began	1946	1966	2016	2016
Capital (US$, bn)	10	1	100	100
Number of staff	30–40	40	79	58
Member countries	45	31	57*	5
		2020		
Capital (US$, bn)	280	153	100	100
Number of staff	12,300	3,646	316	185
Member countries	189	153	103**	5

* At the end of 2016, 50 countries were full members, and seven more were in the process of ratifying the Articles of Agreement.
** At the end of 2020, 83 countries were full members, and 20 more were in the process of ratifying the Articles of Agreement.
Note: Capital is total authorised capital.
Source: (World Bank, 2017; World Bank, 2021; ADB, 2017; ADB 2021; AIIB, 2017; AIIB, 2021; NDB, 2017; NDB, 2021)

the end of 2020,[10] represent 79 per cent of the world's population and 65 per cent of global GDP. AIIB membership is open to all members of the World Bank and ADB, yet neither the US nor Japan have joined. Like the ADB, the AIIB divides its members into two categories: regional and non-regional. Capital allocation is based on "the relative share of the global economy of members […] by reference to Gross Domestic Product (GDP)" (AIIB, n.d.: Art. 5, Para. 4), and its voting shares are weighted in line with the member country's shareholding. China is the biggest shareholder with $29.78 billion committed[11] – 30.8 per cent of the bank's total. This quota grants 26.53 per cent of voting rights and veto powers over a number of issues, including capital increases, changes in a members' capital subscription, and appointing or removing the president.[12] While the US does hold veto powers within the World Bank, its voting share is significantly less than China's share in the AIIB (see Table 2), and it does not have veto rights over appointing or removing the president.

The NDB has a significantly smaller membership. The five BRICS countries founded the bank, and it still had just five members at the end of 2020.[13] Membership is open to all members of the UN, but the bank's President, Marcos Troyjo, has stated that the bank will expand its membership in a "gradual and balanced manner" (NDB, 2021). Quotas are distributed among the five members; $100 billion authorised capital was divided into one million shares[14], and each of the five founding members made an initial subscription of $10 billion, granting them each one hundred thousand shares and 20 per cent of voting rights. Thus, no single NDB member has veto powers; this was a conscious decision not to mirror the IMF and World Bank governance.

The AIIB has set its activity around three thematic priorities: sustainable infrastructure, cross-border connec-

10 Two more countries have since joined bringing the total up to 105 member countries (as of January 2022).

11 Although China's paid-in share capital investment in the AIIB is $5.96 billion (as of June 2021).

12 In order to constrain the influence of large shareholders, 15 per cent of AIIB voting rights were distributed equally among the founding members. Nevertheless, this has had little impact on diluting China's power.

13 The NDB approved the principles for admitting new members in 2017 (NDB, 2017). Bangladesh and the United Arab Emirates joined in 2021, and Uruguay and Egypt are in the process of becoming members. The shareholding of each of the founding BRICS members is 19.42 per cent as of (February 24, 2022).

14 Each share has a par value of one hundred thousand dollars each.

Table 2
China and the US – voting shares in the international institutions

Institution	China's voting share (%)	US's voting share (%)	Country with veto powers
IMF	6.080	16.500	US
World Bank			
– IBRD	5.420	15.560	US
– IDA	2.350	9.910	–
IDB	0.004	30.006	US
AfDB	1.396	7.615	–
ADB	5.437	12.751	–
EBRD	0.096	10.000	The country in which a project is located has a veto right
AIIB	26.532	–	China
NDB	19.504	–	–

Note: '–' either indicates non-membership of an institution, or that no single country within an institution holds veto rights.
Voting shares are latest available as of January, 21 2022.
Source: (IMF, 2022; World Bank, 2021; World Bank, 2022; AfDB, 2021; ADB, 2021; EBRD, 2022; AIIB, 2022; NDB, 2022).

tivity, and private capital mobilisation. The focus on infrastructure investment is in line with and reflects the Chinese government's approach to overseas investment and the engagement with the rest of the world that emerges through programmes such as the BRI (Grieger, 2021).

The NDB has several key areas of operations, including digital infrastructure, clean energy, and environmental efficiency. Its lending is centred around maximising the impact of development in a fast, flexible, and efficient manner.

Like the World Bank and the other MDBs, the new banks use an array of traditional financing tools such as loans, guarantees, equity investment, and technical assistance, which are provided on a sovereign and non-sovereign basis. Terms for fixed-rate loans offered to sovereign borrowers by the AIIB are identical to those offered by the World Bank[15] (Humphrey, 2020:14). During the economic crisis sparked by the COVID-19 pandemic, the AIIB offered temporary policy-financing (i.e. budget support) to its members in partnership with the World Bank and ADB; the NDB also offered pandemic-related support.

The AIIB is a Chinese-led MDB; its creation was unilaterally announced by Chinese leader Xi Jinping in 2013. The tone of the announcement was open and inclusive. However, President Xi stated that the bank would "enable ASEAN countries to benefit more from China's development", making it clear that China would be in the driving seat (Xi, 2013). The AIIB's charter is designed in a way that should insulate the main shareholder's influence – it requires that at least 75 per cent of the bank's subscribed capital is provided by regional members.[16] Nevertheless, with Japan as a non-member, China is the largest shareholder.

The NDB is led equally by all the BRICS countries, but the proposal for the bank came from India.[17] China was hesitant about its creation, with commentators questioning how the bank would perform under equal leadership (Cooper, 2017).

The AIIB is not an extension of the Chinese government. As a Chinese-led institution, the AIIB reflects China's approach towards global economic governance, however the bank has had a strong focus on establishing its independence through high standards of governance from its outset. Adapting the governance template from the World Bank has been a way to strengthen the new bank's reputation as a credible and trustworthy institution.

15 As of January 2020.

16 Non-regional members account for 23.8 per cent of the AIIB's capital and 27.18 per cent of votes (as of January 18, 2022), with Germany, France, the UK, and Italy being the largest non-regional shareholders.

17 Indian Prime Minister Manmohan Singh first proposed setting up a new institution for infrastructure development at the 2010 G20 Summit in Seoul.

Table 3
AIIB projects – top locations

Member country	Number of Approved Projects	Total AIIB Approved Funding, US$ millions	Regional Member?	BRI Participant?
India	29	7074.67	Yes	No
Multicountry	15	2480.00	–	–
Turkey	14	3146.80	Yes	Yes
Bangladesh	14	2639.00	Yes	Yes
Indonesia	10	2899.90	Yes	Yes
China	9	2760.00	Yes	Yes
Pakistan	8	1711.81	Yes	Yes
Uzbekistan	7	1132.60	Yes	Yes
Philippines	4	1507.60	Yes	Yes
Egypt	4	1020.00	No	Yes
Oman	4	523.10	Yes	Yes
Georgia	4	364.00	Yes	Yes
Sri Lanka	3	460.00	Yes	Yes
Maldives	3	67.30	Yes	Yes

Note: All projects approved from the AIIB's inception until January 20, 2022.
Source: (AIIB, 2022).

Sustainability is critical in the area of infrastructure investment and **the AIIB has set itself rigorous environmental and social standards** in order to support its goal of building sustainable infrastructure and implementing the Paris Agreement.[18] These standards also help to define its role in Asia's sustainable development and show that a China-backed MDB could meet global standards (CDB and UNDP, 2019). Complying with environmental and social standards in infrastructure investment and putting in place effective monitoring and reporting mechanisms helps align investments with the UN's Sustainable Development Goals (SDGs), strengthen transparency, and increase stakeholders' accountability. The AIIB has also set standards relating to gender equality, good health, safety, and inclusivity of people with disabilities to ensure that they can benefit from economic development.

Procurement is an area where there are far-reaching implications in terms of anti-corruption, value for money, and conflict of interests – and so the bar here needs to be set high. To maintain and increase reputational capital, fair and transparent processes need to be in place to avoid accusations of being instrumental to the development policy of the Chinese government. While the details of the AIIB's projects are thoroughly documented on its website, information about procurement contracts is not as readily available. The bank's policies require open and competitive bidding for contracts (AIIB, 2016), but Chinese state-owned enterprises have gained a large competitive advantage over foreign competitors when it comes to infrastructure construction. For the purposes of public procurement, AIIB considers Chinese state-owned enterprises to be private entities, which may ensure access to procurement markets that might otherwise be closed (Grieger, 2021: 10).[19]

18 In October 2021, the AIIB announced that it would fully align its operations with the goals of the Paris Agreement by mid-2023 (AIIB, 2021).

19 The AIIB has different procurement requirements for public and private entities (AIIB, 2016).

The multilateral nature of the AIIB and NDB means they grant China some significant geopolitical benefits for a relatively low cost. They provide a neutral setting for countries to work alongside each other. Even countries that otherwise are not on good terms are able to collaborate through this platform. This is particularly evident when looking at the relationship between China and India. With 8.6 per cent of the AIIB's capital and 7.59 per cent of voting shares, India is the bank's second-largest shareholder.[20] Within the NDB, where all founding members contribute an equal amount of capital in return for an equal share of the votes, China and India co-exist on equal terms. That the new MDBs provide China and India with common ground is made even more apparent when looking at the portfolio of projects of both banks. India is the AIIB's biggest borrower by far (see Table 3), with 29 out of 163 approved projects in total, amounting to over $7 billion out of $32.28 billion in total approved financing. Notably, 65 per cent of AIIB's projects have been sovereign projects, which typically constitute a lower financial risk. The countries with the second highest number of AIIB projects are Turkey and Bangladesh with 14 approved projects each. Turkey's AIIB funding amounts to over $3.1 billion and Bangladesh's amounts to over $2.6 billion. Out of the countries that host the most AIIB projects, India is the only one that is not also a member of China's BRI (Table 3).

CHINA AND THE EVOLVING LANDSCAPE OF GOVERNANCE

The AIIB and NDB have successfully been designed and developed to fit into and complement the international financial architecture. Even if the new banks have a limited track record due to their relatively short life, their governance framework and environmental and social standards have nonetheless resulted in high-quality projects and partnerships with other development banks, notably the World Bank.

There are two factors behind the effective building of these new institutions: China's willingness to learn from the World Bank's playbook and the advanced economies' willingness to engage with China as a large and systemically-important economy. In addition, the new banks were designed and developed in an environment of moderate reciprocal trust and understanding during the height of Robert Zoellick's 'Responsible Stakeholder' era.[21] During this era, significant foundations were laid that kept the dialogue going on the back of China's "conciliatory multilateralism" (Doshi, 2021: 108).

Two key moments tested the Chinese leadership's commitment to the 'Responsible Stakeholder' approach: the Asian financial crisis of 1997 and the global financial crisis of 2008. Both crises are important contextual factors that need to be taken into consideration to understand China's approach to governance and the reorientation of its strategy from international to regional. During the Asian financial crisis, the Chinese leadership held on to the renminbi-dollar exchange rate so as not to further undermine monetary stability in the region. This decision helped the economic recovery of the countries most affected by the crisis. During the global financial crisis, when the US called on the major economies to participate in a coordinated large-scale fiscal stimulus package in the run-up to the 2009 G20 Summit in London, China answered promptly with a 4 trillion renminbi (about $580 billion) stimulus plan (He, 2014: 3). At the 2009 London Summit, China joined the other G20 members in a $1.1 trillion stimulus plan led by the IMF and committed a further $50 billion to the IMF non-conditional liquidity lines. These acts of cooperation won China a great deal of praise from the international community, including from Robert Zoellick. However, these steps were also aligned with China's national self-interests (He, 2014: 3).

The significant trust and goodwill that was built between China and the US in the time between the two crises **dissipated with the election of Donald Trump.** The Trump administration rekindled and intensified past mistrust. The election of Joe Biden and the change of US administration has not fundamentally changed the US approach to China. Not surprisingly, public perception in China is that there is little difference between Trump and Biden. Given the fraught diplomatic context that has emerged since 2016, it is not clear whether China's initiatives in global governance, especially the establishment of AIIB, would have been possible to initiate today (Humphrey and Chen, 2021).

China is now a key part of the international financial architecture in two significant dimensions: as an institutions-member and as an institutions-builder. Having driven several economic and financial initiatives, some bilateral and others multilateral, China has shown that it can be a "responsible stakeholder" in a system created and led by the US and its western allies. It has also demonstrated that it can build and lead multilateral institutions and provide public financial goods – notably, development finance – within the framework of multilateral institutions.

The interaction of these two dimensions has changed the dynamics of the institutional architecture in a similar way to how China's economic development changed the dynamics of the world economy. The growth of the Chinese economy – it overtook Japan in 2010 and is now head-to-head with the US – has made the need to reform the governance of the Bretton Woods institutions obvious. The representation of China and the other emerging economies in these institutions is not proportionate to

20 Russia is the bank's third largest shareholder, with 6.7 per cent of capital and 6.0 per cent of votes.

21 In 2005, the US Deputy Secretary of State Robert Zoellick, who subsequently became the President of the World Bank, advocated for China the role of 'responsible stakeholder' in an "open, rules-based international economic system" (2005).

their weight in the world economy. At the same time, it has made evident the fundamental zero-sum game implicit in the reform of the Bretton Woods institutions.

Governance reform is politically thorny, especially with regard to the World Bank and the IMF, given the position of the US. Thus, the evolution of the financial architecture is unlikely to register any significant progress within the existing institutions any time soon. During the 'responsible stakeholder' era, China was eager to grow within the existing Bretton Woods institutions and become a bigger shareholder without overtaking the US. Nowadays, China's proven capacity in institution-building allows for a more varied multilateral institutional framework with a regional focus and distributed leadership. Thus, the key question is whether China will continue to engage with the rest of the world within the existing institutional framework. Or – will institution-building be a way for China to pursue "offensive economic statecraft" (Doshi, 2021: 161)?

Development finance is the area where China has been focusing its external financial action. While the establishment of the new MDBs has proved relatively smooth, and the new institutions have so far generated little or no controversy, this is not the case for China's bilateral initiatives. Here, China's footprint is especially significant; domestic institutions (policy banks) are engaged in bilateral development lending with many countries, especially low-income ones. China is now the largest official creditor worldwide, with over $1.5 trillion in loans and trade credits to more than 150 countries (Horn et al., 2020).

The policy banks have evolved over the years to become the leaders of China's external action. China Development Bank (CDB), Export-Import Bank of China (Exim Bank) and Agricultural Development Bank of China now account for approximately 70% of China's official financing, making them the world's biggest lenders in development finance. They are globally competitive financial institutions that offer preferential, or market-based, long-term development finance for infrastructure projects in developing countries, aiming at generating economic and social benefits for the recipients. They also enjoy strong political support and receive large capital injections from the People's Bank of China (PBoC) at low borrowing costs. As a result, they have more resources to put towards projects compared to other lenders. At present, the CDB has total assets (domestic and international) that exceed the combined total assets of the World Bank, the European Investment Bank (EIB), and all four major regional development banks (Morris, 2018).

It is not easy to estimate the size of China's lending, which presents a serious problem for the international institutions. We know that many developing countries over the years have borrowed from various Chinese entities using different instruments such as development finance loans, commercial loans, export buyers' credit, and so on. However, the amount of debt owed to Chinese lenders, mainly the policy banks, is vastly underreported, and the data available is limited. China maintains that sensitive information should be available only to the lender and the borrower, but this should also be privy to the international financial institutions that need to intervene when a country can no longer face its debt obligations.

Best practices for debt restructuring and debt resolution involve a multilateral and coordinated approach. The Debt Service Suspension Initiative (DSSI) and the Common Framework are a step in the right direction, but the ambiguity related to China's debt affects their practice. In particular, it is unclear whether China's policy banks should be classified as public or private, raising the question of whether these institutions should be involved. The Chinese leadership maintains that they are private entities and should therefore not be involved in the DSSI, despite the size of their lending and ties to the Chinese government.

China's standards when it comes to bilateral financial relationships are at odds with the high standards of governance in the AIIB. China's entangled bilateral debt outlook epitomises the conflict between the competing demands arising from domestic institutions and pressures coming from abroad. This begs the question: is the AIIB representative of China's approach to the international financial architecture?

On many occasions, **President Xi has spelt out China's commitment to be an active and responsible partner** within the multilateral institutional framework. China's desire for international reforms that will enable it to engage more deeply emerges unambiguously from the official documents and speeches. President Xi has also stressed China's will to contribute to a "a fairer and more equitable order"; for China, a fairer order is one that is not dominated by the US and the main European countries, and where all developing countries have space and voice.

The limits of the "responsible stakeholder" approach have been laid bare. Congress' hostility and the US veto rights in both the IMF and the World Bank mean that these institutions are not politically neutral, and the Chinese leadership is concerned about the fact that they can be held hostage to the anti-China sentiment in the US. As such, the international institutions that offer valuable space for negotiations have become less comfortable for China. Even the G20 seems to have lost its appeal, and the Chinese leadership no longer seems eager to be deeply engaged.

Against this background, what are China's options? The Chinese leadership has so far articulated its response around three points. First, it has defended international trade and globalisation against the US retreat. Second, it has been made clear that, in a world where the US is no longer the largest economy, action must be regional rather than global. Third, it has created regional institutions and initiatives, especially in development finance, both bilaterally and multilaterally, to establish a firm presence in Asia and offset US influence.

There are a number of risks that arise from China's response. The first is the fragmentation of the international financial architecture and reduced support for multilateralism, which has the potential to constrain the ability of the international institutions to provide international public goods. The second risk is that the stakeholders in the international financial architecture, especially those from developing countries, may look elsewhere for the delivery of the international public goods, turning away from the existing institutions and thus reducing their effectiveness. The third risk is that China may build an alternative institutional framework that explicitly includes the small and medium-sized developing countries as equal partners in governance. However, because of China's limited experience in institution-building, this is a low-probability, long-term scenario.

China still values being a part of the international financial architecture, but some areas of this architecture now appear to be disposable. For instance, development finance is where China has considerably increased its international and regional footprint and institutional engagement. Currently, the World Bank is a partner to AIIB projects and so helps with capacity building. This partnership is ultimately an endorsement of China's venture in institution-building. The case for the IMF is different. The constraints on the domestic financial and monetary system make the international financial safety net provided by the IMF necessary and non-disposable. Should China decide to force the issue and leave the Bretton Woods institutions out of frustration with the governance deficit and lack of progress, it would be easier to leave the World Bank than the IMF. This is, however, the worst-case option, not in China's best interests, nor in line with its approach to international commitments. Throughout the years, such an approach has been ambiguous rather than confrontational.

Given China's visible disengagement and benign indifference to existing financial institutions, **what is the most effective way to deal with China in the area of economics and finance?** According to US Secretary of State Antony Blinken, China poses a challenge to the rules-based system, and the US purpose is to uphold this rules-based order, "not to contain China, to hold it back, to keep it down" (quoted in O'Donnell, 2021). But, the G7 has been more conciliatory, urging China to "participate constructively in the rules-based international system" (2021).

This suggests that **an alternative approach to that embraced by the US would be possible.** China now has options that were unavailable twenty years ago. Accordingly, China likely expects that it can do and get away with more than before (Patten, 2021). It is therefore critical to continue to provide the space for dialogue and negotiations within the multilateral institutions. There is a role here for the advanced economies and like-minded countries to look for practical ways to deal with China. The G7, in particular, under the leadership of Germany in 2022, should take up this role and devise an engagement strategy.

But China is not a market economy nor a liberal democracy; its system, objectives, and incentives are not aligned with those of the G7. Hence, the challenge of dealing with China is to work out how to get the best possible outcome when engaging and collaborating with a partner whose incentives are not aligned with those of the post-war international liberal order. To achieve this, Germany and the other G7 countries should focus on finding areas of common interest where manageable and practical issues are at stake and where the risk of misunderstanding and tensions is low.

The focus should be on finding valuable opportunities for collaboration and thus delivering positive outcomes with practical implications. Drawing on the "responsible stakeholder" approach and its positive outcomes – such as the G20 London Summit, the IMF spillover report, the inclusion of the renminbi in the Special Drawing Rights (SDR) basket, and the Paris Agreement on climate – will help keep this on track. A G7 initiative led by the European members will have the additional benefit of showing that the liberal order is less US-centric than it used to be. Deeper engagement to promote common interests at the global level and reinforce cooperation in multilateral fora to "establish a rules-based system of global governance" (European Union External Action Service, 2020) is at the heart of the EU's China strategy (European Commission, 2019). Thus, Europe, which is China's largest trade partner and has a market of about 450 million people, could act as an honest broker between the US and China.[22]

There are already many instances where collaboration with China is the norm rather than the exception. Almost two decades of positive engagement have generated a way of working inside the multilateral organisations and the G20. Building on existing cooperation in economic and financial affairs, the best way to engage with China is to focus on concrete problems where common interests make collaboration possible. Climate finance, for instance, is an area where interests tend to converge. Debt relief and debt sustainability is another area where China has a large footprint and is willing to engage. The governance of debt relief and debt restructuring, in particular, is an urgent matter. There are too many "gaping holes" that often leave poor countries with limited options. The US Treasury now recognises this urgency and the necessity of making multilateral financial tools available to countries in need.

22 A common strategy towards China implies for the EU member states to look out for common interests rather than their own.

The European members of the G7 should also reiterate their support for the AIIB and their willingness to appoint senior and high-level people to take up positions at the bank. This would make clear that sound institution-building is not a matter of external circumstances, such as a favourable diplomatic context. Instead, institution-building is about promoting and abiding by good governance and standards. In doing so, the European members of the G7 would acknowledge and welcome China's initiatives in expanding the multilateral institutional framework and providing economic and financial public goods within such a framework. Further collaboration and partnership in co-financing between the AIIB, NDB, and the 'old' MDBs should also be encouraged and supported.

THE WAY FORWARD: AN EFFECTIVE GLOBAL FINANCIAL ARCHITECTURE

The world cannot function without China. China is a critical component of the international financial architecture as both a member of the international financial institutions and as an institution-builder. The interaction of these two dimensions has significantly shifted the international financial architecture's dynamics.

To fit China into the evolving international system, the Bretton Woods institutions need to be reformed. Achieving international balance in the global processes of economic rule-setting depends on this. At the same time, new institutions are needed to accommodate China's quest for better-distributed governance. Accommodating old and new institutions within the same system should result in improved, more balanced, and more inclusive provision of global public goods, defined here as development finance and global financial safety net.

Yet, China is not a market economy nor a liberal democracy. The challenge, therefore, for the G7 – but also for like-minded countries in the G20 such as Australia – is to work out how to get the best possible outcome while dealing with China. In other words, what can be done to encourage China to be a productive and engaged partner and thus create the conditions for harmonious coexistence with the rest of the world?

It is critical to identify low hanging fruit and work in areas where policy-makers who have been managing the international financial architecture have long-standing collaboration. Common interests should underpin the international dialogue and policy cooperation. This report identifies these interests in specific areas such as development finance and infrastructure investment, debt relief and debt sustainability, cooperation on strengthening domestic macroeconomic frameworks, economic growth and the challenge of environmental sustainability, and a strong and responsive financial safety net underpinned by a reformed and more representative IMF. More trade arrangements, especially at the regional level, and encouragement for better collaboration between the WTO and regional agreements would also be helpful (EABER-CCIEE, 2016: 236). Finally, action should be directed towards areas where there is some genuine learning from mutual engagement – for example, economic development.

China is undergoing a complex and gradual economic and social transition that will take another two or three decades to finish. In order to continue to fit China in the world economy, we need an institutional framework that is inclusive, rules-based, and organised around fair and effective governance. Countries should work collaboratively on global economic issues, and this mutual collaboration should be based on common interests rather than shared values. The risk otherwise is that the world's largest economies and China will head off down two separate paths with no way to converge.

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