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THE IFF CHINA REPORT 2020

Insight and perspectives from the world's leaders, premier policy-makers and financiers

- Financial stability
- China's opening-up
- The Belt and Road Initiative
- Green finance and fintech
- Regional and multilateral co-operation

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The importance of international co-operation

The troubled state of US–China trade relations acted as a brake on the global economy for most of last year. A US–China trade deal expected in the first quarter of 2019 failed to materialise, giving way to a ratcheting-up of tariffs and other protectionist measures throughout the year. As the trade dispute lengthened, it had a more lasting effect on global supply chain disruptions, and influenced new economic development plans for China, the US and third parties that engage in trade with both nations.

A 'phase one' agreement was finally reached in January 2020. This included assent by China to move away from forced technology transfers and offer foreign companies greater access to Chinese markets, plus a commitment to increase purchases of US manufacturing, energy and agricultural goods and services by US$200 billion over the next two years. The US, meanwhile, cancelled its plans for so-called 'penalty tariffs' it had scheduled for $156 billion of Chinese goods and cut the tariffs imposed in September 2019 on $120 billion of these goods from 15% to 7.5%. It also dropped its labelling of China as a 'currency manipulator' as part of the deal.

'Phase two' of the talks are ongoing. They aim to address issues related to cyber theft and US calls for changes in Chinese law to reinforce agreements reached during the trade agreement. In return, the US has promised to end its punitive tariffs on Chinese goods. These talks may be fraught, particularly when they are linked to issues related to sovereignty and future economic success.

The *IFF China Report 2020* offers insight by going behind the headlines. The report focuses on five main themes: financial stability; China's opening-up; the Belt and Road Initiative (BRI); green finance and fintech; and regional and multilateral co-operation. The *IFF China Report 2020* also includes the third annual BRI Survey of central banks, the results of which indicate that central banks still view the BRI as important in promoting global growth. They also see BRI investment as broadly sustainable in relation to other forms of external debt and say protectionist policies have yet to have an impact on BRI membership and investments – but this could change in the future.

By reaching a phase one trade deal, Chinese and US officials have demonstrated they can work together in a constructive manner, and promote an atmosphere for greater trust. The importance of co-operation and trust has once more been brought to the fore by the outbreak of coronavirus (Covid-19). China's lockdown now appears to be working, although it has come at great sacrifice to its people. Now the inhabitants of Europe, the US and elsewhere face a similar ordeal. Covid-19 knows no borders. Nations can effectively combat the latest threat to global development by sharing data, detailing optimal quarantine techniques and working together on clinical trials and the production of treatments and, hopefully, a vaccine. Multilateral efforts are essential to addressing issues related to illness, poverty and climate risks, and securing a safer and brighter future.

We are privileged and extremely grateful for the support of the global leaders, policy-makers, finance experts, business leaders, politicians and scholars who have contributed to and supported the publication of the *IFF China Report*. We hope it provides you with important insights and fresh perspectives.

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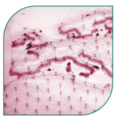

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China's opening-up

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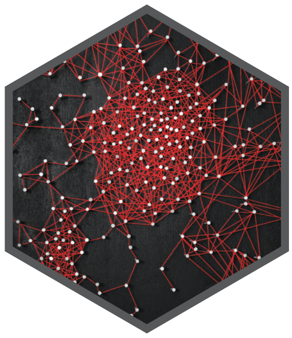

Regional and multilateral co-operation

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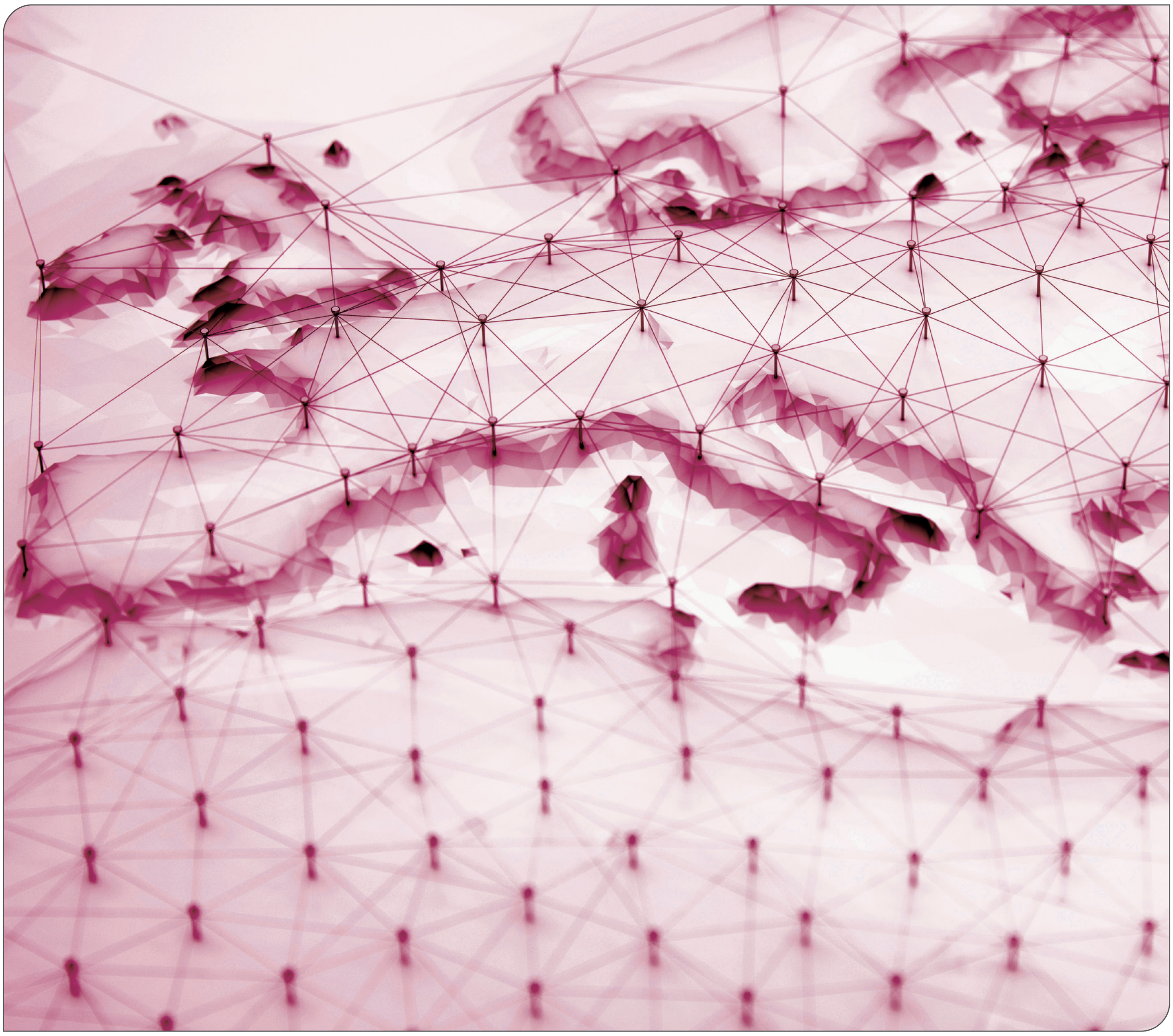
FINANCIAL STABILITY

Order or chaos? – Safeguarding multilateralism

Multilateralism has never been so important, or more under threat, says IFF co-chairman, former chairman of the European Council and former prime minister of Belgium *Herman Van Rompuy*. Perceived global economic harmony has only masked economic polarisation in nation states



Globalisation affects everyone, but its benefits pass many by. These people remain 'locals', with often sedentary and parochial outlooks. Globalisation polarises our societies between these locals and the 'cosmopolitans', who broadly benefit from and welcome globalisation. Sometimes this division can be overlaid on that between young and old, in which the cultural changes wrought by globalisation antagonise young people less. It also increases the division between urban and rural areas. Moreover, there is a danger that the growth poles of a new globalised economy will concentrate wealth and accelerate cumulative growth, while other regions fall into a downward spiral of deprivation.

Economic globalisation seems to have already peaked. This is partly because the global financial crisis of 2007–08 had already dealt a major blow to globalisation. Trade was in the doldrums before the US–China trade dispute. Between 2012 and 2016, the volume of global trade grew by around 3% a year, less than half the average rate of the previous three decades.[1] Since the financial crisis, a growing share of global trade has been subject to protectionist measures, creating new distortions, often in the form of state subsidies for exports. Cross-border flows of capital, direct investment and lending have also slowed over the past decade. Factors unrelated to protectionism have also weighed on trade: companies increasingly needing to control regulatory, reputational and political risk in their supply chains, which encourages companies to keep supply chains short and production close to market.

The aspect of globalisation most disruptive to Western societies is uncontrolled migration. Sometimes a fear of migration takes on irrational and disproportionate forms – such as nationalism, populism and protectionism. Migration itself is undergoing globalisation – on Europe's doorstep is Africa, where a demographic explosion could make it the most populous continent by the end of the century. It therefore has great potential for migration, far beyond the European Union's economic needs.

The perils of protectionism

New globalisation has had a major impact on economic growth and its distribution – at least on a global scale. It has never been possible to lift so many people out of extreme poverty in such a short time. This is the result of at least two movements: the global institutional framework aimed at opening up borders – particularly in the area of trade – and economic reforms in some countries that allowed them to benefit fully from global openness. Rich and poor countries strengthened each other: advanced economies provided employment for people from countries as yet undeveloped. The theory of comparative advantages played an important role. From a global vantage point, it was a win-win situation. But, as we have seen, global harmony goes hand in hand with internal polarisation, which has led to the questioning and even threatening of the legitimacy of the multilateral framework – globalisation itself.

What can be done to preserve multilateralism? First and foremost, the redistribution of the fruits of economic growth must be taken seriously, including at a national level. Social issues are once again at the heart of politics everywhere. It should be made clear that the process of 'creative destruction' need not inexorably lead to absolute or relative decline. A regional development policy can encourage new economic activities and retraining of the workforce, as the EU has successfully demonstrated in many of its regions.

Herman Van Rompuy

Freeing up market forces must go hand in hand with a compensatory regional policy; the market must be corrected by the public authorities. If, on the other hand, the government adopts protectionist measures, it disrupts the market to the detriment of consumers and their standard of living. Moreover, there is a risk of ending up in a game of 'tit for tat' directed against national economies and other producers not previously affected by globalisation. Above all, protectionism creates uncertainty for investment, which is the very engine of future economic growth.

However, this preference for openness can only be sustained if all countries comply with the rules of the game. The legitimacy of the multilateral system depends on both free and fair trade. If there are any disputes, they must be resolved by the proper mechanisms. Countries committed to multilateralism must be able to demonstrate that dialogue leads to conflict resolution; otherwise, the door is open to protectionist measures, even if they would be rationally counterproductive in the longer term. The EU's attitude is simply 'firmness and dialogue': respect the principles, but always be ready to speak.

The EU remains a strong supporter of rules-based trade, but developments in recent years have also raised awareness of the need for the EU to be less dependent on imported new technologies or on non-European companies in strategic sectors.

Globalisation also means strengthening interdependence, thus eroding national sovereignty. The EU is very familiar with this process. The UK is now exploring how it will continue to trade with other markets as well as the EU, which is currently the export market for half of its goods and services, following its secession from the EU.

It is no longer possible to have full control over policy when one is so dependent. The US, too, is aware there are limits to its own trade policy in view of the advanced state of the value chain and of international trade. This interdependence was spectacularly expressed during the financial crisis, which demonstrated how the movement of capital is even more global than that of goods and services. Only a collective effort by the Group of 20 and the International Monetary Fund (IMF) at regional and national level averted an implosion of the global financial system and far more serious economic consequences than a recession.

After overcoming the acute phase of the financial crisis, all countries reacted with an exuberant expansion of the money supply and an unprecedented reduction in interest rates to stimulate economic growth and avoid deflation. At the root of the financial crisis was a lack of banking supervision at national and international level; laissez-faire economics had made the system extremely fragile. Governments had to save the market economy by rescuing a large number of banks and by adopting a structural approach to banking supervision. Although most of the measures are still at a national level, international collaboration meant governments were working in the same direction.

There is now a danger that governments almost automatically revert to this type of policy when a problem arises: for example, the response to the trade war has been – and remains – a wave of expansive monetary policy. The recession is global and synchronous, and all global actors react in almost the same way. This type of monetary policy is becoming a substitute for all other policies.

Prophet warning

Politics lies at the base of the economic problem, which must therefore be solved politically. The current extremely low interest rates encourage exaggerated risk-taking on the part of individuals, companies and governments. The simple fact that the current level of global private and public debt is clearly higher than 10 years ago is a significant warning shot. A large proportion of this debt is down to non-performing loans in banks' portfolios. There is more government control over the known channels of credit, but also the market is 'crawling where it can't go' and is looking for ways out for those who want to take more risks. Before the banking crisis, there were low interest rates and little surveillance – an explosive cocktail. This danger has not completely passed.

Inflation remains low, so monetary authorities are more inclined to adopt an accommodative monetary policy. The prophets of doom predicting a resurgence of inflation have thus far not been proved right. Inflation – or a lack thereof – may now have more to do with supply factors (such as energy or wages) than with demand. Globalisation has changed the nature of inflation. In Western democracies, current monetary policy is also defended because a restrictive policy and the resulting recession would play into the hands of populists. In other countries, there is a fear of social malaise. Low interest rates, however, contribute to another type of dissatisfaction by affecting savers' assets. It creates tensions between older people living off the incomes of saved assets, and young people who are in debt and whose jobs are threatened by policies that are too restrictive.

Budgetary policy is also under pressure from populism. Austerity drags on incomes and slows down the economy and employment, which benefits populists. It should be borne in mind that, in the West, populism is on the left in socioeconomic terms, and on the right in sociocultural terms (migration). Political reasons therefore also determine monetary and budgetary policy. Even independent central banks do not work in a political and social vacuum.

Back to the abyss?

A 'normalisation' of monetary policy depends, to a large extent, on the solution of political problems – the sooner this happens, the better.

In the event of another financial crisis, it will be more difficult to formulate a global response because, in recent years, trust between global actors has declined sharply as a result of economic and political tensions. This negative climate is a handicap in crisis management and a brake on the rescue or strengthening of multilateral institutions.

New globalisation has had a major impact on economic growth and its distribution – at least on a global scale. It has never been possible to lift so many people out of extreme poverty in such a short time

It is a pity the international community was only able to act forcefully at a time of crisis, with its back to the wall and on the edge of an abyss. This is also too often the case within the EU. Strengthening and modernising multilateral institutions in normal times can reduce and even avoid the cost of a crisis.

One of the major global priorities today is to safeguard the functioning and existence of multilateral institutions. It is a choice between order and chaos. The modernisation of these institutions – in particular the World Trade Organization (WTO), is necessary to deal with new forms of market-distorting subsidies. The world has changed, but the WTO has not. In the case of the IMF, it is a question of further adapting to the new economic power relations. These reforms must give these institutions a new legitimacy. Like-minded countries can take initiatives, not against others but for a more stable world.

After the financial crisis, the G20 became more of a forum than a centre of decision-making – which was a disappointing development. The co-ordination of economic and monetary policy is almost non-existent. In addition, there are systemic problems such as the level of private and public debt and the impact on financial institutions.

Therefore, a need for global governance exists, though this will not take the form of a single new institution or a single government. Global governance will be the work of different institutions, each of which will include the main actors. However, this reform is only possible if a minimum level of confidence is restored, requiring efforts on all sides. Some bear more liability than others, but no-one is without responsibility. ⬢

1. *UN Conference on Trade and Development (2018),* Key statistics and trends in international trade 2018, *https://bit.ly/39Ih9HF*

Renminbi internationalisation – The new dollar?

It may be unstoppable, but renminbi internationalisation requires wisdom and foresight on the part of the business and financial services communities to consolidate the currency's achievements, says *Pan Gongsheng*, deputy governor of the People's Bank of China

In the 21st century – especially since the 18th National Congress of the Communist Party of China (CPC) in 2012 – China's economy has accelerated its integration with the rest of the world. Offshoring renminbi began with cross-border trade settlement and has expanded its international usage by successfully joining the International Monetary Fund special drawing rights (SDR) currency basket. The success of renminbi internationalisation has manifested itself in four ways.

First, the renminbi's payment function has become widely accepted. Since the beginning of 2019, the proportion of renminbi held in foreign currency cross-border receipts and payments has exceeded 30% – the highest level in history. The renminbi has also become the second-largest international payment currency in China for eight consecutive years. The proportion of international payments in renminbi reached 2.22%, ranking fifth worldwide.[1]

Second, the renminbi's functions in investment and financing have been consolidated. By the end of September 2019, foreign institutional investors held 2.5% of the total amount of bonds entrusted in China's interbank bond market, and 3.9% of the total market value of A-shares in circulation.

Third, the valuation of the renminbi continues to improve. Foreign trade, investment, international balance of payments and other statistics have been denominated in renminbi, and SDR bonds have been successfully issued. Commodity futures – including crude oil and iron ore – have been priced in renminbi and introduced to overseas traders. This has increased the renminbi's pricing power.

Fourth, the reserve function of the renminbi has transpired gradually. The renminbi is now the world's fifth official foreign exchange reserve currency, with more than 70 central banks adding the currency to their reserves. The share of renminbi in terms of forex reserves now stands at 2%.

Potential for development

At a macro level, China's sustained and sound economic development and steady financial opening-up have laid a solid foundation for the renminbi's internationalisation. Whether a currency can grow into an international currency depends fundamentally on the status and influence of the issuing country within the global economy and the confidence of the international community in it.

After the global financial crisis that began in 2007–08, China's economy took the lead in recovery and maintained a high growth rate. The renminbi is a high-interest currency and generally remains strong. At present, China's economic and financial fundamentals are sound: its economic structure has been continuously optimised; endogenous driving forces and resilience have been significantly improved; the balance of international payments are generally in equilibrium; forex reserves are sufficient; monetary policy remains stable and neutral; the renminbi exchange rate is able to fluctuate in both directions; and the steady development of renminbi internationalisation has solid macro support.

History shows that the most fundamental and main driving force of renminbi globalisation is the demand of market players to use it in trade and investment. As long as China remains an active trading partner, demand for the global use of renminbi will continue. The international use of renminbi has also provided enterprises and individuals with an alternative to the US dollar, reducing exchange costs and exchange rate risks, improving the efficiency of cross-border capital settlement, diversifying asset risks and providing diversified asset allocation options.

Considering the development of China's open economy and the demand of domestic and foreign investors, renminbi globalisation still has room for improvement. This is especially the case for investment, trading and reserves. For example, by the end of September 2019, total bond market custody in China was close to CNY100 trillion – already the second largest worldwide. Foreign investors held about 2.5% of bonds, far below the level of more than 20% in other developed economies and below the level of 10% in emerging markets.

Three principles of renminbi internationalisation

At the Fifth National Financial Work Conference in 2017, President Xi Jinping insisted the growth of renminbi internationalisation should be steady. The outline of the 13th Five-Year Plan (2016–20) also made it clear the renminbi should be convertible under the capital account in an orderly way, which would improve the degree of convertibility and flexibility, steadily promoting renminbi adoption overseas. The Fourth Plenary Session of the 19th Central Committee of the CPC, which concluded in October 2019, reinforced this discreet and steady approach.

Looking to the future, the People's Bank of China and the State Administration of Foreign Exchange (Safe) of the People's Republic of China will actively, yet prudently, accelerate renminbi internationalisation in accordance with unified arrangements set out by central government, focusing on the following three principles:

1. **Market-driven and demand adaptation.** Renminbi internationalisation is a natural and historical process. China should be guided by the principle of serving the real economy and facilitating trade and investment, and in line with the reasonable demand of market subjects. Renminbi promotion will therefore be achieved smoothly.

2. **Fair competition.** The policy framework and financial infrastructure for the cross-border use of the renminbi should be further improved to create a level and fair playing field on which the currency can compete with other convertible currencies.

3. **Good governance.** China will not stop its financial reform and opening-up strategies. In addition, China will co-ordinate its renminbi internationalisation and reform programme, and will open up by establishing an exchange rate mechanism, promoting capital account convertibility, strengthening capacity building in financial regulation and completing the macro-prudential management policy system.

China's financial reform programme and its aim to open-up to the rest of the world cannot be achieved without the wisdom and care of both the financial and business communities. Renminbi internationalisation has sailed successfully for a decade. The People's Bank of China and Safe are ready to continue to work with all parties to forge the stable and sustained development of China's local currency. ⬢

1. *Gao Haihong and Yu Yongding (2011), Bank for International Settlements,* Internationalisation of the renminbi, *https://bit.ly/2QhVGNq*

If it's broke, fix it

Han Seung-soo, IFF co-chairman, former prime minister of the Republic of Korea and president of the 56th session of the UN General Assembly, recognises the slowing of growth and the rise of transnational tensions, but insists the multilateral system is fit for purpose

In October 2019, the International Monetary Fund (IMF) downgraded global growth for 2019 to 3% – its slowest since the global financial crisis of 2007–08. The main reason given for this was rising trade barriers and increasing geopolitical tensions.

The IMF estimates that US–China trade tensions will cumulatively reduce global GDP by 0.8% by the end of 2020. Growth is also weighed down by country-specific factors in several emerging market economies, and by structural forces such as low productivity growth and ageing populations in advanced economies.

The weakness in growth is driven by a sharp deterioration in manufacturing activity and global trade, with higher tariffs and prolonged trade policy uncertainty damaging investment and demand for capital goods.

In contrast to extremely weak manufacturing and trade, the services sector fortunately continues to hold up worldwide. This has kept labour markets buoyant and wage growth and consumer spending healthy in advanced economies. There are, however, some initial signs of softening in the services sector in the US and eurozone.

The IMF projects a modest improvement in global growth to 3.3% in 2020 – a further downward revision of 0.2% from its April 2019 projections. However, unlike the synchronised slowdown, this recovery is not broad-based and remains precarious.

However, there are several downside risks to growth. Heightened trade and geopolitical tensions, including risks related to Brexit could further disrupt economic activity and derail an already fragile recovery in emerging market economies and the eurozone. This could lead to an abrupt shift in risk sentiment, financial disruptions and a reversal in capital flows to emerging market economies. In advanced economies, low inflation could become entrenched and constrain monetary policy space further into the future, limiting its effectiveness.

A deterioration in business sentiment, weakening economic activity and intensifying downside risks to the outlook have prompted central banks worldwide – including the European Central Bank and the US Federal Reserve – towards an easy-money policy. Weighted by GDP, around 70% of economies have adopted a more accommodative monetary stance.[1] The shift has been accompanied by a sharp decline in longer-term yields. In some major economies, interest rates are even negative.

Investors have interpreted central bank actions as a turning point in the monetary policy cycle. As the pace of global economic activity remains weak, financial markets now expect rates to stay lower for longer than anticipated.

Han Seung-soo

But loose financial conditions come at a cost. They encourage investors to take more chances in a quest for higher returns, and lead to a continued build-up of financial vulnerabilities – particularly in the corporate sector and among non-bank financial institutions. Even Warren Buffett is reported to be sitting on a massive cash pile of US$128 billion and not investing.

Very low rates have prompted institutional investors such as insurance companies, pension funds and asset managers to reach for yield and take on riskier and less liquid securities to generate targeted returns. For example, pension funds have increased their exposure to alternative asset classes such as private equity and real estate.

This situation poses a dilemma for policy-makers. On one hand, they may want to keep financial conditions easy to counter a deterioration in the economic outlook. On the other, they must guard against a further accretion of vulnerabilities.

What then should the world and China do at this time? Asia remains the fastest-growing major region in the world, accounting for more than two-thirds of global growth in 2019.[2] China alone accounts for 39% of global growth, India 16% and members of the Association of Southeast Asian Nations 10%.[3] In the global environment of low growth, Asia – with China in the leading role – emerged as the world economy's growth engine.

This development provides room for global economies to pursue difficult structural reforms. It is hard to deny that China's massive growth in the past decade was the single most important factor in alleviating negative spillovers of the global financial crisis into Asia, as well as many commodity-exporting economies in the world.

The role for China today

China is now a globally integrated $13 trillion economy, the actions of which have global reverberations. If China is to continue to benefit from globalisation and support the aspirations of developing countries, it will need to focus on how to limit adverse spillovers from its own policies and invest in ensuring that globalisation can be sustainable. China would likely serve itself well by addressing many of the policy issues that have thus far been contentious. These include:

- **Stronger protections for intellectual property** – This will benefit China as it becomes a world leader in advanced technologies and granting international patents
- **Reduced trade barriers** – Particularly related to investment rules and government procurement procedures, this will increase competition, reduce costs and enhance productivity – all benefiting the Chinese people in the long run
- **Acceleration of market-oriented economic reforms** – This will help China make more efficient use of scarce resources.

Palazzo Salimbeni in Siena, headquarters of Banca Monte dei Paschi di Siena, widely considered the oldest active bank in the world

During the Qingdao Multinationals Summit in October 2019, which was approved by the State Council of the People's Republic of China, and co-hosted by the Chinese Ministry of Commerce and the People's Provincial Government of Shandong, President Xi Jinping sent a message praising the further opening-up of China's markets. At the second China International Import Expo, held in Shanghai in November 2019, President Xi reiterated the further opening-up of China's economy by expanding imports and cutting tariffs.

It is also noteworthy that the new major Foreign Investment Law of the People's Republic of China, passed by the 13th National People's Congress in March 2019, came into force in January 2020. The new law replaces three foreign invested entities laws. It introduces national treatment and a negative system regime, and promotes and protects foreign investment and intellectual property rights.

However, the world cannot stand aside and let one country do all the hard work. We seem to be living in an era of doubt and questions about the global order. We have seen an erosion of trust in bedrock institutions at national, regional and global levels, a trend especially evident in the advanced economies of Europe and the US.

Digital and financial revolution

And yet multilateralism is our only way forward. Even though trade co-operation has driven an unprecedented period of growth and prosperity over the past 70 or more years, today it faces backlash – partly because too many people have been left out. Clearly, we need to de-escalate these disputes of inequality among nations and people. We must reform the global trading system to make it even better, fairer and stronger for all. That means fixing the system together – not tearing it apart.

In the area of advanced technology, for example, we know that the digital revolution presents both great promise and great peril. Biotech, robotics, artificial intelligence, the 'internet of things', big data, financial technology – known as fintech – blockchain and other advanced technologies will all create new industries and jobs.

Fintech, especially, is an area to take note of. Indeed, within a little over 10 years of smartphones appearing on the market, banks are being threatened by fintech as never before since the foundation of Banca Monte dei Paschi di Siena in northern Italy in the late 15th century.

This phenomenon is nothing less than a revolution in the financial sector – the first 'financial revolution'. Fintech certainly has the potential to unleash economic dynamism and reduce poverty – especially by providing financial services to the 1.7 billion people currently without access to banking. But again, it needs to be managed carefully to protect financial stability and safety and, since digital means global, will require a multilateral effort.

In this day and age, multilateralism could not be more important to improve the lives of all of the world's citizens and ensure the economic benefits of globalisation are shared much more broadly and evenly.

Multilateralism happens when governments and institutions are both accountable and working together for the common good. Only this can allow them to take on the many transnational challenges that no government alone – nor any small group of governments working together – can handle.

Working together, we will be better able to prevent a damaging downturn in the coming years and a dystopian future in the coming decades. With ingenuity and international co-operation, we can make the most of new technologies and new challenges and create shared and sustained prosperity.

1. *IMF (October 2019),* Global financial stability report: Lower for longer, *https://bit.ly/37LfgYP*
2. *Idem,* Regional economic outlook – Asia and Pacific, *https://bit.ly/37KFXwQ*
3. *Idem,* Prolonged uncertainty weighs on Asia's economy, *https://bit.ly/2sam2Za*

The long march to global growth

Liang Tao, vice-chairman of the China Banking and Insurance Regulatory Commission, says that China's growth is fuelling innovation and modernisation, but financial regulation and governance needs to be tightened up for China to take its place at the top table

Liang Tao

The Fourth Plenary Session of the 19th Central Committee of the Communist Party of China, which concluded in October 2019, formulated a comprehensive plan to uphold China's socialist system and accelerate the modernisation of the country's governance. This included changes to the financial sector, where requests for stronger governance will result in changes to the institutional structure of firms and ensure more stable financial development.

Financial stability – A global issue

Since the global financial crisis that began in 2007–08, regulators worldwide have viewed maintaining financial stability as a core task and adopted a series of measures, including improving monetary policy, strengthening supervision and optimising financial structures. The goal is to improve the governance and strengthen the stability of the financial system, and mitigate the destructive power of the crisis. The Financial Stability Board (FSB), the Basel Committee on Banking Supervision, the International Association of Insurance Supervisors and other international regulatory organisations have introduced a series of regulatory reform measures to improve regulatory standards and promote regulatory co-operation to enhance risk management capabilities.

At the same time, the global political, economic and financial landscape has become more complicated. Global economic growth is slowing, and the momentum of major developed and emerging economies has weakened. Organisations such as the International Monetary Fund and the World Bank have downgraded forecasts for global growth. In response to economic downturn, the US, Japan and other major economies have resorted to quantitative easing by pumping more currency into circulation and depreciating their local currencies, which has caused spillovers into exchange rates, capital markets stability and liquidity in emerging economies. In some countries, because of negative interest rates, the capacity for monetary policy was compressed. Many countries increased their fiscal expenditure, resulting in a sharp rise in government debt and ballooning deficits. Some are already facing financial difficulties, and others have adopted protectionist stances, increasing trade frictions that are further choking global growth.

Geopolitical risks are also threatening the stability of global economic markets. On the whole, global economic and financial risks are rising to a worrying level, the diminishing effect of economic stimulus policies poses a threat and the maintenance of financial stability will be a long march.

Steady as she goes

In recent years, China's financial supply-side structural reform agenda has been further advanced, and the corporate financial system has been running smoothly, its risks firmly under control. This has provided strong financial support for the steady and sound development of the economy.

On the whole, China has maintained financial stability thanks to a number of measures. First, policies to improve economic development have given China opportunities to enhance its financial services. Currently, new forms of industry, such as advanced manufacturing, IT, green environmental protection and 'resident services' – which are defined as those that contribute to the improved livelihood of the population – have increased the pace of economic growth. These new, thriving industries are now driving economic development, which allows greater innovation in the financial services sector. At the end of the third quarter of 2019, bank loans had grown year-on-year in high-end equipment manufacturing (42.1%), IT services (17.4%) and technology services (35.3%). The growth rate was significantly higher than that of all other loans. The outstanding green credit of major banks exceeded CNY10 trillion, accounting for almost 10% of all loans.

Second, China's macro policy has allowed more space for flexibility. Countercyclical mediation has been strengthened to within a reasonable range to ensure internal stability and economic performance. China has recently enacted various policies and measures for orderly structural deleveraging and maintained the stability of the leverage ratio, an important instrument for defusing financial risks.

Third, by mitigating and defusing accumulated financial risks, China's financial sector has gained further expertise. Over the past few years, measures have been taken to correct disorder and dislocation in the financial sector. Since 2017, regulatory bodies have reduced the number of high-risk assets by about CNY16 trillion, handled the risks brought about by the development of digital finance and clamped down on illegal financial activities, such as illegal fund-raising. Disorderly growth in the financial sector has, for the most part, been contained and financial risks are now under control. China is gaining more experience in preventing and defusing risks.

The financial industry has also sustained strong risk resistance, with major financial institutions, in particular, maintaining healthy operations. China's financial institutions have sufficient capital provisions – around CNY6.7 trillion – which exceeds 180% coverage. The capital adequacy ratio of commercial banks has reached 15%. The comprehensive solvency of insurance companies has reached 247%, with strong loss absorption capacity and risk resistance.

Finally, the banking industry has stepped up its monitoring of non-performing loans (NPL) – a total of CNY4.9 trillion over the past two years. The NPL ratio of commercial banks remains below 2%, leaving room for improved risk management. However, the development of the financial sector is unbalanced and remains inadequate: the quality and level of financial services to the real economy must be further improved to tackle the hidden dangers of weak corporate governance, insufficient risk prevention ability and risk management. It will therefore be necessary to further enhance the financial industry's governance capabilities to ensure the continued sound operation of the financial system and promote high-quality economic development.

Improving financial governance

To strengthen the governance of the financial industry, systemic financial risks must be resolutely prevented. Procyclical credit will likely increase the range of economic fluctuations. During economic downturns, the risk preference of financial institutions declines, which can increase downward pressure on the economy. We should further strengthen countercyclical mediation and encourage financial institutions to invest in the real economy. This can be achieved by introducing liability exemptions, incentives and assessments to enhance virtuous interaction between finance and the economy.

In addition, greater attention should be paid to preventing the spread of financial risks in financial markets and interbank networks. We will further improve the oversight of systemically important financial institutions (Sifis) and prudently handle institutions with high risk levels and low competition in their sectors. China will also guide financial institutions to strengthen the management of their counterparties, improve risk management and prevent the spread of risks by a single institution. It will enhance the governance capability of the financial industry, deepen its financial supply-side structural reform and improve its ability to serve the real economy.

At present, there are more than 5,000 financial institutions in China, but there are only a few types of institution with similar business models and concentrated client bases. While the problem of multi-financing and over-financing is serious in some popular industries, growing enterprises have less financial support. These enterprises, without appropriate collateral, cannot obtain effective financial services because the adaptability and inclusiveness of financial supply is insufficient. China's financing structure, financial institutional system, market system and production system must all be improved to offer more client-focused and market-driven services.

Small and medium-sized banks should improve their business models and carefully design new development strategies by targeting niche markets instead of those already saturated. The financial industry should make good use of emerging technologies such as blockchain, big data, artificial intelligence and cloud computing, which have the potential to solve the problem of small businesses being unable to to borrow money.

Corporate governance of financial institutions should also be further improved. A good corporate governance structure can magnify the initiative of shareholders, management, employees and other stakeholders. China should therefore combine its incentive and restraint mechanism, internal control mechanism and risk control system to establish a scientific assessment system that does not solely concentrate on quantitative indexes such as development scale and speed. Rather, the system should include indicators of quality development and ensure financial institutions are operating on the right track while remaining aware of external risks.

The importance of compliance

It is also necessary to strengthen compliance construction. China must position compliance in line with laws and regulation, and establish it as the bottom line for conducting business. Other institutions involved in financial activities must also abide by regulatory rules and bring them into their internal frameworks. We need to continue to enhance regulators' supervision capacity so activities of financial practitioners, institutions, markets and operations are delivered under the umbrella of law. Punitive costs must also increase to toughen up the enforcement of laws and regulation. Regulatory bodies must improve their capacity of foresight to identify potential risks in time and reduce risk losses and liquidation costs.

China needs to strengthen the establishment of an early warning mechanism for financial risks. This could include mandating financial institutions conducting stress tests under adverse circumstances and asking them to formulate operational risk response plans. We should take adequate measures to prepare for risks, and strive to identify, warn, detect and respond to risks at an early stage. We also need to better co-ordinate financial regulation, pooling regulatory resources and creating regulatory synergy to eliminate regulatory arbitrage and ensure the sound and steady operation of the financial system.

It is also imperative to strengthen international co-operation. After the global financial crisis, the FSB, the Basel Committee and other international organisations issued a series of international financial regulation measures aimed at eliminating weak links. Given the complex challenges facing the financial system, we should strengthen international co-operation once more and enhance macroeconomic co-ordination. We should take into account the realities of our economic development and implement regulatory measures consistently and effectively on a global scale.

At the same time, there is a need to improve oversight of Sifis. International co-operation is needed to improve the mechanism for handling cross-border risks and the capacity of the financial industry to govern and prevent and control risks in the spirit of financial openness, and maintain financial stability more effectively.

Strengthening financial industry governance to safeguard global financial stability is the responsibility not only of financial authorities, but also of every financial institution and participant. We need to support each other and work together. It is a blessing for China's financial sector that close attention is paid globally to its industry reform and regulation. Wisdom, common efforts and collaboration are required to strengthen the governance capacity of finance, maintain financial stability and achieve high-quality development.

Faster, deeper, newer

The Chinese economy is sprinting towards top spot in the global pecking order, but *Li Chao*, vice-chairman of the China Securities Regulatory Commission, says the Asian giant is adopting new methods to improve quality and efficiency

Li Chao

The international political and economic landscape is undergoing complex and profound change. Increasing economic uncertainties and destabilisation go hand in hand with downward economic pressure. But, at the same time, a new round of global scientific and technological evolution and industrial transformation has emerged, injecting new impetus into economic development.

In this environment of new challenges and transitions, China is adhering to a fresh development concept, deepening supply-side structural reform and resorting to new methods of improving the quality and efficiency of economic development.

As an important part of the modern financial system, capital markets play a unique role in reducing the macro leverage ratio. They also support scientific and technological innovation, and accelerate industrial restructuring. Consensus is that deepening reform of the capital market will result in high-quality economic development. Thus, the increasing demand of investment and financing required will improve the investment and financing system.

Reforming the real economy

In accordance with the overall plan to deepen financial supply-side structural reform, since the beginning of 2019 the China Securities Regulatory Commission (CSRC) has advocated that the direction of marketisation and legalisation be in line with international best practices and comprehensively support the development of the capital market. The CSRC prioritised the optimisation of capital market supply and took the following measures to address any challenges between the financial sector and the real economy.

First, the CSRC launched the Science and Technology Innovation Board (Star Market) and implemented reforms around the listing system. Since July 2019, the Star Market has been operating smoothly, with 56 listed companies and a market value of more than CNY700 billion. After the reforms, the basic system of issuing, listing, trading and continuous supervision has withstood market tests.

Second, the CSRC is creating a favourable policy environment, conducive to direct financing and the normalisation of newly issued shares. In 2019, the CSRC revised the *Measures for the administration of the material asset restructurings of listed companies*,[1] which allows eligible enterprises to be reorganised and listed on the Growth Enterprise Market (GEM). *Several provisions on the pilot program of listed companies' spin-off of subsidiaries for domestic listing* have been recently completed and public opinion is being solicited.

Third, the CSRC has extended the two-way opening-up of the Chinese capital market to the outside world, announcing nine measures – of which six have already been implemented, including easier access for foreign investors to securities investment and funding custody business, reform of full circulation of H-shares, and expanding the range of futures. A-shares were smoothly added to FTSE Russell, Standard & Poor's, the Dow Jones Industrial Average and other international indexes. In addition, the Shanghai–London Stock Connect and Sino–Japan ETF [exchange-traded fund] Connect programmes were officially launched. In the first 10 months of 2019, 143 companies in Shanghai and Shenzhen completed an initial public offering, raising a total of CNY162.4 billion of financial capital. Listed companies achieved CNY839.4 billion of refinancing, and the total value of mergers, acquisitions and restructuring transactions across the market reached CNY1.42 trillion. A total of CNY6.16 trillion of bonds were issued on the exchange market, including CNY2.59 trillion of corporate bonds. All of these figures exceeded the 2018 total.

In recent years, foreign capital has continued to flow into the Chinese stock and bond markets. More than CNY240 billion of foreign capital flowed into the stock market, indicating that international investors have long-term confidence in China's capital market reform and sound economic development.

The Guangdong–Hong Kong–Macao Greater Bay Area (the Bay Area Development) has the highest degree of openness and the strongest economic vitality in China. It is also the frontier for the high-quality development of a capital market service economy. Historically, the formation of world-leading bay areas and city clusters cannot be separated from mature, efficient, innovative capital and a strong financial intermediary service system.

The Ping An International Finance Centre in Shenzhen, Guangdong Province, where the number of securities, fund, futures, accounting and law companies is among the highest in China

The Bay Area Development has always maintained close ties with and mutual support to the capital market. As for listed companies, by the end of October 2019 there were 563 A-share listed companies in the Bay Area Development – 15% of China's total – worth CNY10 trillion, representing 18% of the total market value. Intermediary agencies have considerable scale in this region: the number of securities, fund and futures companies registered in Guangdong Province is among the highest in China, combined with a large number of accounting and law firms.

With the launch of the Shanghai–Hong Kong and Shenzhen–Hong Kong Stock Connects, and the Mutual Fund Connect, the Bay Area Development has become an important bridge to deeper connectivity between the financial markets of mainland China, Hong Kong and Macao. In general, the capital market is playing an increasingly important role in co-ordinating the development of Guangdong, Hong Kong and Macao.

Moving forward

The Fourth Plenary Session of the 19th Central Committee of the Communist Party of China, which concluded in October 2019, reinforced explicitly how capital markets should be constructed, and outlined the characteristics of a modern financial system: high adaptability, competitiveness and inclusiveness. This should ensure the prevention or diffusion of economic and financial risks. Led by the CSRC, these principles have become the core of China's institutional reform agenda. The aim is to establish healthy, effective and high-quality economic development.

In the future, the CSRC will further extend its breadth of coverage to enhance the inclusiveness of China's multilevel market system. It will prudently enforce admittance to the Star Market by supporting and encouraging science and technology enterprises with core technology and high market recognition. Three reforms – that of the GEM, a pilot registration system and the reform of a new over-the-counter market – will continue. To achieve synergetic and co-ordinated development among markets at all levels, the CSRC will support qualified regional equity markets to carry out trials for institutional reform and business innovation.

Second, the CSRC will expand the Star Market pilot. Information availability and transparency will be key to enforcing effective regulation and efficient resource allocation, which will accelerate the formation of a market-oriented pricing mechanism for issuance. The CSRC also aims to establish mechanisms for enquiry, pricing and placing – with institutional investors as the main participants – and improve the system for refinancing mergers, acquisitions and reorganisations.

Third, the CSRC will continue to strengthen supervision, promote the construction of the primary market system and improve the quality of listed companies. It will optimise the increment, adjust the stock and unclog the diversified delisting channels – all while speeding up the construction of high-quality investment banks. For this to be successful, the CSRC has committed to harmonising divergent regulatory measures and improving the service capacity and core competitiveness of industry institutions.

By 2020, restrictions on foreign equity ownership of securities, futures and fund companies will be completely lifted. There will also be a revision of Qualified Foreign Institutional Investor and Renminbi Qualified Foreign Institutional Investor programme rules – the barriers to entry will be lowered and the scope of investment expanded. The CSRC will open up the exchange and bond market through easier access, expand the scope of investment and diversify entry channels for foreign capital. Meanwhile, in its supervision and risk control capacity, in particular cross-border law enforcement, the CSRC will ensure co-operation is improved.

Constructing a legal framework to optimise the ecological environment of the capital market is also a goal for the CSRC. The authority is determined to protect the legitimate rights and interests of investors; it therefore needs to establish a class-action litigation system that will introduce legal institutions for the capital market. The cost of and punishment for violations should be increased to strengthen legal enforcement. Through strengthened supervision and institutional reform, China's capital market will become a reliable and valuable market for all types of investors.

1. *CSRC (July 2014),* Measures for the administration of the material asset restructurings of listed companies, *https://bit.ly/2RAgDTP*

No country is an island

With the World Trade Organization's rule-enforcing capabilities on ice and the US pursuing the path of unilateralism and isolationism, *Ernesto Zedillo*, former president of Mexico and director of the Yale Center for the Study of Globalisation, asks how the multilateral rules-based system can survive

World leaders at the April 2009 G20 summit in London established an ambitious agenda to strengthen global economic governance, but these goals failed to be met

New globalisation and new economic governance sound provocative, but do we really have new globalisation? Unfortunately, the answer is no. In reality, the world is facing the huge risk of deglobalisation, which requires serious consideration.

Before the onset of the global financial crisis in 2007– 08, there were already symptoms of weakening globalisation. But, at that time, it seemed clear these were happening for structural reasons. In the late 1990s and the early part of this century, China had completed its first phase of intense participation in the global economy, and the economies of Central Asia, the Middle East and Eastern Europe had already engaged in the global economy. These were important engines for the growth of globalisation or economic interdependence.

The financial crisis forced a slowdown in globalisation. It also slowed down trade, which made a slight recovery before faltering again in 2017; at this time, we saw the financial crisis mirrored in trade's weakened growth compared with global GDP.

The question now is, are we facing a strengthening in global economic governance? Again, the answer is definitely no.

Dereliction of duty?

Beginning in 2007–08 and into 2009, a painful financial crisis affected economies worldwide. The leaders of the Group of 20 acknowledged, at the first G20 summit in Washington, DC, in November 2008, that the root of the crisis lay in the lack of co-ordination and coherence among the macroeconomic policies of the key economies. In response, the G20 committed to strengthening and enhancing international co-ordination to mitigate the risk of a new crisis. The G20 – particularly at the London summit of April 2009 – established an ambitious agenda to strengthen global economic governance. Unfortunately, this momentum was not maintained.

The G20 agenda adopted 10 years ago failed to accomplish much. Important adjustments to international financial regulation were made but, in all other aspects of that agenda, the G20 failed to deliver.

Instead, financial institutions such as the International Monetary Fund and the World Bank enhanced their capacity to perform their duties. But these institutions also failed to implement significant reforms.

At the Pittsburgh G20 summit in September 2009, world leaders claimed that the Doha Development Agenda – a trade negotiation of World Trade Organization (WTO) nations that commenced in 2001 – would be concluded before the end of 2011. However, as we know today, those talks are dead. My concern now is that we are not really strengthening global economic governance.

The global economy still faces significant risks. Almost all financial leaders and experts at the International Finance Forum concur that the global economy is in a slowdown that could eventually cause a synchronised recession. The financial system will be the weakest link. Should this occur, we will see – as we saw in 2008 – that the crisis was caused by avoidable problems. We need a globalised economy, we need economic interdependence and we need strengthened global economic governance.

Sadly, today we are further from global economic governance than we were 10 or 12 years ago. Despite the latest crisis, key players in the global economy have neither the ambition nor the political will to strengthen global governance.

In fact, the current rules-based multilateral system is under unprecedented stress that not only weakens its efficiency but threatens its very existence. This critical situation is most unfortunate, considering international governance and institutions agreed and constructed over many decades, although far from perfect, have supported the pursuit of peace, security and the protection of human rights as well as economic and global social progress.

The multilateral system has been useful for all countries: weaker countries preferred to interact with all the nations, according to rules and institutions, for their interest to be considered – even if inefficiently in the end. For stronger countries, the case is no less compelling; obliging others to co-operate on issues of their own national interest by means of international agreed mechanisms is less costly and more reliable than the use of unilateral imposition of force, which invariably leads to the acrimony and resentment that could undermine their economic and geopolitical position.

Notwithstanding the proven value of the rules-based international system – on fronts from nuclear disarmament and non-proliferation to climate change mitigation and the regulation of international trade – is being severely challenged.

Ironically, the most significant aggression against this system is being led by the US – which designed, constructed and benefited enormously from it. Termination of the Intermediate-Range Nuclear Forces Treaty between the US and Russia; withdrawal from the nuclear deal with Iran – known as the Joint Comprehensive Plan of Action – and the 2015 Paris Agreement on climate change; departure from the Human Rights Council and Unesco; reduction or cancellation of funding for numerous multilateral instruments; and unilateral and arbitrary erection of trade barriers are examples of actions undertaken by the US government that are eroding and seriously compromising the strength of international law and institutions.

Unfortunately, the reaction of other influential powers to mitigate that harm to the multilateral system by the US offensive has been muted, and in some cases erratic, unco-ordinated and unilateral – frankly, counterproductive. Whether that has been through omission or commission, countries still have gravitas and resources and their own national interest to protect the international rules-based system, instead of watching its demise.

Ernesto Zedillo

A brake on progress

Only in exceptional circumstances have countries with the economic and geopolitical capacity to make a difference in response to US escalation proposed reforming and strengthening international institutions. Most have opted to negotiate bilaterally with the US. In this regard, it is at the price not only of legitimacy of the existing multilateral frameworks, but also of the capacity to fulfil their goals.

The consequence of subordinating rather than modernising the international order could have enormous and negative consequences for the pace of human progress – a regression from the rules-based system into power-based mechanisms to address international disputes. All the matters will not be resolved in a safe, predictable and propitious environment for any country. Rather, this would lead to higher costs and greater impediments for every stakeholder within the global order, irrespective of their might. Power-based mechanisms of interaction among countries would prove – as has historically been the case – expensive, likely to cause conflict and even tragic for all those involved.

All countries – the US certainly included – should rectify the present trajectory of the multilateral system rather than replicating the US's unilateralism and isolationism. Governments must engage in negotiations and agreements to sustain the co-operative framework that has already been established to confront common challenges.

Although the stresses and threats to the multilateral system are numerous, urgent and exceptional, co-operative action must be stepped up in two multilateral areas: climate change mitigation and the trading system.

In view of the US formal notification of the withdrawal from the Paris Agreement, the remaining signatories must be urged to both enhance their commitments to reduce their carbon dioxide emissions and adopt rigorous monitoring of compliance. This escalation is urgently needed, considering that current commitments are not just insufficient but – for many countries – unlikely to be achieved at the current level of compliance.

In addition to starting unjustified and illegal trade wars, the US government has been blocking the appointment of new members of the Appellate Body of the WTO dispute settlement mechanism. Without new appointments, the number of judges is below the necessary amount to rule on an appeal. The result is a collapse of the dispute settlement capabilities the WTO has wielded since its creation. Consequently, it is urgent that the WTO membership must reach the decision to resolve the majority voting to appoint the necessary new judges to the Appellate Body.

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CHINA'S OPENING-UP

Open wide

Sun Shilian, research fellow at the Research Center on World Issues of Xinhua News Agency, says China has made great headway, but further prosperity depends on stronger two-way liberalisation and the relaxation of capital markets

Since its establishment, China's capital market has not ceased its efforts to open up. In recent years, it has seen ever more accelerating movement and profound reform.

In February 1992, the first B-shares – in Shanghai Vacuum Electronics – were publicly issued on the Shanghai Stock Exchange, marking the inauguration of the opening-up of China's capital market. The Qualified Foreign Institutional Investor (QFII) programme was established and resulted in the emergence of H-shares in Hong Kong. In December 2002, China further opened its capital market with the *Provisional measures on administration of domestic securities investments of QFII*, jointly issued by the China Securities Regulatory Commission (CSRC) and the People's Bank of China.[1] Under the QFII programme, foreign institutions were able to directly invest in China's securities market within the quota permitted by the State Administration of Foreign Exchange (Safe).

In December 2011, the CSRC, Safe and the People's Bank of China released the *Measures for pilot domestic securities investment made by Renminbi Qualified Foreign Institutional Investors* (RQFII) *of fund management companies and securities companies*.[2] This allowed foreign institutional investors to carry out renminbi-based investment in the domestic securities market within the permitted quota: a great stride forward, yet still an opening-up in only one direction.

With investors and the domestic market maturing, China accelerated the gradual opening-up of the capital market with more depth and width – this time in both directions. In November 2014, the Shanghai–Hong Kong Stock Connect programme was officially launched as a bridge between the two stock exchanges. This proved the first movement of the two-way opening up of China's capital market and also laid the foundation for the operation of the Shenzhen–Hong Kong Stock Connect and Shanghai–London Stock Connect programmes, which were launched in December 2016 and August 2018.

After the establishment of QFII and RQFII mechanisms, the permitted quota amount grew rapidly. Restrictions on the investment quota of QFII and RQFII were abolished by Safe in September 2019, and restrictions on the pilot countries and regions of RQFII were also cancelled.

2019 – A year of accelerating opening-up

Since March 2019, A-shares have been included in the MSCI, FTSE Russell, Standard & Poor's, Dow Jones and many other international indexes. At the same time, China continues to open its renminbi-denominated bond market and move even faster. Remarkable outcomes have been achieved throughout 2019.

In January, Standard & Poor's was admitted into the Chinese credit rating market and, in April, several Chinese bonds joined the Bloomberg Barclays Indices. To further facilitate foreign institutional investment in the domestic interbank bond market, the People's Bank of China and Safe jointly announced new rules in October that allowed the non-transacting transfer of bonds under the same overseas entity (QFII/RQFII), direct entry channels and transfer between capital accounts. The rules also stated that the same overseas entity entering the market through these channels only needed to file a single record once. Thanks to these preferential rules, overseas institutions are flooding into the Chinese bond market. In November, there were 2,517 institutions in the domestic interbank bond market – double the number at the end of 2018.[3]

Li Chao, vice-chairman of the CSRC, commented at the 2019 annual meeting of the International Finance Forum (IFF) that, in recent years, overseas capital has continued to move into China's stock and bond markets, including over CNY240 billion into the stock market alone, reflecting the confidence in China's reform of the capital market and the sound long-term development of China's economy (see *Faster, deeper, newer*, page 18). China has significantly relaxed foreign equity restrictions, allowed overseas institutions to open fully funded enterprises and has moved forward to mutual recognition of financial products and tools. All of these efforts serve as evidence that China has entered a new phase of opening-up.

A key milestone in the development of China's capital market occurred in June 2019, when the Science and Technology Innovation Board (Star Market) was officially launched. The next step for the Chinese government will be to further facilitate Shanghai's genesis as an international financial centre, with emphasis on supporting Shanghai to phase out foreign ownership limits in securities and fund management companies, thus expanding the business scope of foreign financial institutions. No matter how circumstances change, the CSRC is committed to building a business-enabling environment based on market principles, governed by law and adhering to international standards, and will firmly promote the opening-up of the capital market. In June, an agreement for a Sino–Japan ETF [exchange-traded fund] Connect programme was signed, opening the door for Chinese investors to the Japanese ETF market. In July, the Financial Stability and Development Committee under the State Council of the People's Republic of China revealed 11 measures to open the financial sector, including the lifting of restrictions on foreign ownership of securities, fund management and futures companies by 2020.

A profound impact

Without the development of the capital market and its ability to channel finance, the economy and its enterprises will lack sufficient foundation to thrive, resulting in a shortage of new job opportunities. The capital market is able not only to fulfil the financial demands of government, enterprises and other participants, but also to create investment opportunities for capital suppliers. A globalised capital market is also critical for cross-border enterprise financing, fund investment and asset management.

Zhou Xiaochuan, IFF chairman of the general assembly and vice-chairman of the 12th Chinese People's Political Consultative Conference, said at the IFF 2019 Annual Meeting that a strong capital market is necessary to distribute savings, improve efficiency and prevent the market from becoming divided.

Also in attendance was Sultan Bin Nasser Al Suwaidi, IFF vice-chairman and former governor of the Central Bank of the United Arab Emirates, who said that the opening-up of the capital market was essential, without which economies would not prosper, especially small and medium-sized businesses.

Martin Scheck, IFF board member and chief executive of the International Capital Market Association, pointed out that the opening-up of an emerging economy's capital market can make the economy itself more open, increasing fund sources, easing the burden on the banking system and enabling the fund to move in a freer, more convenient manner (see *Access all areas – Tapping into China's capital markets*, page 32).

Chen Chunyan, secretary-general of the Asset Management Association of China, noted that the opening-up of China's capital market should include more efforts to bring in overseas financial resources, and that the domestic market, with a mere 30 years' development, should learn from overseas counterparts about risk management, investment strategies, analysis of the market and investor education, among other areas.

Zhan Yuyin, chairman of E Fund Management, which issued one of the first four China–Japan ETF funds, said opening-up is a process of mind emancipation that would affect market participants' behaviour in investment, management, supervision and operation. This is key to transforming mechanisms and establishing a vibrant and resilient capital market. Because of differences in the development stage, legal system and basis of financial infrastructure, the opening-up of the capital market – especially in emerging economies – may inevitably encounter some barriers.

Sultan Bin Nasser Al Suwaidi added that the globalisation of capital markets makes markets more interdependent, and risks may also cause contagion.

Zhu Ning, IFF co-secretary-general, said that, first, in the process of opening-up, overseas investors are better at predicting capital market trends and making decisions than domestic investors. Second, evidence clearly shows that institutional investors have stronger investment capabilities than individuals and, third, experience has proved that individual investors have many flaws in their investment behaviours.

1. *CSRC and the People's Bank of China (December 2002),* Provisional measures on administration of domestic securities investments of QFIIs, *https://bit.ly/2NZosBh*
2. *CSRC, Safe and the People's Bank of China (December 2011),* Measures for pilot domestic securities investment made by RQFII of fund management companies and securities companies, *https://bit.ly/36zdKrD*
3. *Xinhua News Agency (December 2019),* Overseas institutional investors up investment in Chinese bonds, *https://bit.ly/2GqFAf9*

Feeling the stones – A brave transition to openness

Kevin Rudd, IFF co-chairman and former prime minister of Australia, is impressed by the transformation of China from a state-planned monolith to a vibrant, enterpreneurial economy – and hopes such reforms will continue

Kevin Rudd

Looking at China's reform and opening-up over the past 40 years, we are deeply impressed and see the evidence on the ground when we travel there.

In the early 1980s, China represented 2% of global GDP. It now represents about 16%. At that time, China was, by any measure, a poor country. It has since transformed itself into the middle-income – in some respects, upper middle-income – country it is today. The World Bank recently reported that 850 million people have been lifted out of poverty.[1] This has been made possible by a succession of Chinese political leaders deciding that the market economy had to occupy centre stage in China's reform process – in goods markets, product markets and labour markets – and certainly in financial markets as well.

The nation has undergone an impressive transformation. Consider the psychological challenge undertaken by young Chinese entrepreneurs previously employed by a central government department, and who grew up in a culture of state-owned enterprises (SOEs). These people have left the comfort and security of government employment and built their own enterprises, and then taken the first tentative steps into the global marketplace following the 'Go Out' policy. This has all been anchored to a single underlying principle: the discipline of the markets that can succeed or fail on the strength of their competitive success – or failure – in an open marketplace.

China emerged from its post-1949 tradition a planned economy. In a series of long-lasting debates in the 1980s and 1990s, the leadership considered the role of markets and planning, and whether China should transition to a market economy. But the paramount leader of China between 1978 and 1992, Deng Xiaoping, always had the same response: "We are going to find the balance between what the state does through planning, and what the market does by crossing the river, feeling the stones one by one."

There is a continuing role for state investment in national infrastructure, but a declining role for SOEs, particularly in non-infrastructure sectors of economy. Meanwhile, private firms are increasingly important in labour-intensive, low-wage manufacturing for exports. By 2013, there was a recognition by Chinese national economic planners that the model had to change and a new economic model sought. The international community looked carefully at the the market reform document of the Third Plenary Session of the 18th Central Committee of the Communist Party of China (CCCPC) in 2013, which attempted to ensure further reform of China's economy and to further embrace the principles of the market – not just in the financial sector, but across the entire economy. There are 66 sets of reforms, one of which deals with financial sector reform. These methods are inspiring because the Chinese economic model is not static but continues to change dynamically to meet the demands of the future.

In 2015, for a variety of complex reasons, instability threatened the Chinese financial market. Policy-makers in China responded quickly in August that year, with economy-wide market-based reforms, particularly in the financial sector.

There was a slowing of the reform process in the years that followed, but the past 24 months have seen an uptick. Considerable progress is being made in the financial sector, such as announcements in 2018 and 2019 to release a timeframe on removing caps on foreign equity in financial markets in 2020.

China is moving in this direction because the efficiency of capital allocation in the Chinese economy remains low. The capital intensity of a given unit of production is around one-third that of a fully functioning, market-based financial system. Driven by a greater foreign market presence in all areas of the financial services industry, the Chinese leadership has decided to increase financial sector reform.

The Great Hall of the People, the political hub of Beijing

In certain areas of the financial industry – such as digital finance – China has not only caught up but has become a global leader. However, other sectors of China's reform programme remain slow. Its competition policy – a fundamental principle in any approach to market economics – is another classic case in point. So far, there has been very uneven progress, which has brought private equity into existing SOEs.

Headwinds against progress

The growth of the Chinese economy over the past few years has slowed considerably. The trade war with the US creates a headwind against China's growth, but it is not the only one. Another are the drivers of the growth itself. On the positive side, direct state investment in Chinese infrastructure has declined by almost 20%. In many areas, infrastructure spending had reached capacity, in some instances, resulting in overbuild. The decline in investment in infrastructure is therefore a welcome development. On the other hand, Chinese domestic consumption – which is to become the primary driver of economic growth under the new model – has been growing, but not fast enough to offset declining state investment.

Another significant factor is the slowing in private fixed capital investment by private firms, suggesting challenges to China's overall growth performance. The change appears to be a result of uncertainty among Chinese private sector participants around the final balance between the role of state planning on the market, state or private allocation of capital, or the relative competition policies standing between private firms and SOEs in the future.

Many private firms are adopting a cautious approach towards capital usage instead of further expansion at home and abroad. This change in private fixed capital investment behaviour is also contributing to slower Chinese growth.

As Chinese leaders organise the 14th Five-Year Plan (2021–25), which will be determined in the first half of 2020, the essential question for Chinese private firms and the international marketplace will be the future role of the market in China's evolving economic model.

At a recent meeting I attended at the Great Hall of the People in Beijing, President Xi Jinping spoke on the continued importance of the role of the private sector and the market. But the private sector and international financial markets will be looking for more than speeches: they are seeking actual policy changes that will shape the future of domestic markets in general – competition policy, in particular – and the liberalisation of China's domestic capital markets.

For the world at large, including China's private sector, there is an open question on everyone's mind: Which way will China now go? Will the government retake the decision of six years ago at the Third Plenary Session of the CCCPC to deepen reform and opening-up? Will it continue to use the current economic model? Or will we see a greater role for the state sector and a lesser role for the private sector in the future?

It is likely Chinese entrepreneurial firms will take on a greater role in driving growth in the future. These firms have already pushed forward growth over the past 40 years. Currently, 60% of China's GDP, 80% of employment, 70% of tax take and probably 90% of innovation comes from these extraordinarily dynamic firms. But, as we look to the next five years – will this trend change?

1. *The World Bank (December 2019),* The World Bank in China, *https://bit.ly/3ab0P26*

Coming of age

Chen Wenhui, IFF vice-chairman and vice-chair of the National Council for Social Security Fund, considers how the ageing population of China is leading to a demographic deficit, and the diversified allocation techniques that are being applied to tackle the rising grey tide

Compared with other countries, China has a large and ageing population. The government closely follows the development of ageing issues, and continues to improve the aged care welfare system. From 1997 to 2011, the primary pension schemes – the basic pension insurance system – covered 950 million people, and the fund balance today is more than CNY5.81 trillion (see figure 1).[1]

In 2000, China established the National Social Security Fund (NSSF), a strategic reserve fund intended to supplement and support the basic old-age insurance system during the peak period of population ageing. Currently, its assets total around CNY2.27 trillion.[2] The establishment of the basic pension insurance system and the reserve fund fulfils the basic needs for public welfare within the limited fiscal expenditure framework, and prevents the surfacing of social risks during China's structural transformation.

However, China faces the dilemma of people ageing before they attain wealth. This problem has emerged as the economy is insufficiently developed and income levels remain relatively low compared with those of Japan, Europe, the US and other developed nations. The current pension reserve in China is approximately CNY1.1 trillion, accounting for only 1.6% of GDP – far lower than the average of 50.7% in Organisation for Economic Co-operation and Development (OECD) countries (see figure 2).[3]

The basic pension insurance system accounts for 83% of reserves, while the remaining 17% comprises enterprise and occupational annuities, personal savings and commercial insurances. Thus, the government shoulders the majority of the costs, raising concerns that the growth of the elderly population in China will soon squeeze its fiscal capability. China has therefore been promoting alternative avenues of funding and the pension asset management industry should be able to enjoy new opportunities for rapid growth.

Risk control in pension funds

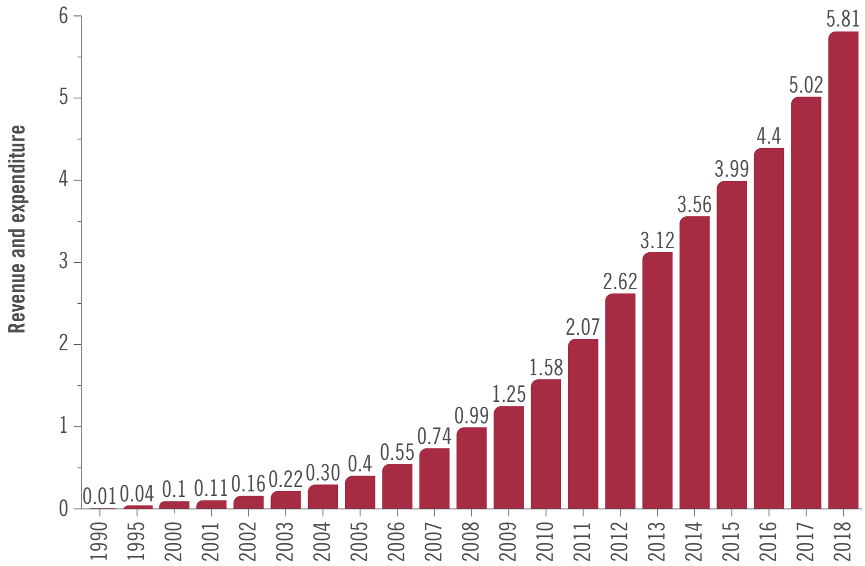
From the perspective of investment operation, the NSSF was the first market-based investment and, over the past 20 years, has averaged an annual return of 8.05%, achieving its goal of maintaining and increasing pension reserves.

Until August 2015, the basic pension insurance system would invest only in bank deposits and national bonds, so the yield remained relatively low. Since then, the Chinese government has enhanced its investment operations and expanded the investment scope. In addition, pension fund investment and operation was entrusted to the National Council for Social Security Fund (NCSSF). As of October 2019, it has signed investment commission contracts with 18 provinces, districts and municipalities worth CNY966 billion.

The accumulated volume was expected to exceed CNY1 trillion by the end of 2019, and the current average annual return has reached 5.89%. On the other hand, the enterprise annuity, which invests in a broader scope, commissions qualified asset management enterprises, including fund management enterprises, to carry out investment and operations. This path has led to an average annual yield of 6.97% in the recent decade – far higher than the inflation rate.

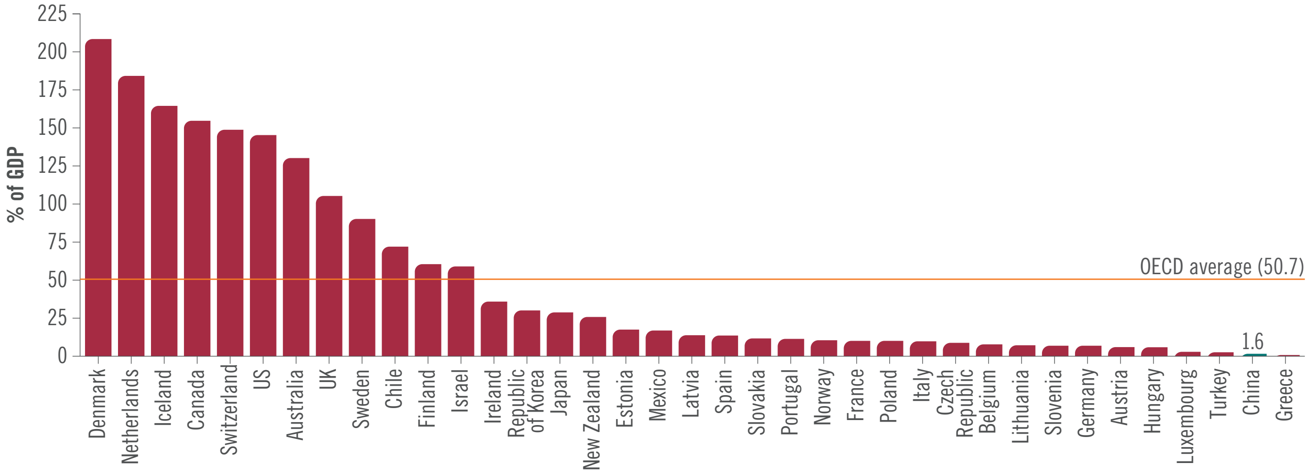
The pension's strength lies in its large volume and its long-term outlook, its low risk appetite and its strict supervision. Financial institutions that participate in pension fund business have to fully understand the features of the pension to conduct relative investments.

Figure 1 – Balance of basic pension insurance funds in China (CNY trillions)



Source: The Ministry of Human Resources and Social Security of the Government of the People's Republic of China, the Ministry of Civil Affairs (China) and the National Bureau of Statistics of China

Figure 2 – Total assets in funded and private pension arrangements for OECD nations (2017)



Source: OECD Global Pension Statistics

As supervisor, the NCSSF always assigns priority to risk control in the management of social security funds and basic care insurance funds for the aged, and is committed to long-term value investment and responsible investment, achieving good performance and experiences in this regard.

As a result, the asset allocation should be emphasised in the fund's investment. Effective asset allocation is the decisive factor for obtaining long-term yields. Those in small volumes can take advantage of market opportunities, while the larger ones must take a more strategic asset allocation approach. After years of development, the NCSSF has established a relatively complete set of asset allocations.

The NSSF used to focus on domestic asset allocation. It has now begun to 'go global' and expand its asset allocation overseas to maintain a high investment yield in the face of the decline of demographic dividend, the increase in economic aggregate and the moderation of economic growth during restructuring.

First, it is necessary to diversify portfolios. Regional allocation can share the benefits of other countries' economic development and find more investment opportunities within the global industrial chain and economic cycle. More emphasis should be placed on overseas assets. The correlation between assets of different markets are significantly lower than those in the single market. This is why portfolios with assets from both home and abroad are able to hone their efficiency. Major asset allocation includes investment in domestic and foreign markets, also in the fixed income, primary and secondary markets.

Second, external resources can be useful for improving investment performance. Considering the labour cost, favourable policies and other factors, deposits are the major source of direct investment. Meanwhile, around 50% of large enterprises' assets are focused on financial investments. Since the establishment of the NCSSF, more than 40 fund management enterprises assigned by the Chinese government and more than 20 Chinese fund management enterprises have become managers of the social security fund. These enterprises conduct open market investments for the NCSSF, contributing significantly to the sound returns of the fund – especially domestically, where the assigned asset managers have achieved remarkably higher yields than the benchmark interest rate.

Third, investment opportunities can be found in new areas as a result of China's economic transformation and upgrade. China's rapidly growing innovation-oriented enterprises play a more important role in promoting economic transformation and upgrading. While the long-term nature of the pension fund fits well with science and technology investments, injecting energy into the development of related enterprises will help share the economic benefits of innovation. The NCSSF also invests in hi-tech enterprises such as Alibaba and Ant Financial through direct investment and private equities. It also invests in other areas of technology, including artificial intelligence.

Reform and revival

The state-owned enterprises that dominate China's economy have strong talent resources and credibility in the tech sector. The government has sought to reform these enterprises further with the introduction of social capital, which it hopes will improve the corporate governance structures of these firms, enhance synergy among shareholders and improve market-oriented operation management and profitability. The reform process brings remarkable capital demands, and the NCSSF – alongside other investors – can support the national strategy and share its benefits. In addition, the mixed-ownership reform agenda also contributes to the growth of productivity through the optimisation and upgrading of corporate system and mechanisms.

In strategic terms, the NCSSF invests in promising projects through private equities. It makes use of its professional strengths in the science and technology sector, and applies its experience in mixed-ownership reform to control risks by diversifying portfolio allocations.

1. *Statista (October 2019),* Balance of basic pension insurance funds in China between 1990 and 2018, *https://bit.ly/2tLBagq*

2. *Sovereign Wealth Fund Institute,* National Council for Social Security Fund of the People's Republic of China, *NSSF: Sovereign Wealth Fund in China, https://bit.ly/30YtUK1*

3. *OECD (2018),* Pension markets in focus, *https://bit.ly/2O3S9RN*

Transfer season

Trade frictions with the US have caused a mass industrial transfer to China's neighbours. *Zhou Chengjun*, IFF Academic Committee member and inspector of the Macro-prudential Policy Bureau of the People's Bank of China, says that shouldn't stop China continuing to globally integrate its format and financial markets

There is still room for improvement in the next round of opening-up within the Chinese financial market. So far, China has implemented a series of measures to deepen opening-up in the financial sector, yet there are obvious insufficiencies. International investors who intend to enter the Chinese market are challenged by a series of obstacles – from regulation to a lack of transparency and predictability. Clearly, China still lags behind international standards.

The fundamental reason the renminbi joined the special drawing rights (SDR) basket in 2016 was to integrate China's financial sector, financial market and currency into the global marketplace. The renminbi would be recognised as an international benchmark, allowing each market participant access to the Chinese market.

Regulating the exchange rate of the renminbi to keep it generally stable on a reasonable and balanced level is the prime target. China is the largest manufacturer, the largest importer and exporter of goods and commodities, and the second-largest outward investor worldwide. As a result, countries may find it difficult to respond if the exchange rate overshoots or experiences volatility.

The Macro-prudential Policy Bureau of the People's Bank of China, established in May 2019, is responsible for monetary policy, the two-way opening-up of financial markets, renminbi internationalisation and currency co-operation. The bureau implements the framework for financial macro-regulation that is underpinned by monetary policy and macroprudential policy under the direction of the Central Committee of the Communist Party of China and the State Council of the People's Republic of China. The latest round of reform and opening-up takes place against a backdrop of uncertainty over escalating China–US trade frictions, which began in May 2018.

Across the border

China must consider how to respond to the possible challenges these new frictions could pose to its next round of opening-up. An important outcome from the US tension has been an outflow of certain industries to neighbouring countries such as Vietnam, Kazakhstan and Pakistan due to declining competitiveness caused by rising costs in China. The outflow can be seen as a result of China shifting its focus towards industrialisation; trade friction with the US has intensified this process, but a calm and objective attitude should be adopted – change is inevitable. Change can also be found in the development of Japan and the 'Four Asian Tigers' – Hong Kong, Singapore, the Republic of Korea and Taiwan.

Zhou Chengjun

Some argue the mass industrial transfer will lead to a hole in existing industries in China. However, this is all simply part of the process of industrial upgrading and optimisation – which is essential in the new round of opening-up for China to seek new competitiveness and comparative advantages.

This poses the question of how to prevent the risks brought about by this inevitable process. The Plaza Accord of 1985 caused a dramatic appreciation of two of the most important currencies of the time – the Japanese yen and the Deutschmark. Although the yen and the mark increased to almost the same relative value as the US dollar, their journeys from that point have been quite different. Today, Germany remains the country with the largest trade surplus and best competitiveness in the industrial sector, while Japan appears to have lost its competitive advantage.

China is facing a similar challenge as it moves towards becoming an industrialised nation. With rising levels of productivity and China's increased engagement in global resource allocation, the renminbi should not depreciate in the long term, despite temporary downward pressure. In the medium to long term, the renminbi will gradually increase in value; signs of this are already visible in trends in the yield of China's Treasury bonds. Currently, the yield of 10-year US treasuries is 1.77%, while that of Japan and France is around zero, and below zero in Germany. Meanwhile, the current yield of 10-year treasuries in China is 3.197% – almost double that of the US.

Homoatrox/Wikimedia Commons

The Great Stone Industrial Park in Belarus

Despite the outbound transfer of some industries and China's worldwide resource allocation, increasing production capacity and efficiency ensures all investors can enter the domestic market and enjoy the benefits of China's rapid economic growth and the relatively high yield of its assets. As a result, it is likely the exchange rate of the renminbi will increase in the medium to long term.

Berlin, Tokyo... Beijing?

Having studied the lessons of Japan and Germany, what path should China pursue? Germany offers the most useful use-case. The mark increased in value as much as the yen, but how has the country maintained its competitiveness?

One important reason is that Germany used to be the largest investment and trade partner among European member states. These countries did not peg their own currencies to the US dollar, but to the German mark. In other words, almost all currencies in Europe appreciated as the mark increased to three times its original value between 1988 and 1995. As the mark appreciated and depreciated, the rest of Europe underwent the same changes; Japan's yen was not linked to regional partners in the same way and so experienced volatile fluctuations.

China has learned from this example, understanding that those with which it has close trade relations should respond jointly to uncertainties aroused by the China–US trade frictions. The mass industrial transfer has resulted in the establishment of substantial joint industrial parks in neighbouring countries and those with which China has formed a strong economic relationship. The largest park – the Great Stone Industrial Park in Belarus – covers an area of 92 square kilometres. A large number of these parks are run by private – not state-owned – enterprises. However, more than 90% of the foreign investment and related trades occurring in these areas are still settled in US dollars, which will lead to great uncertainties in the current context.

There are clear benefits to settling these transactions in local currencies. For a start, it can minimise and avoid currency mismatches, exchange costs and exchange rate risks caused by the third-party currencies.

China has a large financial market: its securities market is now worth CNY96 trillion – almost the same as its GDP – and foreign investors account for 2.3% of this. The stock market, meanwhile, is worth CNY55 trillion, with foreign investors accounting for 3.2% – or CNY1.77 trillion. Global foreign reserves totalled US$11.7 trillion in value as of the third quarter of 2019; reserves in renminbi only accounted for 2.01% – or $219 billion.

China needs to bring its presence in these markets up to the same level as other emerging market countries. On average, these countries see foreign investors hold 10% and 15% in the securities and bond markets. Were all International Monetary Fund member countries to hold 10.92% of their reserves in renminbi – the same as that held in the SDR – the renminbi market would expand rapidly.

During the industrial transfer, if more trades and investments with other countries are settled in local currencies, these partners will hold more renminbi in their reserves and markets. With China's financial opening-up, these overseas investors are able to buy high-yield renminbi assets and share the benefits of China's rapid economic growth. This will encourage them to have more positions and assets in the Chinese currency.

Should this change occur, overseas investors will have to conduct liquidity management and hedge against their foreign exchange transactions – the expansive onshore renminbi transaction demand generated will promote the development of a renminbi forex market that has depth, demand and vitality. Moreover, this market should be developed both onshore and offshore, working towards the goal of the offshore market surpassing the onshore.

As the offshore renminbi forex market develops – particularly in neighbouring countries – pricing needs to be formed through forecasting and the transactions of all market participants, reflecting the renminbi's supply and demand. Once decided, this price will be relatively stable and balanced, and will act as the exchange rate between renminbi and the local currencies of neighbouring countries.

China is the largest investor and trade partner to almost all of its neighbours and the countries participating in the Belt and Road Initiative. Coupling the renminbi to their currencies will help stabilise investors' expectations and facilitate bilateral trade and investment. Until this occurs, China and the relevant stakeholders will have to soldier on dealing with the uncertainties wrought by China–US trade frictions.

Access all areas – Tapping into China's capital markets

Martin Scheck, IFF board member and chief executive of the International Capital Market Association, looks at the steps China has taken to improve access for international investors and calls for more clarity on regulation

Martin Scheck

The International Capital Market Association (ICMA) is a trade association whose many members primarily belong to the private sector – some central banks, but mostly financial institutions and issuers; intermediary, primary and secondary investors; and market infrastructure providers. All of these institutions are interested in how debt capital markets operate, and they attach great importance in particular to the opening-up of the Chinese Interbank Bond Market (CIBM).

A balance between direct and indirect funding is extremely important. Generally, in developing markets, the level of capital markets funding is relatively low compared with bank funding. This is still the case in China. If you compare the US – which is probably the most sophisticated nation in its capital markets funding – around 70% of the industry has been financed through this type of funding. In Europe, the figure is somewhere in the middle – around 30% – and then it is slightly lower in China.

China's policy objective is to increase the allocation of capital through the capital markets – a common objective that wins support in other areas such as the European Union, which is currently focusing on a capital markets union. Financing through the capital markets not only facilitates capital allocation, but also increases capital flow across borders, which is much easier in debt capital markets than banking markets.

The mazy road to market access

There is no simple route to China's policy of reform and opening-up – there are bound to be deviations and setbacks. Nevertheless, the direction of opening-up has been unwavering. In 2017, at the World Economic Forum in Davos, President Xi Jinping presented an impressive defence of globalisation, saying that globalisation should not be thrown out, and that multilateralism was still important.

This is why the ICMA has been working with Chinese infrastructure providers and banks over the past decade to aid this internationalisation process. The CIBM is now the second-largest bond market in the world, and is simply too big to be ignored. The opportunities here are absolutely immense, yet the level of international investment is still less than 3%.

Many steps have been taken to allow for international investors' access: reforms are moving quickly on removing quotas, for example. Nevertheless, China started from a relatively low base, where the market was closed to international investors. Even now, it remains a challenge for international investors to understand what is needed to enter into the market.

We have to look not only at the investment side but also at the other route for issuers to actually tap into the money in China. Investors and issuers need predictability and clarity – not opaque regulation and uncertainty in rules and timeframes – and transparency around what they need to do to get into the market.

All participants – ranging from the world's largest investor groups all the way down to small private banks – require the process to be transparent. These large groups are well structured, and will most likely have Mandarin speakers on their staff or an office in China to analyse how to access the market. But the new round of opening-up needs to make market access easier for the next level down – a normal process of investing in which prospective participants don't have to dedicate too much time understanding how to access the market and what to expect.

Some routes to access the market already exist – including Bond Connect, the Qualified Foreign Institutional Investor programme or the Renminbi Qualified Foreign Institutional Investor programme – but what to expect once access is gained is unclear to many investors. There is a lot of work to be done internationally to familiarise them with what they will find there: What are the dynamics of the market? How much of the market

President Xi Jinping offers a defence of globalisation, and highlights the importance of multilateralism at the World Economic Forum in Davos in 2017

is government bonds? How much of the market is policy banks? What's happening to the credit sector? What's happening in terms of ratings? We know international rating agencies can now operate in China, which is a big step forward. But how does that compare with the ratings they expect internationally? What are the regulations on bankruptcy and insolvencies?

The problem is not unique to China. The EU is a hotchpotch of legislation, with insolvency laws by no means harmonised. Creating a unified capital market in Europe is a big issue. But these are the things we could work on together: What are the liquidity dynamics? What are the new issue dynamics?

From an issuer's perspective, some clarity around the regulation for the issuance of Panda bonds being more active is welcome news. There are many ways to familiarise participants with the Chinese market and communicate the information needed to access the market: more roadshows, conferences – Chinese securities summits, for example – and investor centres in the US, Europe and other parts of the world.

Thematic investment – Green finance and fintech

China is already a leader in the widening arena of thematic investment. One of the best examples of this is the growth of environment, social and governance, sustainability and green finance. This new trend has been working its way to the the forefront of investing since 2007, when the first green bond was issued by the World Bank and the European Investment Bank. China has led the way in this field and is still the only country with comprehensive regulation around the green bond market. It has a catalogue of qualifying assets and projects and a number of well-developed supervisory regulations. Chinese companies, both domestically and internationally, have been heavy users of the green bond market.

In the West, the green bond market has been driven largely by investor demand – investors are putting up their hands and saying they want more sustainable products in their portfolios. In China, however, the process has been slightly different. It has been a faster, top-down approach – and, frankly, easier to implement than in other countries, which can become bogged down in almost interminable political discussion.

The development of a green bond market should not be underestimated – it is currently the biggest growing trend in the capital markets. In most of the Western world, green bonds were kicked off by the investor base, but most of its governments are now very much on board with this. Governments are starting to equate climate risk with financial risk in the long term. As a result, many central banks have been able to foster green bonds as part of their remits.

The other big theme in the market is financial technology – known as fintech. Again, China is a leader in this realm. Fintech is not something to be frightened of, but an enabler, streamlining the financial markets to become much more efficient and effective.

One example of innovation in fintech is a host of applications that can be used in alternate parts of the value chain of capital markets. This innovation has been around for a couple of decades in the secondary market, and in the post-trade space of the repo and collateral markets.

Another example is using a fintech application that completely rewrites a process and may disseminate part of the existing value chain. In the future, investors and issuers could implement certain types of fintech that will allow them to get together without the need for intermediaries.

Hungry like the wolf

Nie Qinping, chairman of the China Securities Finance Corporation Limited, warns that opening up markets to foreign capital and competition – while the culmination of bold Chinese economic experimentation – comes with risks

"The wolf is coming" – which is how some foreign institutions, set to compete in China for the first time, describe China's capital market as it finally opens up to the rest of the world.

This latest opening-up is both comprehensive and bilateral. First, capital market financial services – including securities companies and even private equity firms – will be able to accept foreign capital. According to a notice from the China Securities Regulatory Commission (CSRC), ownership limits of qualified foreign investors in foreign-invested futures companies has been relaxed to 51% and will be fully removed in three years.

Second, barriers on capital flows will be gradually removed. In 2012, the Qualified Foreign Institutional Investor (QFII) and Renminbi Qualified Foreign Institutional Investor programmes were implemented, followed by the Shanghai–Hong Kong Stock Connect and Shenzhen–Hong Kong Stock Connect programmes. Soon, China will also have access to the Shanghai–South China Connect and Sino–Japan ETF [exchange-traded fund] Connect programmes. International capital will also be able to enter China's domestic capital market through mutual recognition of funds. This current all-round opening up is completely different from the past.

Nie Qinping

The move to phase three

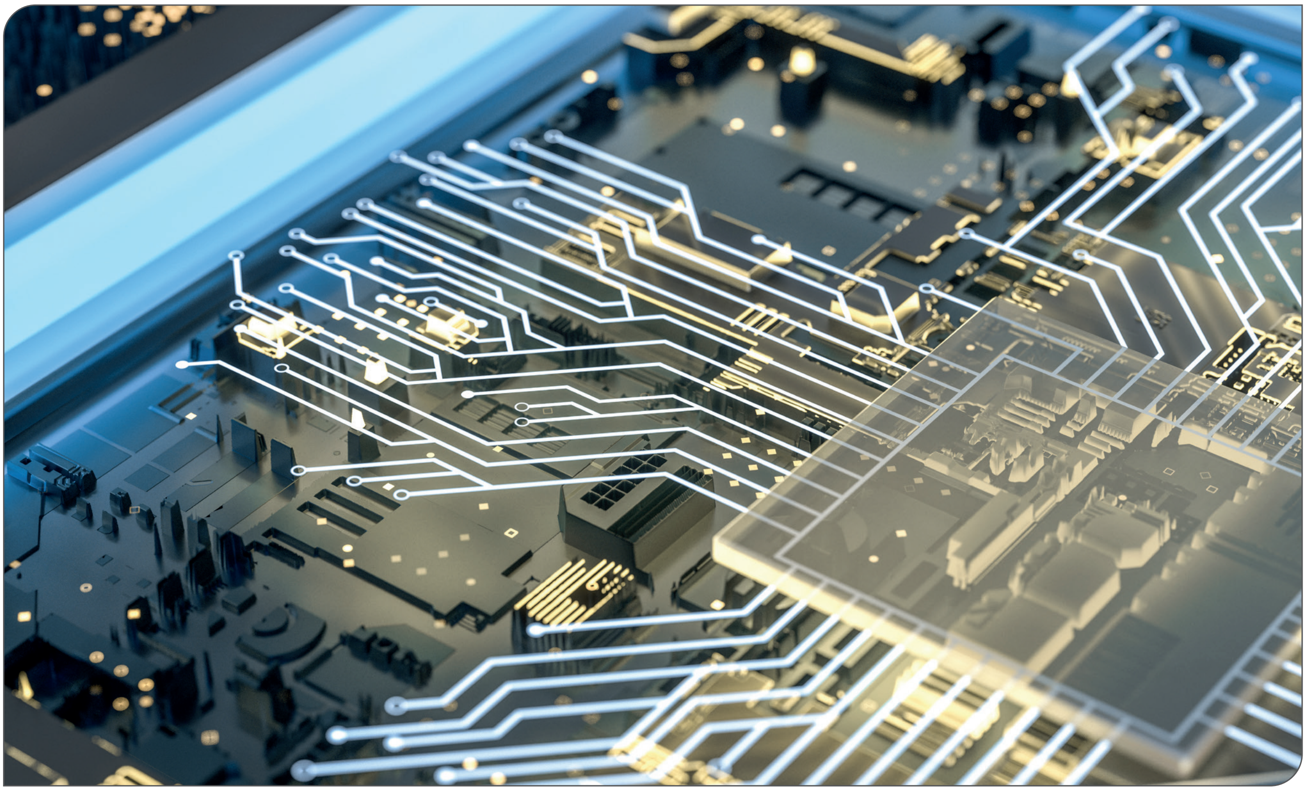
China's opening-up can be divided into three phases. The first phase began in the late 1980s. From 1989 to early 1990, China allowed Chinese companies to list overseas to attract foreign capital – although there was a red line that could not be crossed on the flow of international capital: foreign capital could only invest in those overseas-listed Chinese companies.

In the second phase, China has liberalised the QFII system since 2012, allowing foreign capital to enter the country to a degree. But QFII had a quota control, and had to be approved and managed accordingly by the State Administration of Foreign Exchange.

Now China is in the third phase – its capital market finally opening up fully. The foreign equity ratio and foreign firm access will be widened, and restrictions lifted. For example, the QFII quota control is likely to be cancelled soon. Regions such as Taiwan that employ the QFII system will see its removal within two or three years. In this regard, the 'wolf' really is coming.

However, global capital markets should continue to pay attention to the fragility and instability of the US financial system. Following the global financial crisis of 2007–08, the Federal Reserve Board introduced the policy of quantitative easing, effectively bailing out the market. As a result, the US government bought between $3.5 trillion and $4 trillion worth of toxic assets such as collateralised debt obligations and credit default swaps from commercial banks and investment banks. Now the US central bank cannot either reduce or erase its balance sheet, and nothing has been achieved over the past decade. How can these toxic assets be digested? There is a big hole in the American financial system.

In addition, the US stock market still looks as though it is in a bubble. Since taking office, President Donald Trump has not allowed the US stock market to decline even by the tiniest fraction. The basic indicators for measuring the stock market bubble are the price-to-earnings (P/E) and price-to-book-value (P/B) ratio. Since 2015, the P/E ratio of the US stock market has continued to soar. For example, the current P/E ratio of the Dow Jones and Standard & Poor's 500 is close to 20, and their P/B ratio is about 3. The Nasdaq now has a P/E ratio of around 38–40 and a P/B ratio of 4. Whether it is measured from the P/E or P/B ratio, the US stock market is tracking within a dangerous range.



China has become an influential global player in technological innovation, working towards becoming a science and technology giant

Then there is the trade conflict – an additional source of friction for China–US relations – which is now known as the 'China–US decoupling'. Decoupling is having a deleterious effect on the global economy. What China wants is win-win co-operation instead of decoupling, but it is the US that will be affected worse by hard decoupling and continued trade frictions. The interdependence of China and the US's economies is reflected in global capital markets, where the US capital market is more dependent on China.

US stock market data reveals that IT accounts for 25% of its value – close to $11.3 trillion. The remainder is made up of financials (14.46%), consumables (13.76%), healthcare (11.88%) and others. Technology – namely Apple, Microsoft and Amazon – makes up the lion's share of the US stock market's capitalisation. Technology companies rely heavily on China, the largest consumer of US tech products, including electronics, computer operating systems, and software and chip technology. The China–US trade friction may lead to an economic slowdown in the US, which will cause a series of problems in the capital market.

Two important lessons

China must open up its capital market even further. But in this process, there are two lessons to be learned.

First, the 'catfish effect' – the theory that strong competitors force weaker ones to improve – is often referred to when considering lifting restrictions on foreign investment: opening-up will promote competition. But we can learn from the cases of other emerging economies that what really happens after opening up is the 'alligator principle' – the more you struggle, the more you are bitten. When financial services were fully opened up in emerging economies, foreign capital – especially US capital – defeated all the local financial institutions. When trading H-shares in Hong Kong in 1990, I dealt with investment banks that were all British-owned. But, after China launched H-shares in 1992, the US investment banks discovered that it was a huge market, rushing into the Hong Kong market one after another. As a result, most of the investment banks in Hong Kong today are US companies. It is the same in Japan and the Republic of Korea. We must therefore avert the alligator principle.

Second, opening-up may impact on international capital flows – what is known as the 'fleecing of the flock', or by Chinese A-share investors as 'leek harvesting'. Since the implementation of QFII in 2012, a total of CNY120 billion successively entered Chinese markets before major abnormal volatility occurred in 2015. During the same year, foreign capital withdrew from the A-share market, taking with it nearly CNY170 billion. Currently – although the stock market is faltering – foreign capital is still pouring in. According to the China Securities Finance Corporation, as of November 15, from the fund flow into the mainland China stock market from Hong Kong via the Shanghai–Hong Kong Stock Connect and Shenzhen–Hong Kong Stock Connect programmes, the net purchase amount of the A-shares has totalled around CNY880 billion. The market value of these shares purchased and held is nearly CNY1.3 trillion. The A-share stock market is not performing, but foreign capital is still making money. Of course, the composition of foreign capital is more complicated, but is still flowing into China from overseas.

These lessons should be borne in mind when opening up markets – and especially the capital market – to foreign capital.

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THE BELT AND ROAD INITIATIVE

A more sustainable road to growth?

The third annual Belt and Road Initiative (BRI) survey reveals that central banks view BRI investment as sustainable compared with other forms of external debt, particularly given it is often proportionally less significant. Despite growing global trade tensions, protectionist policies have yet to impact BRI membership and investments, but this could change in the future. By *Zhang Jizhong*, *Christopher Jeffery*, *Rachael King* and *Adam Csabay*

Karakoram Highway, a key route of the China–Pakistan Economic Corridor

China's Belt and Road Initiative (BRI) has continued to evolve and expand in its sixth year. Originally conceived to foster greater connectivity between China and the countries along the traditional Silk Route, the initiative has now become global in scale and ambition. More than 150 countries and organisations – from Latin America to the Pacific – have reportedly signed BRI agreements with China, and this vast new network of infrastructure, trade and investment is reshaping China's engagement with the world.

A report released by German company Siemens at the World Economic Forum in January 2020 states that China is set to become the world's biggest economy by 2030, in part due to the BRI helping China to expand its presence.[1] BRI countries account for about 70% of the global population and more than 50% of global GDP. According to estimates, China will have initiated or completed BRI infrastructure projects worth a total of US$1.08 trillion by 2025.

This is not surprising. In April 2019, Beijing hosted the second Belt and Road Forum for International Cooperation.[2] The event sought to boost the intiative by setting out a clearer direction in the face of concerns around debt servicing, corruption, environmental impact and delays or cancellations of flagship projects. The aim of the Belt and Road Forum was for China to reassert its commitment to the flagship foreign policy initiative, address major challenges and demonstrate a greater willingness to adopt a more inclusive approach moving forward. China also stressed the practical benefits of the BRI for participant countries at a time when globalisation is fraying and US leadership has come under greater scrutiny.

During the forum, President Xi Jinping outlined four key pillars to support the BRI in years to come – finance, transparency, the environment and inclusivity.[3] One of the biggest achievements of the forum was the commitment to create a debt sustainability framework to improve the assessment of financial risk associated with projects. The guidelines build upon those released in late 2018, which looked to enhance BRI project standards and quality, as well as discussions on improving financial governance.

The measures strongly indicate the effort being made to strengthen the institutional underpinnings of the BRI. This, in turn, may help to reduce concerns expressed by some international parties that China has engaged in a form of 'debt-trap diplomacy'. Despite the recent first-stage trade agreement between the US and China, there are still risks that outstanding issues could result in further protectionist policies that may further disrupt trade and investment patterns. As a result, the BRI could become increasingly more important for China and member countries as they look to restructure supply chains and adapt to shifting trade patterns.

Key findings

- All respondents to the survey view the BRI as important in promoting global growth
- 53% believe BRI projects will boost GDP by 0–1%, while 47% of respondents believe the boost will be even greater
- More than 90% believe the BRI will support other projects in their country
- Better co-ordination is needed with national development strategies
- BRI debt is smaller in scale and carries less onerous terms relative to other external debt
- All respondents consider their jurisdiction's BRI debt to be sustainable
- There are concerns the BRI could cause debt to reach unsustainable levels in other countries
- Chinese development banks and multilateral institutions are expected to provide the most BRI funding
- The US dollar is the most advocated funding currency, followed by the euro and domestic currencies
- Renminbi funding is favoured by just 15% of respondents – 1% greater than the 2019 survey
- BRI financing tends to mature sooner than five years
- More than 65% of respondents believe the BRI will be very important in promoting sustainable and green finance.

PROFILE OF RESPONDENTS

Central Banking received responses from 30 central banks participating in the Belt and Road Initiative. Almost half of the respondents were European, with central banks from the Middle East and Asia each making up 17%. In 2020, there was an increase in responses from central banks in Africa and the Caribbean, while the proportion of responses from the Oceanic region declined. More than 53% of responses to the 2020 survey came from emerging/developing countries, while 33% were from advanced economies and the remaining 13% from those in transition.

Region	% of respondents
Europe	47
Asia and Oceania	20
The Middle East	16
Africa	10
Latin America and the Caribbean	7

Economic classification	% of respondents
Emerging/developing	53
Advanced	33
Transition	13

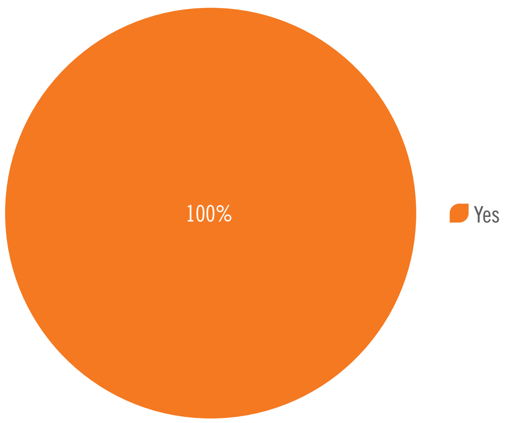
Percentages in some tables and graphs may not total 100 due to rounding.

Promoting growth and development

When established six years ago, the BRI's core aim was to foster growth and development along the original Silk Route. The survey results reveal that all respondent central banks perceive the BRI as important for promoting global growth and development in the current international economic environment (see figure 1). This is largely in line with the position of supranational organisations, including the Organisation for Economic Co-operation and Development, the International Monetary Fund (IMF) and the European Bank for Reconstruction and Development.

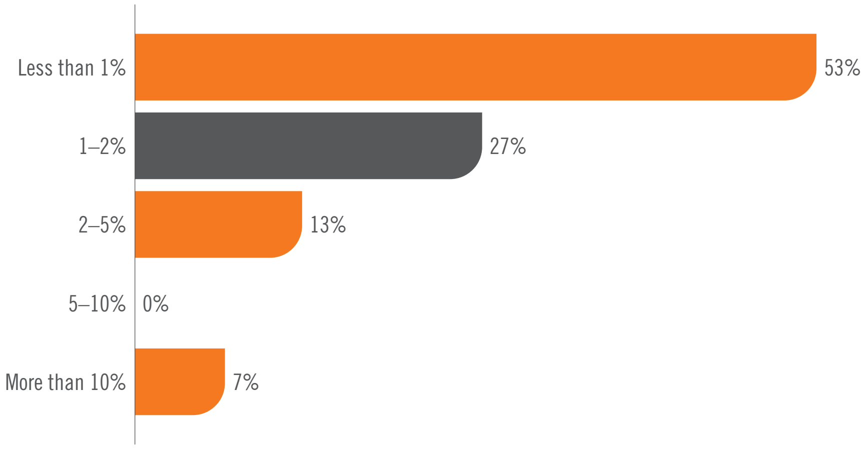
"The project will ease access to finance, trade and economic resources between different countries. Furthermore, it decreases the cost of transportation, increasing competition among producers and efficiency," a central bank from the Middle East said. Similar views appear to be shared by jurisdictions outside the BRI's traditional focus regions. "China has been assisting developing countries by providing loans at reasonable costs to develop their infrastructure and primary industries," said a central bank from the Caribbean.

Figure 1 – Is the BRI an important measure promoting global growth and development?



No repondents say the BRI is not an important measure promoting global growth and development. Thirteen central banks did not respond.

Figure 2 – How much do you expect your jurisdiction's GDP to increase over the next five years as a result of BRI projects?



No respondents expected BRI projects to have zero impact on GDP. Fifteen central banks did not respond.

It was clear, however, that respondents were aware of the potential strategic risks associated with their jurisdictions' involvement in BRI investments. While appreciating the opportunities for economic growth and development, a central bank from south-eastern Europe explicitly stated that: "The BRI should comply with economic principles and not discriminate against other projects."

The BRI is expected to act as a catalyst to growth in participant countries, with four-fifths expecting a boost over the next five years of up to 2% (see figure 2). Half of respondents have relatively moderate expectations – indicating an expected increase of below 1% – while one-quarter expect an increase of 1%–2%. Responses were relatively consistent across jurisdictions regardless of the type of economy represented. There were also a few more optimistic responses. A central bank from South Asia indicated that the BRI-related increase to its GDP in the next five years could be 10% or greater.

Two central banks representing developing economies in the Middle East indicated an expected BRI-related increase to GDP of 2%–5% over the next five years. The Middle Eastern region not only is located at the crossroads of Europe, Africa and Asia – which the BRI aims to strategically connect – but also represents the hub of the 'oil roads' that feed China's growing energy needs.

According to a report by the World Bank, countries along BRI corridors undertrade by 30%.[4] Upgrading infrastructure, expanding trade and increasing investment would likely increase growth and income in most corridor economies. Real income gains could increase by up to 3.4%, according to the World Bank – but these gains would largely differ across countries. BRI transport projects could help lift 7.6 million people from extreme poverty (defined as earning below $1.90 per day) and 32 million people from moderate poverty (earning below $3.20 per day).

A breakdown in relations?

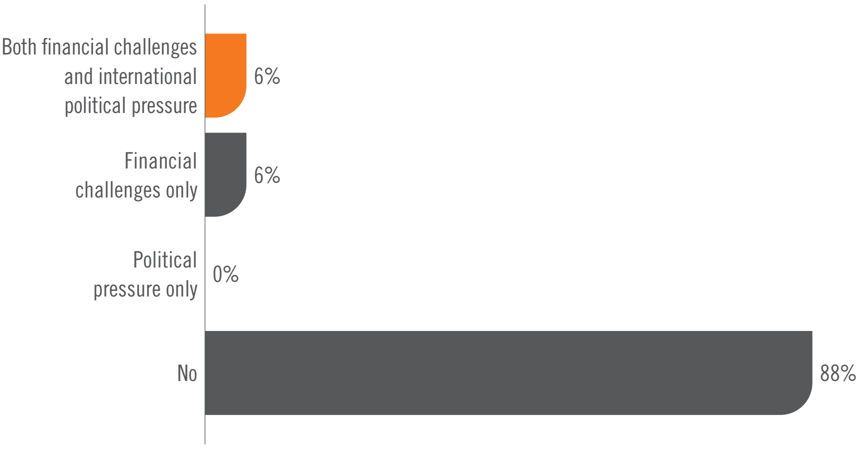
Trade tensions between China and the US have had a dampening effect on global growth over the past 18 months. As of February 7, 2020 the US had imposed tariffs on $550 billion worth of Chinese products. China, in turn, has set tariffs on $185 billion worth of US goods.[5] While the impact of these protectionist policies has yet to fully materialise, the trade dispute appears to have had little impact on the BRI so far, according to those surveyed.

More than 85% of respondents indicated that implementation of BRI-related projects in their jurisdictions had not encountered any increased international political pressure or financial challenges due to trade frictions. A central bank from south-eastern Europe – one of the regions where the strategic interests of the US and China increasingly overlap – explicitly stated: "Trade tensions did not have a specific impact on the course of the projects financed through loans originating from China."

However, respondents are aware of the potential fallout from the China–US trade dispute (see figure 3). This was particularly evident in Southeast Asia, where one central bank said that, while it was "not really affected", the country is "prepared for any side effects of the China–US trade war".

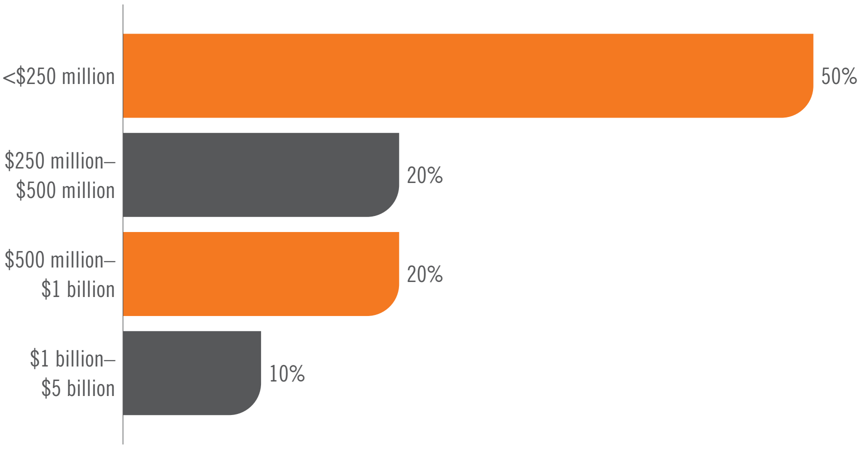
The results also indicated that some African and Middle Eastern countries could be caught in crosscurrents if trade relations weaken further. A respondent from an African central bank noted that China–US trade tensions were challenging BRI implementation on a financial level, while a respondent from the Middle East said BRI projects were facing both political pressure and economic challenges. Both of these central banks are in regions whose growth is, to a large extent, dependent on foreign investment. As a result, they are often more vulnerable to the political and financial consequences of international tensions – particularly when it involves the world's two largest economies.

Figure 3 – Have BRI-related projects in your jurisdiction encountered any increased financial challenges or international political pressure?



Fourteen central banks did not respond.

Figure 4 – What is the value of the largest BRI project taking place in your jurisdiction?



No respondents reported projects with a value exceeding $5 billion. Twenty central banks did not respond.

Project evolution

In parallel to a shifting political and economic climate, the scale and scope of BRI projects has also evolved. Many early BRI projects focused on energy creation and infrastructure – particularly related to transportation. This is a continuing theme. In April 2019, China and Kenya agreed to build two projects with a total value of $2.23 billion: the Konza Data Centre and Smart Cities deal was valued at $1.72 billion, while the Jomo Kenyatta International Airport–Westlands Highway project is to be built at a cost of between $510 million and $650 million, 80 kilometres south of Nairobi.

There are plenty of smaller transactions too. Of those surveyed, 90% indicated the size of the largest BRI project taking place in their jurisdictions was valued at less than $1 billion – with half of respondents highlighting that combined investments into a single BRI project do not exceed $250 million in total.

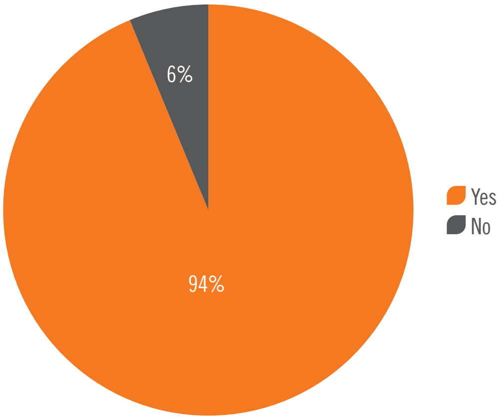
This suggests the BRI does not focus solely on the mega infrastructure projects it is traditionally associated with, but also involves local investments of a relatively smaller size.

Twenty per cent of respondents indicated that the combined investment value of the single largest BRI project in their jurisdiction is between $500 million and $1 billion (see figure 4). These respondents heralded from central and Eastern Europe, which confirms the strategic importance of the region for China and indicates the BRI's potentially significant role in future China–European Union relations. Additionally, the survey results revealed that, in 20% of respondent jurisdictions, the value of the largest BRI project falls within the range of $250–$500 million; while 10% of central banks indicated the size of their jurisdictions' largest BRI project as above $1 billion.

Acording to data from Refinitiv, Sri Lanka has emerged as the country with the highest number of BRI projects announced as of July 2019, with seven developments with a combined value of nearly $700 million.[6] While Pakistan has attracted plenty of attention for its involvement in BRI projects, Russia has received the largest investment from China – $298 billion worth of projects are currently under way, according to Refinitiv.

Specific BRI-related projects include Moscow's Metro Line 3 – the first metro project undertaken by Chinese enterprises in Moscow. The building of the 4.6km metro network began in 2017 and will be completed by the end of 2020. Another deal was signed during the second Belt and Road Forum in Beijing in April 2019: China National Offshore Oil and China National Oil and Gas Development acquired a combined 20% of Novatek's Arctic Liquefied Natural Gas 2 project in northern Russia.

Figure 5 – Do you expect the BRI to support projects in your jurisdiction?



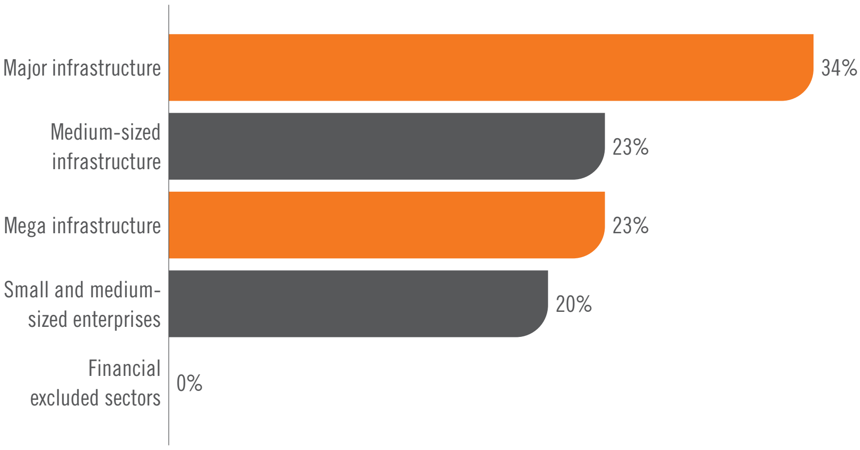
Fourteen central banks did not respond.

Meanwhile, more than 90% of respondent central banks expressed an expectation that the BRI would support projects in their jurisdictions (see figure 5). A central bank from the Caribbean region added: "The support is evident via continued road infrastructural expansion, primary industries and public buildings."

Some qualitative responses also focused on the spillover effects of BRI investments. A respondent from a Southeast Asian emerging market economy stated that the BRI is expected to support projects indirectly as it "will help with job creation and subcontract business activities". A Middle Eastern central bank in a developing economy suggested the impact of BRI investments will materialise "through increasing and easing trade and mobility between countries".

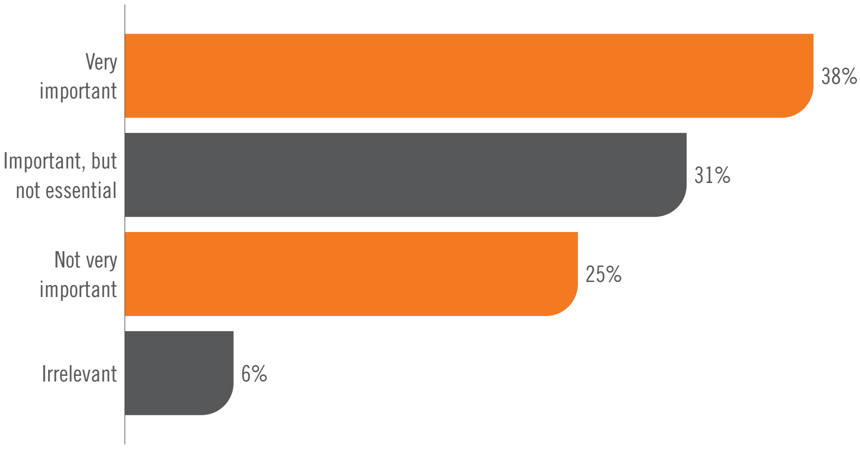
Regarding the taxonomy of projects expected to receive the greatest funding support, respondent central banks expect the BRI to simultaneously target projects of different sizes and scope across a range of jurisdictions. However, the results revealed major infrastructure projects represent the most significant focus of BRI investments, featuring in 34% of responses (see figure 6). Mega and medium-sized infrastructure projects featured in almost a one-quarter of responses each – with small and medium-sized enterprises selected in one-fifth of participating central banks' responses. None of the respondents indicated BRI support for financially excluded sectors.

Figure 6 – Which types of project will receive the greatest funding support?



Respondents were invited to select multiple options where applicable. Sixteen central banks did not respond.

Figure 7 – How important is sustainable and green finance to the promotion of the BRI?



Fourteen central banks did not respond.

Environmental and technological impact

At the second Belt and Road Forum, President Xi signalled the environment as one of the key pillars underpinning the success of the BRI moving forward. The BRI, at its core, is probably the most ambitious infrastructure project in history. However, building the land-based Silk Road Economic Belt and the Maritime Silk Road will require massive amounts of concrete, steel and chemicals, creating new power stations, mines, roads, railways, airports and container ports – often in countries with poor environmental oversight.

Since 2000, Chinese banks have invested $160 billion in international energy projects, almost as much as the World Bank and regional development banks.[7] But, unlike the World Bank, 80% of China's overseas energy investments went to fossil fuels compared with just 3% to solar and wind, and 17% to hydro projects.

While China has imposed a cap on coal consumption at home, its activities abroad appear to have grown. Chinese companies are involved in around 240 coal projects in numerous BRI member countries, including in Bangladesh, Pakistan, Serbia, Kenya, Ghana, Malawi and Zimbabwe. China is also financing about half of proposed new coal capacity in Egypt, Tanzania and Zambia.

However, just over two-thirds of respondents believe sustainable and green finance will be important to the promotion of the BRI (see figure 7). Thirty-eight per cent said it was very important, with a further 31% reporting it as important but not essential. One-quarter said it was not important. More effort may be required to reinforce President Xi's vision of a "green, healthy, intelligent and peaceful" BRI. While the Chinese government has released guidelines such as the *Green investment principles for the Belt and Road*, which parallel domestic green finance guidelines.[8] At present, they are non-binding.

While 77% of respondents said the BRI would help achieve global climate commitments, 23% did not (see figure 8). "The project will require a huge investment in infrastructure and other economic projects, which in turn is expected to lead to more climate changes," said a small central bank from the Middle East.

The BRI, however, looks well positioned to help improve the technological capacity of its member countries. At the second Belt and Road Forum, President Xi said: "Innovation produces productivity, which makes companies competitive and countries strong." Under the BRI, China has committed to pursuing four major technological initiatives: scientific exchanges, joint research labs, technological parks co-operation and general technological transformation.

The number of technological projects initiated under the BRI has been limited in comparison to energy infrastructure. Around $17 billion has been allocated for projects including fibre-optic cable and telecommunications networks, e-commerce and mobile payments, smart city-related initiatives and data centres. India's telecoms operator Bharti Airtel received $2.5 billion and Russia's Rostelecom $600 million, in part to purchase Huawei and ZTE equipment. Alibaba, meanwhile, invested $4 billion in online marketplace Lazada, and Ant Financial's Alipay has rolled out in eight countries.

Respondents largely agreed that the BRI would be crucial to the development of technology in their region – 33% said it would be very important while 47% said it was important but not essential (see figure 9).

For countries that rank low in the *Global competitiveness report* for technology output, the BRI could be a game-changer.[9] "The BRI could help – especially in having locals working alongside the Chinese," a Caribbean central bank said. "There should be a standard programme for the transfer of knowledge by training locals here and in the source country."

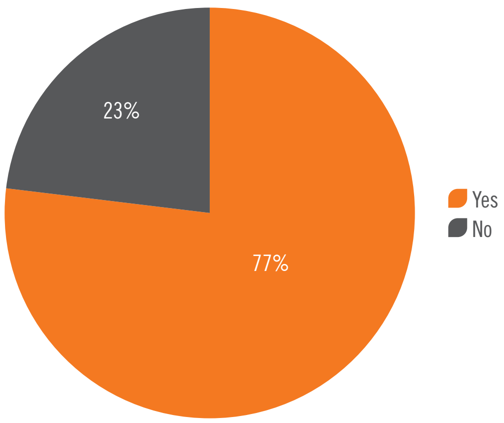
One of the biggest industrial park initiatives is in Belarus, where China has helped established an almost 100 square kilometre park outside the city of Minsk. At the end of February 2019, 43 companies registered at the park – 26 were from China, 10 from Belarus and seven from other countries, including the US and Russia. Such efforts are far from universal, however. A respondent from a small central bank from Eastern Europe said: "At the current juncture, the presence is limited to road infrastructure, and hence has had no major impact on technological capacity."

Preferred sources of funding

Currently, a large proportion of BRI financing comes from China. Responses from member countries corroborate this dynamic: 47% of respondents said they expected the majority of BRI funding to come from Chinese development and state-owned banks, with Chinese-backed multilateral institutions and private Chinese corporations also seen as core sources of funding (see figure 10).

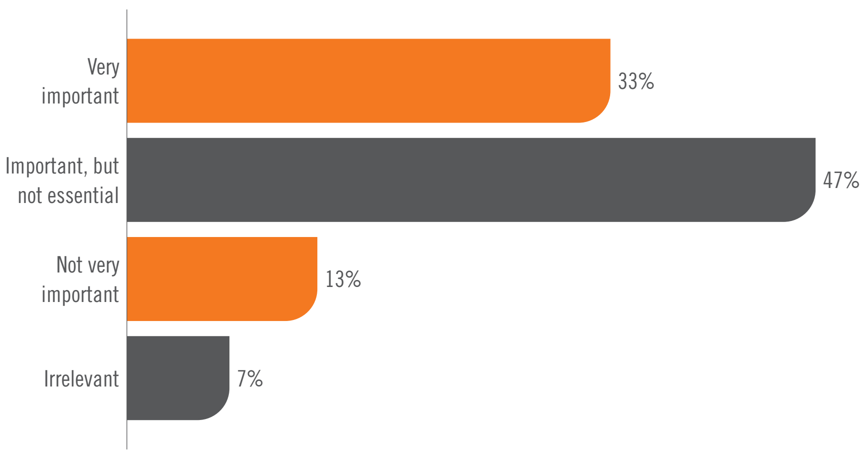
Chinese development banks are the most involved in BRI projects from the perspective of survey respondents, with the China Development Bank (CDB) and the Export-Import Bank of China singled out by a number of them as providing core funding for projects. Both lenders operate directly under the State Council of the People's Republic of China, and are responsible for raising funds for and implementing economic policies of the government at home and abroad. Their BRI investments total hundreds of billions of dollars, with the CDB committing more than $200 billion.

Figure 8 – Will the BRI help achieve global climate change commitments?



Seventeen central banks did not respond.

Figure 9 – How important is the BRI in helping to upgrade technological capacity in your jurisdiction?



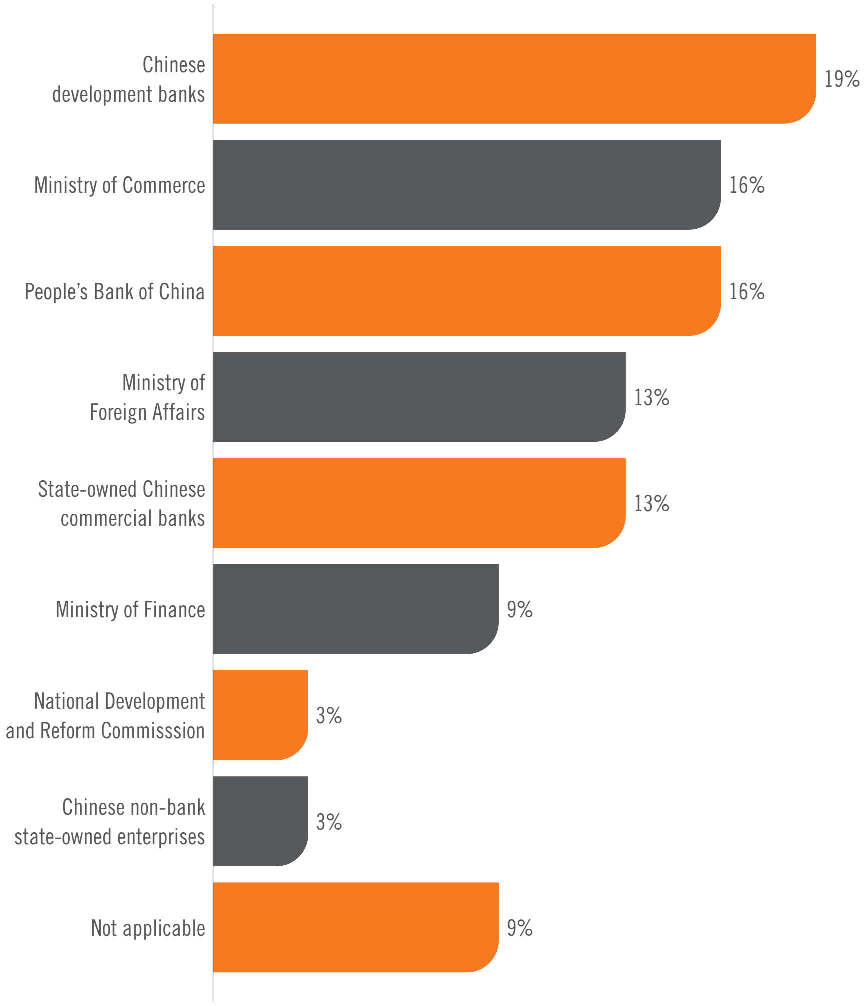
Fifteen central banks did not respond.

Figure 10 – What will be the most significant source of funding for BRI projects in your jurisdiction?

	1	2	3	4	5	6
Chinese development and state-owned banks	47%	31%	25%	0%	0%	0%
Multilateral institutions	40%	8%	0%	27%	9%	14%
International commercial banks	7%	15%	25%	18%	27%	14%
Private Chinese corporations	7%	15%	8%	45%	9%	14%
Chinese-backed multilateral institutions	0%	31%	42%	0%	27%	14%
Financial markets	0%	0%	0%	9%	27%	43%

Votes were cast using a scale of 1–6, where 1 denotes the most significant source of funding and 6 the least significant. Fifteen central banks did not respond.

Figure 11 – Which Chinese institutions are most involved in BRI efforts in your jurisdiction?



Respondents were invited to select multiple options where applicable. Fifteen central banks did not respond.

The CDB – which specifically finances infrastructure, energy and transportation projects – is one of the largest financial backers. As a result, the institution is an important driver behind the BRI and its contribution is consistently growing. It is also the largest foreign-currency lender, and the second-biggest bond issuer in China.

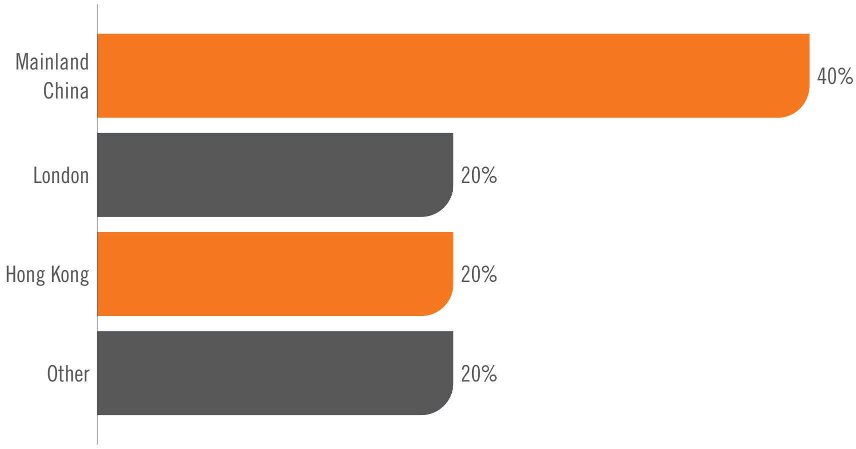
A shared feature of the other Chinese institutions that feature prominently in the responses of the participating central banks – the Ministry of Commerce (16%), the People's Bank of China (16%), Ministry of Foreign Affairs (13%) and state-owned commercial banks (13%) – is that these institutions are also either part of, or come under the direct jurisdiction of, the central government (see figure 11). These figures largely confirm the strategic position of the BRI in the context of China's foreign policy efforts; and, to some extent, also highlight the additional, political dimension of the individual BRI projects and investments.

However, with the total trade volume between China and participating countries surpassing $6 trillion in 2019 and a need for an additional $26 trillion in investments by 2030 to keep the economy growing, significant additional sources of funding will be crucial to ensure the continued success of the initiative.

A small proportion of respondents now expect funding for BRI projects to come from financial markets. Markets in London, Hong Kong and mainland China were all mentioned by respondents as possible sources of funding (see figure 12). The London Stock Exchange (LSE), for example, supports the BRI through a variety of services and initiatives. At the end of 2019, it facilitated $80 billion to be raised in equity capital and $170 billion in debt capital. It also claims to provide a "world-class listing infrastructure" for the BRI. Kazakhstan, one of the countries along the BRI, has listed 12 companies on LSE, with $14.4 billion in total market capitalisation. More than 100 renminbi-denominated bonds are currently listed on the exchange. It also supports Chinese firms issuing bonds denominated in other currencies. The Bank of China, through its Hungarian branch, for example, listed its first euro-denominated bond on LSE to fund BRI projects.

While 40% of respondents that specified markets as a source of funding named China as the destination of choice, renminbi usage

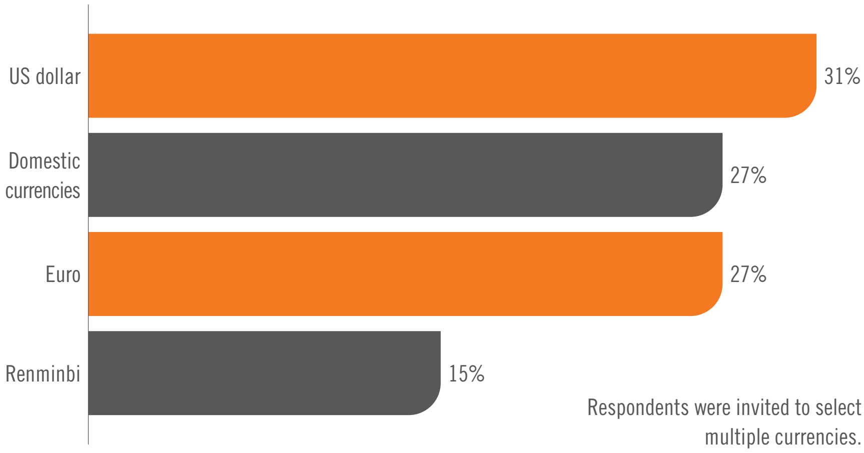
Figure 12 – Which financial markets do you expect most BRI funding for projects in your jurisdiction come from?



Of the seven respondents who selected financial markets (figure 10), two did not respond.

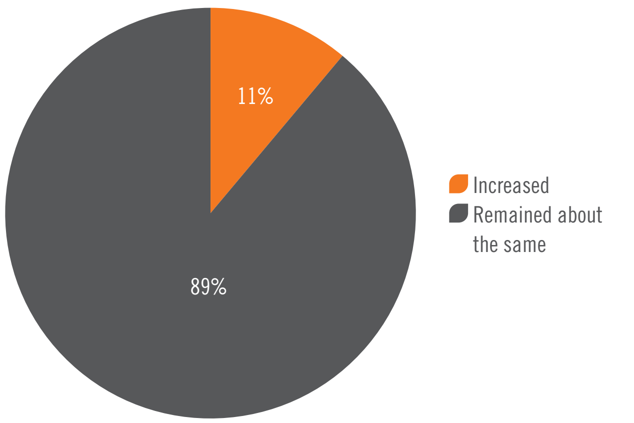
$298 billion of China-funded projects are currently under way in Russia. Moscow's Metro Line 3 is the first metro project undertaken by Chinese enterprises in Moscow

Figure 13 – What currency should be used for financing BRI-related projects?



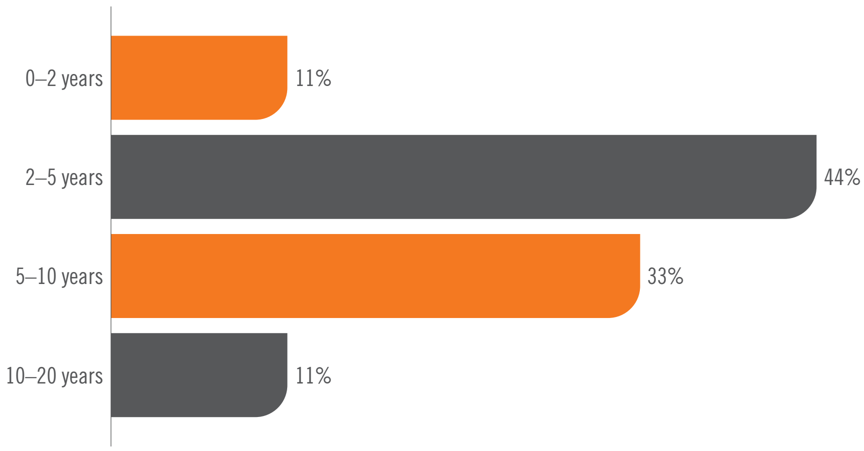
Respondents were invited to select multiple currencies.

Figure 14 – How has renminbi usage in BRI projects changed in your jurisdiction in the past 12 months?



No respondents reported a decrease in the use of renminbi in BRI projects. Twenty-one central banks did not respond.

Figure 15 – What is the average time to maturity of financing for BRI projects in your jurisdiction?



No respondents reported financing maturity of more than 20 years. Twenty-one central banks did not respond.

remains limited (see figure 13). A total of 15% of respondents said they would advocate using the Chinese currency for financing BRI-related projects. Despite US–China trade tensions, the US dollar remains the currency of choice (31%), followed by the euro (27%) and domestic currencies (27%).

In recent years, Chinese officials have made a concerted effort to facilitate the renminbi's international use. Since 2009, the People's Bank of China has signed more than 30 bilateral currency swap agreements with a range of central banks in countries ranging from Argentina to Nigeria. Meanwhile, the IMF officially inducted the renminbi into its elite club of global reserve currencies in 2016.

Despite these developments, almost 90% of respondents said the use of renminbi in BRI projects had not changed in the past 12 months (see figure 14). There are even signs that international renminbi use may have declined. In August 2015, the renminbi stood as the world's fifth most active currency for domestic and international payments, with a 2.8% share according to Swift. By January 2020, it had slipped to sixth, with a share of 1.94%. The US dollar, however, has maintained its leading share of domestic and international payments at roughly 40%.

Debt sustainability

The average time to maturity of financing for BRI projects varied among respondents: 55% said less than five years, 33% between five and 10 years, and 11% said between 10 and 20 years (see figure 15).

Currently, there appears to be only been one instance of China taking control of a BRI asset – it now operates Hambantota Port in Sri Lanka on a 99-year lease.

The Center for Global Development says another seven BRI recipient countries – Djibouti, Kyrgyzstan, Laos, the Maldives, Mongolia, Montenegro and Tajikistan – are potentially in BRI-related debt distress.[10] But Sri Lanka is not the only country showing signs of struggling with BRI-related debt. Some believe Pakistan's previous government overcommitted on its $62 billion China–Pakistan Economic Corridor, which resulted in the need for an austerity budget and an IMF bail-out – although Pakistan officials stress that Chinese support has already contributed to the introduction of vital infrastructure that will promote its future tax revenue growth.

Respondents to the survey tend to view BRI debt as less significant in scale than other forms of external debt (see figure 16). Only 10% said it was greater in scale, while 20% said it was the same.

A lot of external funding comes from sources other than China. "Most of the loans are from the international capital market and international financial institutions such as the IMF, International Development Bank and World Bank," said a small central bank from the Caribbean region.

A central bank in Eastern Europe said the reason for the smaller proportion of Chinese debt was because of the smaller scale of the projects involved. "The BRI is limited only to two highway projects in our nation, and so the debt obligations are smaller," it said.

BRI debt is generally perceived not to carry onerous terms and conditions (see figure 17). Almost 60% of respondents said BRI debt had more manageable terms relative to other external debt.

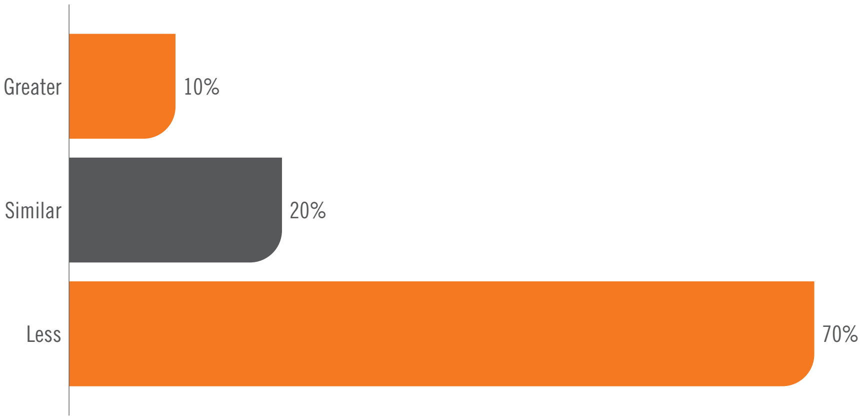
One central bank in the Caribbean region said debt sustainability was not a significant issue for their nation due to changes to its own fiscal policies. "We are in a position where we can easily manage BRI loans due to prudent fiscal policies," it said.

At the Belt and Road Forum, President Xi made explicit China's commitment to supporting global debt goals and environmental sustainability. Christine Lagarde, at the time managing director of the IMF, responded positively: "I have said before that, to be fully successful, the BRI should only go where it is needed. I would add today that it should only go where it is sustainable in all aspects," she said. "Fortunately, the Chinese government is already taking some steps to ensure this is the case. The new debt sustainability framework that will be utilised to evaluate BRI projects is a significant move in the right direction."

The changes could be having the desired effect. All survey respondents said they would categorise BRI-related debt as sustainable in their jurisdictions (see figure 18). However, they did exhibit some fears about debt levels in other BRI states. Fifty-seven per cent of respondents said they were concerned the BRI was causing debt to reach unsustainable levels in five or more countries, with 14% saying they were concerned about debt levels in 20 or more countries (see figure 19).

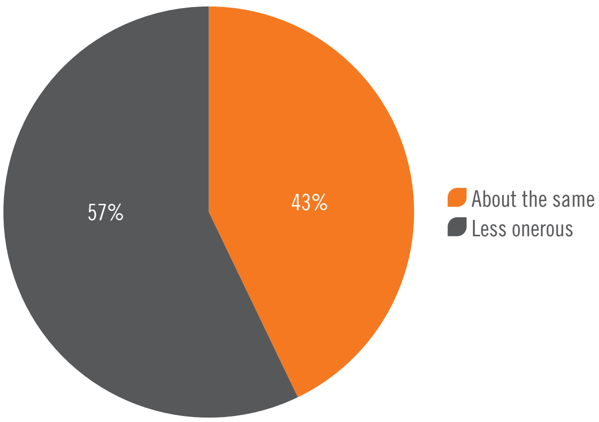
President Xi and other Chinese officials have repeatedly said they do not want debtor nations to be in difficulty. China and 27 other countries have jointly adopted the *Guiding principles on financing the development of the Belt and Road*,[11] which highlights the need to ensure debt sustainability in project financing. To assist nations in avoiding excessive debt, new institutions have also been created. The China-IMF Capacity Development Center is being funded by China, as is the International Development Cooperation Agency.

Figure 16 – Relative to other external debt, how significant is BRI debt in your jurisdiction?



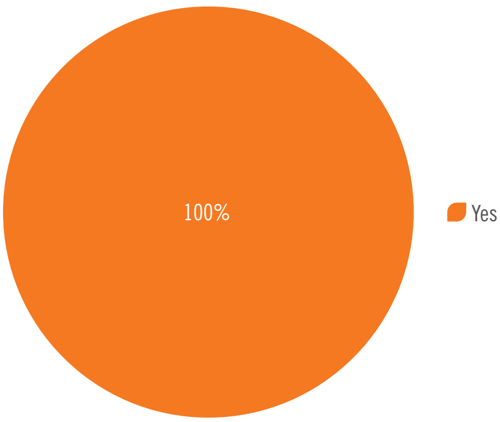
Twenty central banks did not respond.

Figure 17 – How onerous are the terms and conditions of BRI debt in your jurisdiction compared with other external debt?



No respondents described the terms and conditions of BRI debt as more onerous than other external debt. Twenty-three central banks did not respond.

Figure 18 – Is BRI-related debt in your jurisdiction sustainable?



Twenty central banks did not respond.

Room for improvement

During the six years the BRI has been in operation, much practical progress has been made. Many projects concerning transport construction and industrial infrastructure have already started to benefit member countries. In Africa, Chinese investment has seen the development of the first electrified railway line in East Africa between Ethiopia and Djibouti. More than 750km long and with an operating speed of 120km per hour, the Addis Ababa–Djibouti Railway has reduced travel time from the Port of Djibouti to the Ethiopian capital to less than 12 hours. The journey previously took three days.

However, some respondents reported that BRI project plans need to be better co-ordinated and aligned with national and regional development strategies (see figure 20). In addition, in most BRI countries, China has focused on building partnerships mainly with central governments and high-ranking officials. There is still a need for Chinese enterprises and officials to engage more with local communities on projects.

In Uganda, the Export-Import Bank of China provided 85% of the funding for the Isimba Hydroelectric Power Station. Built by China International Water & Electric Corporation, the 183 megawatt power station is the third-largest in Uganda and was built to address the country's power shortages. The project required 3,000 workers, 85% of whom were Ugandan.

"More emphasis should be placed on the mix of workers – local versus Chinese – and how the selection process is done," said a central bank from the Caribbean region. "The working environment should have basic amenities suitable for a proper working environment. Also, more co-ordination is needed with various local government agencies to ensure smoother completion of the project."

The survey results reveal that two-fifths of the respondent central banks are actively advising their government and state development bodies about the BRI. With the exception of one central bank from Europe, all of these respondents represent emerging market and transition economies, where central banks tend to play a more active role in a country's economic growth and development.

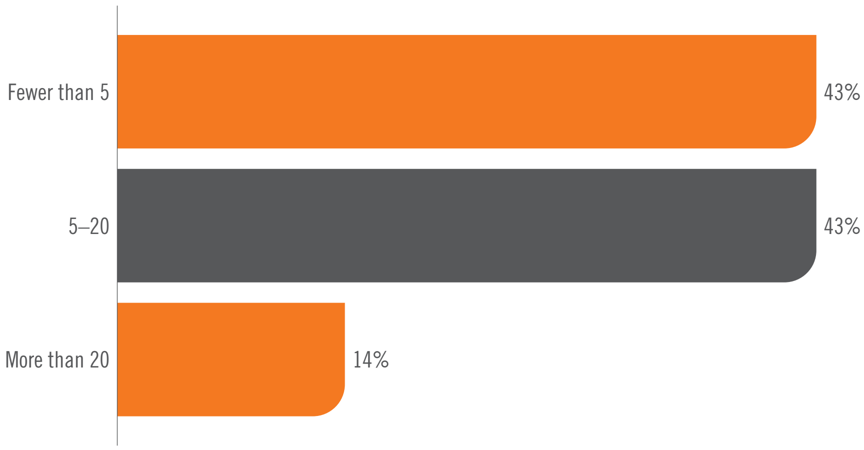
Unsurprisingly, the actions of China's central bank have been crucial in supporting the project. As of May 2019, the People's Bank of China has signed bilateral local currency swap agreements with 21 central banks in countries participating in the BRI.

Advisory responsibility more generally, however, sits with the relevant government departments. In these instances, government bodies – including domestic ministries of customs and trade, economic development, finance and foreign affairs – tend to be the driving force. Given the scope of the projects, it is unsurprising they are responsible for BRI-related matters. Nevertheless, as the scope of the BRI continues to expand, it may become crucial for central banks and financial regulators to take a more prominent role.

In addition to government departments, central banks taking a more active advisory role also tend to engage with Chinese authorities (see figure 21). This includes central banks from Asia, Europe and the Middle East, which indicates there may be little pattern when analysing the results by region of state of development.

Project selection was ranked as the second most important aspect of the BRI requiring improvement. While there tends to be discussions between governments regarding project selection, there remains a risk of stranded infrastructure if BRI projects are not included within wider strategies. Respondents also expressed a need for improved financial and project management support from the development banks involved in the projects.

Figure 19 – In how many countries are you concerned the BRI is causing debt to reach unsustainable levels?



No respondents reported the sustainability of BRI debt not to be a problem. Twenty-three central banks did not respond.

Figure 20 – Which aspects of the BRI should be improved?

	1	2	3	4	5
Co-ordination with national development strategies or regional strategy projects of the BRI	60%	21%	7%	8%	8%
Project selection	20%	43%	21%	23%	0%
Ethics	13%	0%	14%	0%	62%
Regulatory transparency	7%	14%	14%	54%	8%
Financial and project management support by development banks	0%	21%	43%	15%	23%

Votes were cast using a scale of 1–5, where 1 denotes the most important aspect to be improved and 5 the least important. Fifteen central banks did not respond.

Current challenges

There is no doubt the BRI faces challenges. But, against a backdrop of tense trade relationships among the major trading blocs, the BRI has continued to gain a strong foothold. Indeed, BRI countries may have benefited from a fall in Chinese investments in the US. At its peak in 2016, the US accounted for roughly one-third of China's overseas investments according to *China global investment tracker*, which looks at deal sizes of $100 million and above. Since President Donald Trump took office, Chinese investments in the US have plunged. It is therefore not surprising that 20% of respondents view political stability as a significant challenge.

Nonetheless, maintaining good relationships among BRI members will be crucial in the future. Respondents noted relations with major countries worldwide (18%) and within their region (20%), as the most significant challenge (see figure 22). "Other major countries could begin to get concerned regarding China's expansion globally," a Caribbean central bank said.

Managing relationships through election cycles also remains a challenge for Chinese officials. Projects can be susceptible to renegotiation risk, as demonstrated in 2017, when Malaysia looked set to terminate BRI projects following a general election. However, a year later, the government revived transport and property development projects with China, but the cost of the projects was reduced by one-third from $16 billion to $11 billion, according to research by Wharton University.[12] Myanmar, too, has downsized a BRI-related port project from $7.5 billion to $1.3 billion.

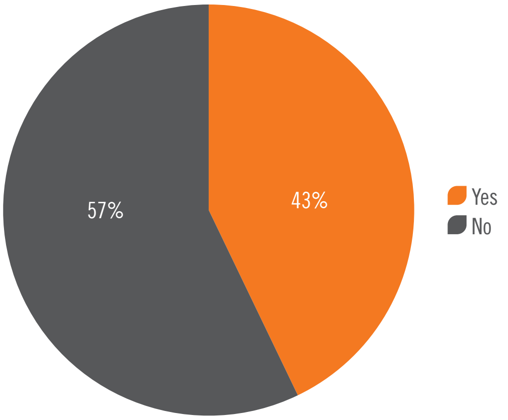
Overall downward pressure on domestic economies was only listed as a concern by 11% of respondents. The new *Debt Sustainability Framework for participating countries of the Belt and Road Initiative*, combined with looser monetary policy in the US, appears to have stemmed 'debt trap' fears. Following extraordinary action from the Federal Reserve in March, emerging markets may feel their debt burdens lessening some more – at least in the short term.

THE 2019 BELT AND ROAD INITIATIVE (BRI) SURVEY

In 2018, the IFF, in collaboration with Central Banking, inaugurated the BRI survey. Last year, with responses received from 28 global central banks, the findings concluded the BRI would support globalisation. However, there were concerns projects under way were not in line with current climate goals. The 2020 survey reveals the BRI debt is viewed as sustainable compared with other forms of external debt, particularly given it is often proportionally less significant.

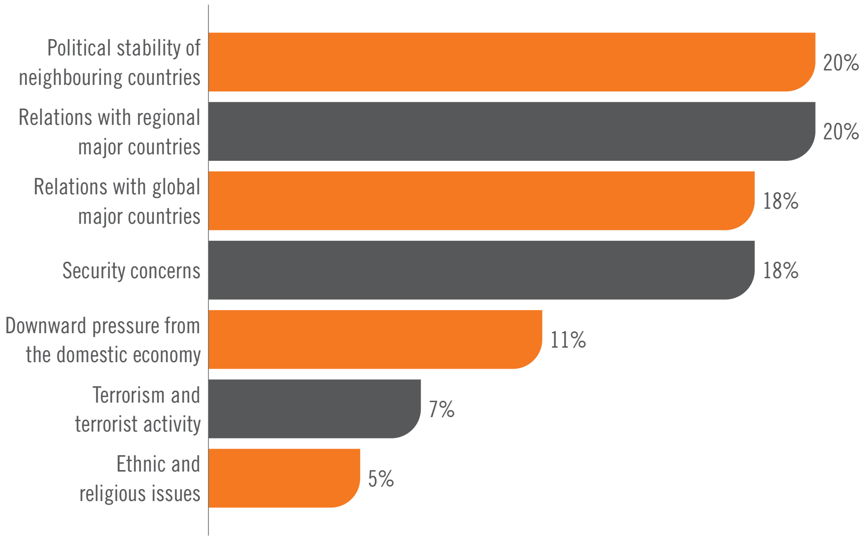
www.centralbanking.com/4129801

Figure 21 – Does your government or state development body engage with Chinese authorities on the BRI?



Fifteen central banks did not respond.

Figure 22 – What are the most significant challenges BRI countries face?



Respondents were invited to select multiple options where applicable. Fourteen central banks did not respond.

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Dispelling the gloom of globalisation slowdown

The world economy may be in the doldrums, says *Zhang Shenfeng*, vice-chairman of the China Council for the Promotion of International Trade, but there are rays of sunshine despite the cloudy forecast, with the Belt and Road Initiative the new driving force toward global prosperity

The world economic landscape is currently experiencing profound and complex changes. The past two years have been some of the most unstable and uncertain ever for global economic development, and economic and trade patterns have undergone deep adjustments.

Economic globalisation is slowing down: the International Monetary Fund (IMF) projected global growth to rise from an estimated 2.9% in 2019 to 3.3% in 2020 and 3.4% for 2021.[1] Global trade is also losing momentum – accounting in 2017 for 22.5% of global GDP, compared with 28.1% in 2007. Its growth rate is moderating too – noticeably higher than the growth rate of the world economy, but now flat. The global Purchasing Managers' Index has fluctuated around the 50 mark since May 2019, and the World Trade Organization (WTO) lowered its expectation on the growth of global trade in goods to 1.2% – the lowest since 2016.[2]

Meanwhile, tussles in the international economic and trade arena are becoming more frequent and intense. China–US economic and trade frictions are increasing – as are dispute settlement cases on antisubsidy investigations initiated by WTO members and at the China International Economic and Trade Arbitration Commission, where the number of economic and trade disputes has grown 30% year on year.

There has also been a shift towards decentralisation. Rising protectionist sentiments pose unprecedented challenges to the current multilateral trade system, while WTO members have failed to achieve an agreement on how to conduct reform, and even which aspects of its role require it. Major economies move faster to sign bilateral trade agreements, which will clearly lead to a more decentralised trade situation.

The force awakens

In such a landscape, it is important to explore the role of the Belt and Road Initiative (BRI) as a new driving force toward global growth. How do we promote the regulatory and project management of BRI to enhance infrastructure construction and secure the stable and sustainable development of economies in general – and finance in particular?

The BRI is a major international co-operation initiative, planned, deployed and promoted by President Xi Jinping. Over the past six years, China has signed 200 co-operation agreements with 138 countries and 30 international organisations as at January 2020.[3] All BRI participants, following the guideline of wider consultation, joint contribution and shared benefits, have established a vibrant and open system for joint decision-making and collaborative work. This system, in return, directly stimulates investment and trade growth in the relevant countries and regions. Here is a chance to inject a new driving force into the current gloomy world economy.

Since 2013, China's accumulated direct investment has exceeded US$100 billion, and the value of import and export to BRI countries reached $7.47 trillion. From January to October 2019, the growth of imports and exports to BRI countries was 9.4% – the fastest among all regions, accounting for 29.1% of China's total foreign trade volume. A World Bank report, *Belt and Road economics – Opportunities and risks of transport corridors*, estimates that "trade will grow from between 2.8% and 9.7% for corridor economies and between 1.7% and 6.2% for the world", and that "increased trade is expected to increase global real income by 0.7% to 2.9%, not including the cost of infrastructure investment".[4]

Building on current achievements and divining how to continue the high-quality development of the BRI to benefit the international community and world citizens remains a crucial topic for all stakeholders.

First, the core principles must be firmly upheld – wide consultation; joint contribution and shared benefits; and connectivity in policy, infrastructure, trade, finance and people – as reinforced and elaborated on by President Xi at home and abroad. One-way communication is not viable – these principles emphasise the input of stakeholders and the importance of decisions being delivered after joint discussions. Every participant should make full use of their strengths and capabilities to achieve mutual benefits and win-win outcomes through bilateral, trilateral or multilateral co-operation.

Closer connections should also be established in five major areas:

- **Policy** – to enhance intergovernmental co-operation
- **Infrastructure** – including hardware as well as other connections
- **Trade** – the starting point and the most fundamental area
- **Finance** – the lifeblood of the modern economy
- **Connectivity of people** – among whom openness and understanding of inclusiveness lie.

There is also a need to continuously promote the construction of mechanisms and platforms. Domestic development and co-operation schemes should be co-ordinated with those of the UN, the Association of Southeast Asian Nations (ASEAN), the African Union, the European Union, the Eurasian Economic Union and other international and regional organisations, as well as the development strategies of specific countries. Multilateral co-operation mechanisms – including the Group of 20; the Asia-Pacific Economic Cooperation; the Shanghai Cooperation Organisation; the China–ASEAN Investment Cooperation Fund; the Forum on China–Africa Cooperation; the China–Arab States Cooperation Forum; the China and the Community of Latin American and Caribbean States Forum; and Cooperation between China and Central and Eastern European Countries, known as '17+1' – should be used as forums for stakeholders to engage further in policy co-ordination to safeguard multilateralism and free trade.

Platforms for intergovernmental policy dialogues – including the Belt and Road Forum for International Cooperation and the China International Import Expo – are also improving quality and efficiency to more rapidly achieve consensus among parties and facilitate the physical outcomes of collaborative work.

Priority must be given to constructing infrastructure and laying the foundations for connection, co-operation and development. Currently, the majority of investment in the BRI is allocated to infrastructure construction and building the framework, proposed by President Xi at the second Belt and Road Forum for International Cooperation in April 2019, of "six corridors, six routes serving multiple countries and ports".[5]

So far, the China–Europe Railway Express has taken almost 20,000 trips through 16 foreign countries and 53 cities. It has the potential to unlock Asia–Europe land logistics and trade routes, and transform production and trade patterns.

A pincer approach

The multilateral trade system represented by the WTO and the regional trade schemes epitomised by free-trade agreements (FTAs) are the two driving forces of economic globalisation. A two-pronged approach should be adopted here. On one side, China will support and actively participate in WTO reform, uphold majority rule and commit to narrowing the worldwide development gap. On the other, China should proactively negotiate and sign FTAs, increasing its tally of 16, and encouraging enterprises to use them more frequently, giving full rein to promoting favourable policies.

The Regional Comprehensive Economic Partnership – potentially the world's largest economic bloc – is expected to be signed and to take effect soon. It will establish a free-trade area with the largest population, the most diverse membership and the most potential for development. More high-level FTAs are also brewing within BRI participating countries.

With the growing penetration of the BRI into the rest of the world, demand is gradually increasing: for infrastructure construction, trade and investment, industrial project co-operation, cross-border payment and settlement, and other financial services.

China should not only take advantage of international financial institutions, development financial institutions and policy banks, but also motivate commercial financial institutions to expand funding resources. A multifaceted financial services system should be established, including development, industrial, trade, cross-border and internet financing, to ensure the sustainability of commercial and fiscal financing.

Meanwhile, China should make full use of direct financing, upgrade the connectivity of capital markets, create new financial instruments and develop more inclusive insurance and financial derivatives to meet the various demands of risk management regulation. Cross-border financial supervision and credit co-operation should also be fortified to ensure the financial security system is stable, sustainable and risk-controllable.

Improving publicity and increasing trust to gain support and confidence from the public will also be crucial for the success of the BRI. Over the past six years, China has established dozens of economic and trade co-operation parks in BRI countries. It has also generated more than 300,000 local job positions and tax revenues of more than $2.7 billion for the host countries. Many enterprises have enhanced economic and social development in culture, education, healthcare, sanitation, people-to-people exchange and charities. The BRI is not just an economic policy – it is one that inspires people to live better lives.

However, some countries still have doubts about the BRI, with some even regarding it a geopolitical tool and a debt trap. Ancient Chinese wisdom values the soft power of public diplomacy, believing mutual trust holds the key to further expansion of the BRI. It is necessary to disseminate the success stories and progress made to dispel bias and hatred, and create a more welcoming environment.

Last, but not least, we must ensure enterprises' behaviour complies with local regulations, improving domestic business environments and accelerating soft infrastructure construction. Regulation, industrial policies, market basis, culture and custom vary significantly in different countries, so China should establish a well-structured early warning system. It should also provide risk evaluation, a legal service directory and other necessary information for enterprises, as well as supervise enterprises' overseas behaviour and encourage them to abide by law, regulations, ethics and moral standards.

Export control should also come under the Chinese government's remit. Enterprises should be mandated to undergo security checks, abide by unfair competition controls, anti-bribery laws and other risk management provisions. The government should also mobilise professional agencies to provide services, including legal consulting, credit investigation, arbitration and mediation, patent and trademark commissioning, intellectual property protection and antitrust claims. Meanwhile, customs, taxation, certification and other competent departments must implement and co-ordinate the established agreements to avoid repeated work.

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Corridor of power

Pakistan cannot trade with three of its four neighbours, but the Belt and Road Initiative has offered it a uniquely close trading and infrastructure partnership with China, which will benefit the entire region. Three statesmen and financiers share their views on what the future holds for Pakistan

Shaukat Aziz
IFF co-chairman, and former prime minister and finance minister of Pakistan

Pakistan is proud to be one of the pilot countries of the Belt and Road Initative (BRI). Here, the initiative is executed not with the cookie-cutter approach so often employed in the past with other Western institutions, but with professionalism, transparency and adherence to national requirements. Countries such as Pakistan have limited access to capital markets, although the Bretton Woods Institutions – such as the World Bank and the International Monetary Fund – have set up camp here. The BRI has a very specific purpose and a basic philosophy: if you develop your infrastructure properly – in a timely and appropriate fashion related to the needs of your country – your economy will expand and growth will improve. The underlying aim is to create an environment for growth, higher employment and the empowerment of people with more opportunities in their home countries.

Good infrastructure is an enabler of growth, effective poverty reduction and improvement of standards of living. The first BRI project in Pakistan was the deep-sea Gwadar Port, which has been built in record time. Sceptics initially suggested it was a naval base, but if you visit you will discover that it is merely a port, close to the Iranian border, which opens Pakistan up further through greater access to the sea. However, it is not a modest project – it has transformed the entire region. Prior to the port's development, there was not even a proper road connecting the area, but high-standard motorways have since been built where, previously, driving had never been seriously considered as an option.

The BRI is a national game-changer that creates and unleashes positive forces. We should develop this concept continuously and improve it so we can obtain quality growth and quality life for our people, sharing and caring for everybody, rich or poor.

Ashfaque Hasan Khan
IFF Academic Committee member and member of Pakistan's Economic Advisory Council

Globalisation today has made the world richer than before but, in recent years, it has come under severe criticism from its erstwhile champions. In their view, the fruits of globalisation have not been shared fairly, which has led to growing inequality among and within nations. Such thinking has given rise to nationalism and protectionism in the West, which is hampering international trade, global growth and prosperity.

President Xi Jinping, addressing the World Economic Forum in January 2017, clearly stated that there was nothing wrong with globalisation. What was required was to make globalisation work for all – rich and poor. The BRI has clearly demonstrated a way forward to make globalisation work for all as it builds on connectivity and co-operation among participating countries.

Connectivity is vital for the success of regional co-operation, facilitating exchange activities within and between countries. At the first Belt and Road Forum in Beijing in May 2017, President Xi noted that "in pursuing the BRI, we should focus on the fundamental issue of development, release the growth potential of various countries and achieve economic integration and interconnected development, and deliver benefit to all". The key to the success of President Xi's vision is connectivity through physical infrastructure, such as roads, motorways and ports; telecommunications networks; energy infrastructure, such as pipelines; electricity; banking and financial infrastructure; and people-to-people connectivity, such as international tourism, overseas study programmes, and so on. The BRI portal now lists 138 countries and 30 international organisations, as of the end of January 2020, including the recent additions of Italy and Luxembourg.[1]

Evidence suggests infrastructure investment contributes to economic growth and ushers in sustainable prosperity. But the world is facing a large infrastructure gap that constrains trade,

The first BRI project in Pakistan was the deep-sea Gwadar Port, built in record time

openness and future prosperity. According to a study by the Asian Development Bank (ADB), Asia requires US$26 trillion of investment to bridge the infrastructure gap by 2030.[2] Multilateral development banks, such as the World Bank and the ADB, are working hard to close this gap, but China's BRI can also help solve this problem – not only in Asia but in other parts of the world. BRI investment projects are estimated to add more than $1 trillion of infrastructure between 2017 and 2027. The BRI must thus be seen in the context of global infrastructure needs and China's long-term economic strategy, as well as the development strategy of participating countries. The BRI has emerged as a new driving force to global growth and prosperity. By looking at the growing list of participating countries, it is safe to describe the BRI as a vehicle for new globalisation – or 'globalisation 2.0'.

The development strategy of the BRI builds on connectivity and co-operation through six economic corridors, including the China–Pakistan Economic Corridor (CPEC) – the only bilateral corridor connecting the two countries. The remaining five are multicountry corridors. CPEC is considered central to China–Pakistan relations and is part of the national security strategy of the two countries. CPEC is considered the linchpin or flagship project of the BRI. It has provided a unique opportunity for Pakistan to boost its strategic and economic position in the region and has the potential to transform Pakistan into a regional hub for trade and investment.

CPEC covers everything from energy and key elements of infrastructure development including roads, motorways, sea routes and airports, to communication, industrial co-operation, the establishment of special economic zones (SEZs) and the Gwadar Port development. CPEC was officially launched in April 2015 during President Xi's visit to Pakistan, when $46 billion in investment was committed over the following 15 years. The project has since expanded to help overcome electricity shortages in Pakistan, with project investment increasing to $68 billion. CPEC projects will be launched in three phases: 2015–20, 2020–25 and 2025–30.

The first phase of the CPEC projects is almost complete. It is highly encouraging to note that it has made significant contributions to Pakistan's economic development so far. CPEC has already proved a real game-changer for Pakistan and will play a demonstrative role for other countries participating in the BRI.

Like many Asian countries, Pakistan has been facing a large infrastructure gap and acute electricity shortages, which have constrained economic growth. According to the ADB, inefficiencies in energy production cost Pakistan $18 billion, or 6.5% of GDP, in 2015.[3] Given Pakistan's sprawling geography, the development of remote areas has been a gigantic task requiring enormous budgetary resources. Thanks to the BRI and CPEC, Pakistan has been transformed to an electricity surplus country, successfully overcoming electricity shortages through CPEC power projects.

Physical infrastructure has been developed and world-class motorways and road infrastructure have been built. The connectivity of Kashgar in China and Gwadar Port – with close to 3,000km of motorway network – has already been achieved. Since this motorway passes through remote areas of Pakistan, it has opened those areas to business. This surge in connectivity is bound to bring prosperity to even far-flung areas of Pakistan. Massive construction activity is taking place around Gwadar Port and the city of Gwadar itself, and an SEZ has been earmarked for Chinese industries exclusively. This port city should also witness the establishment of oil refineries and oil pipelines.

With the completion of major infrastructure and energy projects, the first phase of CPEC has helped Pakistan address its huge energy deficit, strengthen transportation and communications networks, and build physical infrastructure such as roads and motorways. Pakistan has suffered electricity shortages since the 1980s, but these were aggravated enormously between 2008 and 2015, when power outages became the norm in urban and rural areas, and the country was losing $4.5 billion each year in production and business costs. Pakistan has managed to address these bottlenecks with the help of the BRI and CPEC.

The second phase of CPEC will focus on industrial and agricultural co-operation, the further construction of Gwadar Port, and socioeconomic development. Twenty-seven new projects of the second phase were defined in April 2019, 17 of which are due to commence in the first half of 2020.

In agriculture, emphasis will be placed on increasing productivity of major crops, livestock, the dairy sector and fishing; reducing the post-harvest loss of agricultural crops; and improving warehousing.

After removing bottlenecks in power generation, the pace of industrialisation will be accelerated through the establishment of nine SEZs, to which China is willing to relocate its labour-intensive industries. All SEZs except Gwadar will be open to all countries. Beside industrialisation, this project will also increase Pakistan's exports to China as well as to other parts of the world. Three SEZs will be made functional soon.

Pakistan's southern regions, including Balochistan, are packed with high-quality minerals. The execution of CPEC is divided into five functional zones; the 'western alignment' in Pakistan has been earmarked for exploration and ecological conservation, and Gwadar–Quetta–Dera Ismail Khan for mineral exploration. China has expressed its keen desire to undertake mineral exploration projects here.

The second phase of CPEC will also address Pakistan's human capital development challenges. Emphasis will be given to the establishment of high-quality educational as well as skill development institutions.

Enter high growth

CPEC is not just a bilateral initiative between China and Pakistan, it has a regional perspective as well. It has the potential to become a truly regional pivot if extended to countries such as Afghanistan, the Central Asian republics, Iran, Turkey and Oman. Such a regional initiative, once implemented, will put Pakistan at the centre of regional connectivity and build it into a hub of economic activity, with Gwadar facilitating trade with the region.

The BRI and CPEC have benefited Pakistan immensely, strengthening the country's physical infrastructure and laying down the foundation for balanced regional development. It has so far created in excess of 80,000 jobs, with 90% of the workforce coming from Pakistan. It has also contributed at least 1% to real GDP growth. Once the project is completed, it has the potential to transform Pakistan from a low- (3%–4%) to a high-growth (7%–8%) country, substantially raising the average per capita income. CPEC has the potential to connect many countries in the region, all of which can benefit from this initiative. Without doubt, BRI has emerged as a new driving force of global growth and prosperity.

Muneer Kamal
Former chairman of the Pakistan Stock Exchange and the State Bank of Pakistan

Pakistan is in a unique geographical position. Normally, regions develop together, but Pakistan cannot trade with India, Afghanistan or Iran because of politics, war and sanctions.

Luckily for Pakistan, it has another neighbour that is already the largest manufacturer in the world and, over the next two decades, is likely to become the single biggest economy as well. Over the past six decades, Pakistan has developed a unique relationship with China, one that has led to the early deployment of BRI policies.

When the BRI was launched in 2013, Pakistan was included as one of the six corridors. CPEC is one of the flagship projects and was introduced at a crucial time for Pakistan. Plagued by relentless domestic terrorist attacks, and with the war in Afghanistan raging on its borders, Pakistan was in trouble. At that point in time, there was little hope, and options for loans seemed to dry up. To top it all, the country faced a yawning energy gap.

The pace of development and implementation of the BRI was incredible. Within six years, the first phase of CPEC power projects was completed, following a total of $30 billion worth of investment. Nine projects have been implemented and commissioned: 5,320 megawatts (MW) at a cost of $7.9 billion, on the construction of eight additional power projects at 4,470MW at the cost of $9.5 billion. We are planning 2,544MW more at a cost of $4.5 billion.

In addition, Pakistan has been diligently implementing BRI infrastructure. Some of the motorways – for example from Sukkur to Multan – have been completed, and some are on the verge of completion. In Lahore, the $1.62 billion metro train project will be completed in the first quarter of 2020.

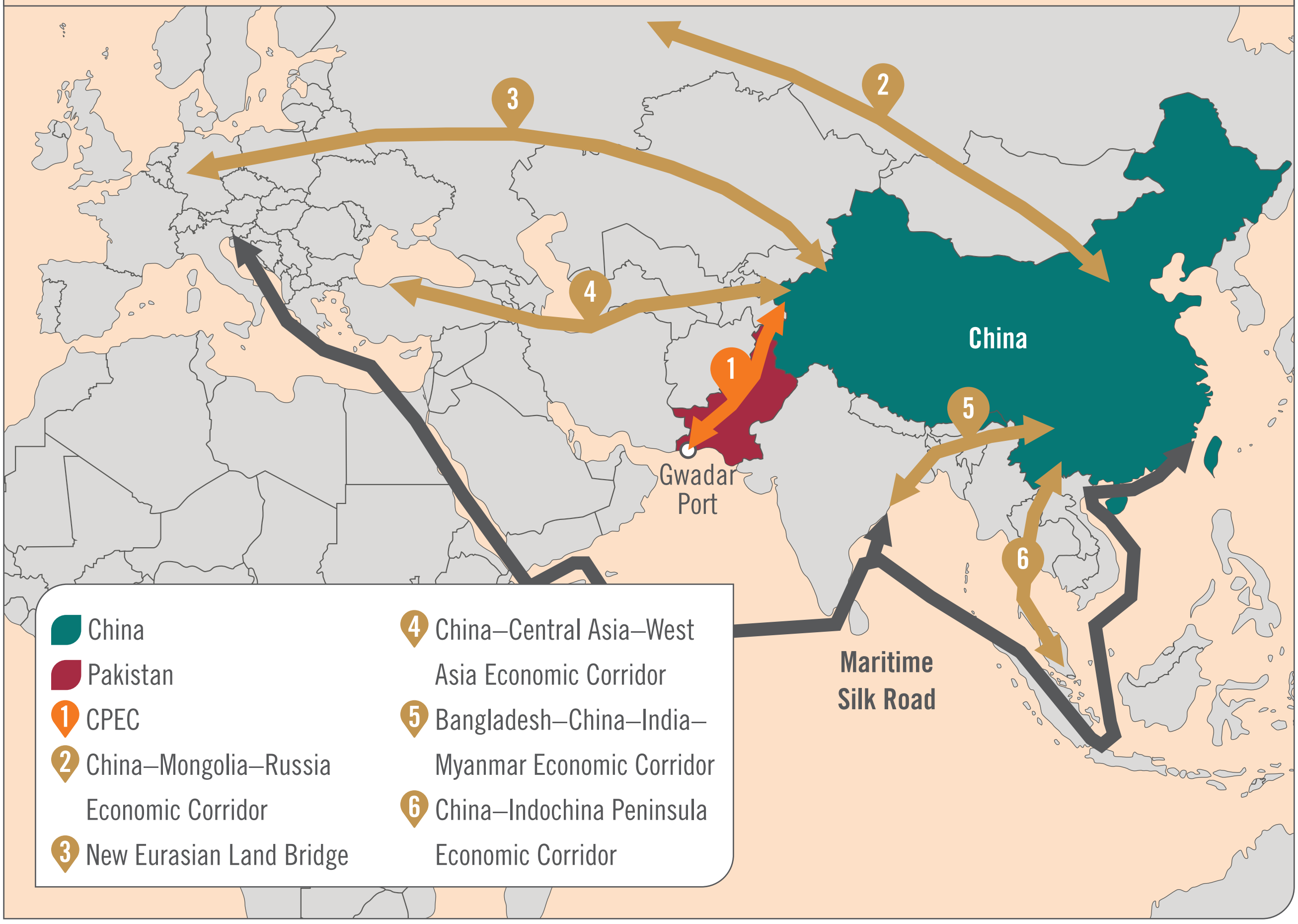
Where was the renminbi?

In the second phase, as we move forward, there are even more significant long-term implications for Pakistan. China has identified nine SEZs, of which three have been deemed development priority areas: Khyber Pakhtunkhwa, Punjab and near Karachi.

What makes the BRI initiative unique is how funding has been provided: for example, in a power-plant initiative, a Chinese company partnered with Engro, one of the largest companies in Pakistan. Habib Bank, Pakistan's largest bank, provided the equity for the project, which was financed in Pakistani rupees and foreign currency, which contributed around 25%–30%. The project cost around $30 billion, which is where the problem arises. All the energy projects were US dollar-denominated, so where was the renminbi?

One lesson Pakistan has learnt is that it needs to calculate how

The BRI's six economic corridors



to project and make loans in Pakistan in other currencies. And, as the BRI advances into other countries, a key lesson should be that financing does not have to be dollar-denominated – particularly for Pakistan projects.

Trade between China and Pakistan stands at between $16 billion and $18 billion. As more BRI projects are implemented in Pakistan, buttressed by the government's stabilisation programme, economic growth and trade will increase.

Renminbi usage in bilateral transactions will therefore have to be achieved very quickly. Pakistan does not currently directly exchange the rupee with the renminbi – the dollar is used as a converter. A capital account should be opened within the central banks to facilitate a direct pairing.

Another issue to consider is that the capital market has barely been used to bridge the funding gap. In December 2016, three of China's exchanges – the Shanghai Stock Exchange, the fourth-largest in the world; the Shenzhen Stock Exchange, the ninth-largest; and China Future, China's only derivatives exchange – along with Habib Bank, acquired a 40% stake in the Pakistan Stock Exchange.

Several road projects under the BRI have either been or are about to be implemented with exclusively Chinese funding. Certain components of the projects, such as the equipment, will be delivered by China, but it is being financed in local currency. But it is not a good idea to finance local currency for foreign currency funding. We must create infrastructure bonds in Pakistan, and the exchanges that are now heavily investing in the Pakistan Stock Exchange would need to support this initiative. We must develop infrastructure bonds to be listed on the stock exchange to fund the rupee requirements of BRI projects.

Currently, the Chinese have contributed funding for six infrastructure projects. I suggest that some of these projects are financed by Chinese financial institutions – a plus point for the stock exchange – and 40% of the free flow in Pakistan headed up by other foreign funds such as BlackRock, Vanguard and Lazard.

If they were to be listed on the stock exchange, BRI projects would gain further exposure and entice the best funds from around the world to invest. In addition, if successfully implemented and floated on the stock exchange, the rupee infrastructure bond would expose the projects to the international global community.

1. *Belt and Road Portal (December 2019)*, List of countries that have signed co-operation documents with China for the BRI, *https://bit.ly/2GBSDdO*
2. *ADB (February 2017)*, Meeting Asia's infrastructure needs, *https://bit.ly/3bfqtDJ*
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Clouds of glory

President Xi Jinping's call for high-quality development requires new, bespoke international standards for the flurry of modernisation and industrialisation in overlooked and underdeveloped corners of the globe, says *Shi Yulong*, director of the China Center for Urban Development at the National Development and Reform Commission

Shi Yulong

The true role of the Belt and Road Initiative (BRI) in promoting economic growth is gradually emerging. Since its inauguration in 2013, international co-operation projects have been signed with countries along the trade routes, boosting industrialisation and modernisation. By the end of 2018, Chinese enterprises' non-financial investment in countries along the BRI was more than US$90 billion. From January to September 2019, it exceeded $10 billion. In Pakistan, for example, energy projects completed by Chinese companies over the past six years account for 30% of total electricity generated – an important contribution to solving energy shortages. In the Gwadar Port Free Zone, more than $600 million has been invested, and more than 20 companies have set up there. Over the past six years, Pakistan has significantly improved its ranking for its business environment and global competitiveness.

In the six years since its inception, the BRI has been endorsed by several international organisations, including the World Bank and the International Monetary Fund. Reports from these institutions, released in 2019, have shown the BRI's effect in the global fight against poverty and spurring economic and trade growth in participating countries.

The BRI should meet the modernisation needs of countries along the routes. In August 2018, President Xi Jinping chaired a symposium on the BRI's fifth anniversary. He proposed that the BRI should transform, taking high-quality development as its new principle. In April 2019, at the second Belt and Road Forum for International Cooperation, President Xi emphasised that the BRI should adhere to the concept of openness, green development, integrity, high standards, inclusiveness and sustainability.

The BRI can take the next steps in collaboration by transferring bilateral projects into tripartite or even multilateral co-operation. BRI projects on the cusp of implementation should be evaluated according to the current development stage of host countries and their real needs. For example, infrastructure facilities and energy projects account for a large proportion of the construction of the China–Pakistan Economic Corridor, which is now the country's top priority.

A shield of steel

Another example is the Longsheng Steel Corporation, a private Chinese enterprise in Guangxi Province that invested in a steel project in Malaysia in 2014. China has the world's largest steel capacity: 1 billion tonnes. To many eyes, the steel industry is a severe surplus industry: steel metallurgy consumes many resources and puts a heavy burden on the environment. Thus, it is believed there is no need to invest in the steel industry. However, Malaysia's steel production in 2016 was 2.76 million tonnes, ranking fourth among the Association of Southeast Asian Nations (ASEAN). The top producer in 2016 was Vietnam, with 7.81 million tonnes of steel production. But, in 2016, Vietnam and Malaysia imported 16.96 million tonnes and 7.65 million tonnes of steel, respectively. What does this mean?

Malaysia, for example, produced only one-third of the steel it needed in 2016, leaving a gap of 5 million tonnes. ASEAN has a huge population and has developed rapidly in recent years, so there is a huge demand for steel, raw materials and basic products. Vietnam, along with Malaysia, Thailand, Indonesia, the Philippines and Singapore – the six larger economies of Southeast Asia – imported more than 60 million tonnes of steel in 2016. Longsheng invested in a project that requires the steel production of 3.5 million tonnes per year, which took four years to fill 70% of the Malaysian steel gap.

The evaluation of BRI projects should be in line with local needs and social context. The demands of development and economic growth should not be ignored. If a country is in short supply of steel, continue to push it to be environmentally friendly. If a country needs to turn raw materials into highly processed products, which means the country needs electricity, we must encourage it to focus on biodiversity. There is nothing inherently wrong with these ideas, but we cannot simply substitute one aspect for the other. We cannot ignore the serious shortage of energy and raw materials in these countries in the process of economic development, while simultaneously dealing with environmental protection and biodiversity.

The high-quality development of the BRI proposed by President Xi requires certain mechanism guarantees, embodied in a focus on the type of project and its location. BRI projects include infrastructure construction co-operation, resource development, processing and manufacturing, agriculture, trade and logistics, cultural exchanges, and environmental protection.


China's steel capacity of 1 billion tonnes is the largest worldwide

Financial co-operation

Let's examine financial co-operation – a supporting instrument. First, it takes the form of outbound investment by enterprises, including cross-border mergers and acquisitions. Second, engineering contracting enterprises can also serve as a corporation's instrument, such as the large number of overseas engineering contracts drawn up by China's Gezhouba Group. Third, it can take the form of tripartite market development – China and France co-operate in developing the African market or nuclear power plants in the UK. China also co-operates with Japan in building the Eastern Economic Corridor in Thailand. Fourth, trade promotion accelerates trade growth in BRI countries. Fifth, multilateral development agencies and financial institutions – such as the Asian Infrastructure Investment Bank, the Asian Development Bank, the World Bank and Inter-American Development Bank – offer their support. It is imperative to get substantial funds from global private capital and official development assistance.

The BRI reflects various investment and financing models in different countries. Three aspects should be emphasised to realise high-quality development of the BRI.

First, financing sources should be diversified – for example, from developmental financing, policy finance, multilateral agency funds and private capital. If collaborative work is adopted in a BRI project, rules and provisions need to be integrated into the entire financial chain. This includes a credit rating; according to the current ratings system, many projects are not viable investments.

Apart from credit ratings, activities such as investment, financing, credit insurance and reinsurance should be conducted within the framework of collaborative rules. In the past two years, concerns on debt sustainability have risen. The second Belt and Road Forum saw the release of the *Debt Sustainability Framework for participating countries of the Belt and Road Initiative*. For countries along the route, debt sustainability is closely associated with financing. Is it necessary for invested countries and receiver countries to jointly discuss the establishment of new rules and models for the sake of debt sustainability? A risk prevention mechanism is also required – to determine how best to evaluate and prevent risks, and how to defuse risks that appear. All these problems require specific regulations.

Second, the bidding rules of a BRI project should happen very early on in the project timeline. For example, with the construction of the Hungary–Serbia railway, a conflict of regulations arose in the bidding for the project – Hungary is a member of the European Union and needs to implement EU regulations, while Serbia is not a member and therefore applied another different set of rules.

Green and sustainability rules should also be included. At the second Belt and Road Forum, China released the *Green investment principles for the Belt and Road*, but further efforts must still be made.

The third and final aspect to drive towards high-quality development is integrity. At the second Belt and Road Forum, the *Beijing initiative for the clean Silk Road* was officially launched. It is a common hope that BRI countries act in the spirit of integrity and 'cleanliness' to ensure the sustainability of the BRI.

How should these rules be designed? By being guided by the principle of extensive consultation. Some countries have existing rules to guide practice, yet we should consider the adaptability and acceptance of all parties. It is not wise to simply apply current international standards, which are often not appropriate or adaptable enough for the unique circumstances of developing countries. By current international standards and rules, many of the BRI projects would fail ratings tests.

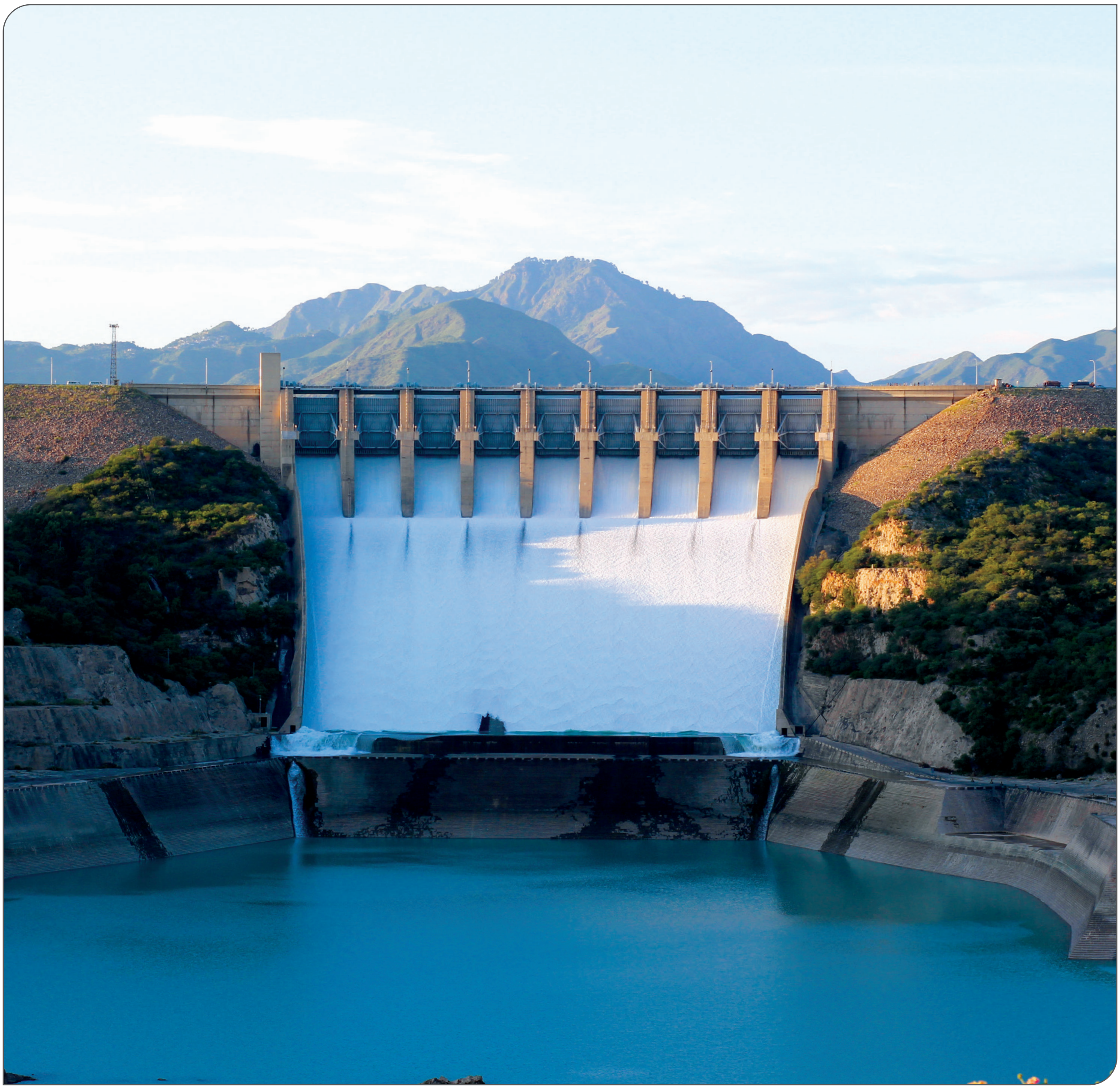
In March 2019, the European Commission released its report *EU–China – A strategic outlook*, which included 10 points of action, including the publication of the EU's international procurement rules and bidding rules by the end of 2019.[1]

If those rules are to be applied to BRI projects for tripartite co-operation, more in-depth discussion and consultations with involved countries will be required. Only by forming a rule more in line with the actual situation – and that is more realistic and operable – can we ensure the real sustainable and healthy development of the BRI, and ensure steady and sustainable development.

1. *European Commission and High Representative of the Union for Foreign Affairs and Security Policy (HR/VP) contribution to the European Council (March 2019),* EU–China – A strategic outlook, *https://bit.ly/372pAuS*

Unresting investing

Wang Dan, executive vice-president of the Silk Road Fund, explains how the fund has vigorously promoted investment in and co-operation with the Belt and Road Initiative countries, and helped overseas companies gain a foothold in China's market



Chinese state-owned hydropower engineering and construction company Sinohydro completed the fourth expansion of the Tarbela Dam in Khyber Pakhtunkhwa, Pakistan, in 2018

Successful projects should be advertised to encourage potential countries to participate in the Belt and Road Initiative (BRI).

The Silk Road Fund is a medium- to long-term investment and financing institution specifically established for the BRI. Since the establishment of the Silk Road Fund in 2014, the institution has invested and supported substantial important projects, primarily through equity investment.

By the end of October 2019, 34 projects had been funded, with a total commitment of US$12.3 billion in investment, including CNY30.4 billion. Although the investment is not large, it is mostly made up of equity, which will lead to greater amounts of funding.

The Silk Road Fund has benefited greatly from its involvement with the BRI, gaining experience from the past five years of projects.

Attaching importance to synergising BRI countries' domestic development plans and adopting an inclusive approach to leveraging the comparative advantages of both parties will help build engines for high-quality development. China's comparative advantage is manifested in its abundant capital as a result of a relatively high savings rate. It also has rich experience in power plants, high-speed railways and industrial manufacturing – core pillars in the economic development of the BRI countries. The first Silk Road project was investment in hydropower in Pakistan, which was struggling to sustain its electricity supply. By replenishing electricity and increasing supply, Pakistan fostered a favourable environment for economic growth. China, thanks to its experience, is able to carry out investment and financial co-operation within BRI countries. In general, its projects are long-term equity investments in areas such as infrastructure, resource development, industrial co-operation and financial services.

Diverse partnerships to achieve multilateral ownership

The Silk Road Fund has also vigorously promoted co-operation with third-party markets, effectively expanding the space for high-quality development. In addition to co-operating with multilateral development institutions, multinational corporations and financial institutions – including the World Bank – the Silk Road Fund also co-operates with developed countries.

This effective combination of third-party markets, China's comparative advantages in capital and production capacity, developed economies' advanced technology and management, and the investment needs and resource endowment in the investment-targeted country can optimise resource allocation on a larger scale and ensure rewarding returns for all stakeholders.

One example is the Silk Road Fund's relationship with the European Investment Fund under the umbrella of the European Investment Bank. The two firms have jointly established the China–EU Co-investment Fund. The investment of sub-funds is market-based, which facilitates the connection between the BRI and the EU Infrastructure Investment Plan – or the 'Juncker Plan', named after then European Commission president, Jean-Claude Juncker. The primary investment objective of the sub-fund is to assist the development of small and medium-sized enterprises (SMEs) in Europe. The fund has successfully promoted the entry of some European SMEs into the Chinese market, and consequently accelerated the integration of Chinese and European markets.

Another example is a joint investment group co-founded by the Silk Road Fund and Singapore's Surbana Jurong. Its mission is to conduct infrastructure investments in Southeast Asia.

Wang Dan

Green investment and sustainable development

In 2015, China proposed a new development concept: "innovation, co-ordination, green development, openness and sharing". At the second Belt and Road Forum for International Cooperation, President Xi Jinping asserted that China should adhere to the concept of "openness, green development and integrity", and strive to achieve the goal of "high-quality benefit to the people and sustainability".

As an investment and financing institution serving the BRI, the Silk Road Fund, as a responsible investor, has signed and joined the *Green investment principles for the Belt and Road*. In the process of investment decision-making, the Silk Road Fund fully evaluates the impact of a project on the local ecology, environment and society, paying special attention to the environmental, social and governance implications of the project. Examples include projects undertaken in Dubai aimed at developing clean energy sources. In alliance with Saudi Arabian power and water company ACWA Power, the Silk Road Fund has invested in the world's largest thermal-storage solar power plant, with a capacity of 950 megawatts, which will facilitate the development of clean, local energy and a transformation in energy delivery.

Broadening the channels for investment and financing

The use of local currencies in the construction of the BRI helps mobilise local savings, reduce the cost of currency exchange and maintain financial stability. At present, the renminbi has been officially included in the International Monetary Fund's special drawing rights currency basket, and the use of the renminbi in cross-border currency investment is on the rise.

The Silk Road Fund is a dual currency fund with total capital amounting to CNY100 billion and $40 billion. The Silk Road Fund has also made some successful forays into renminbi investment, carrying out renminbi equity and loan investments in the Middle East and Central Asia. Here, renminbi funds are used to purchase Chinese equipment, raw materials and services – for example, engineering, procurement and construction – reducing costs and preventing exchange rate risks.

The fund has expanded the popularity and influence of overseas enterprises in China and has helped these enterprises enter the Chinese market and expand the number of trading partners for the future.

Assets versus debt

The old models of North–South development aid simply don't work, but the South can fill the gap, write *Justin Yifu Lin*, IFF Advisory Committee member and dean of the Institute of New Structural Economics at Peking University, and *Wang Yan*, deputy director of the IFF Institute and former World Bank senior economist

In the years following the Industrial Revolution, a historical shift occurred: countries moved away from agriculture and mining to manufacturing activities and then to services. This economic transformation was critical for growing productivity, creating jobs and reducing poverty. Most developing countries have been attempting to catch up with industrial countries since World War II but have failed – some seemingly trapped as exporters of natural resources and primary products.

In the past half century, only 28 countries have closed the income gap with industrial countries by 10% or more. Of these, only 12 are non-European, non-resource-based countries. China, for example, had a per capita income one-fifth that of the US in 2016, despite tremendous efforts to catch up (see figure 1).

Africa has seen its share of GDP in manufacturing decline over the past 40 years – failing to become an industrialised continent. A critical question for economists must now be: why is catching up so difficult? Why have so many African countries experienced deindustrialisation for four decades?

Is North–South aid effective?

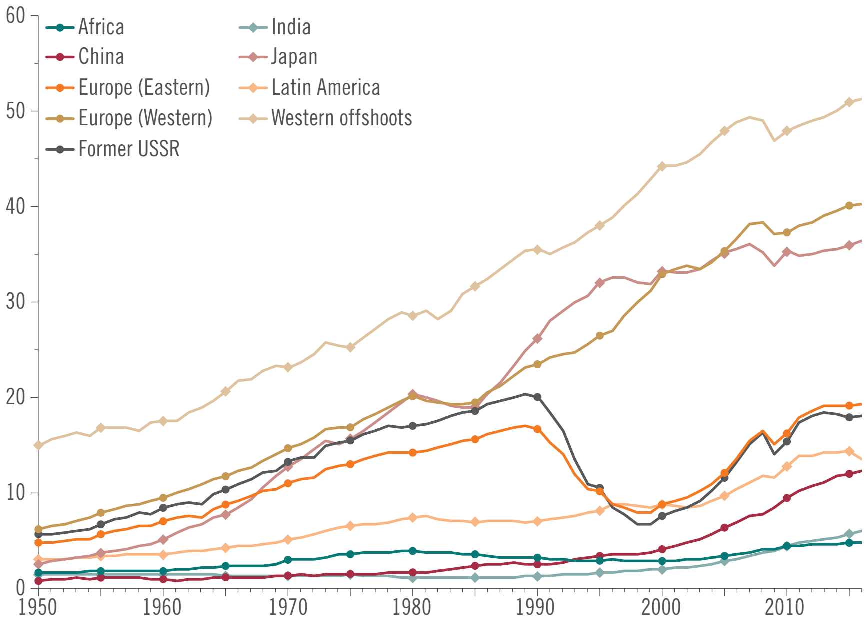
Since the 1960s, more than $4.6 trillion in gross official development assistance (ODA) has been transferred to developing countries, including bilateral and multilateral aid. However, a substantial amount of the world remains in extreme poverty and is enduring stagnant growth.[1] Mainstream economics has, for two decades, paid little attention to structural transformation and industrialisation, and too few resources have been invested in infrastructure bottlenecks. The power sector in Africa has been ignored by donors since the 1990s, leading to deindustrialisation in many countries. Western aid programmes did not – and will not – tell developing countries how to use industrial policies to develop manufacturing sectors. They do not help countries climb the technology ladder, because of their vested interests and because industrial policies have been taboo in many multilateral and bilateral development institutions.[2]

Traditional North–South aid as currently defined is not as effective as desired. However, South–South development co-operation – which combines trade, aid and investment as well as knowledge and skill dissemination – can utilise the comparative advantages of each development partner and complement traditional North–South aid.

China's comparative advantages to help others

China combines trade, aid and investment to assist other developing countries in gaining capacity for self-development. It helps build the hard and soft infrastructure necessary for structural transformation. 'Southern' countries such as the Brics nations – Brazil, Russia, India, China and South Africa – are closer structurally and economically to many low-income developing countries. As is well known, if trade allows each partner to utilise its comparative advantages and achieve a win-win – what then are China's major comparative advantages?

Figure 1 – Development since the 1950s in real GDP per capita in 2011 (multiple benchmarks) (US$ thousands)



Source: Maddison Project Database, 2018

Justin Yifu Lin

Wang Yan

First, China has proposed enhancing global connectivity through the Belt and Road Initiative (BRI), in part because it has demonstrated comparative advantages in building infrastructure, including hydroelectric power stations, highways, ports, railways and telecommunications. China's labour costs for project site foremen is one-eighth of those in member states of the Organisation for Economic Co-operation and Development (OECD). Its vast domestic market and railway network allow China to realise the 'economy of scale' other countries cannot achieve: for example, the construction cost for high-speed rail is only two-thirds that in industrial countries.[3] A recent study from the World Bank highlighted that the economic rate of return from investing in high-speed rail in China is estimated to be 8%, higher than in any other country.[4] China has successfully co-operated on infrastructure projects in Africa, including the Mombasa–Nairobi standard gauge railway in Kenya and Maputo–Katembe Bridge in Mozambique.

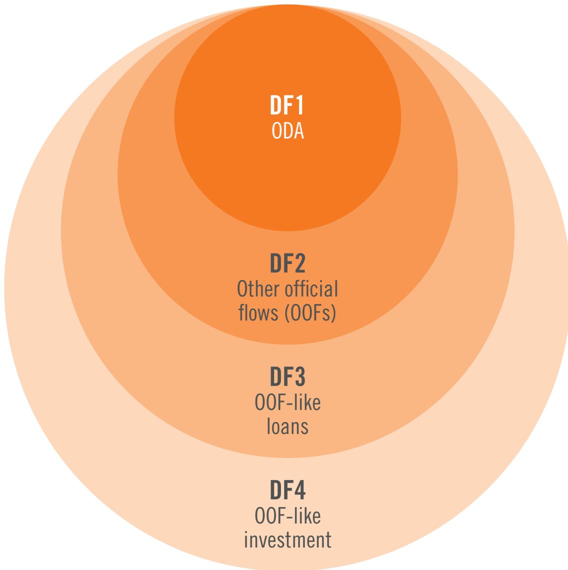
Second, China has a comparative advantage in 46 out of 97 – mostly manufacturing – subsectors and is using this to help other developing countries achieve mutual wins. As labour costs rise in China, its labour-intensive industries are relocating to other low-wage, developing nations, providing millions of job opportunities; Southeast Asia and East Africa have emerged as attractive alternatives. Chinese outward direct investment has created more jobs than the direct investment of others.[5,6]

Third, the concept of 'patient capital' aids understanding of the financing of the BRI. Based on a culture of Confucianism – a system of social and ethical philosophy – China and several other east Asian economies are ranked highly in the 'long-term orientation' index.[7]

In our joint paper, *The new structural economics*, we propose the concept of patient capital – capital to be invested in a 'relationship' in which stakeholders/investors are willing to take a stake in a host country's development (often in the form of equity-like investments).[8] China, the Republic of Korea, Singapore and other East Asian countries have more patient capital in the form of net foreign assets (NFAs). Countries with long-term orientation possess higher savings rates and a larger amount of NFAs.

In a 2018 paper, Stephen Kaplan investigates the implication of Chinese patient capital in Latin America and notes: "Chinese state-to-state lending reduces reliance on conditionality linked Western financing, leading to higher budget deficits."[9] These results suggest that Chinese financing could be a developmental opportunity, but only if governments invest wisely.

Figure 2 – Expanding the definition of DF



DF1 – ODA
DF2 – ODA+OOF
DF3 – DF2+OOF-like loans (long-term loans for development purposes)
DF4 – DF3+OOF-like investment (including equity investment for development)

South–South co-operation could be win-win

We must go beyond aid with a broader concept of development financing inclusive of South–South development co-operation. Differing from the OECD's ODA definition, South–South development co-operation combines trade, aid and public and private investment, and utilises the comparative advantages of each country and their intimate know-how on development. It is therefore more effective in overcoming bottlenecks in partner countries.

An analogue to development financing can be found in the definitions of money type (M), such as M0, M1, M2 and M3 and total social financing. Development finance (DF) is divided into DF1, DF2, DF3 and DF4, as defined in figure 2. A clearer set of definitions on DF would facilitate transparency, accountability and selectivity by development partners, encourage sovereign wealth and pension funds to invest in developing countries, and facilitate blended financing or public–private partnership.[10]

It should be stressed that DF3 includes long-term loans for development purposes such as bottleneck-releasing infrastructure, and DF4 includes equity investments from state investment funds such as the Silk Road Fund, the China–Africa Development Fund and many strategic investment funds, as well as the International Finance Corporation, the UK's CDC, and the US's Overseas Private Investment Corporation, and the newly established US International Development Finance Corporation. If one accepts these broader definitions, then the debt-to-equity swap is not unthinkable – it is merely normal practice in the capital market.

Co-financed and co-built infrastructure projects can help generate economic growth and develop the manufacturing sector in emerging economies

Why the debt-to-GDP ratio is misleading

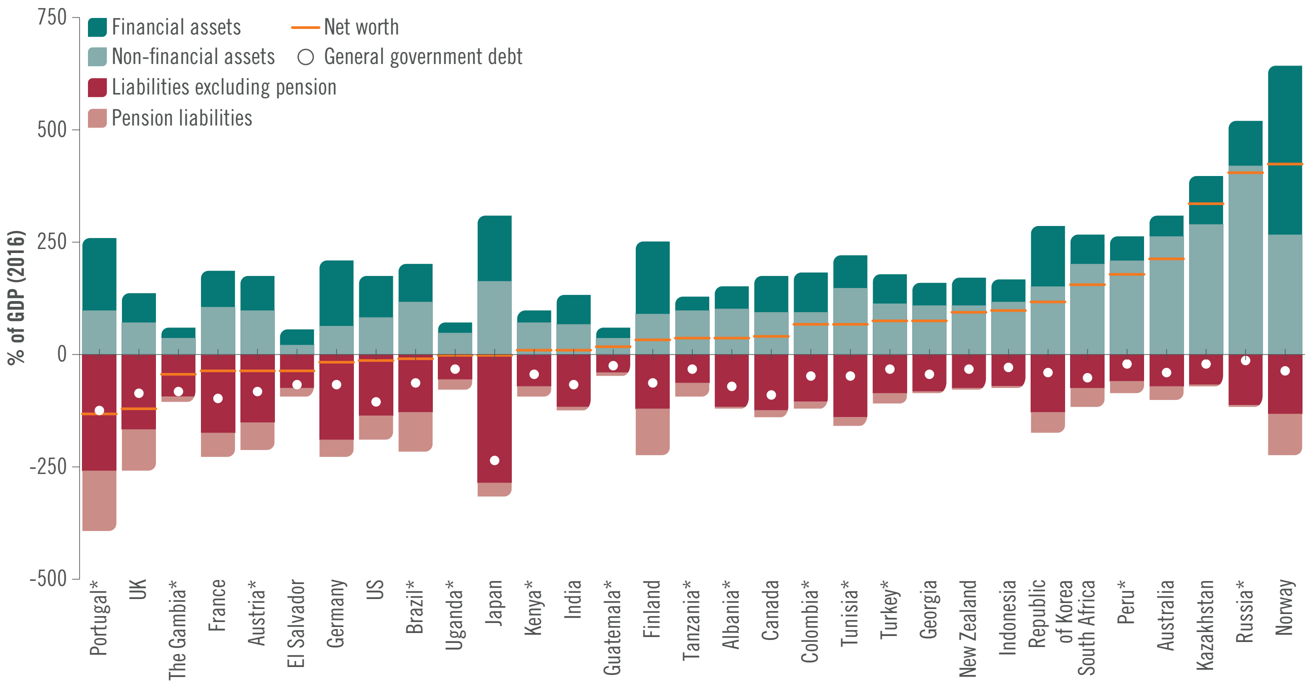
Neoliberalism may have been overly constraining in the International Monetary Fund (IMF) and World Bank's debt sustainability framework, which requires improvement. Current research on the public sector balance sheet, and on 'what governments own and owe' is welcomed as it emphasises public sector net worth (see figures 3 and 4).[11] Net worth is effectively assets minus liabilities – a far more comprehensive definition than the misleading debt-to-GDP ratio. Debt-to-GDP is narrow and misleading because:

- It does not distinguish by type of debt – for example, domestic or foreign
- It does not distinguish what the debt is used for – consumption (salaries or pensions) or investment
- It does not show whether the GDP will be affected in the long term after the completion of the project.

Some sections of the media have consequently accused China of "debt-trap diplomacy", despite a lack of empirical evidence. For instance, a study by the Center for Global Development in 2018 estimated a "worst-case scenario of future debt", and identified eight countries – Djibouti, Kyrgyzstan, Laos, the Maldives, Mongolia, Montenegro, Pakistan and Tajikistan – where debt to China might push debt-to-GDP ratios beyond 50%–60%.[12] However, there is little strong empirical evidence that this level of debt will be 'dangerous', as many countries have experienced similar levels of debt.

According to the IMF, the public sector's net worth is what matters. "China has substantial government assets, reflecting years of high infrastructure investment. These assets are larger than their liabilities, putting net worth well above 100% of GDP – the highest

Figure 3 – What governments own and owe: analysing public wealth using balance sheets



*Based on a single year of data, in most cases compiled as part of the Fiscal Transparency Evaluation: Portugal (2012); Albania, Kenya, Peru, Tunisia and Turkey (2013); Brazil, Guatemala and Tanzania (2014); Austria and Uganda (2015); Colombia and The Gambia (2016).

Source: IMF Fiscal Monitor, Autumn 2018[11] among emerging economies. This is a significant buffer compared with total debts of public corporations, particularly considering that public corporations also have assets. So, while debt-related risks in China are large, there are also buffers" (see figure 4).[13]

While the valuation of government non-financial assets is uncertain, the net financial worth, which excludes these non-financial assets, is much smaller. Excluding non-financial assets, "China's general government's net financial worth remains positive, at 8% of GDP in 2017 – although it has deteriorated in recent years." However, "subnational governments own land resource and invest in infrastructure, which could provide buffers and generate revenue to service their debt [...] Second, the government's holding of state-owned enterprise equity could be higher than the conservative estimates presented here."[11]

The IMF study illustrates how public sector assets could act as a buffer to allow governments with high public wealth to withstand recessions better than those with low public wealth. Stronger balance sheets allow governments to boost spending in a downturn.

China has been trying to co-finance and co-build infrastructure projects, such as hydropower stations, power grids, highways, railways, ports, bridges and internet technology – public sector assets that can be managed to generate revenue and create jobs. If planned carefully, they can help generate economic growth, develop the manufacturing sector, promote exports, create jobs and reduce poverty. Therefore, looking at the debt-to-GDP ratio without examining the asset side is misleading and hypocritical.

All governments can better manage resources by saving more and building public sector assets such as bottleneck-releasing infrastructure and then identifying their existing comparative advantages. Targeted policies to develop these sectors that are consistent with the country's latent comparative advantages should then be implemented. If you need a success story, look no further.

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9. *S Kaplan (June 2019),* The rise of China's patient capital – A tectonic shift in global finance in developing countries?, *https://bit.ly/2Fonavf*
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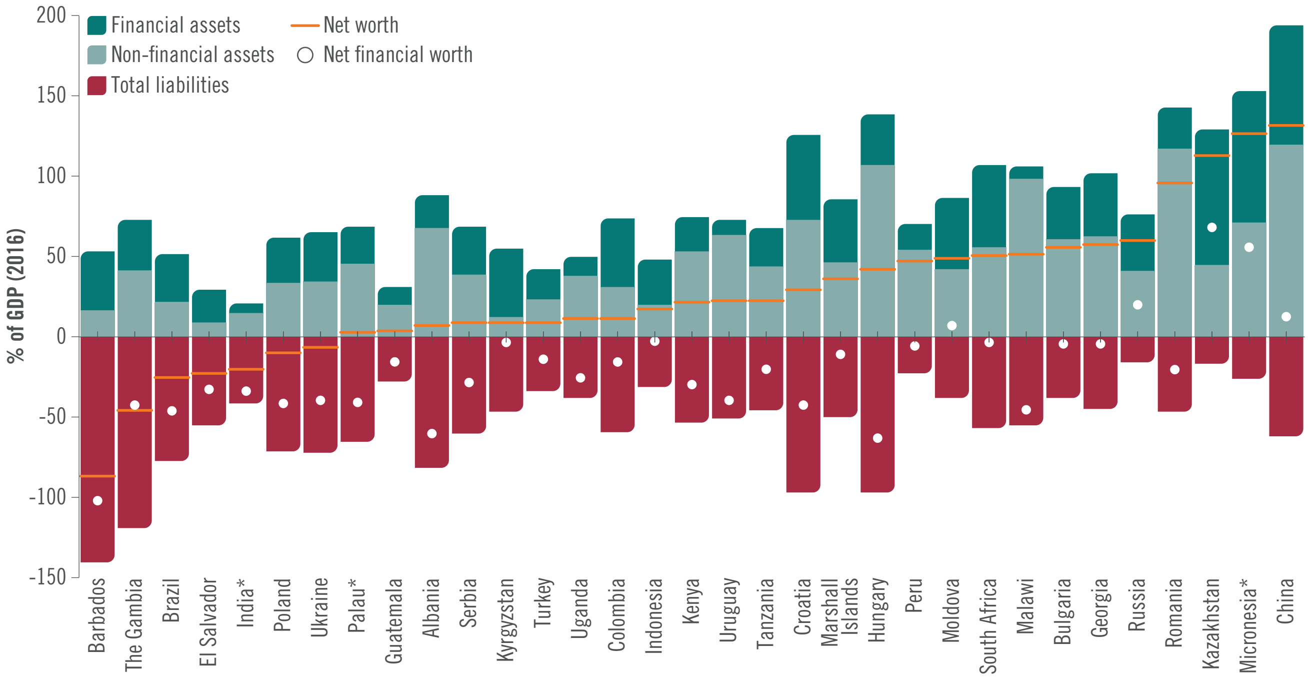
12. *J Hurley, S Morris and G Portelance (2019),* Examining the debt implications of the Belt and Road Initiative from a policy perspective, *in Journal of Infrastructure, Policy and Development, Vol. 3, No. 1, pp.139–175, https://bit.ly/39F415Y*
13. *V Gaspar, J Harris and A Tieman (October 2019), IMF Blog,* The wealth of nations – governments can better manage what they own and owe, *https://bit.ly/35sG7ar*

Figure 4 – Emerging markets' balance sheets



*Central government data.
Source: IMF Fiscal Monitor, Autumn 2018[11]

New links in the industrial chain

Chen Xiaohua, chairman of the China Gezhouba Group Corporation, observes institutions from opposite sides of the globe collaborating on Belt and Road Initiative infrastructure projects, adding industrial, technological and financial value, and sustainable development

Since it was proposed by President Xi Jinping in 2013, the Belt and Road Initiative (BRI) has received a positive response from more than 100 countries and international organisations. After six years of steady progress, the BRI has entered a new stage with a new focus on high-quality, in-depth and solid development.

Deeper integration

Among the BRI's five connectivity principles is infrastructure, highlighting the centrality of construction to the project. Countries along the BRI have huge infrastructure demand and a need for related investment. According to the Global Infrastructure Hub, international infrastructure investment will need to grow by US$94 trillion by 2040.[1] In 2024, the investment gap in energy, telecommunications, transport (airports, ports, rail and road) and water will be $818 billion. Participating in BRI infrastructure projects therefore presents a huge opportunity for international capital markets.

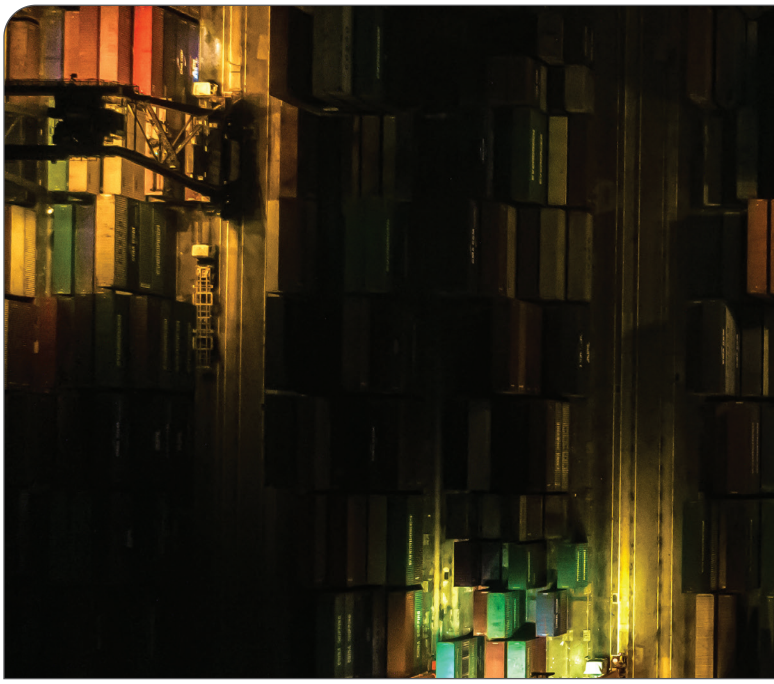
However, in light of information asymmetry in global capital markets, underdeveloped participation mechanisms, incompatible financial regulation, imperfect risk-sharing mechanisms and even the absence of legal construction in some countries, international capital faces challenges when financing BRI projects. On one hand, there is a huge demand for infrastructure investment, and international financial capital – including private capital – is relatively abundant. Thus, there exists a need to explore the path, methodology and mechanism to bridge the capital gap and address this huge demand.

During a state visit to Greece in November 2019 a contract was signed by participating corporates and witnessed by state leaders for a $300 million solar power project. The project is being invested in by London-based Nur Energie and financed by the Industrial and Commercial Bank of China, the National Bank of Greece and the Black Sea Trade and Development Bank. The credit guarantee agency was a UK company, and the general contractor was the China Gezhouba Group Corporation (CGGC). This is an example of collaboration between financial institutions, including credit insurance institutions, commercial banks and development finance institutions, providing services and financial support for the BRI projects that will result in a net increase in people's wellbeing.

Multilateral co-operation across the industrial chain

As President Xi has stated on several occasions, the BRI is not simply China's initiative, but a journey for every single country worldwide to embark upon. Either in infrastructure construction, trade or other aspects, there is an industrial chain for each business that combines the strength of technologies, products or finance in numerous countries to achieve win-win co-operation.

At present, 17 BRI projects conducted by the CGGC have adopted a model of multilateral, bilateral, multiparty and third-party co-operation. Angola, for example, is currently undertaking the largest hydropower project in Africa, with a total investment of $4.5 million.[2] The Caculo Cabaça project uses German generator technology and Chinese financing, with the CGGC as the engineering procurement construction contractor: a great example of successful multilateral co-operation.



A thermal power project recently approved by the government of Bosnia and Herzegovina uses equipment from the US's General Electric and is financed by the Export-Import Bank of China.[3] The general contractor is the CGGC, which integrates technologies and products from all parties.

A desalination project worth upwards of $600 million in Dubai uses French technology, Chinese products and civil engineering and is financed by Saudi Arabian power company, ACWA Power.

These examples are great use-cases of international capital and technology working together and leveraging the construction advantages of Chinese enterprises. Every country involved benefits from these initiatives.

Creating value through investment in BRI projects

Different control principles should be set up according to different sources of investment and financing to ensure the sustainability of the BRI:

1. In many developing countries, the supply of public goods still relies on external financing and construction. In this regard, it cannot break away from the economic development level and geopolitics of the host country. It is irrational to blindly pursue a great scale and amount of investment and financing, which may go beyond a country's capacity to repay its debt. The primary principle, then, is to act according to one's own ability.

2. For debt financing, some projects, identified as having relatively good income flow, are guaranteed by sovereign credit of the host country or invested through development financing and integrated with international capital. In these instances, we must first ensure the feasibility of a return on investment for the project. The investment risk of this project can then be managed, and investment, financing, engineering, procurement and construction contractors will all receive a reasonable return.

Chen Xiaohua

3. In areas where purely commercial social capital enters – including public-private partnership and build-operate-transfer models – governments must improve the business environment and governance frameworks. They also need to implement clear legal mechanisms for foreign investment access so foreign investment and international financing can be confident. There is an abundance of projects awaiting international investment. This gap can be closed by good governance, a favourable business environment, sound legal support and predictable investment returns. Only in this way can the risks of financing be kept under control, and local economic and social development be sustainable.

1. *Global Infrastructure Outlook*, Forecasting infrastructure investment needs and gaps, *https://outlook.gihub.org/*
2. *CGGC (June 2015)*, CGGC signs contract on Caculo Cabaça Hydropower Project in Angola, *https://bit.ly/38SoK5b*
3. *International Trade Administration (July 2019)*, Bosnia – Energy, *https://bit.ly/2teBmEA*

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GREEN FINANCE AND FINTECH

The price isn't right

Laurent Fabius, IFF board member, president of the Constitutional Council of France and former prime minister of France, calls for immediate, steep rises in the cost of carbon emitting, but warns that any carbon tax policies must be competitive, fair and transparent

In any carbon pricing system, funds must be redistributed among projects that protect the environment and the households most vulnerable to climate shocks

Efforts to combat climate change are, unfortunately, not currently in line with the Paris Agreement on climate change. Most economists and experts now consider the best way to decarbonise the planet is to affix a price to carbon. This price will be increased over time to ensure investment in technologies that emit carbon dioxide (CO_2) are not financially attractive. Initiatives aligned with this thinking have already been implemented in the European Union, China and the US.

Laurent Fabius

A triple threat

Carbon pricing

The first threat deals with the price of carbon itself. The World Bank in 2019 estimated that the minimal price range needed to be consistent with achieving the Paris Agreement temperature targets, which lies between $40 and $80 per tonne of CO_2.

One reason for the inefficiency of carbon pricing so far is low prices: less than 5% of global emissions are priced at the level able to implement the Paris Agreement goals.

In highly developed countries such as Germany, the 2021 carbon price for the national emission trading system for transport and construction has been set at a mere €10 per tonne of CO_2. This low price was a reaction to pressure from the automobile industry, reflecting the sensitivity of this issue for many countries.

Raising the price of carbon can be difficult because the price depends on multiple variables. But implementing a floor price or a carbon price corridor set by public authorities, or allocating pay permits are possible solutions.

Clearly, public authorities must integrate carbon pricing into long-term policies dedicated to the reduction of CO_2 emissions. It will be important that the tool covers all sectors.

Combined effort between the EU and China is the starting point not only to develop carbon pricing methods, but to combat climate change as a whole

Competitiveness

The second threat is competitiveness. CO_2 prices vary from zero to around $1 per tonne in Ukraine to more than $120 per tonne in Sweden. Prices in the EU emissions trading system remained below $11 until 2018, and are now around $25.

The disparity of carbon prices between states could lead to a loss of competitiveness. Such disparity could lead to businesses free-riding in the states that have low emission prices; therefore, multilateral enforcement is crucial. One solution might be a carbon border tax, which would help level the playing field between taxed domestic industries and untaxed foreign industries.

Challenges with this initiative would abound: it would be difficult to accurately estimate the amount of CO_2 emitted during a product's manufacture; the border tax might be contrary to international regulations; and carbon taxes need cross-border co-operation, but multilateralism is under threat from certain powerful nations.

As of today, nearly 100 signatories of the Paris Agreement – out of 195 in total – mentioned carbon pricing in their nationally determined contributions (NDCs) to tackling climate change; this indicates that they intend to use climate markets and/or domestic carbon pricing to meet their NDC commitments.

At the Climate Action Summit held in New York in September 2019, UN secretary-general António Guterres proposed accelerating action to implement the Paris Agreement, in particular through carbon pricing and an end to fossil fuel subsidies.

Climate change is a global matter, so international co-operation is imperative. In September 2019, the EU Carbon Pricing Task Force and the International Finance Forum jointly declared the need for a convergent and rising carbon price. This combined effort between the EU and China is the starting point not only to develop carbon pricing methods, but to combat climate change as a whole.

Climate justice

The third threat is ensuring fair carbon pricing and climate justice. Carbon pricing has concrete consequences for people, depending on their incomes, place of residence, standard of living and, more broadly, their way of life. If people think of carbon pricing as an unfair tool, it will not be accepted and may even be rejected, as the French 'yellow vest' movement has demonstrated.

The introduction of a carbon pricing system must, therefore, be transparent. I suggest the funds be redistributed among projects that aim to protect the environment and households most vulnerable to climate shocks.

In Sweden, a carbon tax was introduced as part of tax reforms in the early 1990s, along with a reduction in income and labour taxes. Subsequently, as the carbon tax increased – it is now the highest in the world – employer and social security contributions declined. As a result, the most vulnerable households benefited from lower income taxes.

The European Commission notes that "the European green deal can only work if it brings people along and supports the most affected". This idea should be repurposed in most international partnerships, and I hope that the actions taken in this area by all nations will pursue an urgent and ambitious path.

Futures market can carry carbon cost

China should step up the pace of establishing an integrated carbon emissions trading system, writes *Jiang Yang*, IFF vice-chairman, member of the National Committee of the Chinese People's Political Consultative Conference and former vice-chairman of the China Securities Regulatory Commission

The Chinese government wants to ensure the continued coexistence of humans and nature through green development, a consensus shared globally. China agreed to the Kyoto Protocol in 1995 and signed up in 2016 to the Paris Agreement on climate change, which commits to lowering the earth's carbon emissions by 2050.

A transition to a greener, more sustainable economy will be crucial for the continued development of the Chinese economy. Since the 18th National Congress of the Communist Party of China (CPC) in 2012, China has committed to green development, and so far its efforts have borne fruit. Emissions per unit of GDP have dropped by 46% since 2015, achieving the national carbon dioxide reduction goal of 40%–45%.

Controlling and reducing carbon emissions is a crucial instrument in slowing global warming and addressing climate change. Fossil fuel energy is one of the main sources of carbon emissions – limiting their use and advancing the development of new and sustainable forms of energy will be important for China as it advances.

Currently, vehicles that run on renewable energy in China account for 50% of the global total. Each year, China looks to find new ways to continue reducing its fossil fuel emissions, but some technical problems remain. For instance, batteries are still too big and do not last long enough. Nearly 200 new energy vehicle companies in China are exploring ways of solving this problem. Controlling and reducing carbon emissions is essential for pollution control and to contribute to energy conservation – and China's efforts within the car industry are just one way in which the country is fulfilling its international obligations to address climate change.

An excess of carbon emissions has, in a sense, been triggered by externalities; they are a side effect of economic activity, not costed in. Pollution is caused by enterprises, yet the costs have to be borne by all of society. It is therefore essential to address pollution levels by combining social costs with personal and company costs. The establishment of carbon emissions trading market aims – through market and price – would prevent people from being harmed by external spillovers. Unlike a free market, which trades physical commodities, an emissions trading market circulates products stipulated by government policies. Transactions are generated upon different quotas, and the amount of quota allocated is related to the demand of enter-

Vehicles that run on renewable energy in China account for 50% of the global total prises. More emissions would call for more quotas, and vice versa. Any surplus quotas can be sold on. The government can exploit policies to manage quotas and the products under statutory powers can be differentiated from general commodities. The establishment of the market may have to go through a process different from general commodity market transactions. With a carbon market trading system in place, a price for carbon emission rights can be formed, which could pave the way for low-emission subjects to gain a competitive advantage and force high-emission subjects to pay greater costs, incentivising social capital to lean towards low-carbon technology and low-carbon projects. It is a more appropriate public policy tool.

The European Union was the first jurisdiction to establish a carbon emissions trading market, and some US states, including California, have also taken action. Between 2005 and 2011, the international carbon market developed very quickly. However, following the global financial crisis of 2007–08, carbon trading in the European market dropped like a stone.

Europe, the US and the wider global economy are suffering from an economic downturn, lowering demand for carbon and casting a pall over the carbon market. From 2012 to 2019, there was almost no liquidity in the market – internally, redistribution quotas are to blame. Excessive quotas put on the market led to oversupply. With fewer companies and less demand, prices have fallen, leading to the downturn between 2012 and 2017. After 2018, when the EU expanded the scope of emissions control, more companies increased demand for carbon emission reduction rights and the market gradually recovered. By the third quarter of 2018, carbon market trading reached €25 per tonne, and the market function came into play again.

Key operations of carbon trading

First, a government's public policy must be rational. The extent to which emission reduction targets will be achieved and how emission reduction subjects are determined directly influence the scarcity of carbon emission rights, carbon prices and market scale. For products traded on the basis of market quotas set by government public policies, it is essential to consider overarching regulation and stability from a market perspective. The amount and ownership must be clearly defined by law, and the policy must be enforceable. If it is not, it is doomed to affect the price and increase risk within the market.

Second, a central registration and settlement system needs to be built for trading. An example of this type of system is the China Securities Depository and Clearing Corporation (CSDC) for stocks – all data for buying and selling stocks is collected by the CSDC for settlement and account checks. To establish a carbon market, it is important to have a system to collect public information, such as the number of products traded each day and where they are registered. The credibility of the registration agency, and the number of transactions after each day, will be key to market success.

Third, carbon emission verification methods should be improved. A quota amount needs to be checked by the registration agency, and the volume of transactions should be based on the registered content and amount. It would be difficult for the market to operate if there is oversupply. In addition, governments or public institutions should heed the quota amount when issuing; too many quotas will undermine the market and affect pricing.

If these three elements are implemented, issuance and trading within the carbon market will be reliable and secure. The current European market combines cash commodities with futures. In the transaction, data from the carbon futures market is revealed, which creates a more transparent and continuous trade. The higher involvement of financial institutions, as a result, leads to more accurate pricing. The liquidity provided allows many companies to buy and sell for the purpose of risk management, which can be attributed to several major mechanisms of the futures market. The first is the T+0 mechanisms, or day trading. The second is the leverage mechanism. In some commodity markets, one spends CNY100 for products worth CNY100. In a futures market, products are bought with 5% of the price given as an advance payment. Delivering the product without increasing the inventory in the registration system improves efficiency and reduces costs. Thanks to this mechanism, the European carbon trading market is more active, with carbon futures accounting for more than 90% of total trading volume. However, these two mechanisms may bring potential trouble such as speculation, risk control and market measures problems. This means strong supervision is paramount. Regulators are expected to share information with authorities in charge of emission rights to build a risk prevention system. Risk control and regulation are key to the successful and healthy development of the carbon market.

The achievements of China's carbon market

Building a carbon market in China is one of the goals of the 13th Five-Year Plan (2016–20). In 2012, the 18th National Congress of the CPC proposed implementing a pilot carbon trading market. At the 2015 UN Climate Change Conference, President Xi Jinping stated that its development would be an important aspect of the Five-Year Plan. It became clear that formulating policy to allow for a functioning national carbon emissions trading market was a priority for China.

Following the pilot, China established a unified carbon market across the country. In 2011, the National Development and Reform Commission (NDRC) elected seven pilot cities, which by the end of 2018 covered nearly 3,000 key emission units of electricity, steel and cement. Around 300 million tonnes of carbon emissions were being traded, resulting in a turnover of more than CNY6 billion. The results of the pilot have been remarkable and resulted in a reduction in both the total volume and the intensity of carbon emissions. However, it is still far from the real target of carbon emissions. The problems in the pilots lie in the differences in policy systems, market bases and trading rules, which have led to significant differences in pilot carbon prices. The pilots also pay less attention to preventing market risks such as product financialisation and overspeculation.

After strenuous improvements, the national carbon emissions trading system was officially launched at the end of 2017. In April 2018, China transferred the State Council's main carbon authority from the NDRC to the Ministry of Ecology and Environment (MEE), offering a stronger institutional mechanism for further accelerating the construction of the national carbon market, which has made concrete progress in the areas of infrastructure development and capacity building.

The carbon classroom

China must learn from other success stories worldwide. In Europe and the US, carbon futures and carbon cash commodity markets function simultaneously, which can boost mutual development. The cash commodity and futures markets will be conducive to the formation of carbon prices, and can enlarge the two core functions of circulation of transactions and risk hedging.

There is also the issue of preventing the emergence of illegal futures. Since the establishment of the futures market in China in the 1990s, disguised and illegal futures have continued to emerge. The central issue is that the cash commodities market witnesses fewer transactions per day and thus has less liquidity. Exchanges hope to activate trading but have increased transaction fees at the same time. If the market is to develop, the sole focus cannot be profits – institutions need to consider leverage, goods being traded and current futures trends.

Jiang Yang

So, if carbon trading starts in the cash commodities market, will the market fall into the same trap it has for the past 30 years? Problems can be avoided if China builds carbon futures and the carbon cash commodities market together, and rolls out corresponding supportive measures in risk control and supervision.

China should also increase the pace of national unified carbon market trading. Through unified carbon emission reduction policies, the country should launch a new registration system that will help authorities address distortions in pricing signals brought about by differences in carbon trading prices. Currently, there are inconsistencies in how carbon emission rights are allocated in each pilot city, which has impacted emission verification methods and trading system rules.

The *Interim regulations on the management of carbon emissions trading*, released by the MEE in April 2019, should be promulgated. Focusing on the rarity of carbon emission rights, China can improve the carbon emission rights allocation system, and include more industries and enterprises. Meanwhile, it is imperative to improve the governance of carbon emission verification agencies, train professional personnel and continuously improve market capacity building.

China should also consider accelerating the development of the Guangzhou carbon futures market. The *Outline development plan for the Guangdong–Hong Kong–Macao Greater Bay Area* proposed setting up an innovative futures exchange with carbon emission rights as its first trading commodity.

The Asian giant should also look to establish a supervision and risk prevention and management system for a carbon futures market. With 30 years of experience in the commodity futures market, China has designed a set of systems suitable for its domestic environment. China has also established the futures market by learning from Western examples and adapted them to local contexts. Many years of exploration and analysis were needed before finally formulating rules that have since been recognised globally. Some of China's commodity futures contracts are the most liquid in the world with the largest daily volumes. The carbon market can certainly draw some lessons from this.

The cost of decarbonisation

Building a zero carbon economy might be easier than we think, says *Adair Turner*, chairman of the Energy Transitions Commission and former chairman of the UK Financial Services Authority. But are governments and industry willing to pay the price?

Carbon prices are essential in dealing with climate change and the problem of competitiveness. An agreement between the European Union and China for significant, rising and convergent carbon prices is one of the most important objectives.

The Energy Transitions Commission (ETC) is a global coalition of environmental organisations within the energy sector. The coalition is united in the belief that the objective set out in the 2015 Paris Agreement on climate change of keeping global warming below 2°C – ideally to 1.5°C – above pre-industrial levels must be met.

A report by the ETC published in November 2019 explored how it is technically and economically feasible for China to simultaneously become a fully developed economy – with GDP per capita similar to current Western European levels or above – and achieve net zero carbon emissions by 2050.[1] This is an explicit objective of the Chinese government.

To achieve 1.5°C, we will need to reduce global emissions to around net zero by 2050. That is going to be very difficult. Frankly, 1.5°C is now almost impossible to achieve because – while reaching net zero is possible within the energy and industrial sectors is possible – it will be much more difficult within the agriculture and land sectors.

However, the ETC believes the world can meet the challenge of net zero emissions within the energy and industrial system in a manner compatible with growing energy demand, ensuring continued prosperity and economic growth – particularly in the emerging markets.

It is perfectly feasible for the global economy to reach net zero carbon emissions by 2050 in the energy and industrial systems without relying on offsets from the land use sector. Land use might be still producing emissions, and levels of methane from the agricultural sector may continue to rise, but the energy and industrial system itself could reach its target.

Electric dreams

Why is the ETC so confident this is possible? Because it has become apparent over the past 10 years that electricity production can be decarbonised far faster and cheaper than first hoped. A drop in the price of solar energy, wind energy and batteries raises confidence that electricity can be produced at prices fully competitive with fossil fuels. The ETC is confident we can manage the challenges of balancing the system of supply and demand in areas heavily dependent on variable renewables such as wind and solar.

Adair Turner

The most important industry to decarbonise within the global economy is the electric industry. To achieve a zero carbon economy, the world will need to increase electricity production from levels of around 23,000 terawatt hours (TWh) today to 90,000TWh by 2050. In China, the plan should be for electricity demand to go from about 6,700TWh to 15,000TWh. The good news is that this part of the decarbonisation process of the economy is relatively low-cost – possibly no cost at all. We will eventually create an environment where it will be cheaper to run electricity systems with renewables – and perhaps also with nuclear energy in China – than with fossil fuels.

There are also some sectors of the economy where, in the long run, electrification is going to be costless. Within five years, electric vehicles will be cheaper to buy up front than those with internal combustion engines. People will buy total road transport services at significantly lower costs than they do currently because of the inherent efficiency gains electric engines offer.

In many sectors of the economy, we should be confident technological progress will allow us to build zero carbon economies without it costing anything at all – or very negligible amounts.

But that still leaves the problem of what to do with the 'harder-to-abate' sectors of the economy: heavy industry – steel, cement, petrochemicals – and long-distance transport such as shipping and aviation. But zero carbon electricity could supply the answer. These are sectors where the challenges are greater, but even here technology exists that can take us to zero carbon.

Carbon capture and storage at the back end of existing processes, such as existing cement kilns, could be used. There is also the option to move to new techniques by, for example, using hydrogen in the reduction of iron ore into steel. In plastics, recycling can become more efficient and dramatically reduce primary energy and materials demand. In all of these areas, as well as in shipping and aviation, there are routes to a zero carbon future.

But there will be a net cost to decarbonisation. Even if there is technological progress in steel, it is highly likely that producing steel in a zero carbon fashion will always be more expensive than using coke to produce steel.

Keep the customer king

The key challenge is to deal with these costs. The good news is that at the level of the end-consumer, these costs are actually relatively trivial. Take, for example, the automobile industry: producing zero carbon steel would increase the cost by only 1% for the end-user. That is based on the assumption that one tonne of steel costs between US$100 and $120. At the level of buying a house, the cost is more. It could be an additional 3%, but this is not a huge cost. As for the cost of decarbonising plastics, what does that do to the cost of a litre bottle of water or soft drink? It would be so small and inconsequential that consumers would not even notice.

So we should be confident that, in all sectors of the economy, there are ways to decarbonise without passing on the costs to the consumer. The challenge is therefore at the level of the business of intermediate products. Here, the costs of decarbonisation could be significant. Producing steel with no carbon emissions could result in the cost of steel increasing by $100 to $120; cement prices could rise by 100%; and the cost of ethylene could go up by 50%. Competition therefore becomes crucial – if an industry is going to transition to net zero carbon, the whole industry has to make the commitment.

The challenge remains: how do we transition these carbon-heavy areas of industry without affecting competition and increasing the cost for the consumer? Regulation will play a key role, and governments should re-evaluate energy efficiency standards. Many countries have already implemented tariffs and fees on fossil fuels to encourage the use of renewables, which has proven more effective than lowering the cost of standard commodities.

But, for some areas of the economy, these tools have a very limited impact and carbon prices continue to dictate business. In the industrial sectors – unlike in the power sector – there are many different ways to achieve decarbonisation. But it will depend on the structure of the company and the point from which the transition begins. There will be many intermediate possibilities to improve energy efficiency before moving on to complete the decarbonisation process.

Taxes and tariffs

There are huge opportunities to make the use of steel and concrete more efficient in the production process of construction. Raising the price of these core materials, which require a huge amount of carbon to make, would ensure businesses used them more efficiently. But ensuring this price index is implemented worldwide will be crucial. If we have a price in one jurisdiction, but not others, companies will face a competitive disadvantage and production may shift at the expense of jobs.

The severity of these effects varies by sector – less in cement but huge in metals and chemicals. One example is Swedish Steel (SSAB), which has publicly committed to becoming zero carbon by 2042. It has three blast furnaces and will close them in 2026, 2032 and 2042. Those furnaces, which use carbon-rich coke to reduce iron ore to steel, will be replaced with hydrogen alternatives. SSAB has a clear plan to build a pilot plant and intends to begin production using hydrogen by 2026.

Sweden is one of the cheapest places in the world to produce hydrogen. But, while SSAB has the technological ability to make the switch, it will still add 15%–20% to its production costs. Currently, Europe has not set carbon prices across the region – the company therefore risks being phased out of the market if its competitors are able to produce steel at a cheaper cost.

We must seek a solution to this. One proposal is for countries to set a carbon price and impose carbon tariffs at the border for all imports from countries not applying an equivalent carbon price.

Such a structure, if introduced, has an international incentive effect: every country will be encouraged to introduce a carbon tax plus tariffs if it wants to remain competitive within the region. Carbon taxes plus border carbon tariffs could provide incentives for the rapid spread of carbon pricing. Gaining this type of agreement for internationally co-ordinated carbon pricing may be impossible; we should still strive to establish some kind of international agreement on carbon pricing, either on a completely multilateral or a bilateral basis.

The EU has already signalled it is formulating something similar. Statements by Ursula von der Leyen, president of the European Commission (EC); Frans Timmermans, vice-president of the EC, responsible for the European Green Deal; and the Franco-German Economic and Financial Council are in favour of going down the route of carbon pricings plus carbon tariffs at borders.

But the debate should not solely focus on competitiveness and prices. There needs to be a discussion about the distinction between emissions from production versus consumption. Currently, China has higher total emissions than Europe because it produces a large number of goods that are consumed in other countries. As a result, China has a lower level of carbon consumption relative to production. Countries such as the UK and the US benefit from the production of these goods.

Europe should be thinking about its emissions on a consumption basis. Its consumers are responsible for those emissions being produced in China. But the only way we can act is to ask China to increase the price of those carbon-intensive goods by imposing a domestic carbon price. If China does not impose these measures, the only way to deal with the difference between production and consumption is to have a carbon price at home with a border tax agreement.

This debate is now before us. The best way forward would be a strong bilateral agreement between China and the EU – and the UK, despite its secession from the EU – as leaders on climate change. China and Europe should be strongly committing to what has already been agreed in principle – to raise carbon prices in their jurisdictions.

1. *ETC (November 2019),* China 2050: A fully developed rich zero-carbon economy, *https://bit.ly/2FKmUqF*

New drivers of the global trade engine

The future of trade and payment systems in Asia – including the Philippines – looks bright, raising incomes and productivity, says *Francisco Dakila*, deputy governor of the monetary and economics sector at Bangko Sentral ng Pilipinas

It has been 70 years since the global multilateral economic system was born – when countries decided to build bridges through trade rather than erect walls and dig moats – first through the General Agreement on Tariffs and Trade and then the World Trade Organization (WTO).[1,2] Progress has been substantial and results have been positive when nations began opening up borders to the free flow of goods and services. Increased global trade has created opportunities for entrepreneurs and spurred growth for economies with its welfare-improving outcome.

Total global trade of goods in 2018 has increased by more than 300 times since 1948 – equivalent to almost half of the world's GDP in 2018.[3,4] Emerging market economies (EMEs) account for a larger share of global trade – from around 32% in 1948 to about 43% in 2018[4] – largely due to the global value chain (GVC).[5] For members of the Association of Southeast Asian Nations (ASEAN) in 2018, domestic value added in exports was estimated at an average of 33% of GDP.[6] The GVC also provides an opportunity for more countries to be involved in the production process of tradables – design, manufacturing, marketing, distribution and after-sales support. Thus, EMEs do not need to develop an entire industry – such as an automotive industry – to sell goods abroad. Participation in the GVC also raises income per capita and productivity.[7]

In the Philippines, electronic products – including microchips and semiconductors – currently constitute the largest export commodity. In 1985, electronic products accounted for 22.8% of total Philippines exports. By September of 2019, that share had increased to 56.3%, providing a total export receipt of US$29.7 billion.[8]

With global growth projected to rise from an estimated 2.9% in 2019 to 3.3% in 2020 and then 3.4% for 2021, global trade is also projected increase moderately. The International Monetary Fund (IMF) forecasts a deceleration to 1.25%,[9] while the WTO predicts a slow 1.2% rise in world merchandise trade volume.[10] Global economic slowdown is partly attributed to the trade dispute between the US and China, with US tariffs broadening to include all imports from China. This dispute inevitably has an adverse effect on the world's trade and supply chain. It is hoped this dispute will end soon as there is always room for compromise and co-operation. As global growth is predicted to rise to 3.3% in 2020, all is not doom and gloom. Likewise, global trade is expected to recover in 2020 – the IMF forecasts trade to accelerate to 3.2% and the WTO anticipates a 2.7% growth in trade volume.

Francisco Dakila

To support and enable trade, a credible cross-border payments system should be established to facilitate transactions of goods and services. With GVC trade, companies should be able to order and settle obligations quickly to minimise disruption to the production chain and the delivery of goods and services. Payment systems should be the oil that fuels the trade engine. The global payment system has likewise entered the digital era, and trade has adapted to this. In a June 2019 article, the IMF declared: "The digital revolution has changed the nature of trade."[11] Enterprises now operate as links in the GVC, encompassing multiple economies; overseas providers deliver services such as banking and insurance; and e-commerce has increased its role in cross-border transactions.

Codes and clearing houses

The digital revolution has also altered the retail payment system and opened possibilities for greater financial inclusion. Recognising this potential, the Bangko Sentral ng Pilipinas (BSP) has steered the formulation of the policy and regulatory framework for the National Retail Payments System (NRPS). Under this system, the BSP provides regulatory oversight and policy direction to payment service providers, which are composed of banks and non-bank e-money issuers. The two priority automated clearing houses established under the NRPS are Pesonet, for batch electronic funds transfer (EFT) credit push payments, and InstaPay, for real-time low-value EFT credit push payments. Pesonet launched in November 2017, but has since increased its transactions by 238% in September 2019. The number of InstaPay transactions has risen from 1,740 in April 2018 to 3.5 million by September 2019.

Machine-readable QR codes are a retail payment system gaining traction, but require standardisation to be successfully integrated

Another mode of payments gaining traction is the use of machine-readable QR codes, given the ease, convenience and speed of merely scanning the code. In the Philippines, PayMaya and GCash are the early implementers of QR code-driven payments and financial services. In the absence of a national QR code standard, the QR solutions of these e-money issuers are not yet interoperable. In November 2019, the BSP launched the adoption of a national QR code standard for payments in the Philippines.

The linkage of payments and settlements systems between countries and regions is a continuing process. With increasing integration of trade and investments, as well as tourism and labour in Southeast Asia, ASEAN member states have likewise started to work towards a similar initiative. The ASEAN Working Committee on Payment and Settlement Systems – which the BSP co-chairs with the Bank of the Lao PDR – has been working to implement the policy framework and implementing guidelines in support of the priority to establish an interoperable cross-border real-time retail payment system in the region. It is proposed that the participation of any ASEAN member state is voluntary, and takes into account the varying state of readiness of each member to take part in a regional payment system.

These payments systems' successful integration will hinge on the private sector – particularly the banking community. Commercial banks engaged in foreign exchange business have the capacity to lead the establishment of bilateral or multilateral payments and settlement systems. Aside from cross-border payment systems, the current bilateral/multilateral setup is principally motivated by banks' overall business strategy and their respective clientele's needs.

The future of trade and payment systems in Asia – and, indeed the rest of the world – is exciting. Technology and innovation have spurred further integration of economies, with buyers and sellers not confined by national boundaries. Governments – especially central banks – provide the enabling environment to allow the private sectors, banks and other financial institutions to capitalise on these innovations to reach a common goal: speed and efficiency.

Notwithstanding the ongoing trade tension, co-operation between countries should not cease. We have laid the foundations of enduring partnerships – we must now make it work for the greater good of our nations.

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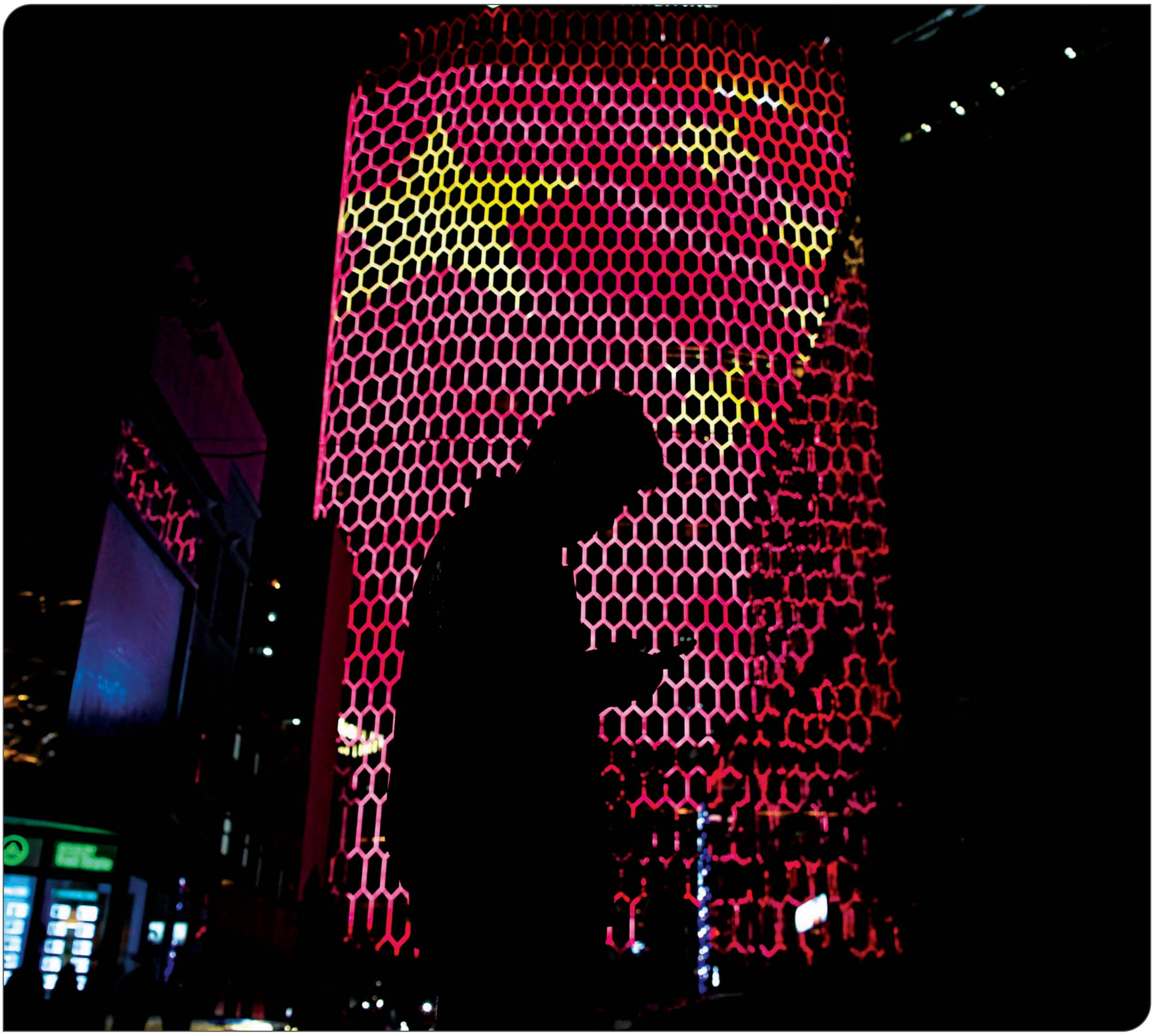
From bones to blockchain – The next currency disruptors

Li Dongrong, president of the National Internet Finance Association of China, and former deputy governor of the People's Bank of China, says that digital technology and financial technology could play a decisive, perhaps subversive, role in shaping the future of financial services – and money itself



Li Dongrong

The future of currency as we know it today will be closely related to developments within the monetary system and laws around currency in circulation.

Currently, developments in the digital currency space are being closely watched, and concerns remain around security, efficiency and how the instrument could be issued. Of course, digital currencies have also been classified as private digital currencies, digital tokens, and so on.

There are four basic criteria that must be met for a currency to be deemed a currency:

- Most critically, whether its value is stable
- Whether it is safe to use, and can be preserved
- Whether it is a convenient payment instrument
- Speed of currency delivery. Currently, network and technical support ensure currency delivery can be made ‘in a flash’, which was unimaginable 10 or 20 years ago.

Since the development of the first currencies, people have strived to achieve these four goals with the help of various emerging technologies. The history of human currency development is the history of scientific and technological progress, through which the issuance and use of currency has constantly been improved and perfected. However advanced the currency, science and technology are always means to help currencies adapt to – or meet the needs of – public use.

Efforts to improve the security and efficiency of currency use has never stopped. From the earliest shells, stones, bones and metals to today’s banknotes; from the earliest cheques, money orders and promissory notes to today’s bank cards; even WeChat Pay and Alipay prevailing in China: they all reflect people’s unremitting efforts to improve the speed, security and convenience of currency use.

Thirty years ago, currency circulation was a critical task of central banks. Currency circulation was primarily about cash – or money type (M) 0 – circulation, the focus being whether cash circulation and commodity circulation activities were compatible. To this day there have been no major changes to this model, only a gradual shift from the adaptation between M0 and commodity circulation to the adaptation of narrow money (or M1) and broad money (or M2) with commodity circulation. Central banks are focusing on establishing a replacement for M0.

With the evolution of modern science – especially digital technology – academics have proposed new ideas: can digital technology play a more significant role or even trigger subversive change in the replacement of M1 or M2? While debates on this issue are certainly innovative, the application and implementation of a new monetary system requires more prudence, strict argumentation and practical verification. In this case, the stability of the currency should always be the top priority. If digital currency proves secure, speedy, easy to use and with a stable value, it can doubtless adapt to the needs of society with the prospect of broad development. Conversely, if digital currency brings instability or shocks to the value of the currency, the impact would be catastrophic.

New trends in fintech development

On a global scale, the value, development principles and consensus of the role of financial technology – known as fintech – have gradually solidified.

When fintech made its debut, countries worldwide were divided. Some welcomed fintech cautiously, while others took a dimmer view. However, over time, major countries, regions and international financial organisations have begun to adopt more positive and inclusive attitudes towards fintech. In June 2019, the International Monetary Fund (IMF) conducted a survey that investigated the fintech attitudes of 96 countries.[1] The findings reveal two-thirds of these countries have realised the potential value of fintech and have begun, at a national level, to implement relevant fintech strategies to help all industries improve financing innovation and application capabilities. More than 60% of the surveyed countries have incorporated fintech into their national inclusive finance strategies.

With the advancement of science and technology, the division of labour in the financial industry has become increasingly market-oriented, specialised and refined. As a result, the operating industry and value chains have been continuously extended. Previously, a number of financial institutions’ processes were outsourced to technology companies; now they can co-operate and integrate with each other more intensively in business areas such as data analytics, cyber security and IT infrastructure.

In prioritising and developing fintech, countries should also note that, although fintech can bring economic and social benefits, it also brings multiple risks. These risks can overlap, posing new challenges to financial regulation and social stability in various countries. At this point, countries should be increasingly aware of the need to develop regulatory technology so as to better develop fintech.

Today, fintech has emerged as a global issue. Countries sorely need to exchange industrial connectivity, technology research and development, talent training, infrastructure construction and governance experience in the fintech industry. It is hoped that, through the International Finance Forum, the needs of all parties for international exchanges and the collaborative governance of fintech will be better connected so fintech can enjoy orderly and effective development.

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A Swift exit?

Yao Qian, general manager of the China Securities Depository and Clearing Corporation, says that cryptocurrencies and peer-to-peer banking offer fast alternatives to the increasingly politicised Swift network, and could help build a world currency unfettered by cross-border barriers

Swift is currently the main service provider for cross-border payments, remittances, clearing and settlement. It has a monopoly: if a bank needs to carry out cross-border business, the principal requirement is to access the Swift network, or to find another bank already connected.

Some people criticise the high costs caused by the relatively long cross-border payment process, which comprises several links. The more nodes are passed, the more tolls are collected and, accordingly, the fee is higher. In addition, some believe Swift – which travels through multiple nodes – is not efficient enough. When a problem occurs, it takes more time to check each point of failure. And the firm has also been accused of lacking transparency.

Undoubtedly, Swift has improved its entire payment and settlement system over time through numerous initiatives, including the innovative global payment initiative (GPI). Even so, despite the emergence of new technologies, some have proposed additional improvements to allow Swift to remain the market leader, including changes to the clearing model, improved connectivity and digital currencies.

Changes to the clearing model

The current inter-account clearing model with commercial banks at its centre could be migrated to a blockchain architecture to minimise the number of intermediate links, achieving a peer-to-peer (P2P) payment.

Cryptocurrencies such as Libra have espoused a vision of a world currency without borders and with stable value and an inclusive economic infrastructure

Yao Qian

This kind of technology has already been deployed, for example, in Ripple's P2P network xCurrent, which uses counterparties' interbank transaction accounts in the clearing network to complete P2P payments. This all occurs at a lower cost and with greater efficiency.

Although the application of blockchain technology itself is currently inefficient, some will explore how to reduce intermediate links to improve payment efficiency.

Improved connectivity

To solve the difficulty of cross-border payment, various countries' central banks should act together to connect their real-time gross settlement systems: for example, connecting Fedwire and the Clearing House Interbank Payments System from the US, the Clearing House Automated Payment System from the UK and the Trans-European Automated Real-time Gross Settlement Express Transfer System – known as Target2 – from the European Union with China's High-Value Payment System in a solution still adhering to the account-based system.

Digital currencies

Of course, cross-border payment also requires foreign exchange policies for the cross-border flow of funds – but technical issues require further discussion. The current major trend is digital currency; the developments of cryptocurrencies and the blockchain technology behind them have led many to question the account-based system, in which they endlessly transfer from one institutional account to another, then to one overseas institutional account, and then to another. Cryptocurrencies have inspired people to solve the problem, which could be completely avoided under certain technical conditions.

The idea of cryptocurrencies was first raised in the late 1970s and early 1980s. When the currency was digitised, the public and private key cryptosystems would be used. By encrypting the message with the sender's public key and signing with the recipient's private key, we could figure out the roles of both ends. In this way, transferring digital cash directly from one end to the other would be like sending an email, avoiding going through so many accounts and intermediaries.

Now we have David Chaum's e-cash system and popular cryptocurrencies such as bitcoin. Blockchain technology will not only work for bitcoin but will also be widely applied in other fields.

The recent introductions of Ripple's XRP and Facebook's Libra 'stablecoin' are based on this idea: by exchanging your national currency for XRP or Libra, and then exchanging it with the currency of the counterpart country, the cross-border remittance is completed.

The global currency payment system is therefore being drawn in two directions. One is to improve and optimise the original system and maintain the status quo, such as with Swift's GPI project. The second is to explore new directions, such as constructing a blockchain-based architecture. This has aroused controversy, mainly over whether cryptocurrency should be based on blockchain. For example, David Chaum's e-cash is not based on blockchain, but it is an academically successful cryptocurrency.

However, it is still necessary to study and elaborate on the plans to reform payment systems, whether we decide to improve the existing Swift system or to build a brand new architecture, choose centralisation or decentralisation, or have blockchain-based or non-blockchain-based cryptocurrency. Libra has espoused a beautiful vision – to build a world currency without borders and with stable value, and an inclusive economic infrastructure that benefits the public. This appeals to many countries and citizens.

The current major trend is digital currency; the developments of cryptocurrencies and the blockchain technology behind them have led many to question the account-based system

Meanwhile, two other questions have emerged. First, will a global digital currency appear in the digital world? Second, can there be a globally inclusive payment platform that is trusted by everyone and not controlled by a single counterparty? A unified payment platform is easier to achieve than a unified global digital currency, which will find it harder to get a foothold. We should therefore stand in awe of digital currency, but at the same time be encouraged to build an inclusive platform that will evade control by a single party.

REGIONAL AND MULTILATERAL CO-OPERATION

Friend or foe?

Herman Van Rompuy, IFF co-chairman, former chairman of the European Council and former prime minister of Belgium, sees the European Union and China as partners in the fight against climate change, economic competitors and systemic rivals, with dialogue remaining an effective approach to dissolving distrust and developing relationships

European Union–China relations must be seen in a global and bilateral context. The relationship is primarily economic, but involves a growing number of facets. In any case, there has been a change in both entities in recent years. The EU has become more assertive in looking after its own interests, and China is deliberately playing a more important geopolitical role.

Dialogue remains the only approach to settling disputes and developing relationships. Both the EU and China want to maintain the multilateral framework – not only in words but also in actions – and both are strongly committed to the most important issue facing mankind: climate change.

The EU–China 'comprehensive strategic partnership' is more important than ever. EU–China relations are mature, complex and highly diversified. The EU is China's biggest trading partner and China is the EU's second largest. The trade in goods between China and the EU is worth in excess of €1.7 billion (US$1.85 billion) daily.[1] Of course, the trade war with the US has affected China–EU relations economically and politically. It has resulted in a sharp slowdown in economic growth – particularly in Germany. The US policy is interpreted by China as a geopolitical move, but it is also motivated by US domestic politics and certain portions of the American working classes who are dissatisfied with the effects of globalisation.

If it was only geopolitical manoeuvring, why were tariffs imposed on European steel and aluminium, and why is the European automotive sector also threatened? It is clear there is unrest in the EU with China's approach to trade and investment. The US and the EU face the same problems in China, but the EU's approach to solving the problems differs from that of the US. The latest EU–China summit in April 2019 promised to solve these problems. The key words to emerge from the meeting were 'openness', 'non-discrimination' and 'reciprocity'. The first steps have been taken recently: for example, on protection of geographical indications – the first ever EU–China trade agreement – and the signing of two aviation accords. But overall progress has been slower than hoped.

In September 2020, there will be a summit in Leipzig between President Xi Jinping and the entire European Council, where there will be an obligation to deliver. A real game-changer would be finalising negotiations on a comprehensive agreement on investment. But we are not there yet. Hopefully, a breakthrough will occur in negotiations between the US and China, thus averting a recession.

The EU flexes its muscles

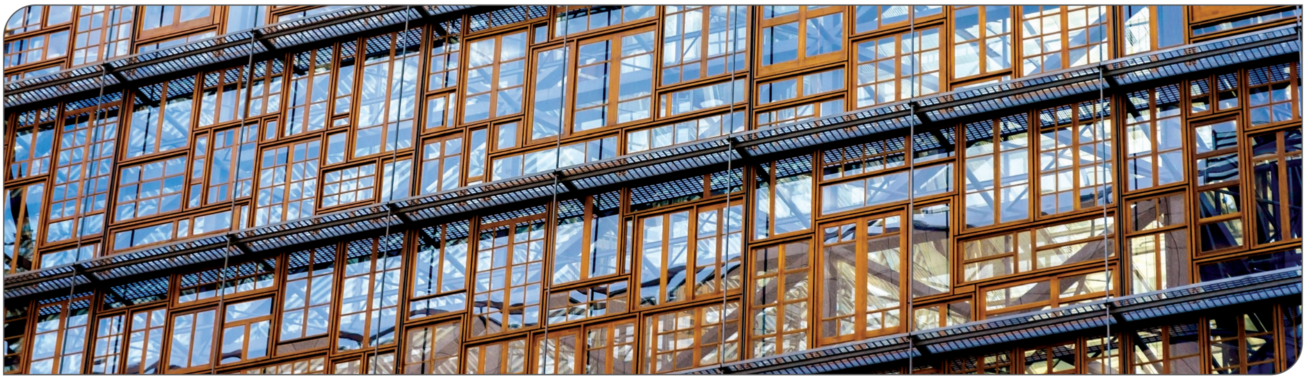
In the EU – certainly among the larger countries and in European institutions – greater assertiveness has grown to push free and fair trade. This translates to the adoption of new instruments to combat dumping and to safeguard the interests of the EU and its member states in the strategic sectors of security and public order. This shows a clear will to defend European sovereignty, which is why the EU is also taking action against the malpractices of the 'big four' tech companies – Google, Amazon, Facebook and Apple. This is why EU countries want to be less dependent on Russian oil and gas, and why the EU wants to further internationalise the euro – the second-largest currency worldwide, with 35% of all payments – to be less dependent on the US dollar. For the same reason, the EU wants to strengthen the European pillar of the Nato military alliance and ensure its security in cyber space and telecommunications by striving for more technological sovereignty.

Opting for more sources of renewable energy will make Europe less energy-dependent on other countries and therefore more sovereign. We want Europe to become the first climate-neutral continent by 2050.

At the same time, the EU remains a strong defender of the multilateral order and is working with China to reform the World Trade Organization (WTO) and keep it functioning. For its part, China has manifested itself as a geopolitical actor along the Belt and Road Initiative (BRI) on all continents, including Europe. The EU has no objection to the BRI, but it requires respect for European legislation and transparency in the procedures for awarding contracts.

China's actions have led to new initiatives in Africa favouring investment from the EU, as well as from Japan and the US. This can only benefit the economic development of Africa, where the EU has been present for decades through its official development assistance, especially in soft sectors such as health and education, accounting for more than half of all aid to Africa.

The EU resolutely rejects protectionism. Recent proof of this is the free-trade agreement concluded with Japan and the political agreement on a free-trade agreement with the Mercosur countries – Argentina, Brazil, Paraguay and Uruguay. China is also promoting an Asian pact that includes the Association of Southeast Asian Nations and Australia, Japan, New Zealand and the Republic of Korea – the Regional Comprehensive Economic Partnership.



The Europa building in Brussels, headquarters of the European Council

The EU's general approach towards connectivity, outlined in in 2018 in the *EU connectivity strategy*, relies on adherence to market rules, EU and international requirements and standards, and a level playing field to deliver benefits for all parties concerned and in all the countries along the planned routes.

The EU wants to promote and defend its ideals and interests at global level, while respecting the sovereignty of nations and multilateralism. It regards the latter as a guarantee of peace. The EU also wants to further deepen its unity. The 27 member states of the EU speak with one voice in the negotiations setting out its new relationship with the UK following Brexit, in the trade talks with the US and in the negotiations for an investment agreement with China. This unity was also seen at the 21st Conference of the Parties of the UN Framework Convention on Climate Change in Paris in December 2015 when adopting the Paris Agreement on climate change, and in the nuclear deal with Iran – known as the Joint Comprehensive Plan of Action (JCPOA). In both cases, China and the EU have remained true to their word.

Major responsibilities for China and the EU

On the subject of unity: leaving the EU is not the wish of the overwhelming majority of citizens of the EU. Support for EU membership is now at its highest in 27 years, and European voters turned out in record numbers in May 2019's European Parliament elections. The Brexit process is still unclear – particularly on the extent to which, or even if, post-Brexit the UK will move away from the European single market.

The relationship between global actors is characterised too much by distrust – which can sometimes run very deep. To counter this, China and the EU must deliver on their announced promises over this year, which is why the Leipzig summit will be so important.

In this spirit, the EU engaged with China in a very successful summit in Brussels in April 2019.[2] China assumed its responsibilities in securing a more balanced relationship, with greater reciprocity, non-discrimination and openness of its system, while upholding a rules-based multilateral trading system. China agreed to address industrial subsidies as part of the WTO reforms and to open up more systematically its economy to foreign investment.

No bilateral contact or regional initiative, such as the Cooperation between China and Central and Eastern European Countries initiative – known as '17+1' – can replace an agreement with the EU as a whole; it could even be counterproductive. It also represents a choice between the short and long terms.

Herman Van Rompuy

Strengthening mutual trust is essential in the uncertain and sometimes confusing times we live in. This will not prevent each global actor from upholding its own values internally and externally. The global community has a number of essential values in common – such as peace, prosperity for all and combating climate change – but it does not share all values. They are also summarised in the UN's 2030 Sustainable Development Goals. China and the EU have a major responsibility in this regard.

For the EU, China simultaneously plays different roles in different policy areas:

- A co-operative partner in, for example, addressing climate change, and implementing the Paris Agreement, the JCPOA and certain dimensions of connectivity
- A negotiating partner with whom the EU must find a balance of interests with – for example, in investment agreement, migration and visa facilitation and certain dimensions of connectivity
- An economic competitor in the pursuit of technological leadership in fast-moving high-tech sectors such as robotics and electric vehicles
- And a systemic rival promoting alternative models of governance. The 'systemic rival' label reflects no hostility; it is a simple statement of fact.

While recognising these areas of difference, the EU wishes to deepen its engagement with China to promote common interests at a global level.

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2. *European Commission (April 2019),* EU–China summit – Rebalancing the strategic partnership, *https://bit.ly/2uJhPMK*

China and the Middle East – A priceless pivot

China once considered the Middle East a 'graveyard for empires', but *Mehmet Şimşek*, former deputy prime minister of Turkey, foresees the Asian giant forging stronger trade and investment links in the region

China's engagement with the Middle East in real economy terms is strong – and likely to get stronger. This is a solid foundation to enhancing financial co-operation going forward. The timing also appears to be right, in that the West is suffering from 'Middle East fatigue', and the US administration's talk of retrenchment from the region is making many nearby countries much more receptive to Chinese outreach.

Equally important, China no longer perceives the Middle East and North Africa (Mena) as a "chaotic and dangerous graveyard, burying empires", as Li Shaoxian of Ningxia University put it. It is exactly the opposite – China now recognises the region as the key to unlocking its status as a world power. Why do China and the Middle East need financial co-operation? There are at least five simple reasons:

1. **China is the largest trade partner in the region.** It is the largest trade partner of 11 Mena countries: Iran and 10 Arab League nations. Across a broader geographical area, China's trade with the 22 Arab League nations reached US$244.3 billion in 2018; trade with Iran, Turkey and Israel totalled $72 billion. Combined, Mena accounts for more than $300 billion of trade with China.

2. **China is already a leading source of foreign direct investment (FDI) and, increasingly, an important source of project financing in the region.** China became the largest source of FDI in the Middle East in 2016. In 2017 alone, the country signed investment contracts worth $33 billion with Arab countries.

   Future projects linking China's domestic development programme to the Belt and Road Initiative (BRI) are likely to enhance trade, investments and financial linkages. As of mid-2019, China had signed agreements with 21 Mena countries, including 18 Arab League nations, on a joint BRI project.

3. **The Mena region already hosts more than 1 million Chinese expatriates.** This number is likely to increase as China ups its engagement in post-war reconstruction in Iraq, Syria, Yemen and, possibly, Libya.

4. **China is the biggest global importer of crude oil.** It imported roughly 500 million tonnes in 2019, half of which came from the Middle East. Oil- and gas-rich Gulf states thus account for upwards of 80% of China's trade with Arab nations.

5. **Demand from some Middle Eastern countries for deeper financial and economic co-operation with China is likely to grow on the back of the increasing threat of economic sanctions, and weaponisation of the US dollar and payment systems by Washington.** Countries such as Iran, Turkey and Russia have publicly expressed a strong desire to use local currencies for trade and investment transactions in the future.

In short, China's growing economic presence in the Middle East necessitates stronger financial co-operation.

Swap lines and de-dollarisation

Discussions now need to be opened on what sort of financial co-operation is likely. There are substantial differences in political, social and economic conditions across the Middle East. It would therefore be difficult to implement a single framework for financial co-operation catering to the needs of all countries. Oil-rich surplus countries and deficit countries have different needs. There are therefore multiple channels of financial co-operation.

China's rise has already led to the renminbi officially becoming a global reserve currency. It currently represents around 10.9% of the International Monetary Fund's special drawing rights currency basket. This makes the renminbi the third-largest reserve currency after the US dollar and the euro. Central banks in Middle Eastern countries are likely to hold, in the future, part of their reserves in renminbi-denominated assets.

One area of co-operation, as a result, could be bilateral currency swaps to achieve a higher degree of financial stability in the region. China already has 36 bilateral currency swap lines globally, and standing facilities that are rarely used; Middle Eastern trade partners could benefit from them.

Second, the weaponisation of the dollar – the currency being used as a weapon in imposing economic sanctions – is likely to lead to de-dollarisation in the long term. If deglobalisation is going to be a global long-term trend, it will be partnered by de-dollarisation.

The development of the internet and blockchain-based payment systems will probably influence multiple global systems. China and Middle Eastern countries could facilitate trade in renminbi or local currencies. Some countries are already seeking ways of reducing their vulnerability to the continuing threat of US sanctions and are considering ways of using local currencies for trade and investments.

Middle Eastern countries are in need of diversification as global demand for oil is expected to plateau around 2030

Mehmet Şimşek

The Brics nations – Brazil, Russia, India, China and South Africa – are reportedly developing a new universal payment system to challenge the Swift international payment network. More recently, Kirill Dmitriev, chief executive officer of the Russian Direct Investment Fund, unveiled some striking numbers: foreign trade payments in dollars have dropped from 92% to 50% over the past few years, while international ruble transactions have risen from 3% to 14%.[1] The Brics nations are also said to be considering a new common cryptocurrency for mutual payments as another way of working around the dollar.

However, the use of renminbi seems a more feasible alternative for oil and gas exporters in the future, as it is hard to sustain trade in local currencies with persistent deficit countries.

Third, the close economic integration between China and Middle Eastern countries also requires market-based financing for corporates and governments. China's Panda bond market is another avenue for co-operation. Panda bonds are renminbi-denominated notes sold by non-Chinese issuers in mainland China. This onshore product, which offers international borrowers a way to tap domestic Chinese investors, is likely to continue to develop and internationalise going forward. The investor base is also likely to become international. This will be a great route forward for deficit countries.

Finally, co-operation between sovereign wealth funds in China and Middle Eastern countries is also an option. The success of any co-operation – in particular financial – between China and the Middle East will be largely dependent on a strong policy dialogue.

Renminbi at the top table

As previously alluded to, the world is likely to move towards a multicurrency global monetary system. The renminbi looks set to play a much stronger and more significant role in international trade and finance. This also requires China to continue reforming its financial markets, further opening up, and deepening capital markets – something the Chinese government today, and in the past, has made very strong commitments to.

Deeper financial co-operation also requires, first and foremost, mutual trust, the existence of which is evident between the two regions. No country in the Middle East sees China's rise as a threat, and there is already a strong strategic and political dialogue between China and almost all countries in the region. This is a good backdrop to build a win-win relationship across the border between China and the Middle East.

Arguably, the regions need each other. China's growth has been stuttering in the face of declining returns to investments, a falling working-age population and thus declining productivity growth. China's search for new growth drivers is going to become even more pressing. Africa – as well as the Middle East – has an extremely young population that can serve this need. Many countries, except members of the Cooperation Council for the Arab States of the Gulf, are in the growth phase.

Middle Eastern countries also need China because they are in dire need of diversification. The International Energy Agency (IEA), in its latest *World energy outlook* report, foresees global demand for oil reaching a plateau around 2030.[2] Youth unemployment rates in the Mena region have been the highest in the world for more than 25 years; in 2017, they were around 30%.

The regions are a perfect match: China is searching for growth drivers globally and the Middle East presents good opportunities. Meanwhile, the Middle East needs Chinese investments and financing to accelerate its own development and industrialisation.

1. *A Ostroukh (November 2019), Reuters,* Russia says Brics nations favour idea of common payment system, *https://reut.rs/2QU2Jgc*

2. *IEA (November 2019),* World energy outlook 2019, *https://bit.ly/2RkzjqA*

Battle for bilateral payments

With China's cross-border trade and investment with the United Arab Emirates growing, *Hao Pengyu*, deputy general manager of the Dubai branch of the Agricultural Bank of China, says that bilateral payments systems are convenient, lack risk and should be facilitated through political policy

The ultimate purpose of a bilateral payments system is to ensure countries can make trade and investment payments in their local currency instead of payments in that of a third country.

Since the 1990s, China has developed cross-border trade with its neighbours, using their domestic currencies or renminbi for settlement, and allows each commercial bank to open local currency accounts to facilitate this arrangement. Since 2009, China has promoted pilot projects for cross-border settlement in which renminbi is used not only in cross-border trade settlement, but also for all general trade, including investments.

Bilateral payments and settlement systems are developed from bilateral trade and investment. In recent years, economic and trade exchanges between China and the United Arab Emirates (UAE) have developed rapidly. In 2018, the trade volume between China and the UAE reached US$24.3 billion, an increase of 28% since 2017. The value of new contracts signed by China and the UAE reached $35.6 billion – an increase of 9% over the same period. And China's investment in the UAE has reached $1.2 billion. These business activities have laid a solid foundation and serve as motivation for a bilateral payments system.

An exchange of visits between Chinese and UAE leaders has ushered in to both countries the best of times. China has become the UAE's most important trading partner. And the UAE is China's second-largest trading partner and the largest importer in the Arab region. In 2018, the bilateral trade volume reached $45.92 billion, representing a year-on-year increase of 12.1%. In the first half of 2019, the total trade volume between the two countries reached $22.66 billion – a year-on-year increase of 9.6%. Around 8% of the UAE's imports and exports are related to China. And investment has also grown rapidly. Therefore, this economic and financial interaction demonstrates the necessity of bilateral settlement and payments.

Meanwhile, policies implemented by the two nations allow banks to open agency accounts for each other. The filing of customs records can allow the cash transfer of the two countries' currencies. At the end of 2017, China had signed agreements on bilateral domestic currency settlement with nine neighbouring countries, and bilateral local currency swap agreements worth CNY3.67 trillion with the central banks and currency regulators of 38 countries. The UAE allows cross-border trade to be paid in any currency, including renminbi – that is, with no restrictions on currency payments.

Hao Pengyu

The strengths of the bilateral payments system

Bilateral payments systems have two major advantages. First, the settlement will be more convenient. Through the accounts of the central banks or commercial banks, the transactions can be settled directly, which is time-efficient. Second, they can reduce exchange rate risk from the third party, meaning the currencies of the two countries are directly exchanged. As a result, the transactions won't be affected by the exchange rate fluctuations of the third party's currency.

But what is the main basis for establishing and connecting bilateral payments systems to national infrastructure? From the perspective of commercial banks, it should be based on the current payment infrastructure of the two countries. The renminbi has its own domestic payment systems comprising the clearing systems of banks and financial markets as well as its cross-border interbank payment system (Cips). The second phase of Cips, launched in May 2018, ensured cross-border payments could be made overnight. The system's operating times have been extended to 24 hours on working days, with four extra hours on the first trading day after weekends and holidays – effectively covering the working hours of all financial markets worldwide.[1] Six continents are covered under the system. The cross-border payment of renminbi can be made through directly and indirectly participating banks.

The UAE also has its own clearing system that allows local currency payments to be made through commercial banks' accounts in the central bank. No matter the direction of the two countries' currency flows, they will eventually flow into the clearing system of the home country. It is therefore clear the interconnection of the payment system between the two countries must be based on their own payment systems.

Regarding the establishment of a bilateral payments system between any two countries, from the perspective of the central bank, no country has yet reached the levels of interconnection. However, six central banks on the Arabian Peninsula – those of Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the UAE – are developing a regional dealing system, where commercial banks in these territories can conduct regional clearing through direct communication. It is inspiring that such a system has been built at the level of central banks.

The payment system will need to factor in how each commercial bank behaves, and then how the interconnection between the central banks will work. In May 2017, the Agricultural Bank of China established a Dubai branch. It has a wholesale banking licence issued by the Central Bank of the UAE and can conduct renminbi clearing, a power granted by the People's Bank of China. The bank can also conduct deposits, transactions, clearing, trade, and financing and renminbi products.

At present, the currency clearing between the two countries can be achieved through the commercial banks in a number of ways:

Arab Regional Payments System participants

Listing mechanism and exchange rate mechanism between the two countries

In the Middle East, China has exchange rate licences for the UAE dirham and the Turkish lira. It can exchange 62 currencies at the Central Bank of the UAE. Currency exchange is therefore viable between the two countries in terms of exchange rates.

The liquidity of renminbi

Commercial banks can stimulate renminbi circulation by providing the currency to financial institutions in the UAE and the market composed of highly liquid assets, such as treasuries. It can also meet the renminbi demand of local enterprises through exchange remittance.

Currency clearing

The commercial bank systems can connect with the local currency clearing system of the Central Bank of the UAE, as well as the Swift system adopted by banks in China. Therefore, dual currency clearing can be achieved.

Clearing banks have unique strengths

China's interbank foreign exchange market can be accessed, alongside the interbank lending market and the interbank bond market, as a member. The message format of the Dubai clearing branch is directly changed from the message format of Swift so the transaction can be cleared through the interbank renminbi clearing system. Straight-through processing can therefore be achieved.

Establishing a bilateral payments system is a long process. Policy mechanisms required to achieve interconnection at the central bank level are challenging, and include the need for currency agreements signed by the two countries. But, in its early stages of development, the functional interconnection of a bilateral payments system can be achieved through the agency accounts of commercial banks. ⬢

1. *People's Bank of China (May 2018),* Phase two of renminbi cross-border interbank payment system fully launched, *https://bit.ly/377Ts9d*

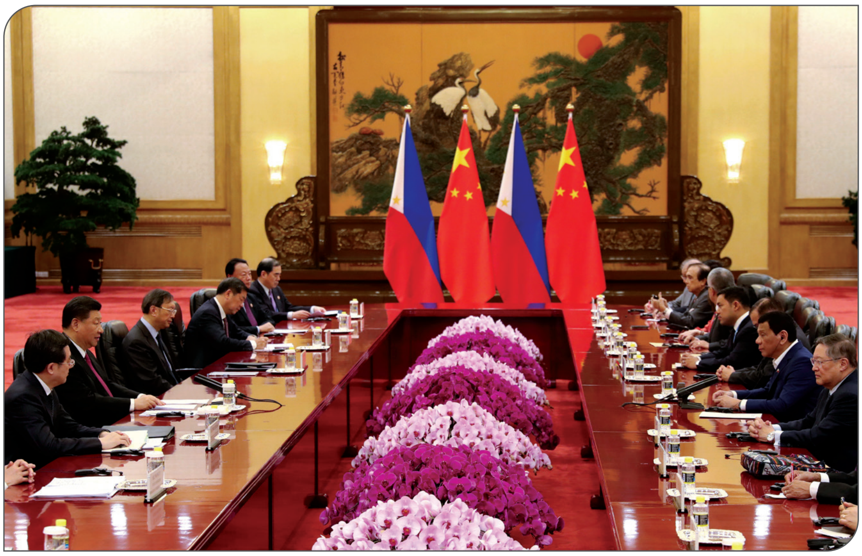
A budding partnership

China is the Philippines' biggest trading partner and its leading source of tourists, says *Carlos Dominguez*, secretary of the Department of Finance of the Philippines. With agreement on the transformative powers of free trade, co-operation is likely to broaden

In the face of a broad slowdown of the global economy, the countries comprising the Association of Southeast Asian Nations (ASEAN) and China continue to show resilience and dynamism.

These economies have fostered strong domestic markets. They have dramatically expanded their trade links and built infrastructure for more efficient payments and settlements across borders both to sustain their domestic markets and make cross-border trade more efficient. Currently, these countries are in the advanced stages of negotiating the Regional Comprehensive Economic Partnership (RCEP), which will be a game-changer for all of those economies.

However, the rapid achievement of global prosperity is threatened by the rise of protectionism. This is expressed in policies that inhibit the free movement of goods across borders, including the imposition of tariffs to achieve political ends. New hindrances to trade have resulted in an economic slowdown – consumers are forced to pay more for the goods they need, and supply chains are disrupted.



President Xi Jinping (second left) and President of the Philippines, Rodrigo Duterte (second right) attend a meeting at the second Belt and Road Forum for International Cooperation, in the Great Hall of the People in Beijing

Fortunately, in Southeast Asia, consensus prevails that free trade and more efficient movement of capital is the way forward. While protectionism plagues other parts of the world, the economies of Southeast Asia have invested in the free flow of goods, capital and services. This is a major reason why the economies of this region continue to lead the way in growth.

We appreciate China's support in building institutions for open trade and investments in the ASEAN region. The ASEAN–China Free Trade Area was the first of the free-trade agreements signed by ASEAN with its major trading partners, and its success continues to be celebrated. For 10 consecutive years, China has been ASEAN's biggest trading partner, with total trade growing at an average of 10% a year since 2009. In 2018, ASEAN's total trade with China reached US$483.14 billion – 10% higher than in 2017.[1]

Under the leadership of President Rodrigo Duterte, the Philippines has adopted a more forward-looking policy towards China. The country understands the great synergy that will be generated by a closer partnership between the two countries – the opportunities that unite them are far greater than their differences.

With the warming of relations between the two countries, China has become the Philippines' biggest trading partner and its largest tourism market. Since 2016, the Philippines' total trade with China increased at an average of 15% annually. In 2018, total trade with China reached $52 billion – 15% higher than in 2017. Chinese tourist arrivals in the Philippines, meanwhile, have grown at an average of 27% per year since President Duterte assumed office in 2016. The number of Chinese tourist arrivals reached 1.25 million in 2018 – 23% higher than in 2017 – and reached 1.63 million by the end of 2019.[2]

The Philippines also enjoyed the best terms in its Panda bonds floated on the Chinese market in 2018. The three-year Panda bonds worth CNY2.5 billion were priced at 3.58% and received a very tight spread of 32 basis points over the benchmark. China Lianhe Credit Rating rated the bonds as triple A – its highest rating.

The Philippines also fully supports China's Belt and Road Initiative (BRI), appreciating its vast economic potential for all nations of the region and beyond. Improved infrastructure will enhance trade among regional economies, enhanced trade will encourage more efficient investment flows, and improved connectivity will improve the inclusiveness of our growth patterns. We have everything to gain from this.

Soft loans, hard results

The Philippines has a BRI of its own – its economic strategy centres on a massive infrastructure modernisation programme to provide the logistical backbone for a dynamic economy. Known as ‘Build, Build, Build’, the programme involves 100 highly strategic infrastructure projects, as well as thousands of infrastructure and logistics improvements all over the country. It will lower the costs of moving people and goods across the Philippine archipelago, bring once remote communities closer to the economic mainstream and create numerous investment opportunities that will unleash the latent strengths of the country’s economy.

The Philippines is relying on this programme to induce internally generated growth to enable expansion, despite a challenging global environment brought about by protectionist policies in the West.

Its forward-looking investments in infrastructure benefited from the strong support of multilateral development banks such as the Asian Development Bank, the World Bank and the Asian Infrastructure Investment Bank, as well as bilateral development partners. China has committed $9 billion as official development investment to support the infrastructure modernisation programme.

China and the Philippines have so far signed three highly concessional loan agreements amounting to $493 million to fund the construction of the Kaliwa Dam, the Chico River irrigation system and the Mindanao railway project. Since 2016, the Philippines has secured a total of $430 million in grants from China to fund the construction of bridges and drug rehabilitation facilities, and conduct several feasibility studies on infrastructure projects, among other forms of investment.

The Philippines is also in the midst of creating more institutional facilities to further enhance trade and economic co-operation. For instance, payments and settlement arrangements are being put in place to improve the efficiency of using its own currencies. In 2018, 13 local mainstream commercial banks and a local branch of the Bank of China entered into a memorandum of agreement for the creation of the Philippine Renminbi Trading Community. The volume of business between the two economies justifies its establishment. The Philippines foresees a significant reduction in the cost of doing business across the two economies as a result of this initiative.

> *The synergy created by closer Philippines–China economic co-operation is mirrored across the region, with increasingly closer economic integration between China and ASEAN*

A deeper friendship

The progress of the Philippines–China bilateral relationship is underscored by the increasingly frequent exchange of high-level visits, including those of the country’s two leaders. President Duterte is the only leader that President Xi Jinping has met eight times, five of these in China.

The synergy created by closer Philippines–China economic co-operation is mirrored across the region, with increasingly closer economic integration between China and ASEAN.

Multilateral institutions such as the Asian Infrastructure Investment Bank have been extremely helpful to the economies in the region. We could complement this by working further on establishing a multicurrency payments and settlement system to improve the efficiency of an open trade regime.

Carlos Dominguez

RCEP will be the centrepiece of the Philppines’ collective efforts to build beneficial multilateral partnerships. The well-developed relationship between China and ASEAN forms the core of this emerging partnership.

The Philippines looks forward to the finalisation of agreements for RCEP. With this framework for enhancing trade and investment, the development of the economies of the region will be further enhanced. It will be able to build a sanctuary for free trade and investment co-operation against the forces of protectionism elsewhere. This will be a major force shaping the development of the world’s economy.

The prosperity and wellbeing of billions of people in the region will depend on how the Philippines can foster growth through increased connectivity and deeper integration of these economies. Enhancing the Philippines’ co-operation with China is essential in ensuring the region’s vibrant economic future and achieving our shared goal of dramatically reducing poverty among our peoples.

The partnerships and agreements the Philippines continues to build today will provide a solid foundation for a more beneficial future for the region. These channels of co-operation are among the many reasons there is so much optimism that the countries of this region will lead the rest of the world in economic growth long into the future. ⬢

1. *Philippines Department of Finance (November 2019),* RCEP crucial to ASEAN, China economic integration, *https://bit.ly/30l7B10*
2. *China Global Television Network (September 2019),* Improved ties spur Philippine tourism, *https://bit.ly/36Yac3c*

ASEAN and China – Boundless opportunities

Ros Seilava, undersecretary of state at the Ministry of Economy and Finance, Cambodia, says the Association of Southeast Asian Nations is strengthening ties with China to promote trade, communications and investment to the benefit of both parties

In the face of current global economic uncertainties, a partnership between China and the wider region of the Association of Southeast Asian Nations (ASEAN) is becoming an important and strategic channel for promoting global growth. Financial co-operation is undoubtedly significant in facilitating economic activities, raising the quality of growth and enhancing the well-being of the region's people.

ASEAN recognises the necessity of collaboration and the boundless financial potential it can bring to its socioeconomic development, integration and community-building. Over the years, Cambodia has been delighted to witness the ever-expanding co-operation between ASEAN and China, which is one of our major partners in dialogue.

Following the 1997 East Asian financial crisis, ASEAN focused more closely on its monetary and financial co-operation. The association continues to further deepen its commitment to fostering friendly relations with China – a relationship that promises to be mutually beneficial, and bring peace and prosperity.

For instance, with the *Master plan on ASEAN connectivity 2025*,[1] China's Belt and Road Initiative (BRI) and the China–ASEAN 3+X co-operation framework, China and ASEAN have implemented a series of concrete measures as part of their joint efforts to synergise the various connectivity strategies on political security, the economy and people-to-people exchanges.

Furthermore, the ASEAN Plus Three member countries – ASEAN, China, Japan and the Republic of Korea – have also inaugurated the Chiang Mai Initiative, which is a multilateral currency swap arrangement among its members. This has expanded a foreign exchange reserves pool worth US$120 billion in 2010 to $240 billion today, which aims to manage regional short-term liquidity problems and to avoid heavy reliance on the International Monetary Fund.

In addition, efforts are under way to develop a regional bond market known as the ASEAN Bond Market Initiative to strengthen financial stability and reduce the sudden reverse of the capital flows witnessed by much of the region. In this context, it is important to consider how we can realise the objectives of both the *Master plan on ASEAN connectivity 2025* and the BRI.

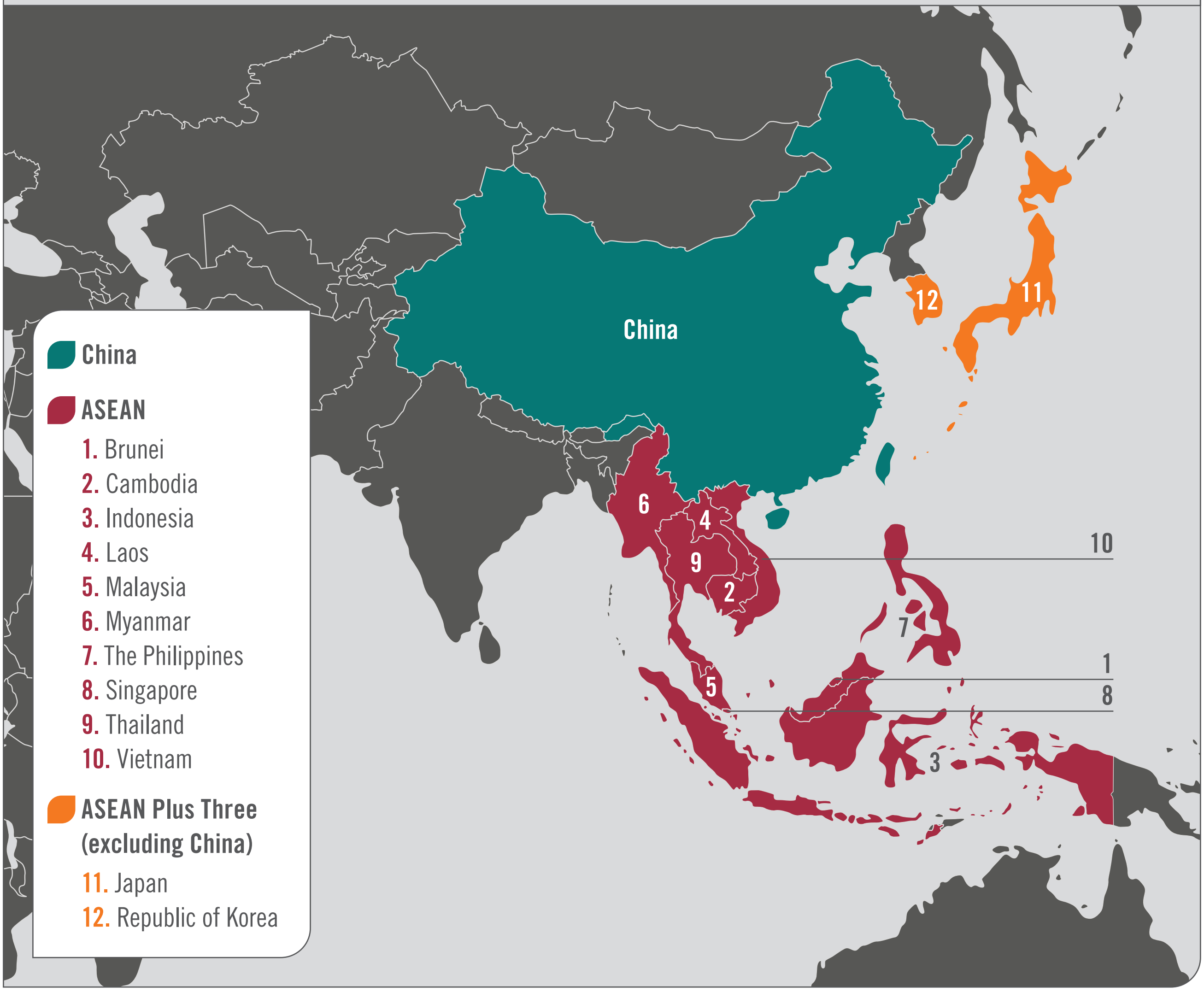
Due to the strong ties in this region, China has maintained its position as ASEAN's largest trading partner since 2009. In 2018, it became the third-largest external source of foreign direct investment (FDI), and acted as an important source of foreign tourism to the ASEAN region.


Ros Seilava

In 2018, FDI flows from China to ASEAN amounted to $10.2 billion, accounting for 6.6% of the region's total FDI. Both regions plan to intensify their efforts to meet the joint target of $1 trillion in trade volume and $150 billion in investment by 2020.[2] It is hoped this can be achieved through the deepening of economic linkages and improvement in connectivity.

Strong economic ties and relations have huge potential for the development of the financial market between China and ASEAN. To further deepen integration, co-operation and connectivity, the two parties have been working diligently to finalise plans for the modern, comprehensive, high-quality and mutually beneficial Regional Comprehensive Economic Partnership (RCEP). This agreement will contribute significantly to the growth of global trade, and enhance economic growth for all partners. Moreover, the ASEAN–China Free Trade Area and protocol for the framework have been implemented to further promote trade and investment liberalisation.

ASEAN Plus Three member countries



Stocking up on financial firepower

The two parties are also focused on strengthening their financial collaboration through actively engaging with international financial institutions, such as the Asian Infrastructure Investment Bank. They have also advocated mobilising private capital and enhancing capacity building to support infrastructure development in the region.

The China–ASEAN Investment Co-operation Fund was founded in 2010. It is a dollar-denominated offshore quasi-sovereign equity fund sponsored by the Export-Import Bank of China, among other institutional investors, under the direction of the State Council of the People's Republic of China and approved by the National Development and Reform Commission. The fund targets investment opportunities in large-scale infrastructure projects – such as roads and ports – energy and natural resources. The firm ultimately plans to raise $10 billion to invest in the ASEAN region. Such financial investment will significantly add to the firepower of the BRI.

Through close financial strategic partnership and collaboration, I am confident that both China and the ASEAN region will continue to grow and achieve new heights and mutual benefits for the future.

Without doubt, greater regional financial co-operation for lasting resilience and inclusiveness will accelerate and increase the quality of economic growth through a connected financial network. This will ultimately improve the wellbeing of our people, and it plays a critical role in promoting trade and increasing capital flows in the region. This can, to a large extent, help the ASEAN integration process, and contribute greatly to regional community building.

ASEAN and Cambodia look forward to an even more robust and long-lasting partnership with China, and Cambodia is ready to extend its commitment and contribution to realise new opportunities for a better future.

1. *ASEAN (August 2016),* Master plan on ASEAN connectivity 2025, *https://bit.ly/2QYbQfJ*
2. *China.org.cn (November 2018),* China, ASEAN adopt Strategic Partnership Vision 2030, *https://on.china.cn/2Q86Y7d*

Uncorking the financial bottlenecks

After successful infrastructure and co-operation projects in Brazil by the New Development Bank (NDB), *Zhu Xian*, IFF vice-chairman, vice-president of the NDB, former vice-president and chief ethics officer at the World Bank Group, sees Latin America as fertile ground for continent-wide development

Brazilian infrastructure such as water supply and power lines requires considerable governmental financial support

Zhu Xian

In Latin America, the New Development Bank (NDB), founded by the Brics nations – Brazil, Russia, India, China and South Africa – currently funds and manages projects in Brazil. However, the NDB has ambitious plans to conduct projects in other Latin American nations to foster greater co-operation within the region.

In Brazil, much of the NDB's work is concentrated on infrastructure. Brazil is at a critical moment of profound economic restructuring but faces two conundrums in its infrastructure development and financing. First, Brazil has invested too little in infrastructure for too long, severely constraining economic growth. Second, given its lacklustre fiscal situation, the country is unable to use large-scale budget funds for public investment and infrastructure development.

The Brazilian government's policy is thus to channel as much private capital as possible into the infrastructure sector and develop infrastructure through public-private partnership (PPP), which boasts great potential.

Meanwhile, it is essential to fully recognise and address the challenges and risks in infrastructure development. Despite enormous private capital available globally, there are thresholds for private capital to be utilised in infrastructure. We cannot simply assume private capital will enter the infrastructure sector as long as government implements incentives or pushes corresponding measures. Brazilian authorities must emphasise that infrastructure remains largely different in various fields and sectors, and a variety of measures will be needed to uncork the financing bottlenecks.

For financers, infrastructure can be categorised into three types. The first is commercially viable infrastructure, such as toll roads, airports in big cities and ports with sound business prospects. Governments can attract private capital by improving the business environment and rolling out PPP models. There are plenty of success stories in emerging market economies and developing countries, and Brazil is at the heart of many of them.

The second is infrastructure with large externalities and social effects – such as water supply, sewage treatment and power lines – which requires considerable governmental financial support. The financial benefits of these projects are not rewarding enough to fully entice private capital investment. This type of infrastructure requires favourable policies and supporting measures from governments – for instance, a better price standard should be set, and the leverage and guidance role of public resources should be utilised through equity investment, guarantees and even discount interest.

The third is public good infrastructure, serving people's livelihood and society as a whole. Here, government should play a leading role by mobilising public capital, while private sectors improve efficiency.

When low-income countries are struggling financially, they should optimise their debt structures, manage and control risks in development financing, and refrain from putting their futures – for example, in the form of debt sustainability – at risk.

In the past, the term infrastructure was reserved for public goods and services, and the government was supposed to shoulder the responsibility of providing the major funding. However, today many countries – especially emerging market economies – face huge restrictions in debt sustainability and public resource feasibility. That is why it is essential for private capital to be engaged. However, if we adopt a packaged approach to attract private capital without distinguishing the different types of infrastructure and financial returns, we may actually get half the result with twice the effort. To this end, there should be a category of infrastructure and corresponding policy approaches for each funding.

Development financing institutions

Conventional development financing institutions – in particular the World Bank, the Inter-American Development Bank and the Development Bank of Latin America – have contributed much to infrastructure and social development during their many years in Latin America. The NDB is a relative newcomer to investment in the region, compared with the aforementioned conventional development financing institutions, with Brazil as the starting point for NDB's venture into Latin America. In the past four years, the NDB has approved US$12 billion in funding for a total of 40 projects, including some possible co-operation projects with China.

Brazil's infrastructure development can boost trade and investment between the two sides. One project under discussion, for example, is to build an entirely private port in northern Brazil. The NDB will provide loans to private companies, and Chinese companies will engage in construction with some equity investments. The port, when completed, could greatly enable Brazilian soybean exports to China. Besides, through its contacts and co-operation, the NDB has also found that Chinese enterprises have shown remarkable strength in experience and capital in infrastructure development over the past 20 or 30 years. Chinese companies are extremely competitive in Brazil and are able to undertake more infrastructure projects on a transparent and level playing field.

In short, Brazil and China are highly complementary in economic structures. Lifting the investment and trade co-operation between the two nations to a new level through infrastructure development will surely create a win-win situation for both China and Brazil. ⬢

Think local

China's bottleneck when it comes to capitalising on financial opportunities in Latin America is due to political volatility, see-sawing currencies, and China's skills gap and lack of local knowledge, writes *Ye Fujing*, director of the Foreign Economic Research Institute, National Development and Reform Commission

In recent years, there has been considerable progress in financial co-operation between China and Latin America. With increased space for collaboration, and greater consensus on the need for these relationships, financial co-operation has established a solid foundation and is progressing smoothly. Latin America has remained broadly positive about co-operation with China because the relationship has focused on integrity, sustainable development, people-to-people connectivity, inclusive development and the extension of co-operation benefits.

Buenos Aires financial district, one of Latin America's main financial centres

Problems on the horizon

Undoubtedly, challenges exist. In the eyes of China, there are three issues that require careful monitoring.

First is the political environment in Latin America – regime changes can often result in instability. Currently, governance incapabilities that are manifested in trade unions flexing their muscles, are holding the continent back.

Second, the instability of the currency system has taken a huge toll on the scope of co-operation. With the US dollar still dominating as the preferred global currency, Chinese financial institutions are vulnerable to additional losses because the exchange rate of Latin American countries fluctuates wildly against the dollar, leading to large depreciations. This extreme volatility is evidenced by the depreciation of the Brazilian real by 28.6% in the first half of 2018, and the Argentine peso by 49% across the same year. The Venezuelan bolivar depreciated by more than 100% several times in 2018 alone. This is unsurprising given the political volatility that continues to isolate the country from the rest of the world. Intense exchange rate fluctuations have also given rise to serious shrinkages of domestic currencies in Latin America. This severely threatens the security of Chinese loans and investments in the region, and restricts further development of financial co-operation between the two parties.

Third, China's connection with – and understanding of – the local market is insufficient. In China, there is a skills gap when it comes to familiarity with Latin American financial markets, mergers and acquisitions, and management. This has severely limited the scope of business activities for enterprises. Moreover, there is a lack of understanding of local policies, laws and regulations, and culture. Colliding with local laws and regulations, Chinese projects are often suspended or stranded, decreasing the chances of financial co-operation.

In addition to the three issues China faces, Latin American countries need to open up further. More Chinese companies may be establishing a presence in Latin America but, in many cases, they are merely offices to provide services for Chinese-funded enterprises and Chinese citizens abroad. Access to the local market still comes up against too many obstacles.

Two further problems haunt China–Latin American co-operation. The first of these is that Chinese investments in Latin America are clustered mainly in the energy and infrastructure sectors. Over-concentrated investments, insufficiently scattered risks and the long recovery cycles of large projects can easily break the capital chain in an already vulnerable and unstable economy.

Second, from a macro perspective, Chinese financial institutions gain a stronger sense of presence – and exert a more powerful influence – in Latin America than the other way around.

Fixing the co-operation gap

Strategic interests should be obtained on the basis of economic sustainability, and attention should be paid to cost/benefit analysis. China–Latin America financial co-operation should adapt to the changes in the structure of an economy and the mutual demands of each side. In this regard, Latin America should make good use of the favourable opportunities of China's financial expansion and new round of opening-up.

Advancing financial dialogue between the two sides

Financial dialogue between China and Latin America can be enhanced by achieving the following:

- Bolstering political mutual trust, eliminating doubts and deepening financial co-operation with the assistance of the Belt and Road Initiative (BRI).
- Increasing dialogue and co-operation between the central banks, financial regulatory agencies and development finance institutions to accelerate information exchange.
- Reinforcing financial co-operation – particularly in policy system and currency clearing, local currency swaps, bond issuance and insurance. China must accelerate the upgrade and integration of the 1+3+6 co-operation framework into the BRI, to rapidly attain organic unity of financial co-operation and financial integration.
- Fortifying co-operation with Latin American financial institutions and jointly developing Latin American markets.

Improving co-operation localisation

China should target further opening of the Latin American market – especially the financial market – to accelerate integration and achieve long-term sustainable development. This will require the following:

- Establishing talent pools comprising those with financial sector expertise, local languages, laws and culture.
- Indigenising employment – particularly encouraging Latin American students in China to engage with projects to strengthen China–Latin America co-operation.
- Collaborative work with local institutions in taxation, law and accounting.
- Co-operation with local financial institutions and multilateral financial institutions such as local banks, government regulators and the Inter-American Development Bank.

Ye Fujing

Broadening investment fields

More investments can be made in infrastructure, agriculture, manufacturing, technological innovation and social livelihood. Latin America has huge investment needs across various industries. According to the UN Economic Commission for Latin America and the Caribbean, the continent will need a total of between US$3 trillion and $14 trillion in financing for agriculture, manufacturing and environmental protection before realising the UN's 2030 Sustainable Development Goals, of which between $800 billion and $7 trillion will be required in infrastructure alone.

Mitigating the impact of exchange rates on financial co-operation

The proportion of renminbi transactions should increase to reduce dependence on the dollar. Furthermore, measures to reduce currency mismatches can be adopted to appropriately increase liabilities denominated in local currencies. Under special circumstances, China can demand physical delivery to avoid exchange rate risks. Second, financial instruments that ward off financial risks can be brought in to enhance investment security. Third, it is important to heighten research into, and judgment of, the political and economic landscape to choose the right time for financial co-operation.

Making the most of the opportunities provided by financial opening-up

Currently, there are many free-trade zones under construction that can usher in foreign financial institutions as a key to developing China's financial services industry. Conversely, it is an opportunity for Latin American investors to access the Chinese market and expand their influence.

Exploring new sources of growth

To find new avenues for financial co-operation in traditional industries, China can enhance collaboration in the areas of insurance and bonds, as well as with traditional banks. Second, it is vital to shore up risk sharing mechanisms and improve risk monitoring capabilities. This can be done through creating new highlights in the supply chain of financial and financial technology co-operation and looking for breakthroughs in the realm of payment and settlement.

After the super boom – China in the LAC region

Alessandro Golombiewski Teixeira, IFF board member, former special economic adviser to the president of Brazil and former president of the World Association of Investment Promotions Agencies, examines the role of Chinese trade, finance and investment in Latin America and the Caribbean

China Merchants Port Holdings acquired 90% of Brazil's second-largest container terminal, in the Port of Paranaguá

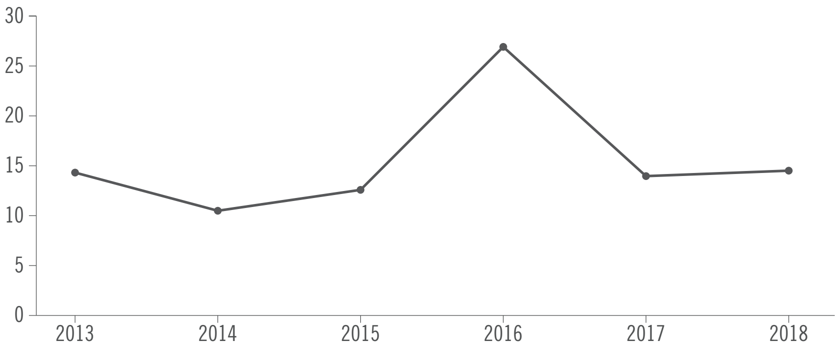
Having reshaped investment and trading flows since the country's reform and opening-up that began in the 1980s, China's economy has expanded rapidly to become the second largest in the world. Chinese financing power has become so influential that the fate of the global economy is closely tied to sustaining the Chinese economy and its accompanying investments. Fuelling this success are waves of outbound investments, as well as Beijing's capacity to finance developing countries' economies. Latin American and Caribbean (LAC) countries illustrate the impact of Chinese foreign investment in the past decade, driving economic growth in the region. In fact, the commodities 'super boom' in LAC countries can be directly attributed not just to China's increasing capacity to buy, invest in and finance LAC production, but to its overall capacity for consumption.

From 2010 onward, the world saw a gradual shift in focus away from investing in developed economies towards emerging ones. China and LAC countries have formed particularly strong ties in this context, with China now the largest foreign direct investor in LAC. Owing to changes in the international environment, such as increased Chinese multilateralism and US protectionism, Latin America–China relations have been moving gradually closer – particularly in the past two decades. This culminated in the establishment of a comprehensive co-operative partnership between China and Latin America in 2014. This feature examines bilateral exchange in three key areas – trade, investment and financing – and then offers an insight into the scenario of China–LAC financing.

Trade

The growth of Chinese exports to Latin America has been impressive. The share of total LAC regional imports represented by China increased from 2.3% in 2000 to around 16% in 2017, with total trade reaching a value of US$258 billion – a transformation owed partly to China joining the World Trade Organization in 2001. Additionally, in 2000 China did not feature as a top-three exporter to any of the LAC countries, but today places first or second for all of the major countries in the region. China also imports significant amounts of LAC goods and resources, receiving 10% ($126 billion) of LAC countries' total exports, which accounts for 7% of China's overall imports.

Figure 1 – The flow of Chinese direct investment in Latin America (US$ billions)



Source: Report on development of China's outward investment, Ministry of Commerce of the People's Republic of China, 2018

Investments

China's outbound investments reached a record high of US$183.1 billion in 2016, making the country a net investor, with foreign direct investment outflows exceeding inflows for the first time. Investment by Chinese companies in LAC is estimated to be worth more than $25 billion, equivalent to around 15% of total investment in the region in 2017. According to the Chinese Ministry of Commerce, China's direct investment in Latin America has already exceeded US investment in the region by $200 billion, making LAC the second-largest destination for Chinese overseas investment (see figures 1 and 2).[1]

Mining was the most attractive sector for Chinese investment, receiving 27% of the total value of investments between 2004 and 2017, according to the *World investment report 2018* by the UN Conference on Trade and Development.[2]

In recent years, however, there has been diversification of investment to sectors such as telecommunications, real estate, food and renewable energy, indicating Chinese companies' appetite for entering new sectors in the region. Between 2013 and 2016, the leasing and business services industry was the number one sector receiving investment from China (see figure 3).

Financing

China–LAC financial flows have seen unprecedented growth during the last decade, often concentrated in infrastructure, energy and mining. Chinese lending has become the largest source of external financing for Argentina, Brazil, Ecuador and Venezuela – superseding well-established international financial institutions in the region. While 60% of total financing to Latin American economies comes from the bond market, bilateral loans only represent around 8% of total international financing, a proportion that has remained constant since 2005.

However, in certain countries – including Bolivia, Colombia, the Dominican Republic, Ecuador and Venezuela – the proportion of bilateral loans has increased dramatically in recent years, most notably in the Dominican Republic and Ecuador, where the proportion of bilateral loans has increased by 12% and 26%, respectively.

Other LAC countries are actively engaged with Chinese financing – Argentina (16%), Brazil (19%), Ecuador (9%) and Venezuela (47%) accounted for 91% of Chinese loans between 2005 and 2016.[1] Total investment by China in Latin America is expected to reach $250 billion by 2025, exceeding the $99 billion invested over the past decade.

While such loans are intended to complement the recipient country's economy, loans made by major Chinese development banks to Latin American governments are primarily the result of the strategy to diversify China's foreign exchange reserves with a view to promoting international use of the renminbi. These loans also support a strategy of assisting and directing Chinese enterprises to invest in natural resources.

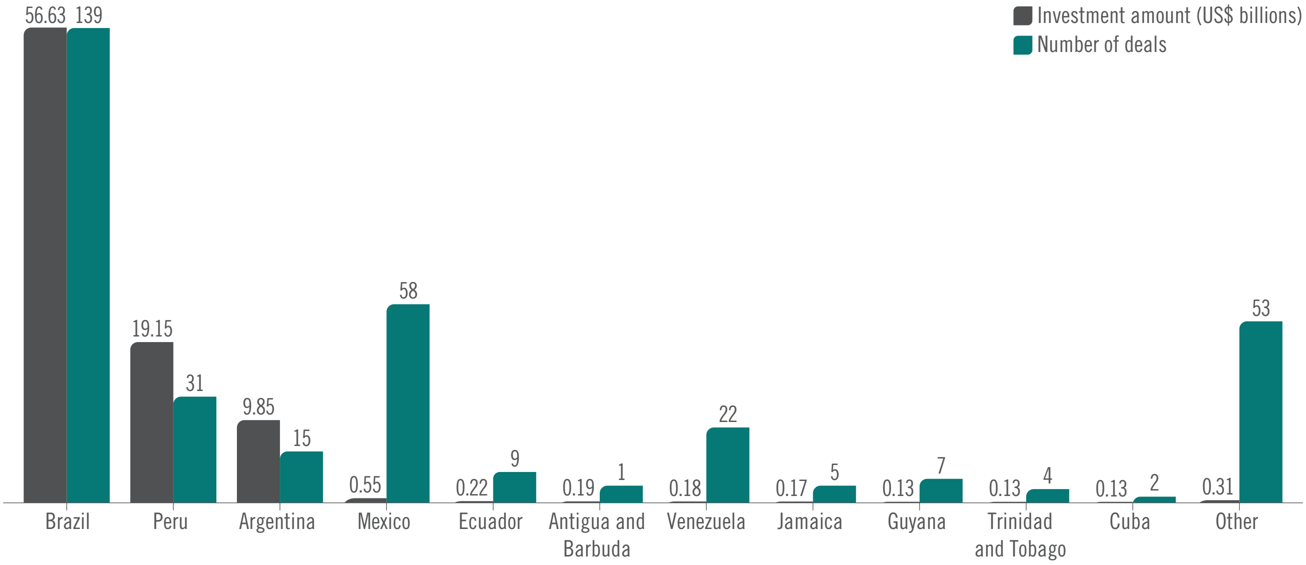
Chinese loans aim to finance a few specific sectors, such as infrastructure, energy and mining, rather than the large number of sectors covered by traditional loans from international financial institutions. The role of China in the future of Latin America's economic landscape, as well as wider impacts on international markets requires further evaluation.

Framing the investment relationship

Between 2005 and 2014, around 80% of total Chinese financing in Latin America supported infrastructure development, including partial or complete financing of hydroelectric dams, gas networks and turbines. Within this, telecoms represent close to 7% of total financing. Commodities accounted for the remaining 20% of financing – in particular, the Aluminum Corporation of China's copper mining in Peru (roughly 9%), and other sectors, such as corporate and working capital operations. Almost 45% of total financing was directed towards transport infrastructure, including roads, airports, railways and metro networks.

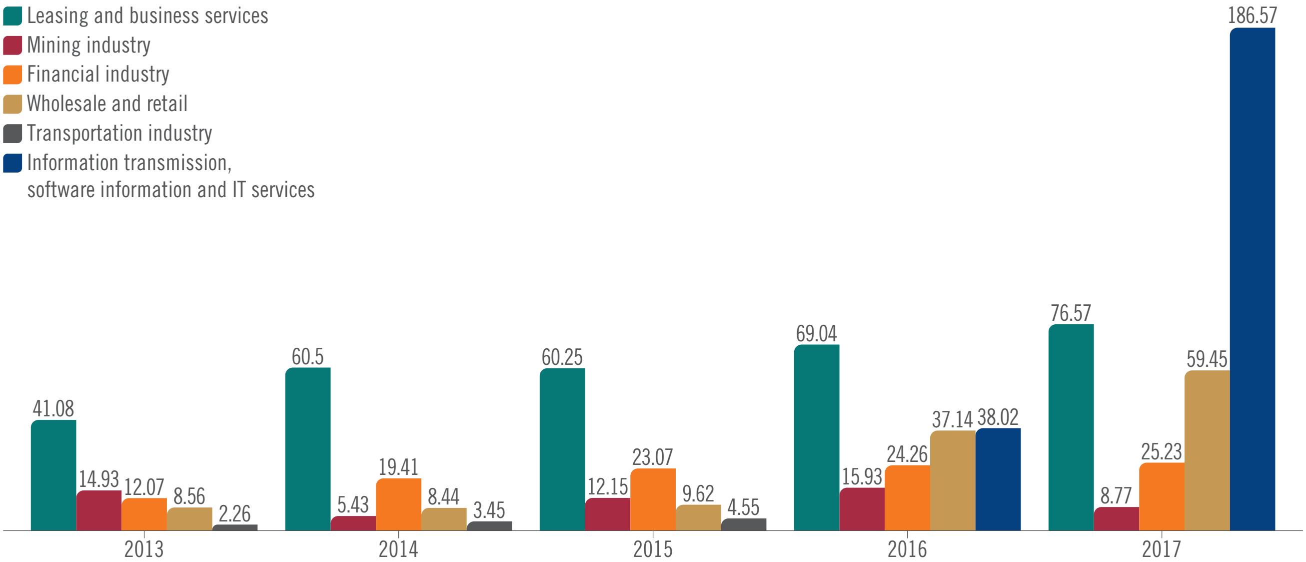
These investments are expected to increase in the near future – especially in the areas of energy, oil and gas and infrastructure. As China takes up an increasingly prominent role in the global economy, LAC countries have shown themselves to be important partners. But it must first be established how to best co-ordinate this relationship.

Figure 2 – Distribution of Chinese investment by nation



Source: Fudan Development Institute and Dealogic

Figure 3 – The top five industries of China's direct investment stocks in Latin America by year (US$ billions)



Source: Statistical bulletin on China's outward foreign direct investment, 2017

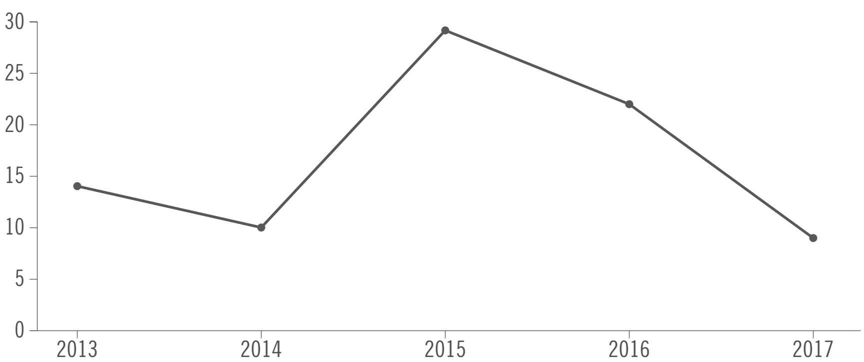
Alessandro Golombiewski Teixeira

Funding by Chinese and international organisations is facilitating LAC financing. China has increased its presence in the region through bilateral loans and its membership in multilateral development banks – from joining the Inter-American Development Bank (IADB) in 2009, to the launch of the New Development Bank operated by the Brics nations – Brazil, Russia, India, China and South Africa.

The China Development Bank and the Export-Import Bank of China have provided $150.4 billion in financing to LAC governments and their state-owned enterprises (SOEs), exceeding lending from the World Bank, the IADB and the Andean Development Corporation – Development Bank of Latin America combined. By comparison, the IADB approved $11.4 billion in sovereign-guaranteed loans to the region in 2017, while the World Bank lent $5.9 billion.

Specific regional funds targeting LAC countries, such as the China–LAC Cooperation Fund and China–LAC Industrial Cooperation Investment Fund, have helped China diversify its strategy.

Figure 4 – Chinese policy banks' loans to LAC governments (US$ billions)



Source: China–Latin America economic bulletin 2018 edition

The future of Chinese financing and the BRI

The Belt and Road Initiative (BRI) is more expansive than its ancient predecessor, the Silk Road, and it is not limited to Asia and Europe. China formalised the LAC region as an extension of the BRI in 2017. The BRI has brought a host of development opportunities to Latin America, boosting the economy with transport and infrastructure projects. However, there have also been concerns regarding the financing of projects, particularly the potential for debt traps. With Chinese SOEs responsible for 70% of the BRI construction project contract value, questions surrounding the transparency of the procurement process remain, alongside environmental, labour and governance issues. These reservations from Latin America do not seem to have perturbed the Chinese government. President Xi Jinping predicts the total trade volume between China and Latin America will reach $500 billion by 2025.

LAC countries are using Chinese investment to fill their gap in infrastructure levels. There remains a significant investment disparity between more established coastal areas and often more remote inland areas, which hampers economic development. Initial investments have centred on infrastructure – such as China Merchants Port Holdings' 90% acquisition of Brazil's second-largest container terminal, located in Paranaguá. However, under the BRI, the scope for future investment co-operation will be more wide-ranging.

Latin America has become an important partner to China in supporting the BRI. A total of 33 countries in Latin America have established diplomatic relations with China, of which 19 have signed co-operation memorandums on jointly constructing the BRI.

Yet growing levels of exchange between LAC countries and China is not without its challenges. President Xi has described the globalisation of the LAC region as a double-edged sword. While it has fuelled and aided economic growth, it has also created social tension, due to further stratification of social classes and a growing middle class. The absence of a robust economic driving force and weak institutional governance has triggered rising levels of unemployment and income inequality, but with wider and more damaging effects in Argentina, Brazil, Venezuela and El Salvador.

Creating a shared community with a unified vision on development goals is essential. High levels of collaboration are necessary to demonstrate that the BRI is not a platform to further Chinese influence, but a co-operative one from which participating countries can derive benefit. The BRI in the LAC region will involve challenges and opportunities that need to be incorporated into a broader development strategy aimed at upgrading, diversifying and integrating. For this to happen, China also needs to understand Latin America's development challenges. The willingness to establish channels of co-operation should go beyond bilateral forms of dialogue and include a structured dialogue with the region. A successful China–LAC partnership needs adequate multilateral governance.

One possible solution is for China to adopt the China–Community of Latin American and Caribbean States Forum as the main channel of communication with LAC countries. Participating countries can use this platform to propose a co-operation action plan for the region that encompasses the following factors:

1. A specific governance system for China and LAC countries to implement the BRI in the LAC region, defining targets, priorities, actions and an implementation timeline.

2. A quantifiable target for exports to China and Chinese exports to LAC countries, in addition to the diversification of exports away from commodities to other sectors such as services.

3. The development of an infrastructure investment plan that would help reduce the infrastructure gap. This is crucial for the medium- and long-term growth for many areas in the LAC region. Furthermore, investment in infrastructure would benefit China by reducing the cost of commodities. If Latin America closes its infrastructure gap, the region could increase its annual growth by an estimated 2%–3%. To meet infrastructure needs between 2019 and 2025, Latin American countries should invest around 5.2% of the region's GDP every year.

4. A science, technology and innovation co-operation plan where Chinese and Latin American universities, research institutions and companies can exchange knowledge, talent, technology and investments in innovation.

5. The exchange of successful policies for the creation of a social development programme that could be adopted in China and LAC countries for the reduction of poverty and improvement of healthcare, education and sustainability.

6. The creation of a China–LAC culture and sports exchange programme to connect societies and promote cultural awareness and exchange.

7. The clear communication by China of the benefits for LAC countries' accession to the BRI. It is imperative that LAC countries understand that this initiative is not a solo Chinese initiative but a co-operative platform that already has a global governance system.

LAC members of the BRI

Source: Belt and Road Portal[3]

It is clear what is expected from all leaders is to solidify co-operation with the region. Latin America needs a comprehensive strategy to direct its engagement with the BRI. This strategy must promote comprehensive development based on the expansion of trading areas, improvement of infrastructure, increasing investment facilitation and new finance instruments to promote not just infrastructure development but also the exchange of science and technology. This can be achieved by putting forward a common agenda for the LAC region: to seize the opportunities to eradicate poverty and to pave the road to development.

The path for China and LAC countries to deepen and improve their partnership is clearly delineated, and achieving this should be an integral part of each government's development agenda. China has been – and will continue to be – a game-changer for the future development of the LAC region. ⬢

1. *UN Economic Commission for Latin America and the Caribbean (January 2018),* Exploring new forms of cooperation between China and Latin America and the Caribbean, *Figure 1.14, p. 22, https://bit.ly/2SccZkq*
2. *UN Conference on Trade and Development (2018),* World investment report 2018 – Investment and new industrial policies, *https://bit.ly/38aD7BT*
3. *Belt and Road Portal (December 2019),* List of countries that have signed co-operation documents with China for the BRI, *https://bit.ly/2GBSDdO*

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