STUDY

ECONOMY AND FINANCE

DE-RISKING THE GLOBAL FINANCIAL SYSTEM

Forging a ‘new consensus’

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August 2023

Executive Summary

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This report explores the risks of fragmentation – where debt restructuring and payments systems lack cohesion and where other rules and standards diverge – in the international financial and monetary systems.

Rules and institutional governance need to be adjusted to reflect the present dynamics of the world economy so that policy cooperation can underpin “strong, balanced, sustainable and inclusive growth”.

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1 GLOBALISATION IN REVERSE

The risk of geopolitical divisions and their implications for global prosperity and for international policy cooperation have become more acute in recent years. The G20 – which became the "premier forum for international policy cooperation" (G20, 2009) in the aftermath of the 2008 global financial crisis – has, since 2017, experienced reduced impact and effectiveness due to tensions among its members, notably between the US and China.

Following an era of deep globalisation, the Covid-19 pandemic and Russia's war against Ukraine have brought about measures, such as, for example, export restrictions on medical goods and foodstuffs, that address domestic vulnerabilities, but risk fragmenting the global economy. The term 'fragmentation' encapsulates these tensions, but what exactly is it? A recent report (2023) by the International Monetary Fund (IMF) draws a distinction between geopolitical factors and economic fragmentation. Thus, for the IMF, geo-economic fragmentation embodies the potential economic ramifications of a policy-driven reversal of global economic integration (Aiyar et al., 2023: 4). Thus, geo-economic fragmentation is the opposite of globalisation.

Before exploring interdependencies and vulnerabilities, it is worth remembering how the system is supposed to work. For this we need to go back to the Bretton Woods conference that in 1944 set up the economic order for the post-war years. For the international economic system to work well and ensure "strong, balanced, sustainable and inclusive growth" (G20, 2023: 8) the following elements are necessary. First, we need a satisfactory level of global aggregate demand, so that, worldwide, there is neither inflationary pressure nor a tendency towards underemployment of resources. Second, the system needs to be balanced, so there needs to be a workable process of international adjustment of current-account balances. Third, an institutional architecture that provides shorter-term adjustment finance to mitigate and resolve financial crises, together with long-term development finance, should be in place. Finally, we need an open international trading system (Subacchi and Vines, 2023: 165). Cooperation is critical to underpin this system, and even more so to respond to current cross-border challenges such as climate, global health, and the global demographic transition.

'Fragmentation' is a big conceptual box that includes cross-border issues that can be divisive domestically and polarising internationally, and so lead to a zero-sum game. In this report, economic fragmentation is defined as the division of the global economy into separate and sometimes conflicting economic blocs and markets, with different sets of rules and regulations. The focus is specifically on the risks of fragmentation in the international financial and monetary system. A fragmented system is one where infrastructure, such as international payments systems, lacks cohesion and where rules and standards diverge.

Even if geopolitical tensions have become more widespread and the risk of economic fragmentation more acute, the global economy remains deeply interconnected through flows of goods, services, capital, people and intangibles. Trade and financial integration remain strong compared to just 30 years ago, even if the pace of growth has slowed down. Most of the expansion of cross-border financial flows in the last thirty years reflects new international borrowing and lending (Milesi-Ferretti, 2022). During the years 2019–2021 capital flows grew by more than 50 per cent a year as banks reallocated liquidity around the world and more multinationals relied on financing (Seong et al., 2022: 6).

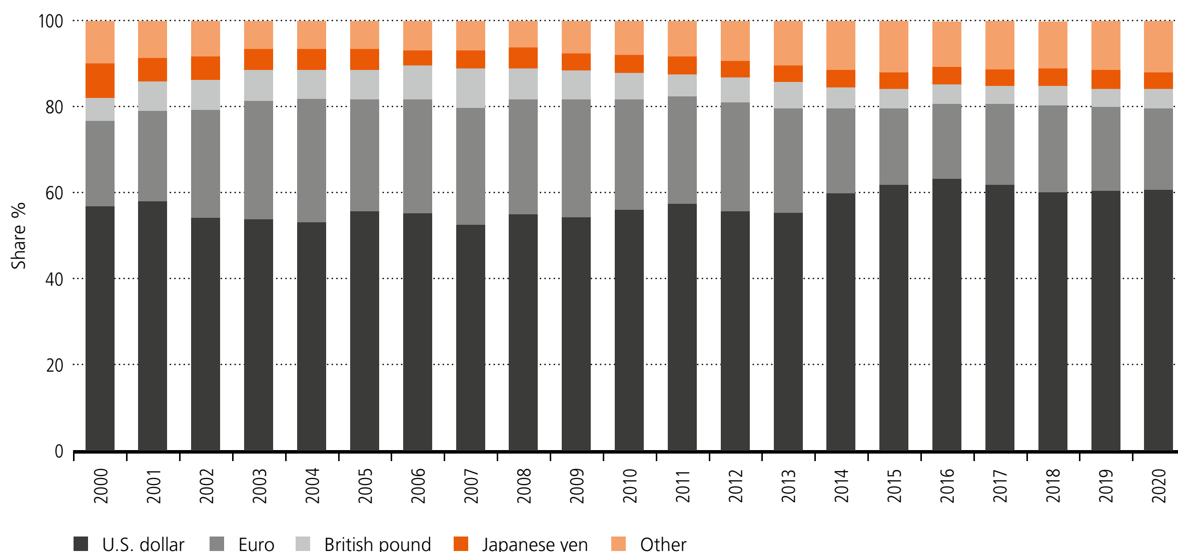
The US dollar, as the key international currency, holds the global economy together. It is the world's most used currency in global trade and finance and this network effect puts it at the centre of the world economy. It is the dominant currency in international banking and the funding currency for non-US banks. The Fed has swap agreements with the major central banks to provide a liquidity backstop when it is needed to ease strains in global funding markets.[1] About 60 per cent of international and foreign currency banking claims (mainly loans) are denominated in US dollars (Figure 1.1). This share has remained relatively stable since 2000 and is well above that of the euro (about 20 per cent). Since 2009, the share of currencies other than the dollar, the euro, the pound sterling and the yen in international and foreign currency banking claims have increased. In October 2016, China's renminbi was included in the IMF's Special Drawing Right (SDR) and the share of renminbi allocated reserves increased to 2.7 per cent in 2022 from 1.1 per cent (Figure 1.2).

There are different levels of integration and interdependencies between countries. A country's economic interdependencies depend on many different factors, including comparative advantages in trade, availability of natural resources, food security, regional networks and institutional arrangements. Cross-border capital flows can signal strong economic interdependencies. Similarly, imports of at least one natural resource or manufactured good that exceed 25 per cent of a country's total imports can be used as an indicator of interdependence on trade with others. Approximately 40 per cent of global trade is 'concentrated' with importing economies relying on three or fewer countries (White et al., 2023: 2).

Cross-border capital flows reflect the trend of greater regionalisation, especially within Asia. Due to investments made by China, emerging Asia was the only region to experience a sustained increase in capital inflows after the global financial crisis – they doubled from around 0.4 per cent of global Gross Domestic Product (GDP) between 2000 and 2007 to 0.8 per cent of global GDP between 2009 and 2019 (Bank of International Settlements, 2021a: 4). Between 2013

1 In the wake of the Covid-19 pandemic, the Fed's liquidity swaps peaked at roughly US$450 billion (Board of Governors of the Federal Reserve System, 2023).

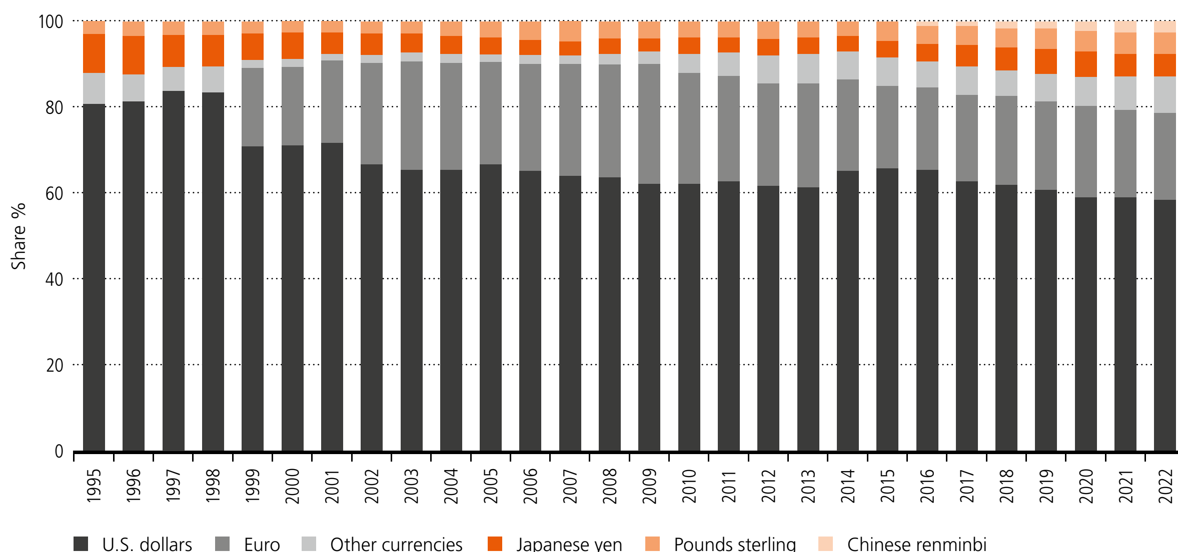
Figure 1.1:
Share of international and foreign currency banking claims, 2000–2020



Note: Share of banking claims across national borders or denominated in a foreign currency. Excludes intra-euro area international claims. At current exchange rates. Data are annual. 100=total observations of currencies.

Source: Federal Reserve

Figure 1.2:
World shares of allocated reserves by currency, 1995–2022



Note: Annual data for world shares of allocated reserves by currency (%). Chinese renminbi available data from 2016.

Source: IMF – Currency Composition of Official Foreign Exchange Reserve (COFER), 2022; author's calculation

and 2017, foreign direct investment from China accounted for 8 per cent of domestic investment in Pakistan, 6 per cent in Malaysia, and 5 per cent in Singapore. Some emerging and smaller mature economies outside of Asia are also highly exposed to Chinese investment.

Interdependencies inevitably carry vulnerabilities, and in fact they are the two sides of economic integration. The greater the depth of the interdependencies, the higher the risk of adverse vulnerabilities. Trade and capital flows can come to a sudden stop because of shocks that affect, for example, the cross-border payments infrastructure, or the transport network and logistical systems. Prices of key goods can suddenly increase because of problems along the supply chain, or the cost of capital can increase because of monetary policy decisions in the US.

Cross-border capital flows as well as global value chains have become more vulnerable to shocks, adverse market dynamics, logistical bottlenecks, and geopolitically motivated disruptions. Concentration in commodities trade has adversely affected countries that

depend on both Russia and Ukraine for imports of food and agricultural commodities. In March 2022 seven Russian[2] and three Belarussian banks were disconnected from the SWIFT network (SWIFT, 2022). The EU and other countries, such as the US, Canada and the UK have banned all transactions with the Russian central bank and other state-owned or controlled entities including the Russian Regional Development Bank (Jones and Wilkes, 2022; EU Sanctions Map: Russia).

Vulnerabilities inherent in interdependencies have created the need for mitigation. Many countries are now looking to strengthen domestic resilience and reduce interdependencies – especially with partners where economic and political relations are or can become problematic. While creating resilience and reducing critical interdependencies should be a priority for policymakers, the latter should avoid weakening international policy cooperation and so risk to drive a wedge between advanced economies and developing countries, notably between the G7 and the BRICS, by, for instance, advocating for interdependencies based on shared values and interests.

How to ensure geopolitical conditions that foster economic integration and policy cooperation? China holds the key here, being the only country capable of entrenching fragmentation and creating an alternative system. No longer a poor and isolated economy, China is now a competitor and rival to the world's most advanced economies. During the initial phases of China's economic ascent, economic growth was driven mostly by exports of low-value goods. Over the past decade, however, China has gained a significant advantage in areas of strategic importance. It is no longer just an exporter of cheap garments and electronics but has become a competitor to the advanced economies in capital-intensive strategic industries such as Artificial Intelligence (AI). Backed with this newfound technological advantage, the Chinese leadership has become more assertive and concerned about the role that China plays in the world.

There is evidently a lack of mutual trust between China and the US. The chief risk of not finding a way to keep China aligned with the dollar-based financial and monetary system is that it may develop an alternative system that accelerates geo-economic fragmentation. Sovereign lending and central bank digital currency is where breaks in the current global order could happen. Through bilateral lending to sovereign entities, China has expanded its financial footprint and has engaged extensively with low-income countries. Through central bank digital currencies (CBDCs) where it holds the lead, China could build an international payment system that does not revolve around the dollar.

2 VTB Bank along with Bank Otkritie, Novikombank, Promsvyazbank, Bank Rossiya, Sovcombank and VEB.

2 SOVEREIGN DEBT: A FRAGMENTED PICTURE

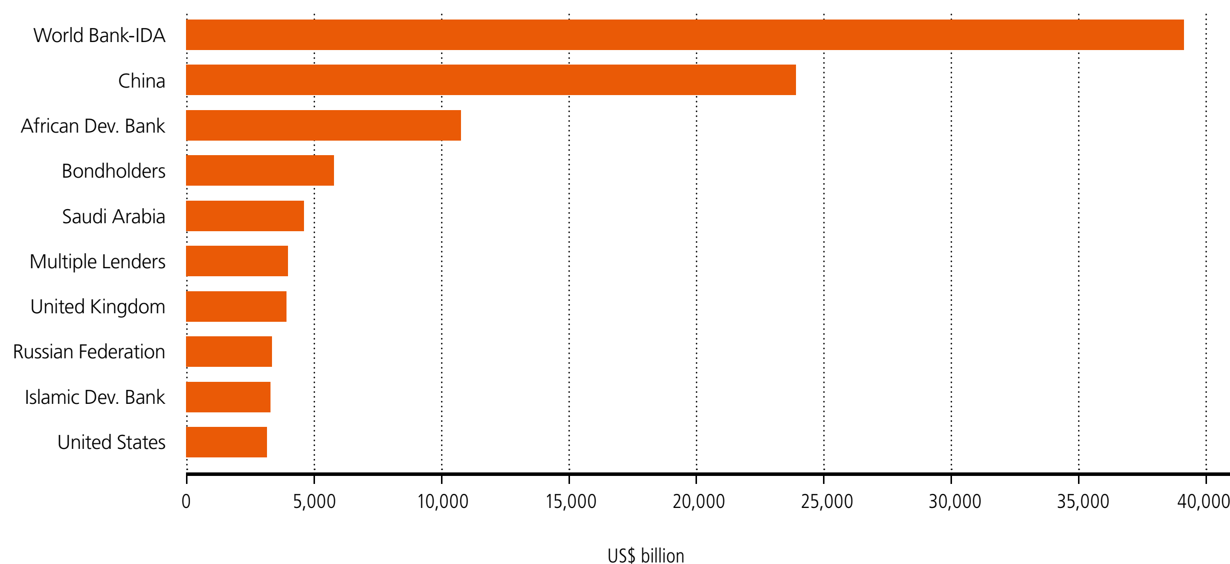
Approximately 56 per cent of low-income countries are now either in debt distress or are at high risk of it – this figure has doubled since 2015. About 25 per cent of middle-income countries are at high risk (IMF, 2023: 16). Some of the countries with unsustainable debt positions – such as Argentina and Ecuador – got through debt restructuring quite easily while for others – such as Zambia – the whole process took a long time. High levels of debt constrain countries' ability to provide for their citizens' welfare and cope with future shocks.

To respond to the debt emergency caused by the pandemic, the G20 unveiled the Debt Service Suspension Initiative (DSSI) in 2020, followed by the Common Framework for Debt Treatments (CFDT) in late 2020. DSSI offers debt relief to developing countries to help them cope with the pandemic by temporarily freezing their debt servicing. 48 out of 73 eligible countries participated in DSSI and approximately US$12.9 billion in debt-service payments were suspended under the initiative (World Bank, 2022b), without, however, addressing the underlying debt issue. CFDT brings together the G20 official bilateral creditors with the Paris Club in a coordinated process to restructure debt on a case-by-case basis.

Governments in developing countries have borrowed less from multilateral institutions and traditional bilateral creditors (i.e. Paris Club members, which are mostly OECD countries), and more from non-traditional bilateral creditors (including China), private lenders and domestic sources. In 2022, of the US$288 billion that the countries eligible for DSSI needed to service their sovereign debts, about US$12 billion were paid to Paris Club's members, US$20.3 billion to China and US$12.8 billion to the main multilateral institutions, including the IMF (World Bank International Debt Statistics: DSSI, series debt service on external debt). The rest was split among the private sector – approximately US$78 billion – and bilaterally. US$1.5 billion were paid to Japan (World Bank International Debt Statistics: DSSI, series debt service on external debt, 2022).

Over the years heterogenous laws, debt instruments and creditors have made sovereign debt more complex. The sources of law regarding sovereign debt include the domestic law of the borrower state, the domestic law of the creditor state and any bilateral investment treaties in force under the IMF Articles of Agreement. Debt instruments such as bonds and loans are subject to different regulations. The increased heterogeneity of creditors has brought a wide range of motivations, strategies and preferences to the table which all need to be reconciled. In the absence of any formal bankruptcy mechanism, sovereign debt restructurings are therefore a complex coordination problem to be solved by the debtor, all types of creditors and IFIs including the IMF. This brings the pitfalls associated with these sorts of prob-

Figure 2.1:
China as the largest bilateral creditor, 2021



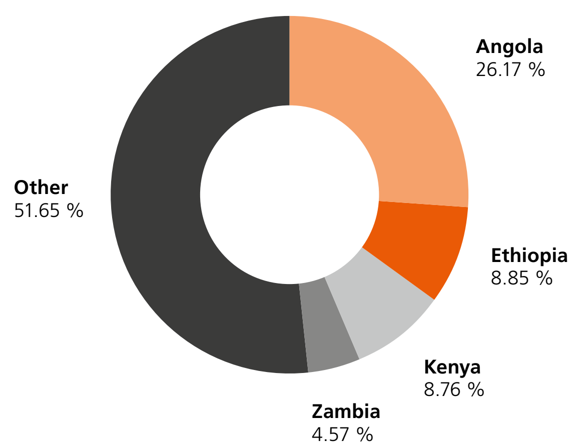
Source: World Bank, International Debt Statistics, External debt stocks (current US$)

lems, namely, moral hazard, informational asymmetry and the possibility of hold outs (Quirino de Souza Filho, 2022).

The rise in the number of creditors, and especially the participation of commercial and non-traditional creditors – those that are not members of the Paris Club – vastly complicates the governance of sovereign debt and hinders sovereign debt restructuring. While the existence of different creditors indicates a healthy diversification of financing sources, it can also increase costs and create problems of coordination, especially for low-income countries. China's lending since the early 2000s in particular has resulted not only in the rapid expansion of debt, but also in its wider distribution by types of creditors and contracts.

With a total stock of about US$180 billion, China is the world's largest bilateral creditor and the second largest creditor overall after the World Bank (World Bank International Debt Statistics, External debt stock, 2021). Low-income countries alone owe approximately US$24 billion to China, whereas the World Bank has around US$39 billion in outstanding loans to these countries (Figure 2.1). The 50 most indebted countries to China have an average of US$3.5 billion outstanding, approximately 10 per cent of their GDP – it was 1 per cent in 2005 (World Bank International Debt Statistics, External debt stock; author's calculation). 29 out of these 50 countries are DSSI eligible; 9 out of 50 are low-income and the rest are middle-income. Official bilateral loans are now higher than non-official loans. For instance, in 2010, Angola's loans from China were equally comprised of official bilateral (50.2 per cent) and non-official loans (49.8 per cent), but by 2019, 77 per cent of its loans were official bilateral (Boston University, CODF Database; author's calculation). Between 2008 and 2021, China's two main development, or policy, banks – China Development Bank (CDB) and China Export-Import Bank (CHEXIM) – provided nearly half a trillion US dollars in development finance to foreign governments (Boston University, CODF Database). This funded 1099 projects, the majority of which were in Africa (45 per cent), Asia (35.5 per cent) and Latin America and the Caribbean (LAC) (10.5 per cent), with some projects also in Europe (6 per cent) and Oceania (2.8 per cent) (Boston University, CODF Database, 2008–2021; author's calculation).

Figure 2.2:
The top four borrowers from China in Africa, 2021



Source: World Bank International Debt Statistics, External debt stock (current US$); author's calculation

African countries have borrowed US$84 billion from China, with the top four borrowers being Angola (US$22 billion), Ethiopia (US$7.4 billion), Kenya (US$7.4 billion), and Zambia (US$3.8 billion) (World Bank International Debt Statistics, External debt stock, 2021). In 2021, those four countries combined made up around 48 per cent of Africa's borrowing from China (Figure 2.2). Chinese funds have been used for infrastructure projects

throughout Africa. These projects were mostly in Angola (21.6 per cent), Ethiopia (6.6 per cent), Kenya (6.4 per cent), Zambia (6 per cent) and Cameroon (5.2 per cent), which combined received around US$62 billion. 35.7 per cent of these projects relate to transport, 18 per cent to power, 15 per cent to public administration/discretionary, and the rest to sectors such as telecoms and wastewater (Boston University, CODF Database, 2008–2021; author's calculation).

South Asia and LAC owed US$41.5 billion and US$14.4 billion respectively to China in 2021. The top four South Asian borrowers from China in 2021 were Pakistan (US$27 billion), Sri Lanka (US$7 billion), Bangladesh (US$5 billion), and Maldives (US$1.4 billion) (World Bank International Debt Statistics, External debt stock). They represented 66 per cent, 17 per cent, 13 per cent, and 3 per cent respectively of South Asia's borrowing from China (World Bank International Debt Statistics, External debt stock, 2021; author's calculation). As for LAC, Ecuador is largest borrower by far, with US$4.9 billion, which makes up around 34 per cent of China's total lending to the region. It is followed by Brazil (US$4.2 billion), Argentina (US$2.8 billion), and Bolivia (US$1 billion) (World Bank International Debt Statistics, External debt stock, 2021). These countries together account for around 90 per cent of China's lending to LAC countries. Overall, China represents 37 per cent of Latin America and Caribbeans' external debt to bilateral creditors (World Bank International Debt Statistics, External debt stock, 2021; author's calculation).

China lends internationally through two main channels: direct investment and development finance. The Belt and Road Initiative (BRI), that was launched in 2013, focuses on providing finance to developing countries for infrastructure projects. These loans have been made through different instruments and different institutions. They include foreign aid loans, non-foreign aid official loans, and commercial loans. There are two types of foreign aid loans: zero-interest loans (ZILs) and concessional loans (CL), which typically have interest rates between 2 and 3 per cent. Both types of foreign aid loan are usually denominated in renminbi. ZILs also have longer maturity (20 years) and grace periods (10 years) compared to CLs (15-year maturity, and 5-year grace period). As for non-foreign aid official loans, they are typically denominated in US dollars or euros. Export Buyer's Credits (EBCs) and Preferential Export Buyer's Credits (PEBCs) have varying loan terms, with PEBCs having a slightly subsidised interest rate and a maturity of around 15 years Additionally, there are medium- and long-term project loans which have a floating rate set to LIBOR at a typical rate of 4.5–6 per cent, and varying maturity and grace periods. Also, Chinese commercial loans tend to be medium- and long-term project loans with the same conditions (Rudyak and Chen, 2021: 13).

Chinese lending to developing countries is mostly through non-subsidised loans, whereas the same countries usually receive concessional lending or aid from the G7 and other advanced economies. While OECD countries tend to separate commercial and not-for-profit activities, the Chinese model of lending integrates aid with trade and investment, providing blended financial packages that mix market rate loans with concessional loans and grants. Most of China's overseas development finance does not offer concessional interest rates.

The main providers of Chinese lending are the policy banks, particularly CDB and CHEXIM, but also ICBC, China Construction Bank and the Agricultural Bank of China. In China, policy banks are ministry-level agencies. In contrast, in other donor countries, policy banks are subordinate to a ministry or government agency. In the UK, for example, British International Investment (formerly the Commonwealth Development Corporation) provides project and development finance to countries in Africa, Asia and the Caribbean, and is fully owned by the UK government with the Foreign, Commonwealth and Development Office being the only shareholder. The Japan Bank for International Cooperation (JBIC) is owned by the Japanese government and managed by the Japanese Ministry of Finance.

China's policy banks – like their equivalent institutions in the advanced economies – are instrumental to the implementation of the government's policy objectives (Chen 2020). All top executives are directly appointed by the Chinese Communist Party.[3] However, the ownership and governance of the policy banks is formally independent from the government and as such, the Chinese authorities classify all policy banks as belonging to the private sector. This has created a fundamental problem in establishing a uniform procedure to deal with such institutions.

China's lending activities have resulted in a wider distribution of loans by type of creditors and contracts, with an increase in unconventional loans such as lending against future oil sales, ad-hoc restructurings, and the use of confidentiality clauses. Unusual confidentiality clauses, which have become more frequent since 2014, prevent debtors from disclosing any of the contract terms or related information, including the extent of their debt – and sometimes even the existence of it.[4] China has been intensely criticised for the inclusion of such clauses which are an obstacle when borrowing countries seek debt relief. Excessive non-disclosure tends to undermine transparency and good governance of debt.

Chinese lenders use collateral agreements and 'no Paris Club' clauses to gain leverage on other parties that might also be seeking the repayment of their loans. Collateralised financing – an established practice in Chinese sovereign debt contracts – reduces China's risk by putting it first in line when it comes to reimbursement (Gelpern et al., 2022: 25). Collateral agreements in loan contracts require the borrower to sell a particular asset

3 Leadership information about the two policy banks can be found in their annual reports.

4 In Gelpern et. al. (2022) all examined contracts made after 2014 with Chinese state-owned entities contained extensive confidentiality clauses.

Table 2.1:
How China deals with debt

	Debt cancellation (total US$ mil)	Debt rescheduling (total US$ mil)	Others (total US$ mil)	Total (US$ mil)
1953–1999	240	1,416	10	1,666
2000–2009	2,672	160	0	2,832
2010–2019	13,663	27,724	0	41,387

Source: Horn et al. (2021); author's calculation

or group of assets and use the proceeds toward the loan balance if the amount due cannot be paid. 'No Paris Club' clauses commit the borrower to excluding their debt owed to Chinese lenders from any debt treatment agreed by the official bilateral creditors of the Paris Club.

Cancellation, acceleration and stabilisation clauses are included to enhance the lenders' influence over the borrowers' domestic and foreign policies in cases of default. Cancellation clauses grant one of the parties in the transaction the right to terminate the contract and demand immediate repayment under certain previously agreed circumstances. In the case of Chinese sovereign debt contracts, if the lender or debtor country goes through significant policy changes, then China alone holds the right to cancellation of the contract.

Chinese lenders often use freezing clauses to shield the lender from political risk. These clauses specifically aim to prevent adverse legislative or regulatory change in the host state. For instance, the sovereign debtor assumes all costs of change in its environmental and labour policies (Schreuer et al., 2009: 588; Crawford, 2019: 606).

Cross-default (acceleration) clauses are included in Chinese contracts to enhance China's influence on the borrowing countries' domestic and foreign policies. For instance, borrowers that default on their debt obligations toward Chinese entities can have their diplomatic relations with China terminated as the default is deemed to be adverse to the interests of an entity linked to the Chinese state. This runs against the common use in commercial debt contracts where the lender has the right to terminate a contract and require immediate repayment in case the borrower defaults on other loans.

Chinese contracts typically include a waiver of sovereign immunity, and almost exclusively use Chinese law as governing law and have China as the seat of arbitration (Gelpern et al., 2022: 7). These contracts often include a requirement for the sovereign borrower to maintain specific bank accounts to serve as security in case of default. Such accounts are funded with revenues from projects financed by the lender and from unrelated government revenues.

While Chinese creditors favour loan extensions, they seem to strictly oppose write-downs or 'haircuts'. Chinese creditors also prefer contractual pari passu provisions when they negotiate loan contracts to ensure that the repayment of their debt will be prioritised over the debtors' other obligations.

Against this background of heterogenous contracts, conditions, instruments, and institutions, what are the options for highly indebted countries? Effective restructuring requires symmetry of information so as to allow the prompt and comprehensive recognition of debt, coordination with and among creditors, agreement on debt restructuring and even commitment to a medium-term plan of reforms needed to achieve debt sustainability (World Bank, 2022b).

When bilateral lenders are hesitant to disclose the loan terms, then the process comes to a halt, as it was for Zambia. China is the largest bilateral lender, but the group of Chinese lenders is heterogenous with interests often not aligned and the loans are made under different terms. Requests for debt relief were made under the CFDR, but it took a long time for a solution to emerge – at the end of June, Zambia reached a tentative agreement with China and other bilateral creditors (Cotterill et al., 2023).

China tackles debt relief on a loan-by-loan basis and by type of creditor. Negotiations are done bilaterally, and reliefs are tailored to specific cases – unlike Paris Club lenders that usually include the whole debt stock in the restructurings. For example, to restructure concessional loans CHEXIM requires a government-to-government agreement, while this is not a requirement for CDB's debt restructuring. These differences complicate the already tangled process of agreeing on debt relief and on debt restructuring.

Debt rescheduling is the most likely outcome in most of the cases where Chinese bilateral lenders are involved (Table 2.2) – for both commercial loans and loans granted by the policy banks. In the period 2010–2019 about US$27.7 billion of debt was rescheduled while about US$13.6 billion was cancelled.[5] This includes cases such as the cancellation, in 2010, of US$6.8 billion in Iraqi debt and of US$$6 billion worth of Cuba's debt in 2011. The cancellation of the Iraqi debt equates to an 80 per cent drop in the net present value and is comparable to the haircuts suffered by the Paris Club creditors (Bon and

5 These figures are based on available evidence; there are however cases where no figures around debt events were disclosed.

Cheng, 2020: 8). Sometime, as in the case of Togo in 2015, partial debt cancellation goes together with negotiations on rescheduling existing loan terms. Or, as in Mozambique in 2017 over a debt of US$34 million, interest payments are cancelled. In some cases, the amount is tiny as, for instance, the US$2.6 million debt owed by Vanuatu for the construction of Melanesian Spearhead Group Secretariat that was written-off in 2018. Compared to the previous period 2000–2009, it is also noticeable the shift from debt cancellation to debt rescheduling – usually in the form of four to 10 years maturity extension.

3 DIGITAL CURRENCIES

CBDCs are digital forms of money issued by central banks. Like physical money they are denominated in the national unit of account and serve as a means of exchange and a store of value. CBDCs use technology to make transactions safer – albeit less private, as they are easily traceable – and allow for the use of a digital wallet in place of a physical one. Unlike other cashless payment methods such as credit transfers, direct debits, card payments and e-money, CBDCs represent a direct claim on a central bank. CBDCs can be retail or wholesale, with the former being for general public use and the latter for financial institutions, for example, to settle large interbank payments. The infrastructure can be based on a conventional centrally-controlled database or on distributed ledger technology (DLT), and the main difference between the two is on how transactions are verified and secured (Atlantic Council CBDC Tracker).

Many central banks have begun to develop CBDCs, with significant progress in technical capacity, skills and investment – all necessary to develop viable digital currencies. Currently there is no single model for framing CBDCs, but rather many design choices that reflect different countries' initiatives (De Bode, Higginson and Niederkorn, 2021: 4). The account-based model requires that consumers hold deposit accounts directly with the central bank, as seen in the Eastern Caribbean's CBDC implementation. Another model relies on private-sector banks to distribute and maintain CBDC accounts for their customers, as in China's CBDC pilot. A third model, that the European Central Bank (ECB) has been considering, is based on granting licences to financial institutions to operate a node of the blockchain network as a conduit for distribution of a digital euro (De Bode, Higginson and Niederkorn, 2021: 4).[6]

CBDCs can support financial inclusion by making payments systems easier, faster and cheaper. Many individuals without banking facilities – often the poorest – can transfer money digitally and overcome the limitations and risks related to cash. CBDCs would help migrants to send their remittances without paying excessive charges. Overall, cross-border payments are slower, less transparent, and more expensive than domestic payments, especially as they use US dollar-based systems that are costly to access for non-US residents. Globally, remittances cost an average of 6.3 per cent of the amount sent – above the G20 target of 5 per cent (World Bank, 2023: 6)).

Central banks are now closing the gap with the private sector that over the past decade has led digital innovations and rapidly transformed the payments system. In China, where in 2020 roughly 555 million people used mobile payments, and about 901 million used digital commerce for general purposes (Klein and Baker, 2023: 8), private-owned companies, Alibaba and Tencent, had developed digital payment systems for smartphones through a QR code digital wallet scan-based system. This enabled the country to move away from being a cash-based economy to digital payments, skipping the debit magnetic cards that had become the standard in the advanced economies.

The People's Bank of China (PBoC) – China's central bank – began researching CBDCs in 2014 (He 2021). Two years later, it created the Digital Currency Research Institute and launched the first tests of the Digital Currency Electronic Payment (DCEP) system which was subsequently renamed e-CNY (Duffie and Economy, 2022: 2). In 2020 the e-CNY became legal tender (Tang, 2020); a year later, the PBoC banned financial institutions and payment ecosystems from handling cryptocurrency exchanges (Shin, 2022).

To date 130 countries, representing over 98 per cent of global GDP, are exploring CBDCs. As of January 2023, 46 of these countries were in the research phase, 32 in development, 21 in pilot, and 11 had launched (Atlantic Council CBDC Tracker). All G7 economies have now progressed in the development stage of a CBDC, and all the G20 countries are now in various stages of CBDC development, and nine are already running a pilot scheme (Table 3.1).

Among the countries that have explored CBDCs, China is a first mover, having built on the same infrastructure as the Alipay and WeChat pay systems – digital wallets, QR codes, scanners. Residents of 26 cities and 5.6 million merchants are now included in the pilot scheme, with a total accumulated transaction value of US$12.2 billion (Cao and Qu, 2023).[7]

China is ahead of the advanced economies – the US included – in the development of CBDCs and digital payments systems (Duffie and Economy 2022). China's e-CNY has been tested across cross-border financial networks – in January 2023 the e-CNY was 0.13 per cent of cash and reserves held by the central bank. In May 2021, former Vice Chair of the Federal Reserve Board of Governors, Lael Brainard, stressed that given "the potential for CBDCs to gain prominence in cross-border payments and the reserve currency role of the dollar, it is vital for the United States to be at the table in the development of cross-border standards"

6 There is also a fourth token-based model in which fiat currency would be issued as anonymous fungible tokens (true digital cash) to protect the privacy of the user.

7 Figures, end-August 2022.

Table 3.1:
CBDCs Pilot Schemes

Country	Year	Use case (Retail/ Wholesale)	Crossborder Projects	Infrastructure (Conventional/Distrib-uted Ledger Technology)
Australia (eAUD)	2023	both	Project Dunbar	Undecided
China (e-CNY)	2020	Both	mCBDC Bridge	Both
Ghana (E-cedi)	2022	Retail	Undecided	Undecided
Hong Kong (e-HKD, e-CNY)	2023	Both	mCBDC Bridge, Project Sela, Project Aurum, e-CNY	Undecided
India (Digital Rupee)	2022	Both	Undecided	Both
Iran (Crypto Rial)	2022	Retail	Undecided	Undecided
Israel (Digital shekel)	2021	Retail	Undecided	Both
Japan (Digital yen)	2023	Both	Project Stella	Undecided
Kazakhstan (Digital Tenge)	2021	Retail	Undecided	Both
Malaysia	2021	Wholesale	Project Dunbar	Undecided
Russia (Digital Ruble)	2022	Both	Undecided	Both
Saudi Arabia	2019	Wholesale	Project Aber	DLT
Singapore	2022	Retail	Project Orchid	Undecided
South Africa	2022	Wholesale	Project Dunbar	Undecided
South Korea	2021	Retail	Undecided	DLT
Sweden (E-krona)	2022	Retail	Project Icebreaker	DLT
Thailand	2022	Both	mCBDC Bridge	Both
Tunisia	2021	Wholesale	Undecided	Undecided
Turkey (Digital Turkish lira)	2022	Retail	Aselsan, Havelsan, Tubitak Bilgem	Both
Ukraine (E-hryvnia)	2023	Undecided	Undecided	Undecided
United Arab Emirates (Digital dirham)	2023	Both	Project Aber; mCBDC Bridge	DLT

Source: Central Bank Digital Currency Tracker (Atlantic Council), last accessed on 16.08.2023.

(Brainard, 2021). However, the US has yet to present its own vision for the integration of digital currencies into global payment systems.

The first-mover advantage in CBDCs lies in the technology and infrastructure supporting the digital currency, which ensure user-friendly and cost-effective adoption. Being useable and relatively cheap drives the adoption of digital currencies, expanding the user network and generating strong network effects. Network externalities play a crucial role in the development of international currencies. Therefore, the development of CBDCs depends not only on the ability to innovate and have the right technology, but also on achieving scale and scope. Central banks and countries that are first movers in CBDCs and attract a significant user base will lead the way – with others following suit – and ultimately will set international standards.

China can combine technology with domestic market size and ensure an advantage for the e-CNY over other CBDCs. In addition, the e-CNY could offer an alternative channel for cross-border payments and shift flows away from the dollar, especially in Asia. As digital currencies offer the possibility of dealing with multiple currencies when settling cross-border trade transactions, then the e-CNY can be used in most cross-border trade transactions in Asia – a role that the renminbi has been playing since 2010, but with the limitations linked to constrained convertibility. In addition, developing countries that are tied to China as part of the BRI may find it easier and more convenient to embrace the e-CNY (Klein and Baker, 2023: 7).

Work on digital currencies is still in progress, and standards are not yet defined, but we are at a critical point for promoting robust policy cooperation over designs, technology and standards. Cooperation is especially critical for central banks that plan to allow their CBDCs to be held offshore, extending their functionality beyond facilitating domestic payments. Without policy coordination among central banks, the interoperability of different digital currencies could become a challenge. The Bank for International Settlements Innovation Hub (BISIH) has been established to develop new multilateral platforms for cross-border payments and ensure that the design of CBDCs is guided by international considerations so to avoid a "spaghetti bowl" of technologies, models and standards (Skingsley, 2023).

Ongoing tensions between the US and China, and growing concerns in Europe about China's lead in digital technology, make policy cooperation difficult. In May 2023 the G7 stressed that the governance of the digital economy should be "in line with our shared democratic values." They also reiterated their commitment to keep pace with the evolution of digital technologies, as well as monitor "potential risks to the stability, resilience and integrity of the monetary and financial system". Two years earlier, in June 2021, they had pledged to work together on CBDCs' "wider

public policy implications" and commit towards "transparency and rule of law" (HM Treasury, 2021a).

Cooperation on areas of common interest with the objective of harmonising standards and rules for digital currencies is on both the advanced economies' and China's agendas. In many occasions the Chinese monetary authorities have reiterated their willingness to cooperate with foreign central banks and monetary authorities to set up exchange arrangements and regulatory cooperation mechanisms (People's Bank of China, 2021: 5). At the G20 Leaders' summit, in November 2020, President Xi called on the world's leading economies to begin discussing "standards and principles for central bank digital currencies with an open and accommodating attitude, and properly handle all types of risks and challenges while pushing collectively for the development of the international monetary system" (Xi, 2020b).

China should be welcomed to contribute to shaping global CBDC standards and governance through the global standard-setting bodies where it is already a major participant. These include the Financial Stability Board, the Financial Action Task Force (the global anti-money-laundering standard-setting body), the Committee for Payments and Market Infrastructure and the International Organization for Standardization (ISO). In addition, China is engaged in the CBDC dialogue both at the multilateral level through BIS and other central banks involved in the m-CBDC Bridge project, but also bilaterally with the UK (Duffie and Economy, 2022: 89).

The potential impact of CBDCs on the dominance of the dollar is a crucial consideration. Through lower switching costs, CBDCs can facilitate foreign exchange payments and the use of currencies other than the main international ones. More currency competition, in turn, can widen the choice of currencies for settling international trade. Also, CBDCs can be designed to spur demand – for example through programmability – in ways that make them more appropriate and easier to use in different processes in global trade and finance (Bank of International Settlements, 2021b: 17).

CBDCs are unlikely to fundamentally change the international monetary system in the short to medium term. This does not mean that CBDCs will have no significant impact on the international monetary system, but that the impact is likely to be uneven and to affect some components of the global financial system, such as market structures and payment services, more than others. This could fragment international payment networks into separate blocs.

In a fragmented system the benefits from digital money could be reduced by higher costs if the scope for lowering transaction costs would be limited. Moreover, the risks associated with financial instability will become concealed, unpredictable, and systemic. Without appropriate safeguards, the cross-border use of CBDCs could hamper central banks' abilility to maintain monetary and financial stability. Differences across jurisdictions could weaken the legal basis of cross-border CBDCs and ultimately alter the homogeneous quality of CBDC services to the final users (World Bank, 2021: 26). Furthermore, fragmentation would curtail international coordinated action on tracking money laundering, terrorist financing and imposing sanctions.

China's lead on CBDCs has been welcomed as providing options others than the dollar. Many developing countries, notably the BRICS, are concerned about their vulnerability to financial sanctions and the risk of being cut off from using the SWIFT network. In September 2022 the Shanghai Cooperation Organisation, of which China and Russia are members, agreed to increase the use of national currencies in bilateral trade among member states (Reuters, 2022).

China shares these concerns, and indeed the e-CNY ultimately responds to the Chinese government's objective of reducing the vulnerabilities that come from trade interdependencies and the use of the dollar in trade and non-trade finance. The e-CNY can contribute to China's long-term policies of renminbi internationalisation. By making direct exchange easier, faster and cheaper, the e-CNY can offer an alternative channel to neighbouring countries and trade partners that are eager to reduce their financial and monetary interdependencies with the US. It could also be used for cross-border retail payments related to tourism. Furthermore, China can share its technology with other countries – mainly developing countries – that do not have the resources to build their own CBDCs and so develop a network of digital currencies that are interoperable with their own. This would allow the incorporation of e-CNY in contracts made by the Chinese government with countries participating in the BRI, and in bilateral trade finance and financial aid.

The foreign adoption of e-CNY technology and an e-CNY-based cross-border payment infrastructure can give China significant leverage on the international monetary system. The monetary authorities, however, have been clear that the e-CNY, at the current stage, is planned to be used for domestic retail transactions – not to rival the dollar. Former PBoC governor Zhou Xiaochuan – one of the most outspoken advocates of the reform of the international monetary system back in 2009 – clarified that the e-CNY is not intended to replace the US dollar as the main reserve and international payment currency, adding that it would not significantly advance the internationalisation of the renminbi (Zhou 2009; Zhou, 2021).

Replacing the dollar at the helm of the international monetary system is not and has never been the Chinese leadership's objective. Instead, the shift to a multi-currency system would allow the rebalancing of the dollar. The e-CNY would make this objective easier to achieve. In fact, the e-CNY would be more easily distributed than the physical yuan, offering a stable and accessible alternative – other than the dollar – to individuals and firms in countries with weak and highly volatile currencies. In addition, the

e-CNY would make it easier for developing countries to access alternative cross-border payments systems and reduce their dependency on the dollar (Wan, 2020: 6).

Policy cooperation among central banks, monetary authorities and multilateral financial institutions is critical to set standards and a regulatory framework. China's ambitions to develop its own international currency should not be undermined but harnessed towards building a multi-currency system based on healthy competition among currencies.

4 CONCLUSION: FORGING A "NEW CONSENSUS"?

In a speech in April 2023 the US National Security Advisor Jake Sullivan invited like-minded countries to "forge a new consensus" and create "a secure and sustainable economy in the face of the economic and geopolitical realities" (Sullivan, 2023). This "new consensus" would bring together the main advanced economies to tackle many challenges, notably the vulnerabilities that come with deep trade and financial interdependencies. Sullivan's speech openly addresses the competition between the US and China and the underlying concern for the US and the other G7 countries, that is how to ensure that China plays by the rules and behaves like a responsible competitor.

In this report I have argued that interdependencies create efficiencies but also vulnerabilities, thus it is necessary to de-risk the global economy (Von der Leyen, 2023) to reduce excessive dependency and diversify the supply of energy and critical raw materials. But this needs to be done without creating divisions and rivalries, especially in relation to China, which is no longer just a partner – i.e. an exporter of low-value goods – but has become a competitor and a rival in strategic industries, as the European Commission put it. China can fragment the world economy. Thus, the US and the other G7 countries should stay engaged with China to ensure a level playing field and a rules-based system.

We cannot address the competition with China, as Sullivan's speech does, without acknowledging the overdependencies in the financial and monetary system where the dollar remains the key international currency. Financial and monetary vulnerabilities inherent in the dollar-based system affect China as well as many other countries, underpinning the view that "the costs of such a system to the world may have exceeded its benefits", as the former PBoC governor Zhou put it (Zhou, 2009). The fact that the US can weaponise the dollar and use it for foreign policy purposes raises further concern.

China is the only non-G7 country that has the capacity to create alternative infrastructure for lending and cross-border payments that can help many developing countries mitigate their vulnerability to the dollar. CBDCs, for instance, where China has the lead, could eventually support cross-border bilateral payments in currencies others than the dollar. China also has a significant footprint in development finance.

Would China's progress in expanding its influence within the international financial architecture eventually lead to a fragmented system at odds with the one that has been in place since the end of World War II? Not yet. At the current juncture China's main objective is diversifying the risk that arises from its own deep interdependencies with the dollar system. Stability rather than disorder remains China's preferred option, so to pursue its own development and manage its own financial transition – decoupling, in fact, from the dollar – in an orderly fashion.

Against this background, the rivalry between the US and China is becoming entrenched and risks undermining policy cooperation and turning de-risking into fragmentation. This rivalry is a consequence of and reflects the changing dynamics of the global economic order. US leadership has been diminishing over the years, while China is seemingly more responsive to the needs and aspirations of many developing countries – including the provision of non-conditional loans. This somehow explains the US's insistence on building a "new consensus" with like-minded countries. China, on the other hand, can only provide limited leadership because of its own constraints – it is not yet at the same level of development as the advanced economies and on many counts still is a developing country.

The above discussion and the findings of this report lead to the following recommendations for the G7.

1. Correctly define fragmentation as the risk of breaking the world economy into separate and sometimes conflicting economic blocs and markets, and recognise the risk of developing different sets of rules and regulations as countries seek to reduce their vulnerabilities and their exposure to unfriendly countries.

2. Ensure that international policy coordination remains robust, so to deal with spillovers and externalities that come from the world economy remaining deeply interconnected with complex supply chains and deep trade and financial interdependencies that are difficult to dismantle and replace.

3. De-escalate the language and explain in non-hostile words the need for economic de-risking as necessary to mitigate vulnerabilities and increase resilience; ensure that de-risking is inclusive and not polarising.

4. Be aware that vulnerabilities arise from deep economic interdependencies, while hostile geopolitics increases the risk of fragmentation and so encourage continuous multilateral dialogue; acknowledge the vulnerabilities that affect many countries because of their exposure to the dollar, and their aspiration to use their own currencies in bilateral trade.

5. Recognise that "a new consensus" that doesn't involve China is a futile attempt to set the clock back to the Cold War years; unlike the USSR, China is deeply integrated in the world economy.

6. Work closely with the G20 as the most suitable forum to bring together advanced economies and developing countries; identify areas where there are common problems, respect countries' preferences where these are aligned and offer incentives when preferences are not aligned; where cooperation is not possible, countries tend to resort to unilateral action.

7. Build a 'positive case' focus on sovereign debt as a policy convergence area with China to find case-by-case solutions that are credible and sustainable; explore scope for greater cooperation between China and the Paris Club.

8. Encourage the IMF and the BIS to coordinate efforts to develop a truly multi-currency international monetary system that can offer a choice of currencies in both trade and non-trade finance while keeping a shared regulatory framework and governance; encourage the dialogue around technological sovereignty, shared standards and safeguarding against regulatory loopholes that could breed illicit transactions and money laundering.

9. Recognise the 'power of the dollar' and the risk of unilateral sanctions, and lead a coordinated effort to devise a multilateral framework that defines the governance of monetary and financial sanctions and regulates their use.

Ultimately, the key question is to how accommodate China – neither a market economy nor a liberal democracy – within the international financial architecture. Where should lines be drawn? China can be a 'responsible shareholder' and play along with the G7, but for this to happen it is necessary to find a new engagement around shared rules and common interests. Rules and institutional governance need to be adjusted to reflect the new dynamics of the world economy, and the value of policy cooperation needs to be underpinned by "strong, balanced, sustainable and inclusive growth".

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