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Financial globalization: moving towards a polarized system?

The Chinese yuan aiming for financial "co-hegemony" with the US dollar

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EXECUTIVE SUMMARY

- **The Covid-19 crisis and, more recently, the war in Ukraine have led to some re-thinking of financial globalization.** In particular, large emerging countries are showing growing discontent against the Western USD-centered framework[1]. The rise of the Chinese economy (and its geopolitical assertiveness) seems to make the CNY a natural challenger.
- **We find that since 2009, the CNY's role in the global financial system has nearly doubled, just surpassing the JPY and GBP.** Getting on par with the USD is likely to take much longer, if it is even possible at all. Our analysis is based on a cross-country comparison of the economic size of the country issuing the currency, the credibility of the currency as well as its internationalization level, convertibility and reserve currency status.
- **The next phase of financial globalization could be a polarized system.** The rise of the CNY is not only a topic of financial development and diversification, but also geopolitically charged. In an optimistic scenario, global finance could be heading towards a multipolar system where economic agents use both the USD and CNY seamlessly. In a pessimistic scenario, two spheres of influence could form (US and USD vs. China and CNY), with little exchanges. The reality could lie between these two extremes as going forward geopolitics is likely to guide economic trends much more than in the past.
- **However, the path towards a polarized financial system is not straightforward**. While progress in China's reforms towards capital account liberalization had been fast in the 2000s and early 2010s, there have been some roadblocks. Stronger capital controls were put in place in 2015-2016 to contain the strong depreciation of the CNY and some bold Belt and Road Initiative investments did not always prove sustainable. Sweeping regulations in 2021 also raised concerns regarding political risks. While Chinese leaders likely still aim to raise the global role of the CNY, a rising number of issues in China could risk slowing down the pace of further reforms and the opening of the financial system.
- **Technological developments as a way to leapfrog?** China has plans to combine its widely used central bank digital currency (CBDC) with blockchain technology – once efficiency and reliability gains are proven. This could accelerate the CNY's role in the global financial system.

[1] *Read our previous report: Rallying Ruble and the Weaponization of Finance.*

The Covid-19 crisis and, more recently, the war in Ukraine have led to some re-thinking of globalization: Supply chains turned out to be more vulnerable than expected and many countries had developed food and energy dependencies that weakened socio-demographic resilience. While trade globalization seems to have plateaued (and seems unlikely to reverse)[2], could the financial globalization centered on the cross-border use of the USD in transactions and trade be challenged? What are the alternatives, and what would it take for them to be viable? Is the coexistence between a challenger currency and the USD possible under the current system, or it would imply a transition to a different one?

Challenging the dominance of a currency: we have seen this before

The rise of the US dollar (USD) as the world's dominant currency during the last century can provide valuable lessons for what might lie ahead. Until World War I, the British Pound (GBP) was still the major international currency, even though the US economy had already overtaken the British economy in terms of national output by the 1870s.[3] However, it took until 1913, when the creation of a central bank (Federal Reserve) helped the US develop a deep, liquid and open financial system that would elevate the status of the US dollar, matching the country's economic power. During World War I, the US also provided large amounts of loans to the UK (and other countries), further strengthening the international position of the USD. After World War II, the USD remained backed by gold, while the GBP (and other major currencies) were not.[4] Since then, the USD has become the dominant global reserve currency. **Now, the rise of the Chinese economy (and its geopolitical assertiveness) seems to make the CNY a natural challenger to the dominant Western USD-centered financial system.** China's rapid rise as a leading trading partner could rival the existing currency regime, much like the USD challenged the status of the GBP. However, as history tells us, economic influence is definitely not the only factor at play. Based on existing academic research[5], we find that the following five factors help summarize the determinants of the global role of a currency[6]:

- *Economic size* of the currency's issuing country
- *Credibility and confidence* in the currency as a storage of value
- *Internationalization* of the currency, namely the usage in cross-border trade and financial transactions
- *Convertibility* of the currency or the level of restrictions on capital flows
- *Reserve currency status*, i.e. whether if other central banks are holding the currency (as protection against crises)

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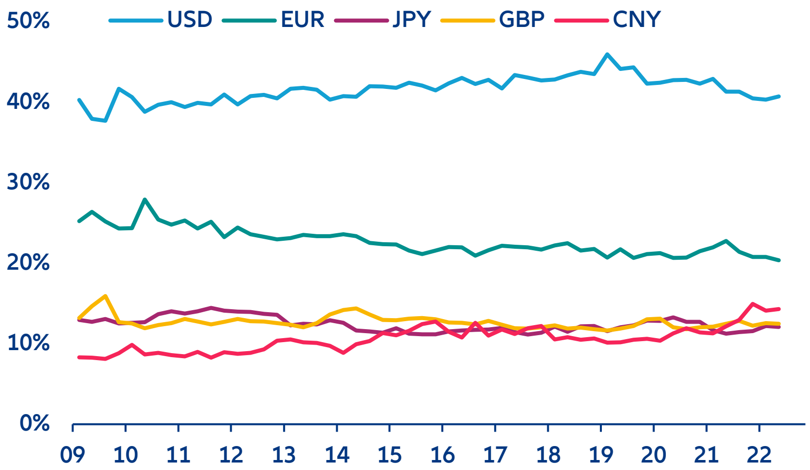
[2] Read our previous report: [Globalization 2.0 - Can the US and EU really "friendshore" away from China?](#).
[3] Frankel, Jeffrey, 2012. "Internationalization of the RMB and Historical Precedents," Journal of Economic Integration, Center for Economic Integration, Sejong University, vol. 27, pages 329-365.
[4] However, other currencies have still been able to gain importance. For example, the Deutsche Mark's ascent during the 1970s was enabled with the devaluation of the USD and the abandonment of the US fixed exchange rate system in 1973, and the expanding German economy and good reputation of the central bank. By 1989, it is estimated that the mark represented almost 20% of global FX reserves.
[5] Arslanalp, S. et al (2022) "The Stealth Erosion of Dollar Dominance: Active Diversifiers and the Rise of Nontraditional Reserve Currencies", IMF working paper 2022/058; Eswar Prasad & Lei Ye (2013) "The Renminbi's Prospects as a Global Reserve Currency," Cato Journal, Cato Institute, vol. 33(3), Fall.
[6] Of course, these components are not completely independent from one another, e.g.: a high level of credibility, internationalization and convertibility is likely necessary for a currency to be held as reserve.

The USD remains by far the most dominant currency

Based on these five concepts, we build a country-specific Global Currency Index for the currencies of the major developed economies, i.e. the USD, EUR, JPY and GBP (sometimes labelled the "Big Four") as well as the CNY. Each factor is measured by a number of indicators (some of which we detail later in this report) and the final Global Currency Index is a weighted average of the five factor. The Global Currency Index is not an absolute scoring measure of a currency's global role. This means that there is no ideal or maximum value to be reached, but rather the Index should be read as a relative measure of a currency's global role compared to others. We find that the USD remains by far the most dominant currency, while the JPY, the GBP and the CNY have been at similar levels in the past years (and the EUR in-between) (Figure 1).

Figure 1: Global Currency Index



Source: Allianz Research

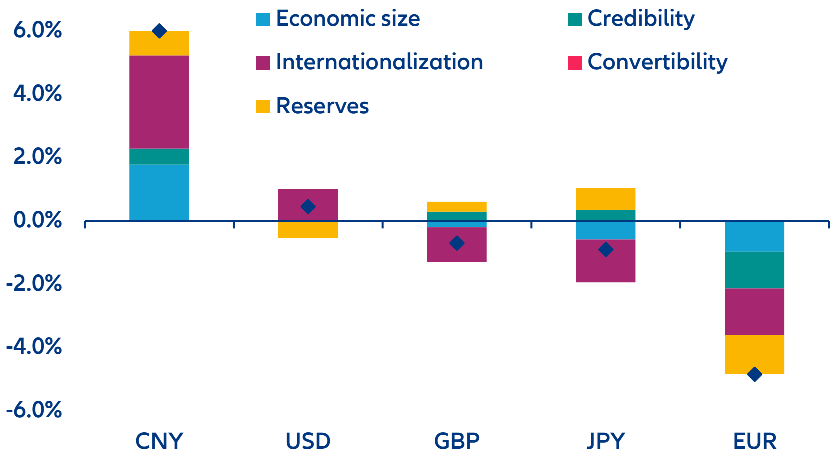
Table 1: Global Currency Index summary table. Values calculated as the average since 2019.

	Component	Indicators measuring the factor	CNY rank	CNY value
Global Currency Index	Economic size	GDP, trade	#2	28%
	Credibility of the economy	CDS spread, exchange rate, inflation, public debt	#2	23%
	Internationalization	Trade invoicing, cross-border loans and deposits, public debt ownership, outstanding bonds, FX derivatives	#3	15%
	Convertibility	Capital account openness	#5	4%
	Reserves	Share in world official FX reserves	#5	3%

Source: Allianz Research.

Since Q1 2009, our Global Currency Index for the CNY has nearly doubled, mostly at the expense of the EUR, and to a smaller extent the JPY and the GBP (see Figure 2). The CNY's rise is mostly explained by the economic size and internationalization sub-components. If we very simplistically extend the trends of the past five years, we find that the CNY's global role could be similar to that of the EUR by 2027, although with respective influences likely in different geographic areas. This is of course dependent on multiple factors both at home and abroad, and getting on par with the USD is likely to take much longer, if it is possible at all.

Figure 2: Global Currency Index (change between Q2 2022 and Q1 2009, with contributions by sub-component)



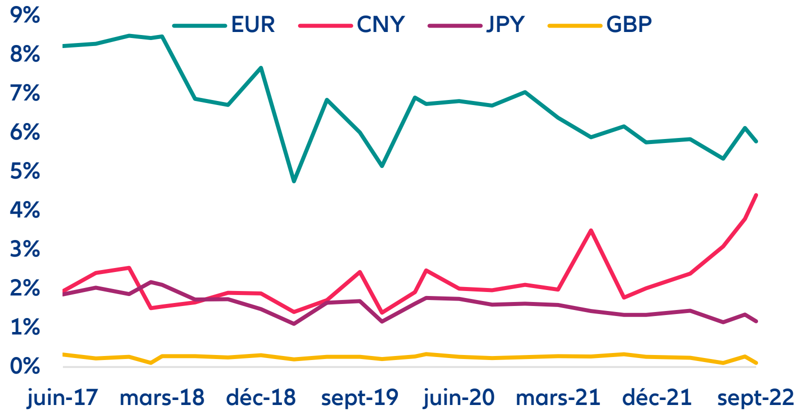
Source: Allianz Research.

Economic size. Intuitively, the larger an economy, the bigger its influence on the rest of the world and the more used the currency it issues is. We measure this factor through the share of global GDP and the share of global trade. Since 2009, China's share in the global economy has risen from 13% (in nominal terms) to 30%, and its share in global trade has increased from about 20% to 30% over the same period. That said, the international usage of the CNY has definitely not risen as much, and other factors are at play.

Credibility. Here, the aim is to capture economic agents' confidence in the currency as a store of value. This is dependent on transparent and predictable public policies, good governance and economic stability, sound public finances etc. To measure this, we use indicators based on sovereign credit default swaps (CDS), inflation, public debt and the long-term rates of appreciation of currencies. Since 2009, the credibility sub-indices have not changed much across the five currencies, apart from a decline in the case of the EUR (due to a higher economic risk premium as measured by the CDS and recent inflationary pressures).

Internationalization. The success of a currency as an international means of payment is related to its use in transactions beyond its borders. As such, to measure this factor, we use data related to trade, cross-border debt and FX market turnover. The development of strategies abroad, particularly after 2008, the high savings rates and the country's gradual opening have rapidly development China's financial network and its creditor role. As such, an improving Internationalization sub-component contributes the most to the rise in the CNY's Global Currency Index. Nonetheless, there is still large room for a further increase in the international adoption of the CNY (e.g. trade finance currency usage in Figure 3).

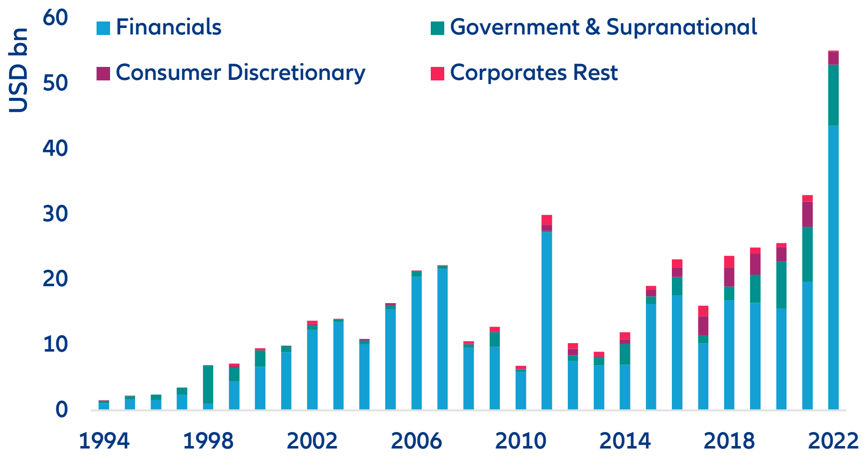
Figure 3: Selected currencies' share in trade finance – SWIFT transactions only (USD > 85%)



Sources: SWIFT, Allianz Research.

The issuance of CNY-denominated bonds (outside China) has surged in the last decade, although it remains a marginal part of the market (unless domestic CNY issuance is included). Financial companies issue the majority of these bonds as a way to have enough CNY liquidity to carry out operations as China's domestic market gradually opens. In the national government bonds market, and besides some HKD-denominated bills in the early 2000s, the UK was the first advanced economy to kick off CNY-denominated issuance (Eurobond system, 2014)[7]. Since then, Mongolia, the Philippines and South Korea in Asia, and Portugal, Hungary and Poland in Europe, have been among the issuers at the sovereign level. When it comes to supranational and other levels of government (rather than national), there are also interesting developments. The CNY has become more and more common for development banks, not only in Asia but also in Europe (European Investment Bank, European Bank for Reconstruction and Development, Nordic Development Bank), Africa or Latin America.

Figure 4: CNY-bond issuance outside China



Sources: Bloomberg, Allianz Research.

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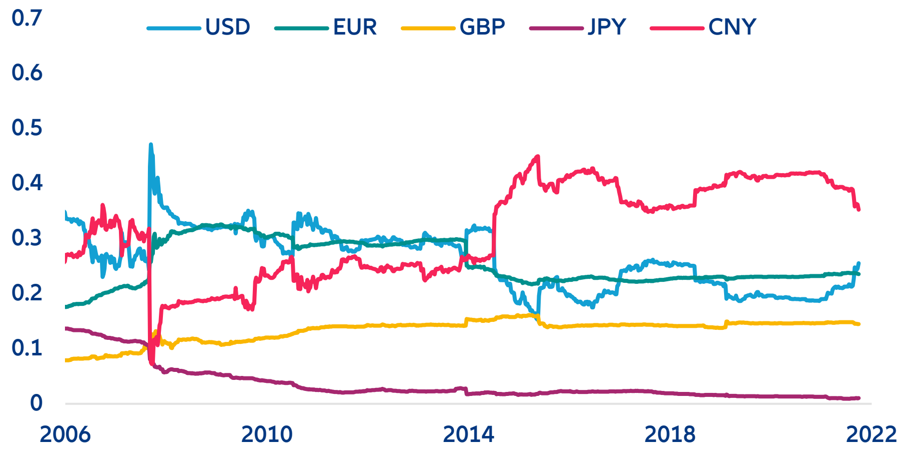
[7] *Importantly, although it started in the Eurobond system, all the issuances since 2016 have been in China. The process of the Russian default reminded the importance of foreign vs. domestic settlement.*

As we wrote a year ago, we already see the emergence of a "CNY-bloc"[8] : For a group of countries, increasing interlinkage with China has contributed to reduce exchange rate volatility. As of today, and besides the USD strength, these findings still hold (see Figure 5) and are a proof that as much as the international use of a currency lags the increase in a country's international relevance, some of its effects are visible earlier (especially on trade and investment partners).

Figure 5: Trade-weighted average of co-movements coefficient



Sources: Refinitiv, Allianz Research.

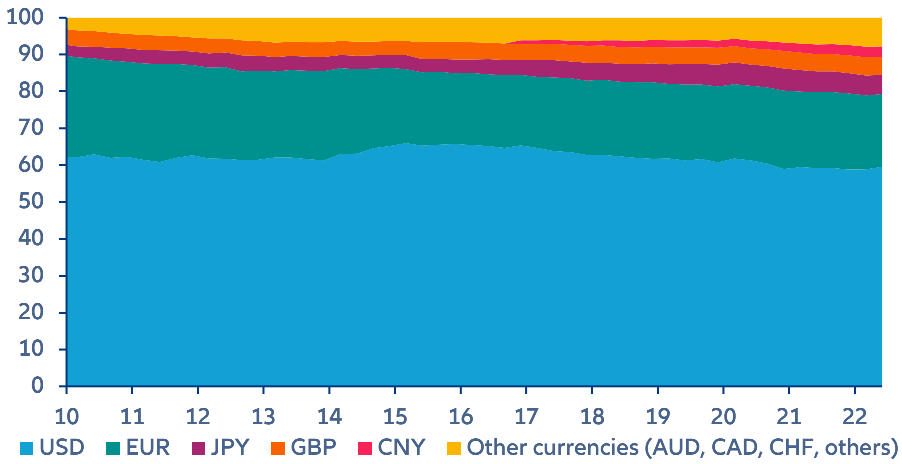
Convertibility, meaning the level of restrictions on capital flows and whether foreigners can be assured that their holdings will always be convertible. Traditionally, emerging market economies have struggled between attempts to make the country attractive to foreign investments and remaining in control of capital flows. Indeed, the Mundell-Fleming trilemma suggests that it is not possible have an independent monetary policy, a stable exchange rate and free capital flows all at the same time (only two out of the three are possible simultaneously). In the case of China, and after reforms to make the CNY exchange rate more market-driven in 2015-2016, authorities put in place stronger capital controls to stem outflows. On one hand, stable exchange rates and independent monetary policy are arguably in line with the country's strategy of financial sovereignty. On the other hand, financial internationalization – at least how we have known it so far, some important authors claim there may be other ways[9] – would require not only stable exchange rates but a degree of financial openness. On this aspect, and besides the fact that some of the internationalization efforts (in)directly enforce trustworthiness, China's progress has been limited.

Reserve currency status, i.e whether other central banks are holding the currency as storage of value and protection against balance of payment crises. The previous four factors definitely affect how much a currency is held as reserve by other central banks. Another interesting criterion is inclusion in the IMF's Special Drawing Rights (SDR). This is an instrument that is composed of the world's most relevant currencies[10] and designed to provide additional liquidity to central banks and support existing reserves. The SDR basket currently includes the five

[8] *See our full report here from Nov21', Global FX volatility: Still waters run deep.*
[9] *E.g. Eichengreen, B, C Macaire, A Mehl, E Monnet and A Naef (eds) (2022), "Is Capital Account Convertibility Required for the Renminbi to Acquire Reserve Currency Status?", CEPR Press Discussion Paper No. 17498.*
[10] *that meet the criteria of export (among top-5 global exporters) and free usability (currency widely used in international transactions and in the principal exchange markets).*

currencies that we focus on in this report, with the CNY having been included since 2016 – at a higher share than the JPY and the GBP that was increased again in August 2022 (the USD's weight was also raised). As a result, the CNY's share in global allocated FX reserves has been rising in the past years, from 1.1% when data started to be reported in 2016 to 2.9% as of Q2 2022.

Figure 6: Distribution of global allocated FX reserves (%)



Source: IMF, Allianz Research.

The next phase of financial globalization: a polarized system?

The rise of the CNY is not only a topic of financial development and diversification, but also geopolitically charged. In an optimistic scenario, global finance could be heading towards a multipolar system where economic agents use both the USD and CNY seamlessly. In a pessimistic scenario, two spheres of influence could form (US and USD vs. China and CNY), with little or no exchanges. The reality could lie between these two extremes as going forward geopolitics is likely to guide economic trends much more than in the past. Tensions between the West and rival emerging market countries have definitely risen. After the invasion of Ukraine, the antagonization of Russia is obvious with coordinated sanctions imposed by Western countries and some of their allies. Note however that an overwhelming number of emerging market countries did not follow suit (including large ones such as Brazil, India, South Africa or Turkey). Similarly, when it comes to China, while the US has started to take steps to reduce bilateral exchanges, the vast majority of the rest of the world is aiming to safeguard economic relations with both China and the US. As such, our baseline scenario is that while the global financial system could gradually become polarized, third countries will not necessarily have to make hard choices between two antagonistic poles.

Trends and initiatives that could accelerate the move towards a polarized global financial system: geopolitics, technology and financial reforms

Large emerging market economies – bonded by a common desire of reshaping the current status quo? Such countries have made progress in many economic aspects in the past decades, but there is still one big item which lags the rest: their role in the financial world. Besides the mismatch between weights in the real and financial economies, there is the underlying sentiment of unfairness, where emerging markets are participants/users of a system controlled by others (basically the Western USD-centered system) and exposed to financial shockwaves coming from the US[11,12].

In theory, reinforcing the relationship between large emerging market countries could gradually change their roles in the financial world from borrowers to creditors, and potentially establish new institutions and channels independent of the “West”. Nonetheless, the fact that large emerging market countries are located in multiple regions is at the same time a strength and a weakness, as on the one hand it allows for a common emerging markets front, but on the other it needs to address multiple and sometimes conflicting.

At the regional level, the Shanghai Cooperation Organization (SCO) is probably the most important in terms of population, size and economic relevance. A Sino-Russo initiative, it comprises most of the Asian continent and is trying to reach the Gulf countries, which would favor a polarized world, and which could have implications for (part) of the oil pricing. Among other goals, it emphasizes the need to boost the use of mutual national currency settlement as a way to reduce dependence on the dollar. Note that research finds[13] that as of the end of 2021, Russia held nearly a third of the world’s CNY reserves.

A different system needs institutions that support it. What matters more is whether successful financial institutions can carry out the undoubtedly crucial role of finance in supporting the global role of a currency. As much as the struggle for a bigger role stresses the problems of the current system, it would be unfair not to acknowledge the positive aspects that the Bretton Woods system brought, which have allowed the globalization of finance after World War II. Along this line, China launched the Asian Infrastructure Investment Bank (AIIB)[14] in 2016, a multilateral bank that aims to rival the World Bank, and whose main purpose is to foster the long-term development of the Asian continent via infrastructure investments. Although the increasing creditor role of China is reflected in other alternatives as well (e.g. the Belt and Road Initiative), the creation of China-lead institutions is a step further in the attempt to create a new financial pole. For the time being, external efforts have concentrated in neighboring countries and Africa, a region less integrated in global financial networks (see Figure 7).

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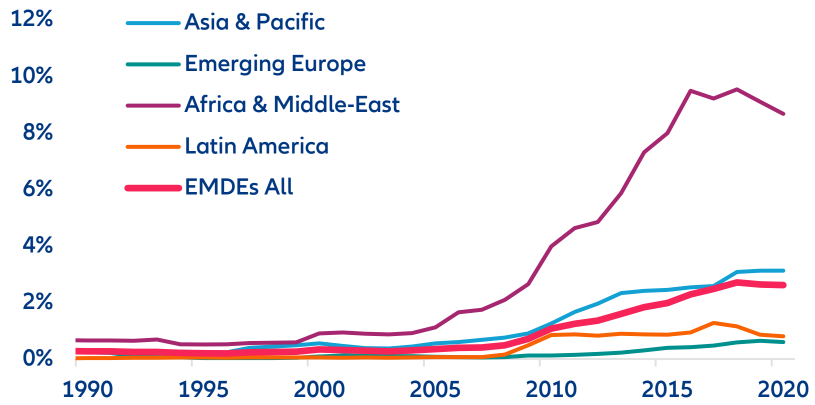
[11] *The latest shockwave to the emerging market world is ongoing as the Fed has embarked in a steep hiking cycle. Read our full report here: Reverse currency war puts emerging markets at risk.*
[12] *Paradoxically, due to the large holdings of USD denominated debt of some of these countries – China particularly – if the USD were to lose ground and its value falter, it could create a shockwave as well (known as “the dollar trap”).*
[13] *Arslanalp, Eichengreen, Simpson-Bell (2022) “Dollar Dominance and the Rise of Non-traditional Reserve Currencies”.*
[14] *Not to be confused with the Asian Development Bank, a “Bretton Woods Institution” where the US and Japan (not members of the AIIB) hold main roles with more than twice more shares than China (each).*

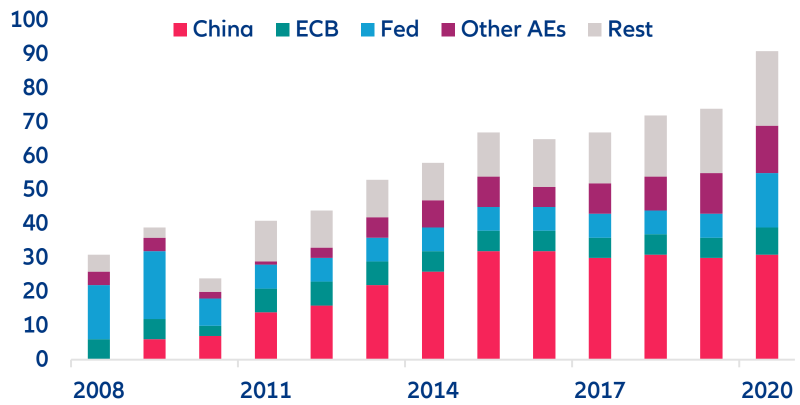
Figure 7: Share of China (as country of counterpart) in external debt of EMDEs



Sources: World Bank, Allianz Research. Aggregated by external debt outstanding.

Another institution crucial in promoting the CNY internationally is the PBOC. History has shown that a transparent and credible central bank needs to stand behind a currency with a global role. This contributes to sound public policies at home, as well as potential cross-border measures to ensure sufficient liquidity of the currency globally. The PBOC seems to be aware of this, and it has adopted some of the tools that are in the Fed toolbox. One of them is bilateral currency swap lines, which are crucial in times such as today (currency depreciations, increasing balance of payment risks in many EMs) to provide exchange rate stability and avoid liquidity-drain events. As shown in Figure 8, China has in the past created a network of bilateral swap lines that has focused on Asia and the countries with which it has stronger trade linkages[15]. The aim has been to increase the usage of the CNY in a not fully-convertible and fully-open capital account framework, and shore-up its international role as lender of last resort, measures consistent with its aim of becoming an alternative pole in the financial world.

Figure 8: Number of bilateral swap lines



Source: Perks et al. (2021), "Evolution of Bilateral Swap Lines"

An EM-based SDR could be a game-changer for reserves composition. But is it vision or delusion? Within large emerging market currencies, the CNY has been part of the SDR since 2016. But despite an increase in August 2022, its weight still does not fully reflect its role in the

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[15] Perks, M., Rao, Y., Shin, J., & Tokuoka, K. (2021) "Evolution of Bilateral Swap Lines", IMF Working Papers, 2021(210), A001. Retrieved Nov 14, 2022, from IMF library.

global economy. As a result, voices claiming for a different SDR – composed of the major EM currencies – have grown. EM-SDRs or a different weighting in the current IMF-SDRs would therefore have important consequences and would translate into a major shift of monetary power to China, as well as major responsibilities that could spark a loss of confidence if poorly managed. In this regard, China's offshore market for the CNY is already a step towards improving convertibility and shoring-up international trust in the currency.[16] In the hypothetical case of an EM-SDR, the weights of the CNY would be clearly dominant, as it accounts for nearly 40% of EM exports, and it is the only currency in this group that has significant usage in international transactions. This could complicate the existing frictions among emerging market countries. In terms of adoption, it is also not clear how a EM-SDR would work, although its initial users would in principle be countries already aligned with a CNY-centered pole.

One (CNY) can't beat someone (USD) at their own game, but technological changes change the rules. China and other vocal critics of the current system realized that developing technology is also needed, in addition to having the financial muscle. The PBOC development of CIPS (Cross-border Inter-bank Payment System) – which allows clearing and settlement in CNY[17] – has been followed by the e-CNY[18], China's central bank digital currency (CBDC). Although in a less advanced stage, the *mBridge* project – with China leading, under the auspices of the BIS – aims to connect multiple CBDCs, which would eliminate the potential problems that cross-border payments could pose against the use of CBDCs.[19] At scale, this represents a major step not only towards decoupling from the USD financial system[20] but to establish a new one.

The path for the CNY to reach financial "co-hegemony" with the USD is definitely not straightforward

Geopolitical headwinds. Many of the largest emerging countries have closer ties with the US than with the "instigators" of a future polarized financial system. The border disputes between India and China, the reluctance of some South-East Asian countries to embrace a stronger China and the still dominant position of the US in the American (and Asian) continent could hinder the progress of the CNY. As of today, while many countries share the desire for reducing their vulnerability to the USD, a pragmatic solution involving multiple emerging markets seems difficult. While the inclusion of the CNY in the SDR basket opened the door to the coexistence within the same system, recent developments (in particular the freezing of Russia's reserves) have proven the importance of being in control of the underlying financial infrastructure, and therefore have made a polarized financial world more likely.

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[16] *The second criterion for being part of the SDR (free usability) does not have such a clear quantitative measure as the export criterion; it combines: the extent to which trade in goods and services is paid for in the currency, relative volume of capital transactions denominated in the currency, volume of transactions in FX markets, the existence of forward FX market and the bid-ask spread in the currency.*

[17] *Initially not thought as a substitution of SWIFT messaging (it actually combines them), the implementation of international sanctions that includes exclusions from SWIFT has opened the exploration of further functionalities.*

[18] *The trials that took place during 2022 Winter Olympics have been extended to 23 major cities, where citizens can use e-CNY from the official app as they would use other payments methods.*

[19] For the time being, none of these projects use blockchain technology, but according to experts on the matter, it is designed in a way that would allow it to take over once it proves enhanced efficiency and reliability. In parallel, China is developing one of the most advanced Blockchain networks (BSN), that would allow the interconnection of different blockchain application, providing the country an additional edge in a new Blockchain-based global payments system.

[20] *It does not mean that the US or the EU are not also taking steps. The US launched the ambitious Project Hamilton and the EU the Digital Euro project, expected to bear some results by October 2023.*

Domestic issues could hinder the international progress of the CNY as rival to the USD. While progress in China's reforms towards capital account liberalization had been fast in the 2000s and early 2010s, there have been some roadblocks. Stronger capital controls were put in place in 2015-2016 to contain the strong depreciation of the CNY and manage the Mundell-Flemming trilemma, and less emphasis has been given to the Belt and Road Initiative in recent years after some bold investments abroad did not always prove sustainable. Furthermore, sweeping regulations in the technology sector in 2021 have also raised concerns regarding political risks. While Chinese leaders likely still aim to increase the global role of the CNY, the increasing number of domestic issues in recent years could risk slowing down the pace of further reforms and consequently the opening of the Chinese financial system.

These assessments are, as always, subject to the disclaimer provided below.