The Dragon Stretches Its Wings

BY ESWAR PRASAD

In October 2015, 12 countries from Asia and the Americas reached an agreement on the Trans-Pacific Partnership (TPP). The trade deal, one of the largest in more than two decades, included most of the Pacific Rim – but not the largest economy in Asia.

The subtext of the agreement was clear. With China's rising economic and political clout in Asia and beyond, this was a way for the United States and its allies to circle the wagons. If the TPP was to be ratified by national legislatures in all the member countries – which later proved a bridge too far – it would represent an important achievement for Japan and the Obama administration in creating a modest, although mainly symbolic, counterweight to China's expanding influence.

Within China, opinions about the TPP ranged from measured to strident. Reform-minded officials in Beijing took a positive attitude, recognizing that outside pressure often helps to overcome domestic opposition to change. Just as China used outside pressure in the form of the conditions for joining the World Trade Organization in 2001 as a spur for domestic restructuring, an aspiration to become a member of the TPP could help dislodge some of the opposition to state enterprise reforms.

The debate took on a sharper edge, however, when an economist from the People's Bank of China (China's central bank) estimated that lost trading opportunities could initially knock half a percentage point off the country's economic growth rate. Reacting to this estimate, Sheng Laiyun, a spokesman for China's National Bureau of Statistics, said that China could take countermeasures.

Beijing has, for instance, been pushing its own trade pact, the Regional Comprehensive Economic Partnership (RCEP), a proposed 16-nation free-trade area that would encompass 3.4 billion people. The RCEP would comprise the 10 nations that constitute the Association of Southeast Asian Nations (ASEAN) plus China, India, Japan, South Korea, Australia and New Zealand. It was seen as a prominent alternative to U.S. plans, but has since lost some of its momentum.

The TPP is dead, thanks to the U.S. election. However, China remains concerned that similar initiatives could result in excessive U.S. influence and the sidelining of China in the process of rewriting the rules governing global trade.

While pushing to increase its economic reach through trade, China began to realize that international finance would be the new and more important battleground for wielding geopolitical influence. Recognizing that the renminbi (RMB) did not yet have the potential to be a reserve currency, China adopted a complementary strategy: using its financial firepower to increase the economy's international influence, with the RMB riding on the back of these efforts.

FLEXING ECONOMIC MUSCLES

In the 2000s, as China's financial clout and foreign exchange reserves grew, it began using those resources to increase its sphere of influence, offering investment and various forms support to other economies. The recipients of much of this largesse were its neighbors in Asia, as well as a number of economies in

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PREVIOUS PAGE: IMAGINECHINA

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Africa and Latin America possessing natural resources that China craved for its manufacturing machine. This led to worries that China was simply exploiting the countries to which it was giving aid or loans – and, even worse, that the money was propping up corrupt regimes, enriching venal officials and creating a debt burden that would come to haunt those countries.

Over the past decade, China has accounted for a cumulative investment of $220 billion in sub-Saharan Africa, as well as $120 billion in South America (compared with about $60 billion in the United States). Moreover, China has been open to providing money to countries that have been shut out from borrowing in private financial markets and are loath to turn to Western institutions or countries.

In Ecuador, whose president, Rafael Correa, aligned himself with the populist government in Venezuela, Chinese money has financed dams, roads, highways, bridges and hospitals. In return, China has, by some estimates, locked in nearly 90 percent of Ecuador's oil exports, revenues which go largely toward paying off those loans. Ecuador's former energy minister said, "The problem is, we are trying to replace American imperialism with Chinese imperialism."

There is a vibrant and far-from-settled debate about whether Chinese money has been a net benefit for recipient countries. A recent, provocative study by researchers at the University of Sussex argues that Chinese aid to

African states increases the risk of civilian abuse by giving their leaders access to funds with which to carry out violence against political opponents, thereby perpetuating the regimes' hold on power.

On the other hand, a study by the research organization AidData has a more positive tone. Still, even this study finds that commercially oriented forms of Chinese state financing are directed mainly to countries rich in natural resources and with higher levels of corruption.

While the academic debate rages, China has moved to strengthen its economic relationships in Africa, including with some regimes that are pariahs in the eyes of the West. In December 2015, soon after President Xi's visit to Zimbabwe, that country's government proudly proclaimed that the RMB would become legal tender within the southern African nation. But in an economy ravaged by hyperinflation and economic mismanagement, the government's sanctioning of the RMB's status as an official currency is unlikely to have much impact, let alone any international implications. Earlier in 2015, the government had euthanized the ailing domestic currency, allowing Zimbabweans to exchange bank balances of up to 175,000 trillion Zimbabwean dollars (that is, indeed, trillion with a "*t*") for $5.

President Xi's visit to Africa culminated with a grand declaration at a summit in Johannesburg that China and Africa were "good friends, good partners, good brothers." To say that African leaders welcomed all of this warmly would be an understatement. China offered not just soaring rhetoric but cold cash as well – $60 billion in grants, loans and capital for various development funds. Not only that, China also wrote off a number of loans it had made to poorer countries (including $40 million to Zimbabwe). And in words that were no doubt music to the ears of the leaders, President Xi made China's policy of noninterference crystal clear: "China supports the settlement of African issues by Africans in the African way."

China's initiatives in Africa have not directly elevated the RMB, and China's government has not pushed hard for these countries to use RMB in their transactions. Nevertheless, the stronger trade and financial relationships that many countries in the region have with China are generating greater interest in using RMB to diversify foreign exchange reserve portfolios and for trade settlement.

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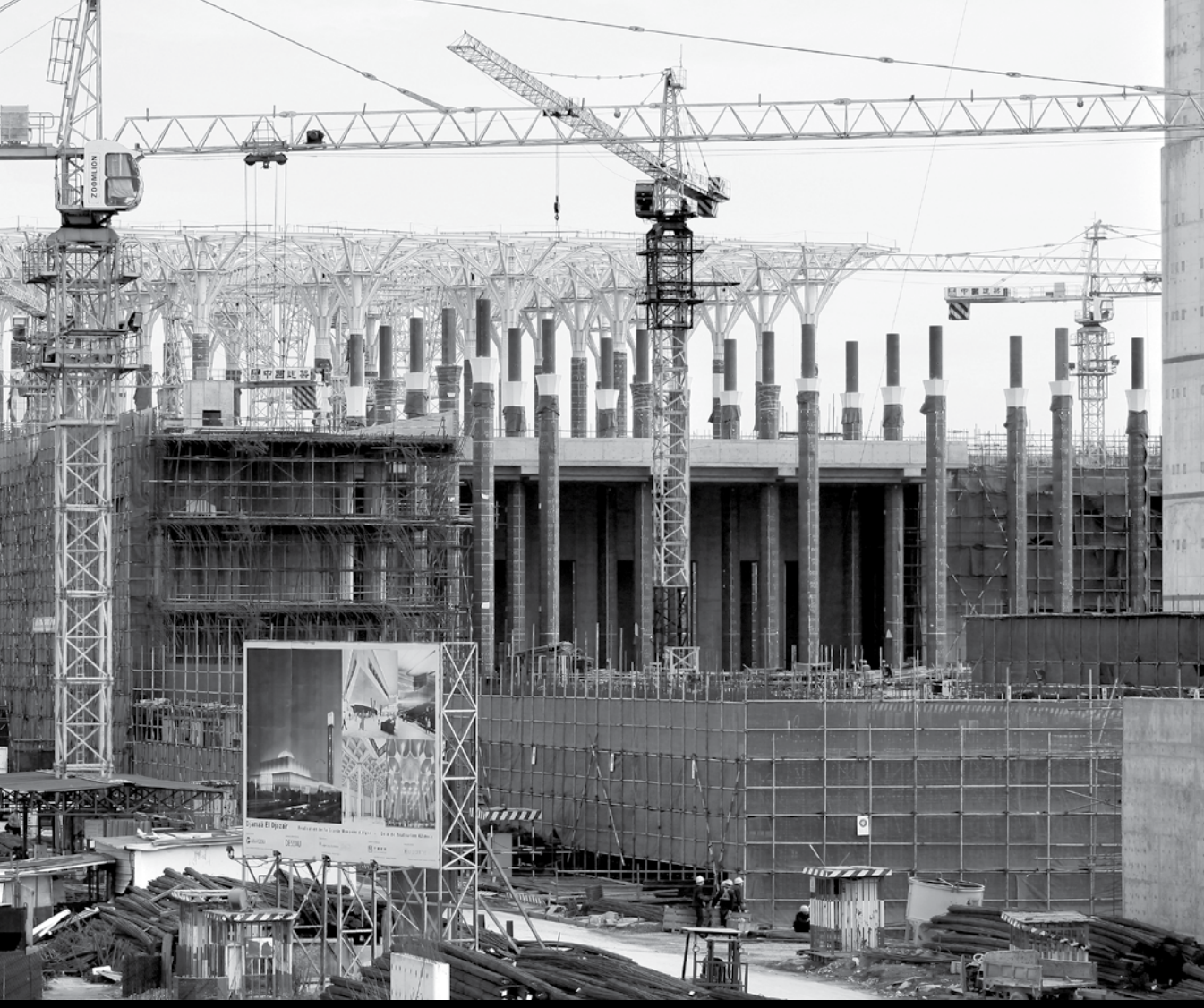

The new Great Mosque in Algiers, being built by the China State Construction Engineering Corporation (January 2016).

RELATIONSHIP RESET

China's investments and aid to Africa and Latin America, which (as noted above) have ramped up over the past decade, strengthened China's economic and political linkages with countries in those two regions. In other quarters of the international community, however, such endeavors were not viewed favorably. A reset in the nature of its economic relationships would clearly help China realize its ambitions without generating as much pushback, eventually paving the way for broader adoption of the RMB. The Chinese are quick learners, adjusting strategy when circumstances demand it. They have grown more savvy and disciplined in their approach to international engagement, using a wide range of tools.

China is now employing a multipronged approach to helping set the global agenda. First, it is gradually increasing its influence in international financial institutions. This allows it to change the rules of the game from the inside. Second, it is setting up multilateral institutions where it gets to call the shots – and serves to subtly catalyze changes in the existing institutions. Third, it is partnering with other like-minded countries to set up institutions that are meant to build trust and stronger economic linkages with countries

RICHARD LEVINE/AGE FOTOSTOCK

that it sees as partners as well as potential competitors. Fourth, it is using other arms of the state, including development agencies and state-owned banks, to increase its global financial reach.

FRIENDLIER MULTILATERALS

The first element of China's global strategy involves increasing its influence in existing multilateral institutions. At the IMF, the granddaddy of international financial institutions (IFIs), China's capital contribution of $42 billion gives it a 6 percent share of the overall capital pool and a corresponding voting share. The United States has a 16 percent voting share, while Japan's share, like China's, is 6 percent. At the World Bank, another major IFI, China has a voting share of 5 percent, compared with 16 percent for the United States and 7 percent for Japan.

The major IFI in Asia is the Asian Development Bank (ADB), which has a capital stock of about $150 billion. Japan and China have been jostling for influence at this institution for a long time. Japan has a voting share of 12.8 percent, making it the largest shareholder. The United States' share – almost 12.8 percent – is by design a smidgen less than that of Japan to emphasize the Asian leadership of the institution. China's share is 5.5 percent, while India's is 5.4 percent, underscoring how even decimal-place differences in voting power are freighted with symbolism at such institutions.

The irony of Japan's maintaining a larger voting share in international institutions has certainly not gone unnoticed by China. Even at the IMF, where recent reforms increased the voting shares of China and other emerging-market economies, Japan remains ahead symbolically, with a voting share of 6.18 percent

compared to China's 6.12 percent.

China has also been gradually marking its presence in less prominent IFIs around the world. It has established beachheads in the African Development Bank, the Caribbean Development Bank and the Inter-American Development Bank, although, as a non-regional member, its direct contributions to these institutions sum up to only $1 billion.

Africa has more trade with the European Union as a whole, but China is the single country that accounts for the largest share of Africa's trade. For many Latin American countries, China has become the largest export market. So China's presence in these regional institutions allows it to start playing a role – modest at first, but easily scalable – in the economic governance of these regions.

How far is China willing to go to engage the existing IFIs on their own terms, rather than seeking changes in those institutions when it is signing up? Consider China's accession to the World Trade Organization in 2001.

After long and difficult negotiations, China agreed to most of the standard conditions for WTO membership, which gave it much greater access to export markets. During its push to increase exports in the 2000s, China benefited greatly from this improved access.

But the government went no further toward integration than the rules required. Foreign investors in China found themselves stymied at every turn by rules that limited their operations, forced them to share technology with local firms and allowed them to enter certain industries only if they partnered with domestic firms. And now that China is a large and powerful member of the WTO, it can play a greater role in influencing how the organization defines and applies rules for international trade.

There is a starker and more interesting example illustrating how China is willing to seem open to compromise when it joins existing institutions. In January 2016, China became a member of the European Bank for Reconstruction and Development (EBRD) with a capital contribution of $400 million, less than 1 percent of the total capital base.

What is particularly interesting about EBRD membership is that China agreed to sign on to the institution's commitment to Western-style governance. The very first article in the EBRD's charter states that its members are "committed to the fundamental principles of multiparty democracy, the rule of law, respect for human rights and market economics."

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It is striking that China signed on despite the inconsistency between the EBRD's mandate and the tenets of the Communist Party, and despite qualifying for only a marginal voting share at the institution. One interpretation is that China is willing to appear reasonable and open to compromise when it seeks membership in existing international institutions. It then strives to subtly influence these institutions from the inside, rather than through brute economic or political force from the outside.

So far, China has made the majority of its capital contributions to the IFIs in hard currencies such as the dollar, the euro and the yen. Now that the IMF has designated the RMB as an official reserve currency, China will no doubt be able to legitimately make further capital contributions in its own currency. As China's economy grows and its role in existing

IFIs becomes more prominent, the RMB will play a bigger role in the capital bases and financial operations of these institutions.

THE END RUN

While it was signing up for membership in multilateral institutions around the world, China was frustrated that, in the international and regional organizations that it most cared about, it still had second-class status. Although all countries, including the United States, had agreed in 2010 to a reworking of IMF voting shares to give China and other emerging markets more voting power, the agreement had to be ratified by national legislatures. Virtually all major countries had done so by 2014, but in the United States this issue became entangled in the political deadlock between the Obama administration and the Republican-controlled Congress. The agreed-on changes only came into effect in January 2016 – and by that time, the new voting shares were already lagging behind economic reality as they had been based on GDP and other economic variables from a few years prior.

Even in its own backyard, China was not attaining the status it felt it deserved. At the Asian Development Bank, the major multilateral institution in Asia, China had been unable to dislodge Japan from that country's position of prominence.

China decided it needed to take a more active role in international finance, which could best be done by bankrolling its own institutions. Its leaders recognized that China could put its money to good use by financing infrastructure projects in Asia – a crying need for countries in the region that lacked the funds to undertake large investments. It would be logical for other countries to sign up for such an institution, where they would have a more prominent role than in other IFIs and could also obtain financing for vital infrastructure projects. Thus was born the idea for the Asian Infrastructure Investment Bank (AIIB).

The United States was wary of China's attempts to create alternatives to the existing multilaterals. With a proposed initial capital of $50 billion that could be increased to $100 billion, the AIIB would clearly be a significant competitor to the ADB and the World Bank. (These latter two institutions together have a capital base of about $400 billion.)

Recognizing that it could not stop other countries in the Asian region, most of which are either small or not advanced, from signing up, the United States decided its best strategy was to undermine the legitimacy of the AIIB by asking whether the governance and lending practices of a China-led institution would mirror China's weak legal and institutional framework. A key element of this strategy was making sure that its advanced-economy allies would not sign up.

The United States was keen to corral not just the major advanced economies such as the Eurozone, Japan and the U.K., but also other advanced countries including Australia and South Korea. However, China had a secret weapon in its arsenal: Jin Liqun, an internationally respected official, well-known master strategist and articulate speaker who does not mince words as a forceful advocate for China's positions. Jin, who has extensive international experience working in multilaterals, including the ADB and the World Bank, was assigned to lead the charge in setting up the AIIB.

Despite Jin's lobbying efforts, it appeared that the United States was winning the diplomatic battle. In October 2014, when a ceremony was held in Beijing to sign a memorandum of understanding to launch the AIIB, just 21 countries had joined. Other than China and India, none of these was a large

Britain's Chancellor of the Exchequer George Osborne with China's Vice Premier Ma Kai.

REUTERS/ANDY WONG/POOL

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economy, and no major advanced economies were on the list.

Then, in March 2015, to the stunned surprise of the U.S. administration, Britain broke ranks. For the U.K., a strong relationship with China was crucial to giving it an edge in the race to persuade Beijing to direct RMB business toward London, rather than Frankfurt and other competing financial centers.

U.S. officials were apoplectic in private but more restrained in public. They couched most of their displeasure in terms of concerns about whether the AIIB would meet the "high standards" of existing multilateral institutions, such as the World Bank, when it came to governance, not to mention environmental and social safeguards.

The U.K. was only the first of many dominoes to fall. Soon after the U.K. signed up, France, Germany and Italy released a joint statement to the effect that they were keen to "join the founding members of the AIIB to work on establishing an institution that will adhere to best practices in the areas of governance, security, loans and public procurement."

By April 2015, when the charter of the AIIB was being agreed on, 57 countries had signed up as founding members. With so many countries falling over each other to join, its initial authorized capital was pushed to $100 billion; the total contribution of members from outside the Asian region was capped at $25 billion. China contributed $30 billion, the largest amount by far of all the members. China has 26 percent of the total voting shares; India has 7 percent; Russia has

Chinese housing project near Luanda, Angola.

6 percent. To leave no ambiguity about who will be calling the shots, the headquarters was located in Beijing.

Only one U.S. ally weighed the costs and benefits of being a founding member of the AIIB and decided that bowing to Beijing might not serve its interests. Local news reports quoted Prime Minister Shinzo Abe as saying at a meeting of his party that "the United States now knows that Japan is trustworthy."

By September 2015, when President Xi visited Washington, the United States and China had decided to call a truce on the AIIB. In an elegantly crafted sentence – elegant less in its linguistic than in its bureaucratic flourishes (to which, as a former bureaucrat, I tip my hat) – the two countries expressed agreement on a set of lofty and sufficiently vague principles:

> Both sides acknowledge that for new and future institutions to be significant contributors to the international financial architecture, these institutions, like the existing international financial institutions, are to be properly structured and operated in line with the principles of professionalism, transparency, efficiency and effectiveness, and with the existing high environmental and governance standards, recognizing that these standards continuously evolve and improve.

China has not been shy when it comes to making the point that the AIIB will not only demonstrate governance that is as effective as that of existing multilateral institutions, but will do even better. At least on paper, the AIIB's governance structure has many positive elements: a simple and transparent formula for setting country voting shares, the absence

ZUTE LIGHTFOOT/ALAMY

of any single country's veto power over major decisions, and a non-resident executive board that supervises, but does not interfere with, the management of the institution.

These are all improvements over the rigid governance structures found in existing multilateral institutions. For instance, the IMF has a full-time resident executive board that costs a lot of money to maintain and ends up interfering in the regular operations of the institution rather than providing oversight. Efforts to change this structure have failed – in no small part because the very same executive board would have to approve the change.

China has declared that, while it has the largest voting share at the AIIB, it will not have veto power over majority decisions. This would mark a clear distinction from the IMF, where major policy decisions require a supermajority of 85 percent. The United States, with a voting share of 16 percent, effectively has veto power, something that many other countries have, on occasion, found galling.

In May 2016, Jin Liqun (who was appointed the AIIB's president) confidently asserted that the institution's membership would expand to 100 countries before the end of the year. He noted that, while Japan and the United States had declined to join, the door would always remain open to them and that, in any event, Japanese and U.S. companies would be treated fairly in the bidding process for AIIB-financed projects. He added, pointedly, that the bank was recruiting top talent from around the world, including from the United States – and was even in the process of appointing a Japanese national to a senior-level position.

Although the AIIB does not directly advance the RMB's role, there is little doubt that over time such institutions will create financial beachheads in other countries that China can use to promote the use of RMB in trade and finance. Meanwhile, even as it was setting up the AIIB, where it will be the dominant power, China has also been engaging its emerging-market allies on other fronts.

BONDING AMONG THE BRICS

China has taken a leadership role in a group of the major emerging market economies dubbed the "BRICS," comprising Brazil, Russia, India, China and South Africa. Together, they account for about one-quarter of world GDP and roughly two-fifths of world population.

Brazil, Russia, India and China held their first formal BRIC summit in Russia in June 2009 (South Africa had not yet been invited to join). The countries were bound together by not much more than an acronym coined by Jim O'Neill of Goldman Sachs, and a desire to exert greater influence in the international monetary system. This was spurred in part by the functioning of the G-20, a group comprising most of the major economies.

The G-20, in which emerging markets have roughly equal numerical representation with the advanced economies, had taken on the mantle of coordinating international policy during the depths of the global financial crisis in 2008. However, by the middle of the next year, the emerging market countries were beginning to feel that the advanced economies, which had precipitated the crisis to begin with, were running the show, both directly and through their control of the IMF and other major international institutions that assisted the G-20 in its work.

The four BRICs demanded a greater say in running major institutions and also in helping to design any changes in the rules and procedures governing international finance. They wanted to send a clear signal that they would no longer accept old arrangements whereby leadership of the major IFIs – the IMF for Europe and the World Bank for the United States

– would be carved up among the advanced economies through an implicit deal.

There was considerable skepticism about whether the BRICs had enough shared interests to be more than just a talking shop. These countries may all have common complaints about the advanced economies, but they are also geopolitical rivals. For instance, China and India have a long history of border tensions. It was hard to imagine that shared grievances directed at advanced economies would be enough for this group to coalesce on more constructive actions. This skepticism was, if anything, heightened when South Africa was invited to join the group in 2010. Clearly, the BRICS would have to put some money on the table to be taken seriously.

China, with its vast foreign exchange reserves, saw its opportunity to lead. First, the Chinese teamed up with others in the group to set up the BRICS New Development Bank. Established in July 2015, its main goal is to promote sustainable development in the five countries. Fearful of being sidelined, India lobbied unsuccessfully to locate the headquarters in New Delhi. China insisted the headquarters would be in Shanghai, and got its way.

Recognizing that further aggressive moves to take charge could create bad blood, China compromised on other elements of control. India was allowed to appoint the first president. The initial $50 billion of subscribed capital is derived from equal contributions by the five members, who also have equal voting shares and no veto power over decisions made by a majority.

In July 2015, the Contingent Reserve Arrangement, a $100 billion reserve pool among the BRICS, also came into being. China is notionally contributing $41 billion; Brazil, India and Russia, $18 billion each; and South Africa, $5 billion. The five countries do not actually put up this money, but simply commit to providing the agreed-on amounts if any one of them were to need hard currency to respond to a crisis.

Through these two new institutions, the BRICS have earned the right to be taken seriously as an economic group. They have shown they can put money on the table in a coordinated way, thereby easing concerns about how the lack of fully congruent – and often conflicting – economic and geopolitical interests could hamper their cooperation on the world stage. And with its vast financial resources, China has become the first among equals.

As is the case with China's growing presence at the IFIs, the BRICS initiatives do not directly elevate the RMB's role. Still, by fostering stronger financial linkages between the key emerging market economies and creating alternatives to the existing global financial architecture, China has devised another way of chipping away at the present configuration of global reserve currencies. It is not stopping at such initiatives, recognizing that its wealth could also be used to simultaneously promote its own development and that of its neighbors.

SILK BELT OR SILK NOOSE?

The Silk Road has long fascinated scholars investigating the many ways in which Asia and Europe were connected far back in history. But it was only in the late 19th century that German geographer Baron Ferdinand von Richthofen coined the phrase to refer to a specific route of east-west trade that has existed for about two millennia.

Despite the general notion that the Silk Road was a major conduit of commerce, some authors have argued that the importance of the routes in economic exchanges was far overshadowed by its prominence in cultural and religious exchanges. These routes

The first YXE international container train travelling from China to Iran.

facilitated the spread of Buddhism from India and of Islamic culture and religion from Arabia and Persia into Central Asia and China.

China's government likes emphasizing linkages to history, but the focus is now clearly on commercial interests rather than culture or religion. In the fall of 2013, President Xi Jinping proposed two major economic initiatives – the Silk Road Economic Belt and the 21st Century Maritime Silk Road. The two have come to be referred to jointly, and rather clunkily, as the Belt and Road Initiative.

The Belt and Road is envisioned as connecting a large and disparate group of economies, from the economically vibrant and rich to those that are poor yet have a huge potential for economic development. On land, it will focus on jointly building a new "Eurasian Land Bridge" and developing a few specific economic corridors: China-Mongolia-Russia, China-Central Asia-West Asia and China-Indochina Peninsula. The initiative will encompass existing plans for a China-Pakistan Economic Corridor and a Bangladesh-China-India-Myanmar Economic Corridor.

In November 2014, President Xi announced that the Silk Road Fund would begin operation the following month, with an initial commitment of $40 billion. The stated objective was "to promote connectivity and contribute to the realization of the master blueprint and bright future of the Belt and Road Initiative in accordance with a principle of market-orientation, international standards and professional excellence."

The notion of following market principles and meeting or exceeding the best international standards of governance permeates many of the documents. This is no doubt meant to emphasize that the Belt and Road initiative is not merely a device to strengthen control of China's or other countries' state enterprises. Moreover, China wants to make it clear that projects undertaken will not tolerate low technical, environmental or governance standards.

It is easy to see how, despite concerns held by developing countries in Asia about hitching their economic and political fortunes too closely to China, the initiative is tempting.

They desperately need better infrastructure, but lack the funding to build it.

During President Xi's visit to Pakistan in April 2015, he announced $46 billion worth of financial support for energy and infrastructure projects. This figure would eclipse all the economic- and security-related financial assistance given by the United States to Pakistan since 2002. Pakistan's prime minister Nawaz Sharif could barely contain his enthusiasm:

> Mountains and rivers join our territories; and our hearts and minds unite our nations.… We are good neighbors, close friends, dear brothers and trusted partners. We have an all-weather, time-tested cooperative strategic partnership. We are truly iron brothers.

The Belt and Road Initiative also conveniently ties in the international expansion of China's influence to the goal of improving the economic prospects of the country's underdeveloped western and southern provinces, many of which are landlocked. This would advance both the regional balance of China's growth and the level of internal integration of the economy. It would also provide a boost to growth, at least temporarily helping to address considerable overcapacity in manufacturing and opening more markets for Chinese exports.

Despite being open about the scope of the initiative, Beijing is sensitive to concerns that it is meant mainly to further China's economic interests and to serve as a tool for the political subjugation of neighboring countries. China is particularly sensitive about the political aspect, as it has long held that the United States and other Western countries have no business interfering in its own internal affairs, such as in the governance of Hong Kong and Tibet.

For instance, China has rejected any comparison between the Belt and Road Initiative and the Marshall Plan, the U.S. government's initiative (from 1947 to 1951) to help Western Europe rebuild its war-ravaged economy. Some scholars have argued that the Marshall Plan was as much a product of America's desire to protect its economic and geopolitical interests as it was an act of altruism.

OTHER ARMS OF THE OCTOPUS

Some of China's financial institutions are also playing a subtle but important part in expanding the country's role in international finance, with the RMB's rise being fueled through them in a backdoor way. The China Development Bank (CDB), for instance, makes overseas loans to Chinese corporations operating abroad, as well as to foreign corporations. At the end of 2014, overseas loans amounted to $163 billion, about 13 percent of the CDB's overall loan portfolio. But a year later, the CDB's overseas loan portfolio had risen to nearly $330 billion.

The Export-Import Bank of China is another institution that facilitates the country's expansion of influence abroad – largely through financing trade deals. Using data from secondary sources, one can estimate that in 2014 there was about $53 billion of overseas lending outstanding, amounting to 19 percent of the bank's overall loan portfolio.

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China is becoming a leader of the international community – not, as the West prefers, by being co-opted into existing institutions under the current rules of the game, but rather on its own terms. This goal subsumes another objective, which is to eventually alter the rules of global finance that China sees as conveying undue privilege to the existing reserve currencies. Among other ends, this would allow the RMB to fairly stake a claim to being one of the world's dominant reserve currencies.