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The Belt and Road Trilemma

THE FUTURE OF CHINA'S ROLE IN INTERNATIONAL DEVELOPMENT FINANCE

Felix Martin

Abstract

This working paper analyses the evolution of China's role in international development finance and explores how that role might develop over the next five years.

The rise of China as one of the world economy's leading trading nations over the past 25 years has been extensively analysed. The growth and persistence of unprecedented global financial imbalances—reflecting in part the so-called "China shock" to the world trading system—is also well documented. China's emergence in more recent years as the single largest bilateral official lender to developing country sovereigns under the auspices of the Belt and Road Initiative (BRI) has also been the subject of detailed academic and policy research.

This working paper seeks to add value by demonstrating the connections between these three trends, and by analysing how they relate to the recent evolution of international financial flows—and especially private financial flows to developing countries—more broadly.

The working paper concludes that as a result of the reversal of private capital inflows since 2021, China is increasingly confronted by a policy trilemma, according to which it will be forced to choose between (1) scaling back lending under the Belt and Road Initiative; (2) delaying or abandoning its commitment to the internationalization of the Chinese yuan; or (3) making domestic policy adjustments to revive capital inflows.

Precisely because China is now such a dominant player in global trade and finance, whichever choice it makes will imply systemic consequences for the international monetary and financial system. As a result, China's future role in international development finance will depend significantly on the increasingly contested geopolitical context for global trade and finance generally.

WORKING PAPER 721 • JUNE 2025

The Belt and Road Trilemma: The Future of China's Role in International Development Finance

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Felix Martin. 2025. "The Belt and Road Trilemma: The Future of China's Role in International Development Finance." CGD Working Paper 721. Washington, DC: Center for Global Development. https://www.cgdev.org/publication/belt-and-road-trilemma-future-chinas-role-international-development-finance

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Introduction

This Working Paper analyses the evolution of China's role in international development finance and explores how that role might develop over the next five years. The rise of China as one of the world economy's leading trading nations over the past 25 years has been extensively analysed. The growth and persistence of unprecedented global financial imbalances – reflecting in part the so-called 'China shock' to the world trading system – is also well documented. China's emergence in more recent years as the single largest bilateral official lender to developing country sovereigns under the auspices of the Belt and Road Initiative (BRI) has also been the subject of detailed academic and policy research. This Working Paper seeks to add value by demonstrating the connections between these three trends, and by analysing how they relate to the recent evolution of international financial flows – and especially private financial flows to developing countries – more broadly.

The historic context (1978–2001)

The story of China's role in international development finance begins with its remarkable domestic economic transformation in the last two decades of the twentieth century. In December 1978, China initiated the "Reform and Opening-Up" period of reforming and liberalising its hitherto heavily collectivised and centrally planned economy. Over the subsequent two decades, agriculture was de-collectivised and commercialised, restrictions on private enterprise were relaxed, markets were liberalised, and the banking sector and state-owned enterprises were restructured and in many cases privatised. These reforms generated dramatic improvements in agricultural and industrial productivity and produced the first episode of China's four-decade-long growth miracle. Real GDP per capita rose more than five-fold between 1980 and 2000. The proportion of the population living in poverty halved between 1978 and the turn of the millennium.[1]

The foundations of China's unique role in the 21st century global economy were also laid in this period. The reintegration of China into the world economy – following decades in which it had been relatively closed to foreign trade and finance – was a central plank of the post-1978 reforms. Under the "Open Door" policy, joint ventures with foreign investors were introduced and the first special economic zone accepting FDI was opened in 1979. In 1984, the same privileges were granted to 14 coastal cities. In the financial sphere, meanwhile, membership of the IMF and World Bank was transferred from the Republic of China (Taiwan) to China in 1980. In 1994, the dual exchange rate regime was unified in order to facilitate international trade and investment. The return of the Hong Kong SAR from UK sovereignty in 1997 marked a very important step-change in access to

1 World Bank/Development Research Center of the State Council, PRC (2022) *Four Decades of Poverty Reduction in China*, Figure 1.1.

international trade and capital markets. By most measures, China's capital account nevertheless remained unusually closed.[2]

For LMICs (low- and middle-income countries) more generally, these decades were characterised by severe volatility of both macroeconomic outcomes and international capital flows. Financial and commodity shocks originating from the advanced economies and the Middle East respectively sparked a widespread developing country debt crisis from 1982 on which effectively closed the private international capital markets for many LMICs. After several aborted attempts at restructuring schemes, the US co-ordinated Brady plan succeeded in reactivating private capital flows starting in 1989 – only to be overtaken by a rolling series of fresh crises in major LMICs including Mexico (1994), Asia (1997), the Russian Federation (1998), Brazil (1999), Turkey (2001), and Argentina (2001–02). The Asian crisis of 1997, in particular, caused a strong reversal of private capital flows to LMICs. The evolution of official capital flows was also dominated by responses to these crises. The 1996 Highly Indebted Poor Country (HIPC) debt reduction initiative released renewed ODA to the poorest sovereigns. The International Monetary Fund (IMF), meanwhile, was very active in emergency crisis lending – with the policy debate over its role dominated by the dilemma over whether its programmes were bailing out or bailing in private flows.[3]

Both China and other LMICs played only a peripheral role in the functioning of the International Monetary and Financial System (IMFS) during this period. Economically, the successive crises of the 1980s and 90s meant that even despite the East Asian growth miracle, LMICs actually accounted for a lower proportion of global GDP in 2001 (21 percent) than in 1980 (25 percent). In terms of global financial flows and balances, their share was smaller still. LMIC domestic banking sectors and capital markets were, in a global context, small and underdeveloped. Even the East Asian crisis of 1997 had little impact on the IMFS more broadly – though this was in part because of the stabilising influence of China's successful maintenance of its currency peg.

The behaviour of international capital markets in the years around the bursting of the advanced economy dot-com bubble in 2000 suggested however that a new era had dawned for LMIC capital flows. The systemically important increase in capital flows to the US and their subsequent reversal in the course of the dot-com boom and bust confirmed that the US remained at the centre of the IMFS. Yet the period leading up to and immediately after the crash also demonstrated for the first time the resilience – and even the counter-cyclicality – of the international market for LMIC bonds in particular. Between 1998 and 2002, the benchmark indices of both emerging market US dollar- and local currency-denominated sovereign bonds returned strong positive gains for US dollar-based investors, for example, even as US and emerging market equities registered double-digit losses. The ability of LMIC capital markets to attract capital flowing out of the US in the wake of

2 See e.g. Zhang, L. (2023) *Capital Account Liberalization and China's Financial Integration*, Harvard Kennedy School Mossavar-Rahmani Center for Business and Government, Figure 4.

3 See e.g. Roubini, N. and Setser, B. (2004) *Bailouts or Bail-Ins? Responding to Financial Crises in Emerging Economies*, Institute for International Economics.

market disruption was a novel phenomenon – and one which turned out to be a useful guide to the next decade.

China's emergence as an international creditor (2001–2013)

Following its accession to the World Trade Organization (WTO) in 2001, China rapidly became central to the international trading system. China continued to enact numerous highly significant, market-oriented, domestic economic reforms in the first decade of the twenty-first century, such as the inclusion of private property rights in the constitution in 2004. But it was China's accession to the WTO in December, 2001 which prompted its rapid emergence as a central player in the international economy. China's current account registered a surplus of just over US$17bn, or 1.3 percent of GDP, in 2001.[4] By 2007, it had grown more than twenty-fold to US$353bn – close to 10 percent of GDP. These large external surpluses reflected China's growing share of global merchandise trade. In 2001, China's share of global goods exports was approximately 7 percent.[5] By 2007, its share had grown to 11 percent. In 2015 it hit 16.5 percent, and has averaged the same level since (peaking at nearly 18 percent in 2021). By way of context, the closest historical comparators in the post-World War II period are the US in the 1950s (when its share of global goods exports averaged 15.8 percent) and Japan in the mid-1980s (when its share peaked at just under 10 percent in 1986).

The financial counterpart to the dramatic growth of China's international trade surplus was its emergence as a major international creditor in the IMFS. China's large current account surpluses – driven by its trade surpluses – generated foreign exchange savings which cumulated over time to make China a leading international creditor. Despite the stock of net foreign direct investment (FDI) in China increasing from less than US$200bn in 2000 to US$1.6tn in 2013, China's Net International Investment Position (NIIP) – the sum of all Chinese foreign assets, net of such liabilities to foreign investors – rose from only US$40bn to US$1.8tn over the same period.[6] If Hong Kong, SAR is included, China's NIIP topped US$2.4tn.

China's accumulation of foreign savings via external surpluses was part of a significant expansion of aggregate global imbalances, in which the US was the principal deficit country. Aggregate trade and financial imbalances in the international system peaked in 2006 – before shrinking significantly in the wake of the Global Financial Crisis of 2008. After averaging around 2 percent of world GDP throughout the 1990s, the aggregate global current account imbalance (the sum of individual country

4 Unless otherwise stated, all macroeconomic data is from the IMF World Economic Outlook database (October 2024).

5 Data on global goods export shares are from UNCTAD Data Hub.

6 All external sovereign balance sheet data from Milesi-Ferretti, G. M. (2024) *The External Wealth of Nations Database*, The Brookings Institution (based on Lane, P. and Milesi-Ferretti, G. M. (2018) "The External Wealth of Nations Revisited: International Financial Integration in the Aftermath of the Global Financial Crisis," *IMF Economic Review* 66, 189–222.) The Net International Investment Position (NIIP) figures reported here exclude gold (*Net IIP excl gold* series in the dataset).

external surpluses and deficits) grew significantly in the early 2000s, peaking at nearly 5.5 percent of world GDP in 2006 before falling back to around 2 percent in the wake of the global financial crisis of 2008–09. The surplus side of this evolving aggregate imbalance was primarily due to the external surpluses of China and of the commodity-exporting nations. On the deficit side, meanwhile, it was driven by a historically unprecedented US external deficit, which peaked at nearly 1.5 percent of world GDP (nearly 6 percent of US GDP) in 2006.

Given China's managed exchange rate policy, China's accumulated foreign savings took the form of central bank foreign exchange reserves denominated in US dollars. The pattern of aggregate international imbalances and US-China bilateral trade meant that the vast majority of China's accumulated foreign earnings were denominated in US dollars. Meanwhile, China's exchange rate policy (a fixed peg to the US dollar until July 2005, followed by a managed appreciation within a narrow trading band – interrupted by a temporary re-peg to the US dollar in between July 2008 and June 2010) meant that US dollar inflows on both current and capital accounts were generally acquired by the People's Bank of China (PBOC) and held as official foreign exchange reserves. The result was that the increase in China's NIIP reported above was more than entirely accounted for by the increase in China's official foreign exchange reserve holdings from less than US$170bn in 2000 to US$3.8tn in 2013 (US$4.2tn if Hong Kong SAR is included).[7]

This in turn determined the allocation of China's foreign assets, which were predominantly invested in US sovereign or quasi-sovereign debt securities. In common with most central banks, the PBOC maintains a very conservative investment policy for its foreign exchange reserves. The vast majority of the US$3.6tn of foreign savings accumulated as foreign exchange reserves over 2000–2013 were therefore invested either in US Treasury bills, notes, and bonds, or in Mortgage-Backed Securities issued by US government guaranteed agencies. The resulting inflows to these markets were so large that many analysts deemed them to constitute a 'Global Savings Glut' with significant macroeconomic effects – even, for some, a defining role in the global financial crisis of 2008–09.[8]

The ultimate drivers of the international imbalances of this period, and thus of China's emergence as a major international creditor nation, are much disputed. Traditional international trade theory furnishes simple and intuitive explanations for why trade exists between countries – but less so why large-scale aggregate external surpluses or deficits should persist over many years. China's cumulative surpluses during the 2000–13 period have therefore been variously explained either as a consequence either of its general economic development strategy (repression of domestic real wages in order to promote urbanisation and industrialisation), its welfare system (the lack of welfare provision by government leading to persistently excessive saving by households), or

7 Reserves figures exclude gold (*FX Reserves minus gold* series in the Milesi-Feretti (2024) dataset).

8 See, e.g. Bernanke, B. (2005) "The Global Saving Glut and the US Current Account Deficit", Federal Reserve Board; Wolf, M. (2014) *The Shifts and the Shocks*, Penguin Press.

its financial system (underdevelopment of domestic savings vehicles). Alternative – though not mutually exclusive – explanations have focused instead on policy and private sector behaviour in the high-income, external deficit economies: examples include excessive deregulation of credit markets and unreciprocated trade liberalisation. Yet another theory – usually associated with the Bank for International Settlements (BIS) – focuses on the IMFS itself, and identifies excessive elasticity of the balance sheets of globally active banks (a 'Global Financing Glut', rather than a 'Global Savings Glut') as a prime factor.[9]

For LMICs more generally, the 2001–13 period saw significant improvements across numerous economic, financial, and broader development metrics. After the crisis-plagued 1980s and 1990s, the 2000s proved a decade characterised by rapid growth, institutional improvements, and social and human development for most LMICs. Commodities – a crucial source of investment and export revenues for many LMICs – entered a structural bull market, driven in large part by incremental demand from China's rapid growth, which proved resilient even to the 2008–09 crisis. GDP growth averaged nearly 6 percent annually for developing countries as a whole between 2001 and 2013 – despite the global financial crisis of 2008–09. Investment rose from 25 to 32 percent of GDP; inflation fell from over 9 percent to under 5.5 percent; terms of trade steadily improved by more than 1 percent a year; fiscal metrics improved; and external debt fell by 7 percentage points relative to GDP, and more than 40 percentage points relative to exports. LMIC economic institutions underwent significant reforms as well. The number of emerging market central banks operating an inflation-targeting policy regime doubled, for example, and the number of governments adopting fiscal rules rose by even more.[10]

Combined with easy financing conditions in the main international reserve currencies, these developments led to a golden era for the globalisation of the IMFS and the integration of LMICs into private international capital markets. Whilst much of the LMIC growth boom was self-financing, 2001–13 was also a period of rapid integration of many LMICs into global capital markets, resulting in historically high and stable private capital flows. Net private FDI flows to developing countries grew from US$165bn annually in 2001, to US$430bn annually in 2008 and subsequently US$476bn in 2013. Net private portfolio investment in LMICs, meanwhile – which was negative in 2001 to the tune of more than US$50bn – turned positive by 2004, and reached a record high of US$240bn in 2012. This broadening of access to international private capital markets had several important ramifications for development finance in the period before the global financial crisis of 2008–09. First, access to private capital from both direct and portfolio investors meant that reliance on official sources of long-term development finance was significantly reduced for a top tier of LMICs (including several that graduated from multilateral and bilateral ODA altogether). Second, many LMICs, especially but not exclusively in Asia, opted to accumulate significant foreign exchange reserves (as China was

9 See for example Borio, C. and Disyatat, P. (2011) *Global imbalances and the financial crisis: link or no link?* Bank for International Settlements.

10 IMF and JPMorgan (2018). Sample analysed includes only 65 constituents of the JPMorgan EMBI index.

doing), as a means of self-insuring against the type of Balance of Payments crises that had plagued LMICs in the 1990s. As a result, reliance on the official sources for short-term foreign currency liquidity support also became a rarity – with Turkey the only large LMIC with an outstanding IMF programme by the mid-2000s.

One particularly novel development was the significant expansion and opening to international private investors of domestic LMIC capital markets. Prior to the turn of the millennium, the great majority of LMICs had suffered from an inability to borrow internationally in their domestic currencies. This 'original sin' – so called because it appeared to be unredeemable even by a history of stable macroeconomic policy – led to a dependence on borrowing in foreign currencies (predominantly the US dollar), and the subsequent balance sheet fragility that this implied.[11] Thus at the turn of the millennium, emerging market (EM) government bond markets had a total face value of US$700 billion and were around 60 percent US dollar-denominated. By 2013, however, this situation had been comprehensively transformed: EM government bond markets totalled US$7.5 trillion, of which more than 90 percent were denominated in domestic currencies.[12] The number of LMIC domestic currency government bond markets classified by JPMorgan, the leading international market maker in this area, as open to international portfolio investors, meanwhile, grew from only 2 in 2000 to 29 in 2013.

In summary, the 2001–13 period seemed to herald the repeal of several supposed laws of international development that had been thought key constraints on LMICs. The multi-decade declining trend in real commodity prices over most of the twentieth century and the resulting secular deterioration in the terms of trade of a significant share of LMICs, had long corroborated the Prebisch-Singer hypothesis that dependence on commodity exports was an insuperable obstacle to development.[13] Yet from the turn of the millennium, a sharp, decade-long recovery in real global commodity prices led to a steep improvement in the terms of trade of LMIC commodity-exporters and a decade of strong growth. For another (overlapping) group of LMICs, meanwhile, the opening up of domestic currency government debt markets to private international investors spelled release from the constraint of 'original sin'. Finally, the emergence of China as a major source of global demand, the reconfiguration of global supply chains, and the more rapid recovery of LMICs relative to High Income economies following the global financial crisis implied that the canonical dependency of the developing world on economic developments in the advanced economies was no longer strictly valid. Nevertheless, the severe shock of the global financial crisis itself undoubtedly demonstrated that even if global output, employment, and growth were increasingly influenced by China and the

11 The concept of 'original sin' was introduced in Eichengreen, B. and Hausmann, R., & Panizza, U. (1999) "Exchange rates and financial fragility".

12 Unless otherwise indicated, all data on LMIC government bond markets are taken from JPMorgan (2024) *EM as an Asset Class Evolves and Diversifies: a comprehensive analysis of the state of the EM fixed income asset class in 2024*.

13 Prebisch, R. (1950) *The Economic Development of Latin America and its Principal Problems*, New York: United Nations, and Singer, H. (1950) "The distribution of gains between investing and borrowing countries", *American Economic Review, Papers and Proceedings* 11 (473–485).

other LMICs, international finance was still overwhelmingly dominated by policy and private sector behaviour in the advanced economies. Yet that too was about to change.

China's emergence as a leading source of international development finance (2013–2019)

2013 witnessed a sharp tightening of global financial conditions, sparked by the 'Taper Tantrum' in US dollar markets. In May, 2013, the US Federal Reserve indicated for the first time that it was considering reducing the pace of the asset purchases it had initiated in 2009 in order to supplement its policy of a near-zero US policy interest rate. This unexpected policy shift caused a sharp sell-off in global bond markets: the yield on the benchmark 10 year US Treasury note, for example, rose from 1.7 percent at the end of April to 2.5 percent by the end of June, and 3.0 percent by early September. Global financing conditions tightened quickly and significantly, and the easy access of many LMICs to international capital, including to fund borrowing in their own domestic currencies, quickly went into reverse. The pace of opening of LMIC domestic government bond markets to international investors stalled, with only two further markets opening in the 2013–26 period. LMICs, it transpired, might have received absolution of their 'original sin' – but they remained very much at the mercy of monetary policy in the US and other reserve currency jurisdictions.

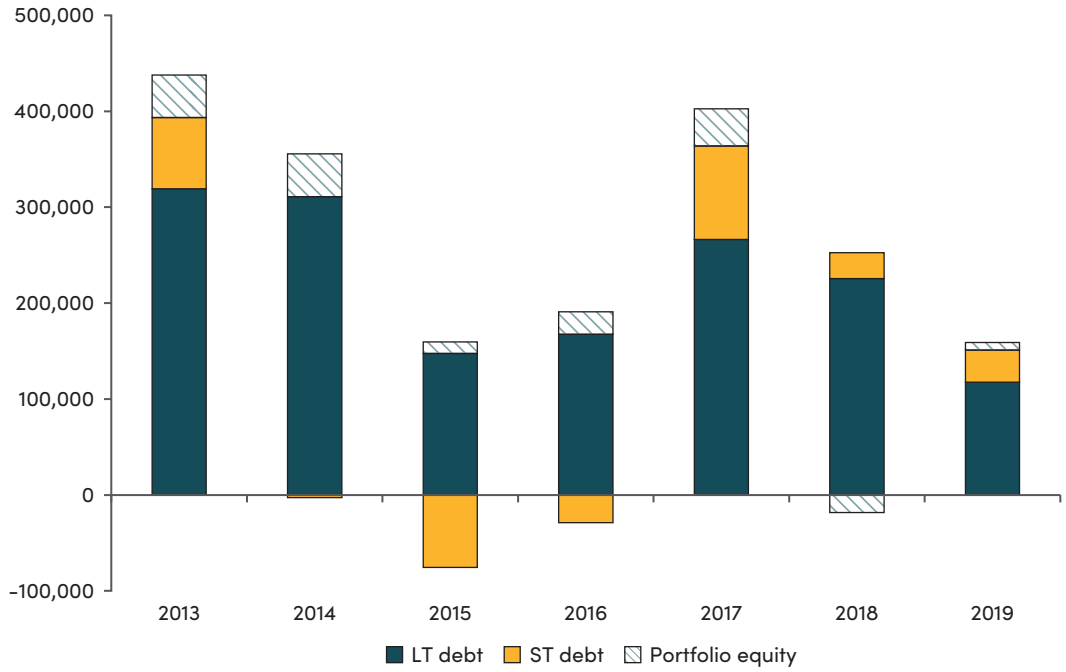
2014, meanwhile, saw a collapse of global commodities prices, which further impaired the access of many LMICs to capital. Following a rapid recovery after the global financial crisis, global commodity prices had stabilised at a historically high level since 2011. In mid-2014, however the slowdown in global economy caused by the tightening of financial conditions coincided with a supply glut induced by prior price increases. As a result, global commodity prices fell by 50 percent between April 2014 and December 2015 – wiping out, in nominal terms, more than a decade of price increases, and the terms of trade improvements these had brought. On its sixty-fifth birthday, the Prebisch-Singer hypothesis received a new lease on life.

The combined effects of these shocks was a severe decline in private capital flows to LMICs – and a lapse back into 'original sin'. Between 2013 and 2015, all classes of private capital flows to LMICs suffered a steep fall, and some went into reverse. Private long-term debt flows intermediated by both banks and bond markets were cut in half; portfolio equity inflows fell by three quarters. Short-term debt flows went into reverse for three years (2014–16). Excluding FDI, total net financial flows to LMICs (excluding China) fell by nearly 70 percent.[14] Non-resident capital inflows to domestic currency government bond markets were especially hard hit, collapsing by 95 percent between 2012 and 2016.[15]

14 All foregoing statistics from the World Bank's International Debt Statistics database.

15 Statistics from JPMorgan (2022) *Emerging Markets Local Markets Guide, 13th Edition*, based on sample of 13 investable LMIC (excluding China) domestic currency government bond markets.

FIGURE 1. Net private financial flows to LMICs (ex-FDI), 2013–19, US$ million



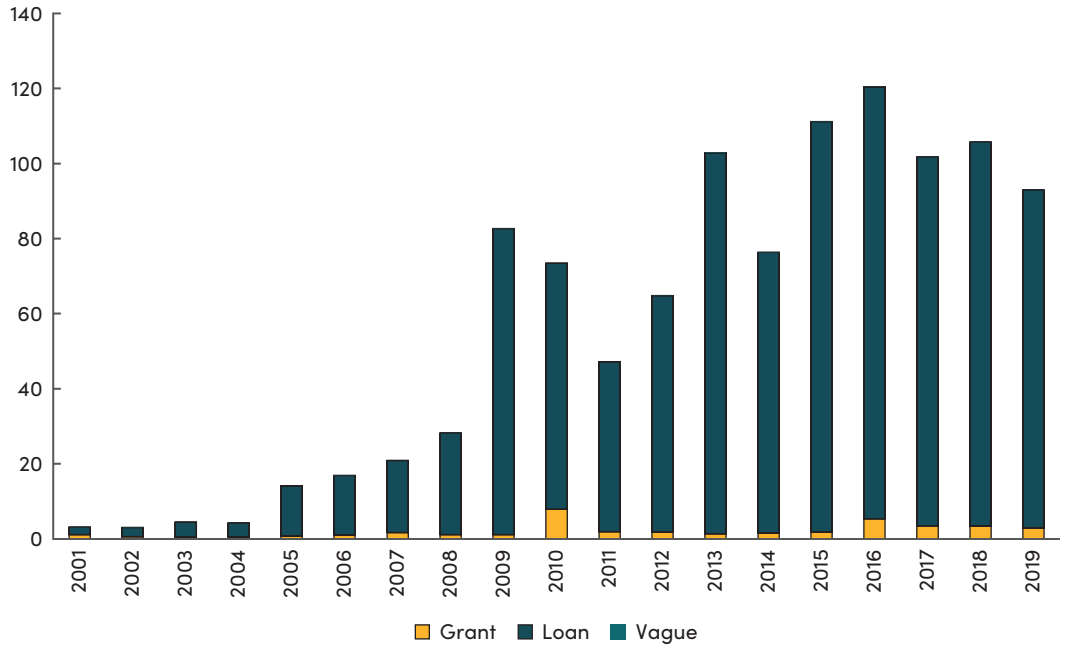
Source: World Bank International Debt Statistics.

This less favourable era for LMIC private capital flows coincided with a new administration in China with a new, ambitious, and multi-pronged international financial strategy. In 2012, Xi Jinping assumed the leadership of China's governing Communist Party. The Xi administration's international economic policy incorporated many points of continuity with its predecessors. In the field of international finance, however, it signalled a shift away from the previous policy of passive accumulation and allocation of China's foreign savings towards a more proactive strategy of deploying China's new status as a leading international creditor nation in the service of a number of specific policy objectives. Objectives included the securing of critical commodity inputs for the Chinese economy, and the development of transport and logistics infrastructure to facilitate Chinese trade with the rest of the world, as well as the promotion of economic development globally. At the same time, the Xi administration sought to continue the liberalisation and opening to foreign participation of China's own capital markets, and made the internationalisation of the Chinese yuan via its use in trade and finance a specific objective.

As a result, China transformed its role from that of a major international creditor alone into that of a leading force in long-term international development finance as well. The 2013–19 period thus saw a series of Chinese initiatives designed to capitalise on the unique, but still limited, role China had built up in the IMFS since the turn of the millennium in order to promote these new policy objectives.

The key, over-arching programme was the Belt and Road Initiative (BRI), launched in 2013.[16] This major, multi-decade (its stated completion date is the centenary of the foundation of the Chinese Communist Party in 2049), strategy anticipates the financing of some US$8tn of investment in more than 140 partner countries, primarily in infrastructure projects designed to facilitate international trade. Under the BRI, China's official financing flows to LMICs more than tripled from an average of US$30bn annually in the period 2001–12 to over US$100bn annually in 2013–19.[17] China also sought to leverage other official and private sector capital behind the BRI through the establishment of the Asian Infrastructure Investment Bank (AIIB) in 2015 – thought the contribution of the AIIB remained minor in the 2013–19 period.[18] Over 2013–19, China thus became by some distance the largest single source of official development finance to the developing world, providing some two and a half times more than the US – an amount almost on a par with all G7 countries combined.[19]

FIGURE 2. China: Official financial flows to LMICs, 2001–19, US$ billion



Source: Global Chinese Development Finance Dataset, Version 3.0.

China also constructed a sizeable network of swap lines between the PBOC and LMIC central banks, and thus became a significant source of short-term BOP assistance. International development finance has traditionally included both grant- and loan-funding for long-term investment projects (the role of IDA, the IBRD, and other MDBs, and most bilateral ODA and OOF) and short-term lending

16 All data on BRI financing in this section is from AidData (2023a) *Global Chinese Development Finance Dataset, Version 3.0*.

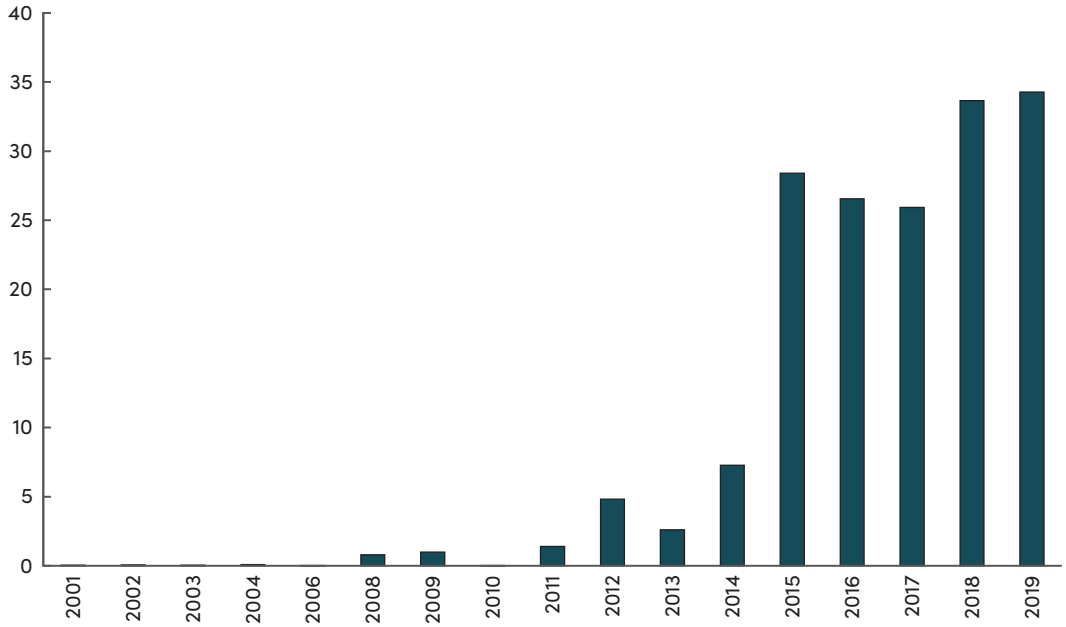
17 Nominal US$ totals, including both ODA (grants), OOF (loans), and other BRI funding (classified as "Vague" in AidData (2023a).

18 As of the end of 2019, the AIIB had raised US$23bn, the vast majority of which was equity contributions from shareholders and made US$2bn of loans. See https://www.aiib.org/en/about-aiib/financial-statements/index.html.

19 See AidData (2023b) *Belt and Road Reboot: Beijing's Bid to De-Risk Its Global Infrastructure Initiative*, Figure 1.5, p.12.

to alleviate emergency BOP needs (the role of the IMF, and also of swap lines between central banks). Only reserve currency central banks have typically been active in the latter role. The US Federal Reserve, for example, maintains swap lines with two particularly important Western Hemisphere LMICs (Brazil and Mexico), as well as a standing collateralised lending facility – the Foreign and International Monetary Authorities Repo Facility – with many others around the world.[20] Over the 2013–19 period, the PBOC dramatically increased its activity in this area, however, constructing a network of nearly 40 bilateral currency swap agreements with LMIC central banks, under which some US$160bn of RMB-denominated lending was disbursed.[21]

FIGURE 3. China: FX swap/emergency BOP lending to LMICs, 2001–19, US$ billion



Source: Global Chinese Development Finance Dataset, Version 3.0.

China's new strategy was not without contradictions, however – nor was China itself immune to the regime change in global financing conditions. China's strategy of internationalising the use of the Chinese yuan was predicated on the continued liberalisation of its capital account – which necessarily permitted greater capital outflows as well as inflows. At the same time, it relied on the ongoing managed appreciation for the Chinese currency against the US dollar which had persisted, with the exception of a temporary re-pegging between July 2008 and June 2010, since July 2005. The 2013 Taper Tantrum and the subsequent regime change in US market interest rates presented the Chinese authorities with the classical 'trilemma' of international economics, whereby it is

20 See https://www.federalreserve.gov/monetarypolicy/bst_liquidityswaps.htm. Lending under such standing swap facilities is usually classified as uncollateralized, in that it is offset by a loan of the borrowing central bank's own currency, but no other collateral is pledged.

21 These swap lines are uncollateralised, in the sense outline in n.20 above. The BOP lending under them is included in the overall official funding flows cited in the previous paragraph. Total IMF credit outstanding fell over the same period from around US$146bn to around US$101bn.

possible for a country to combine two, but not three, of a managed exchange rate regime, autonomy in domestic monetary policy, and an open capital account. China's commitment to internationalising the yuan implied that the openness of the capital account and the stability of the currency would have to take priority. But that meant that Chinese interest rates would have to be permitted to rise along with the yields on offer on US dollar assets – a loss of monetary sovereignty that could hardly be justified given the very different cyclical economic needs of the Chinese and US economies. For just over two years following the Taper Tantrum, the PBOC negotiated this trilemma by using its foreign exchange reserves to buffer capital outflows, even as capital account liberalisation continued with, for example, the introduction of the Stock Connect facility for portfolio equity flows in November 2014. But following a drop in foreign exchange reserves of nearly US$1tn in 24 months, the PBOC finally elected to devalue the Chinese yuan against the US dollar by 2 percent, and permit much greater flexibility in the exchange rate thereafter.

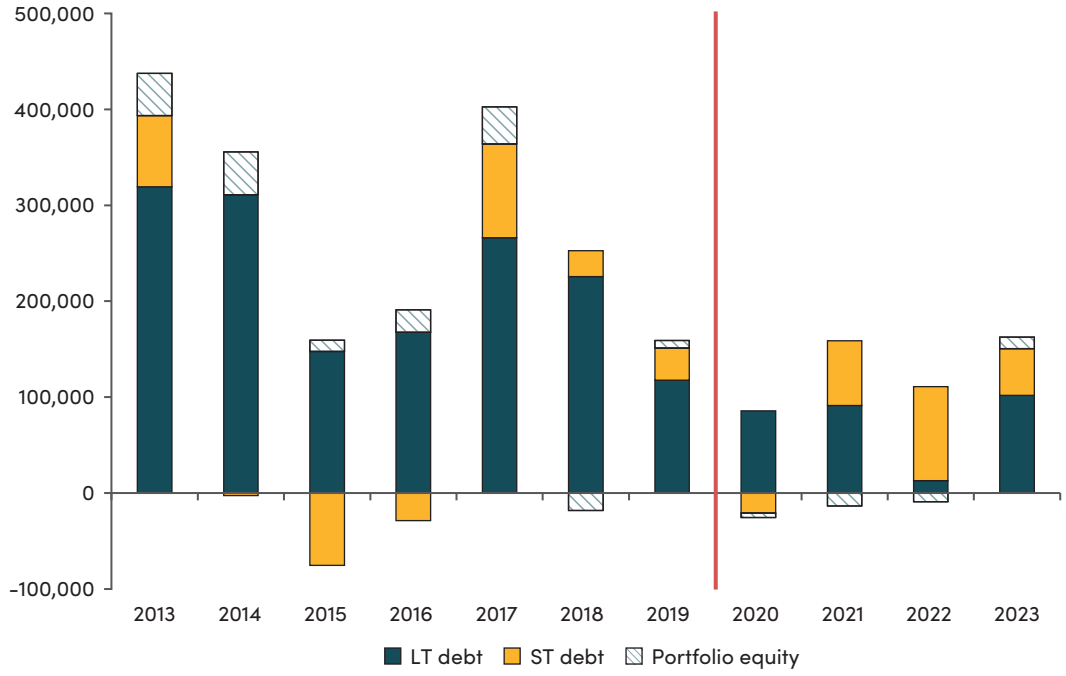
As a result, though 2013–19 was the period which saw China begin to deploy its prodigious stock of foreign savings proactively towards international development finance, it also witnessed the end of the era of rapid and consistent additions to that stock. Over the 2013–19 period, China's gross FDI and portfolio debt inflows slowed dramatically, and – since gross outflows (partly due to official flows under BRI) increased – net flows went into reverse. Starting in mid-2018, these pressures on China's stock of foreign savings via the capital account were exacerbated by the imposition of tariffs on Chinese imports by the US. The subsequent trade war saw foreign currency earnings through China's current account shrink from an average of US$210bn annually in 2013–17 to less than US$25bn in 2018 and only just over US$100bn in 2019. The net result of both factors was a significant reduction in the pace of China's accumulation of foreign assets – the stockpile on which its transformation into a leader in international development finance had been built. China's Gross Foreign Assets grew by an average of less than US$300bn annually in 2013–19, down from an average of US$460bn in 2001–13.

China's adaptation to the post-pandemic period (2020–2024)

The economic shock of the Covid-19 pandemic and its aftermath transformed the environment for China's role in international development finance yet again. The economic impact of border closures, lockdowns, and associated fiscal and monetary support policies across both advanced and developing countries during 2020–22 dramatically changed the context for international development finance. In the advanced economies, the pandemic was followed by a period of rapid inflation, to which central banks responded with aggressive monetary tightening, which saw both policy rates and market yields undergo a phase shift to levels not seen since before the global financial crisis of 2008–09. Between February, 2022 and August, 2023, the US Federal Reserve's target policy rate, for example, increased from 0.25 percent to 5.50 percent. The yield on the benchmark 10-year US Treasury note, meanwhile, peaked at close to 5.0 percent in October 2023, having troughed at 0.6 percent in August 2020.

The severe tightening of global financial conditions from 2022 on resulted in another collapse of private international capital flows to LMICs. From an annual average of US$220bn in 2013–19, net long-term portfolio debt flows to LMICs (excluding China) dropped below US$100bn in 2020 and 2021, and plummeted to US$13bn in 2022 as reserve currency interest rates commenced their steep ascent. Average annual inflows over 2020–23 dropped by two thirds relative to 2013–19.[22] Net portfolio equity flows, meanwhile, went into reverse in 2020, and did not turn positive again until 2023. In the poorest regions, the sudden stop was even more severe: average annual net long-term portfolio debt flows to Sub-Saharan Africa, for example, fell by 86 percent relative to their 2013–19 average. Meanwhile, the proportion of LMIC domestic currency government bonds held by non-residents – a barometer of LMICs' escape from 'original sin' – accelerated its descent, falling to close to 15 percent at the end of 2023 from a peak of nearly 25 percent in 2015.[23]

FIGURE 4. Net private financial flows to LMICs (ex-FDI), 2013–23, US$ million



Source: World Bank International Debt Statistics.

Meanwhile, China's economy has faced novel domestic challenges due to the exhaustion of its historic growth model. China pursued an especially forceful 'zero-Covid' policy response that involved strict border closures, travel bans, and city-wide lockdowns, including a two-month lockdown of the largest metropolitan area in the country, Shanghai in April-May 2022 which prompted a deep fall in measured consumer confidence which has yet to be reversed. The immense

22 Unless otherwise specified, all statistics in this paragraph from the World Bank's International Debt Statistics database.

23 JPMorgan (2024) *EM as an Asset Class Evolves and Diversifies: a comprehensive analysis of the state of the EM fixed income asset class in 2024*, Figure 6.

disruption of the pandemic also coincided with the crystalisation of several structural economic challenges, including a falling rate of total factor productivity growth, the bursting of a decade-long real estate bubble, the resulting financial distress of Local Government Financing Vehicles, and the interaction of low – and most recently negative – inflation with high levels of debt throughout the economy.[24] The net result of these challenges has been a significant slowdown in China's growth rate, from an average of more than 10 percent per annum in the 2001–13 period and nearly 7 percent per annum during 2013–19, to just over 4.5 percent since 2020.[25]

The external environment for China's global role in global trade has also become significantly more hostile since 2020 – though this has thus far not prevented China from continuing to report record surpluses. Following the pandemic, China's geopolitical relationship with many of the advanced economies has become notably more contested. Trade relations between the US and China, and more recently between the EU and China, have continued to deteriorate. The 2018 US tariffs on China were not rescinded by the 2020–24 Biden administration, and the new Trump administration has imposed a further 10 percent blanket tariff on all Chinese imports. The EU, meanwhile, has imposed tariffs on imports of electric vehicles (EVs) from China. China has in turn retaliated with tariffs on US and EU imports. In part due to the slowing of import demand due to the travails of its domestic economy, China's external surpluses nonetheless recovered to historically high (and in 2022, record) levels, with the current account surplus averaging US$325bn annually over 2020–23 after its dip in 2018–19.[26]

These foreign earnings on the current account have however been entirely absorbed in financing a historic reversal of flows on China's capital account, as foreign investors have retreated for both economic and geopolitical reasons. The economic effects of the changing geopolitical context have been felt not only in restrictions on trade, but in an unprecedented reversal of capital flows. Between 2021 and 2023, for the first time in the modern era, all major categories of gross inflows to China went into reverse.[27] Over the course of 2022 and 2023, both gross direct and portfolio equity liabilities fell (by US$320bn and US$50bn respectively), as did gross debt liabilities (by US$300bn), as non-resident investors went into retreat. At the margin, the effect of these gross outflows on China's NIIP has been moderated by a parallel reversal of outward portfolio equity and debt flows – though although

24 Falling productivity growth: Rajah, R. and Leng, A. (2022) *Revising down China's rise*, Lowy Institute. Bursting of real estate bubble: Rogoff, K. and Yang, Y. (2024) "China's real estate challenge", *Finance and Development* December 2024. LGFVs: IMF (2024) *People's Republic of China 2024 Article IV Consultation* and passim in previous IMF reports. Interaction of deflation and indebtedness: Wei, L. (2024) "Xi Digs In With Top-Down Economic Plan Even as China Drowns in Debt", *Wall Street Journal*, 23 Dec 2024.

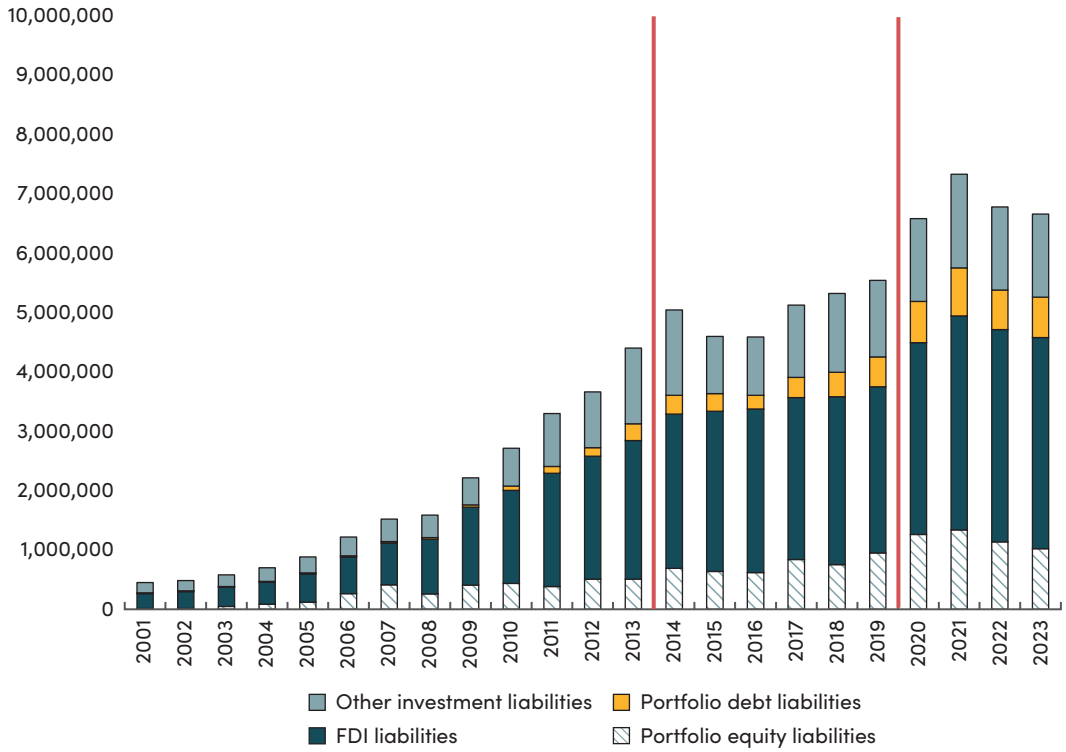
25 IMF World Economic Outlook database (October 2024).

26 Ibid. Also notable is the changing composition of China's aggregate current account surplus. Prior to 2021, it was almost wholly accounted for by China's surplus with the US and EU; but by 2023, approximately one third was due to China's surplus with the rest of the world.

27 As previously, the external sovereign balance sheet data here is from Milesi-Ferretti, Gian Maria (2024).

China's outward FDI flows have continued at a rate of around US$150bn annually.[28] Overall, however, they have effectively absorbed almost all of the near US$670bn of foreign earnings on China's current account in reducing China's gross foreign liabilities, while, for the first time since 2015, China's gross foreign assets have stalled for two years in a row.

FIGURE 5. China: Gross foreign liabilities, 2001–23, US$ million



Source: Brookings Institution External Wealth of Nations Database.

The 2020–24 period has thus surfaced further dilemmas for China's international financial policy: one example is the way in which China's role as a leading surplus nation represents an obstacle to the internationalisation of its currency. Beyond heightened geopolitical tensions, the reversal of capital flows to China was evidently also a result of the return – with a vengeance – of the classical trilemma which bound in the aftermath of the Taper Tantrum and which eventually resulted in the 2015 recalibration of China's managed exchange rate policy, as discussed above. The developments of the 2020–24 period have also exposed other dilemmas for China's international financial policy. One is the intrinsic contradiction between the strategic objective of internationalising use of the Chinese yuan and the fact that China's leading role in the IMFS necessarily consists in the reinvestment of its very large stock of predominantly US dollar-denominated foreign savings – a

28 Data recently released China's State Agency for Foreign Exchange (SAFE) and reported by Bloomberg News on 14 February 2025 suggests that these trends, at least as far as gross FDI flows are concerned, continued in 2024: China saw about US$170bn of outward FDI, while inward FDI was close to zero.

cycling of capital flows which entrenches the US dollar as the world's *de facto* reserve currency, and does little to promote the international use of the Chinese yuan.

It has also exposed tensions between China's reallocation of those savings to finance BRI investments and the stability of its external balance sheet. The novel situation since 2022 in which China's gross foreign assets are no longer growing, as a result of the need for current account inflows to fund capital account outflows, has raised the question of whether the liquidity – and potentially the creditworthiness – of the assets into which China's stock of foreign savings was reallocated under the BRI programme during the 2013–19 period is consistent with the stability of China's sovereign balance sheet, given the rest of its chosen policy mix. As a result of the regime shift in global financial conditions since 2022 and the collapse in private capital flows to LMICs described above, the IMF currently classifies more than half of all LICs either as in or at high risk of debt distress, and several – Ghana, Sri Lanka, Zambia, and Ethiopia – have defaulted on their international borrowings.[29] As part of the BRI, China is the single largest bilateral official creditor of many of these counties.

A third critical factor affecting China's international financial policy introduced in the 2020–24 has been the financial sanctions imposed on Russia following its invasion of Ukraine in 2022. Following Russia's invasion of Ukraine in February, 2022, the G7 group of industrialised nations imposed a series of packages of economic sanctions. Notably, Russia's US dollar- and euro-denominated foreign exchange reserves custodied within G7 jurisdictions (accounting for approximately half of Russia's total US$650bn reserves) were frozen; and the Russian financial system was effectively cut off from the rest of the world via the closure of correspondent banking relationships, the suspension of Russia from the SWIFT messaging system, and the ejection of Russian institutions from the Euroclear and Clearstream settlement systems. The unprecedented nature of these sanctions exposed an obvious risk for all countries holding substantial external savings denominated in the currencies, and custodied in the jurisdictions, of G7 members; as well as those reliant upon the US and eurozone banking systems and their international networks and settlement facilities. They significantly raised the attractiveness of diversification into alternative reserve assets such as physical gold, and of the establishment of alternative correspondent banking and settlement networks.

China's domestic economic policy priorities have evolved in the face of this dramatically changed domestic and external environment. China's domestic economic challenges and the reversal of non-resident capital flows have resulted in several significant shifts in China's economic policy since the start of President Xi's third term of office in 2023. Domestic policy has been refocused on the principle of 'dual circulation' (first introduced in 2020), which aims at building up resilient domestic supply chains funded with local capital to meet China's domestic needs in parallel – but separably – from an externally-oriented, export-focused sector which may be financed with non-resident capital. Policy has been set to encourage the rebalancing of the domestic economy away from the real estate sector and basic manufacturing towards the technology and digital sectors.

29 See IMF (2024) *List of LIC DSAs for PRGT-Eligible Countries, As of October 31, 2024.*

The extensive losses on real estate valuations that have been propagating through the economy since China's property price downturn began in the second half of 2021 have meant that this industrial restructuring strategy has so far proved strongly disinflationary. Indeed, China's GDP deflator – the broadest measure of the domestic price level – has been in outright deflation since mid-2022.

Likewise, China's international financial policy has also changed in light of the emerging tensions in its 2013–19 strategy. The G7's sanctions on Russia have encouraged China to accelerate the diversification of its official reserves out of their traditional focus on US government issued- and guaranteed bonds, and away from custody in the US itself. It seems that the accounts on which reserves are acquired and held are also being diversified – with China's large state-owned banks increasingly acting to absorb foreign currency current account inflows.[30] Alongside these more defensive measures to preserve the objective of internationalising the use of the yuan, China has also reinforced proactive policies. One example is a strategy of seeking to denominate more import transactions in Chinese yuan (for example in the pricing and settlement of commodity imports).[31] Another is the scaling-up of China's competitor international payments settlement system, the Cross-border Interbank Payment System (CIPS), launched in 2015.[32]

Finally, China's strategy for its role in international development finance has also begun to adapt – though as of 2021, it was still maintaining BRI lending at a high level. As of 2023, China's reallocation of its foreign savings towards the BRI had accumulated a total exposure to LMIC sovereign borrowers estimated at between US$1.1tn and US$1.3tn.[33] More than half of these loans had already entered their repayment period – and by 2030, three quarters were scheduled to do so. In several, high-profile cases, China was already embroiled in debt restructuring negotiations as a result of defaults by sovereigns to whom it was the largest bilateral official lender – and by one estimate, 80 percent of its international development lending portfolio was supporting borrowers in financial distress. With its overall stock of net foreign savings in decline since 2021, meanwhile – and potentially more demands on it in future to help support the authorities' domestic economic restructuring strategy – China's deployment of further incremental allocations to international development finance carried a much higher opportunity cost. Nevertheless, China's maintained a significant pace of international development finance in 2020 and 2021 (the latest years for which data is available), providing US$145bn in ODA and OOF across these two years – making it still comfortably the single largest bilateral official lender to LMICs.

30 See Setser, B. (2024) "China's New Currency Playbook", Council on Foreign Relations.

31 See Choyleva, D. and McMahon, D. (2022) *China's Quest for Financial Self-Reliance: How Bejing Plans to Decouple from the Dollar-Based Global Trading and Financial System*, Enodo Economics and Wilson Center.

32 According to research by the Board of Governors of the Federal Reserve System, CIPS "adoption has sped up following war-related sanctions on Russia in 2022 … That said, at a daily usage of about $60 billion, the volume of payments processed by CIPS are dwarfed by the $1,800 billion payments processed each day by the Clearing House Interbank Payments System (CHIPS), which is the main method of settling large U.S. dollar transactions." von Beschwitz, Bastian (2024). "Internationalization of the Chinese renminbi: progress so far and outlook" FEDS Notes.

33 Statistics in this paragraph are from AidData (2023b), Executive Summary.

China's role in international development finance (2025–2030)

China's changed domestic and external economic environment means that it faces important policy trade-offs over the next five years that will directly affect its role in international development finance. The combination of domestic economic challenges with the stalling of external asset growth as a result of the reversal of capital inflows has put China in an unfamiliar position. While China's growth was strong and it was attracting capital inflows from foreign investors on top of its export earnings, it faced no trade-off between the liberalisation of its capital account and the recycling of inflows to finance lending under the BRI. Now that capital flows have reversed, however, potential inconsistencies between these two aspects of China's international economic policy have emerged.

In essence, China faces a policy trilemma which will likely require trade-offs between continued BRI expansion, its ambition to internationalise the Chinese yuan, and its current domestic economic policy mix. A simple framework with which to analyse the constraints on China's role in international development may evolve over the next five years is that of a trilemma between three policy priorities. The first is the continuation of BRI lending. The second is the ongoing internationalisation of the Chinese yuan, and its prerequisite, the stability of China's external balance sheet and the continued liberalisation of capital account transactions. The third is the domestic policy mix to which the Chinese authorities are currently committed in order to resolve financial distress in the real estate and local government sectors, restructure and rebalance the economy in accordance with the principle of "dual circulation", and raise economic growth. Whilst it is not the case that a strict trilemma between these policies now exists, in the sense that any two, but not all three, are compatible, the reversal of foreign capital inflows has made it more difficult to pursue all three of these objectives equally. China is likely to have to prioritise more aggressively between them in the future.

In one scenario, China's role in international development finance via the BRI will be de-prioritised. Perhaps the most likely route out of this policy trilemma would be for China to scale back its lending under the BRI. The extent of the adjustment might be simply to accommodate China's official ODA and OOF outflows to the new, much reduced pattern of private inflows. An additional step might be to reallocate BRI lending away from LMICs and towards more liquid and higher-rated investments as it matures, effectively reversing the shift in the composition of China's official foreign assets since 2013 – though given the typically long tenors of most BRI loans, this could contribute only marginally to any adjustment. As discussed above, there is as yet no evidence that China is implementing either of these options – and indeed, the widespread risk of financial distress amongst BRI borrowers assessed by the IMF would suggest that active reduction of exposure without incurring credit losses

would be challenging.[34] Nevertheless, given the reversal of gross capital inflows to China since 2021, a reduction official Chinese outflows to fund ODA and OOF would represent a simple means of preserving the size and composition of China's external balance sheet.

A second scenario would see less emphasis placed upon the internationalisation of the Chinese yuan in the future. Broader use of the use of the Chinese yuan in international finance depends upon the continued liberalisation of China's capital account transactions – a necessary condition – and foreign investor confidence in the credit quality and liquidity of China's external asset holdings. An alternative route out of the trilemma would be for the Chinese authorities to relax either or both of these constraints, with the expectation that this would slow or even reverse the internationalisation of the Chinese yuan. Continuing BRI lending at a high rate in the context of stalled gross foreign asset growth, for example, would lower the overall credit quality and liquidity of China's external balance sheet, and thereby discourage international adoption of the Chinese yuan. Alternatively, attempting to stabilise capital outflows by the selective re-imposition of capital controls might in principle prevent this deterioration in balance sheet composition, but in practice likely be highly detrimental to the longer-term prospects for internationalisation.

A third scenario would see China adjust its domestic economic policy in such a way as to stabilise or reverse capital outflows and restore the status quo ante. The tension between maintaining BRI-related official outflows and the internationalisation of the Chinese yuan would recede if gross private capital flows were to turn positive again. To the extent that the outflows since 2021 have been exacerbated by the domestic policy mix that the Chinese authorities have chosen in order to promote industrial restructuring and economic rebalancing within China, a third potential scenario is that China continues to prioritise both its role in international development finance and capital account liberalisation, while making material adjustments to its domestic economic policies. It might seem surprising that a country might prioritise the continued provision of ODA and OFF over domestic economic policy – not least in the context of recent decisions by the US and a number of European donor countries to do the opposite. Yet as discussed above, China's BRI represents a unique strategy globally, in that its objectives combine international development policy, diplomacy, and the management of China's accumulated gross foreign assets. It is thus a more integral part of China's overall economic strategy than in other large providers of development finance.

China's prioritisation between these three scenarios will take place in the context a variety of longer-term challenges. China's future domestic and international economic strategy will also be constrained by several structural factors. China's working-age population peaked in 2015 at approximately 1 billion, but is projected to fall by 70 million by 2035 and a further 120 million by 2045 – one of the steepest declines globally, and by far the largest in absolute terms.[35] At the

34 China's record of engagement in several cases where sovereign defaults have already occurred over the last few years (e.g. Ghana, Zambia, Sri Lanka, Ethiopia) has been the subject of much debate and analysis – but as yet has not revealed a settled strategy. See AidData (2023b) for details.

35 UN Department of Economic and Social Affairs (2024) *World Population Prospects 2024*.

same time, China's old-aged population is projected to grow to above 310 million in 2035 and above 370 million in 2045. All else equal, these demographic projections imply a shift towards the depletion of domestic and international savings over the next two decades. More immediately, meanwhile, China's highly successful economic development, and its resulting higher real wage levels, have been stimulating a rebalancing of global manufacturing supply chains even before the recent outbreak of trade protectionism – making China's domestic industrial upgrading and its own off-shoring of manufacturing capacity to lower-wage jurisdictions a matter of necessity to some degree.

Moreover, the size and importance of the Chinese economy in the global trade and the IMFS mean that any resolution of the trilemma will require adjustment from the rest of the international system as well – representing an additional constraint on future scenarios regarding its role in international development finance. As discussed in Sections A and B above, China's ability to assume a leading role in international development finance over 2013–24 is a direct consequence of its parallel emergence as the largest trading nation and the largest net external creditor (if Hong Kong S.A.R. is included) in the international economy more generally. As such, the effects of changes to Chinese domestic and international policies will almost always have systemic effects which will simply be accommodated by trading and financial counterparts. This fact is particularly relevant to any attempt to predict the evolution of China's international capital flows over the next five years – and hence the context for China's role in international development finance – given the increasingly contested geopolitics of global trade and finance. The stated policy of the new US administration, for example, is to reduce the US's bilateral trade deficit with China – a strategy which, if successful, would further slow or reverse China's accumulation of the foreign assets from which it has hitherto financed its ODA and OOF.

The management and allocation of the BRI has already evolved significantly over the past decade. The details of China's BRI strategy have undergone constant adjustment almost since the beginning of the programme. A major shift in emphasis occurred in 2018, with President Xi's call before the fifth anniversary of the BRI's launch for "a switch from *xieyi*, freehand painting for outlining broad strokes, to *gongbi*, the careful inscription of detail".[36] The post-2018 "BRI 2.0" was characterised by a closer management of project repayment, execution, and reputational risks within the BRI portfolio and pipeline.[37] It also saw an increased geographical focus on countries where China deems its soft power to be competitive with the US.[38] More recently, the September 2024 triennial Forum On China-Africa Cooperation (FOCAC) summit has indicated further evolution of the BRI strategy. First, the US$51bn China allocated for Africa over 2025–27 represents an increase on the US$40bn committed in 2021, but a confirmation of retrenchment from the totals of US$60bn committed in each of 2015 and 2018. Second, there has been a significant sectoral shift away from infrastructure,

36 Ang, Y. Y. (2019) "Demystifying Belt and Road: the Struggle to Define China's 'Project of the Century'", *Foreign Affairs*, May 2019.

37 See Parks, B. (2024) *Competing with Belt and Road 2.0*, Written Testimony by Dr. Brad Parks to the US House Select Committee on the Strategic Competition between the United States and the Chinese Communist Party.

38 AidData (2023b).

with only 30 projects identified, and towards projects in green and digital technologies and governance. Third, it appears that much of the 2025–27 commitment will comprise financing for Chinese firms active in Africa, rather than lending directly to African governments or firms. Finally, the emphasis on trade has shifted from export promotion (for which US$10bn was earmarked in 2022–24) to the granting of tariff-free access to the Chinese market for 33 Least Developed African Countries.[39]

The recent steep deterioration in US-China trade relations is likely to increase pressure on the funding of the BRI, and so to spur more dramatic change, if it persists. On April 2, 2025, the US unveiled a comprehensive new system of import tariffs that will be levied on most of America's trading partners. By April 18, the effective tariff rate on Chinese merchandise imports had been raised to 145 percent, with a variety of sectoral exemptions. China has imposed retaliatory tariffs with an effective rate of 125 percent on US merchandise imports. Preliminary international trade statistics for the first quarter of 2025 indicate that China's goods trade surplus hit an all-time high of US$275bn (for a total goods surplus of nearly US$1.1tn over the year to March 2025).[40] That total is likely to represent front-running of the impending tariffs, however. Absent a rapid defusing of the US-China trade war, it is likely that Chinese exports will suffer significantly in coming quarters. If the reversal of FDI and other capital inflows does not abate, the resulting decline in export earnings will increase pressure on China's Balance of Payments, sharpening China's policy trilemma set out above. As discussed above, such a scenario may lead to a further reduction in funding for the BRI, as a direct means of countervailing the reduced availability of external savings via the current account. It is also possible, however, that the sheer scale of the shock to China's international economic relations represented by the US's tariff offensive may stimulate more far-reaching reforms to China's economic policy. In that case, it is possible that less emphasis is placed in future on the other two legs of the trilemma, and BRI funding is maintained at a higher level.

The US's radical reform of its own ODA, its new system of import tariffs, and pressure to increase spending on defence in other major donor countries, meanwhile, are likely to put further severe pressure on capital flows to LMICs. On January 21, 2025, the US suspended all foreign aid for a period of 90 days pending "assessment of programmatic efficiencies and consistency with United States foreign policy".[41] On March 28, 2025, it was announced that the US Agency for International Development will be dissolved as an independent agency, and there is as yet little visibility on the level or composition of future US international development finance.[42] The US's new system of import tariffs will also affect most LMICs negatively – some very significantly so – and so discourage private capital inflows.[43] Finally, the advent of a more contested geopolitical landscape is already leading

39 Sun, Y. (2024) *2024 FOCAC Beijing Summit: A new chapter?*, Brookings Institution; and *FOCAC 2024 Action Plan (2025–27)*.
40 Bloomberg News, 14 April 2025, "Tariff Shock Awaits China After Trade Surplus Hits $103 Billion".
41 US Executive Order 14169, 21 January 2025, "*Reevaluating and Realigning United States Foreign Aid*".
42 See e.g. Kenny, C. and Collinson, E. (2025) *The USAID Fait Accompli*, Center for Global Development.
43 Mathiasen, K. and Martinez, N. (2025) *The US Administration's Tariff Regime: A Case for Moving from Reprieve to Relief*, Center for Global Development.

to budgetary reallocations in other leading donor countries away from development finance and towards defence spending.[44] Taken together, these developments will almost certainly be highly detrimental to LMIC capital flows – especially for the least developed countries – and thus exacerbate any pressures stemming from China's moderating role in international development finance.

Nevertheless, it is possible that a more multipolar world will also present opportunities for LMICs to offset some of these effects – making policy and institutional reforms designed to attract capital flows more essential than ever. The reversals in US economic policy in the first quarter of 2025 have been so large that it is not impossible that they generate some by-products that are ultimately positive for capital flows to LMICs. One example is the early signs that the risk premium attributed to US assets is rising, leading to a reduced international investor appetite for US markets, and rendering LMIC assets relatively more attractive. Another is that – in part as a result of this re-rating of the US risk premium – the US dollar has been weakening on a trade-weighted basis. Since the secular strength of the US dollar over the past decade has been a significant contributor to tight international financing conditions for LMIC borrowers, its reversal would represent an important relaxation. Finally, while the increased geopolitical tensions between the US and China are likely to raise risk premia across the board, there is potentially an opportunity for LMICs which are able to maintain good relations with both global superpowers to benefit from capital flows seeking politically neutral investment destinations.[45] In this highly uncertain environment, policy and institutional reforms designed to maximise the prospect of attracting private capital inflows are therefore more essential than ever for LMICs themselves.

44 See e.g. "UK to target 3% of GDP for defence spending, to cut aid budget", Reuters 25 February 2025.
45 See Martin, F. (2025) "Shifting world order suits 'inbetweener' economies", Reuters 4 April 2025.