

NBER WORKING PAPER SERIES

INTERNATIONALIZING LIKE CHINA

Christopher Clayton
Amanda Dos Santos
Matteo Maggiori
Jesse Schreger

Working Paper 30336
<http://www.nber.org/papers/w30336>

NATIONAL BUREAU OF ECONOMIC RESEARCH

1050 Massachusetts Avenue
Cambridge, MA 02138
August 2022, Revised January 2023

We thank the NSF (1653917), the Andrew Carnegie Corporation, the Sloan Foundation, and the Jerome A. Chazen Center for financial support. We thank Adrien Auclert, Manuel Amador, Andres Drenik, Barry Eichengreen, Zhiguo He, Zhengyang Jiang, Loukas Karabarbounis, Arvind Krishnamurthy, Narayana Kocherlakota, Guido Lorenzoni, Maurice Obstfeld, Pablo Ottonello, Diego Perez, Chris Phelan, Kenneth Rogoff, Christoph Trebesch, Rosen Valchev, Adrien Verdelhan, Olivier Wang, Shang-Jin Wei, Wei Xiong, Pierre Yared, Motohiro Yogo, and Vivian Yue for helpful comments and discussion. We thank Giovanni Bonfanti, Sergio Florez, Oliver Xie, Jialu Sun, and William Stukas for outstanding research assistance. Our analysis makes use of data that are proprietary to Morningstar and/or its content providers. Neither Morningstar nor its content providers are responsible for any of the views expressed in this article. The views expressed herein are those of the authors and do not necessarily reflect the views of the National Bureau of Economic Research.

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JEL No. E0,F2,F3

ABSTRACT

We empirically characterize how China is internationalizing the Renminbi by staggering the entry of different types of foreign investors into its domestic bond market and propose a dynamic reputation model to explain this strategy. Our framework rationalize China's strategy as trying to build credibility as an international currency issuer while reducing the cost of capital flight. We provide a sufficient statistic to measure countries' reputation over time and show that it can be estimated using micro data on foreign investors' portfolios. We use our framework to explore how countries compete to become a reserve currency provider.

Christopher Clayton
Yale School of Management
165 Whitney Avenue
P.O. Box 208200
New Haven, CT 06520-8200
christopherdclayton@gmail.com

Amanda Dos Santos
Columbia University
amanda.dossantos@gsb.columbia.edu

Matteo Maggiori
Stanford University
Graduate School of Business
655 Knight Way
Stanford, CA 94305
and NBER
maggiori@stanford.edu

Jesse Schreger
Columbia Business School
3022 Broadway
Uris Hall 821
New York, NY 10027
and NBER
jesse.schreger@columbia.edu

An online appendix is available at <http://www.nber.org/data-appendix/w30336>

With the third largest domestic bond market in the world behind the United States and the European Union, China is often described as a possible future international currency provider. However, unlike the U.S. and Eurozone bond markets, the Chinese bond market has been largely closed to foreign investors, severely limiting the use of the Chinese Renminbi (RMB) as an international currency. Over the last decade, that has begun to change and China has progressively opened its domestic bond market to foreign investment. While the internationalization process is in its early stages, the size of the market and the ongoing opening-up process makes the evolution of China's bond market an important dynamic at the core of the international monetary system. This paper empirically characterizes the Renminbi's internationalization and the changing nature of foreign investment and provides a tractable framework to shed light on the gradual strategy that the Chinese government is pursuing in the internationalization of the Renminbi.

We begin our analysis by providing a comprehensive characterization of foreign investment in China's domestic bond market (see also [Amstad and He \(2020\)](#) and [Amstad, Sun and Xiong \(2020\)](#)). We show that after being largely segmented from global capital markets, foreigners have now started investing in Renminbi-denominated bonds. The initial increase in foreign investment was driven by central banks while the more recent increase has been driven by private investors.

We demonstrate that this pattern of early investment by stable investors like central banks followed by flightier private investment was driven by deliberate policy choices of the Chinese government aimed at selecting the investor base. By introducing a series of foreign investment schemes with varying quotas, lock-up periods, and registration requirements, China was able to stagger the entry of different investor types into its domestic market. China began by allowing in more stable, long-term investors, such as central banks, sovereign wealth funds, and non-profits. After creating this stable investor base, China gradually loosened its array of restrictions to increasingly allow in flightier foreign investors such as passive and active mutual funds, exchange traded funds (ETFs), and some hedge funds.

The patterns documented above raise many interesting questions on how a large economy can or should internationalize its currency, what is the rationale for gradualism and selecting the investors base, and the effect of Chinese capital market liberalization on other bond markets around the world and interest rates. We develop a theoretical framework to make sense of the above facts and provide a way to think about these issues. The framework has three core ingredients: governments that are potentially opportunistic and may want to capture foreign capital in crises, heterogeneous foreign investors with varying degrees of flightiness, and slow building of reputation of issuing governments in the eyes of foreign investors.

We interpret the policy choices of China as trading off building reputation as a country capable of providing the global store of value and risking a disruptive foreign capital flight. Letting in foreign investors helps build reputation for the issuer in global capital markets, but letting in too many foreign investors, particularly flighty ones, can be counterproductive by exacerbating crises as the investors pull out in times of stress. Crises are costly both directly because they lead to costly liquidations, and also indirectly because attempts to limit a flight of capital via ex-post capital controls on outflows lead to a loss of reputation. In our model, the reputation of a government in the eyes of foreign investors is the perceived probability that the government will not impose ex-post capital controls. This captures

investors' fears of repatriation risk, the possibility that they will not be able to "get their money out of the country." The aim of the government is not to lower overall repayment to foreigners, as in a sovereign default, but instead to temporarily lock-in foreign capital to prevent costly unwinding of positions.

To capture the gradual opening up of markets to different type of investors, we introduce two classes of investors in the model. One class, stable investors, is less flighty in a crisis, in the sense of requiring less collateral in a crisis to roll over the debt. We view this class as capturing the behavior of central banks, sovereign wealth funds, but also some private investors that have particularly long horizons and stable funding (e.g. endowments and other non-profit institutions). The other class, flighty private investors, captures the majority of private investors like mutual funds, ETFs, and hedge funds.

We develop a dynamic reputation model in which a country, like China, chooses which classes of foreign investors to allow into its domestic bond market and how much to borrow from each type it lets in. In a crisis, foreign investors demand high collateral to roll over existing debt, forcing some assets to be liquidated to repay debt that cannot be rolled over due to insufficient collateral. Liquidating assets is costly, and the government is tempted to introduce ex-post capital controls to limit the flight by foreigners. However, the expectation that these controls might be imposed is precisely the reputational problem of the country: the more foreigners expect the country to impose the controls ex-post, the worse the terms of credit are ex-ante. This mechanism helps to shed light on how a country begins the process towards becoming an international currency (see also [Bahaj and Reis \(2020\)](#)).

Consistent with our empirical findings, the government only gradually opens the domestic bond market to foreigners. At low levels of reputation, the government chooses to only borrow from stable investors. At this stage of the internationalization process, the flighty private investors are too costly to allow into the domestic market. If the government does not institute ex-post capital controls on existing stable investors, then reputation increases over time and the interest rate schedule subsequently offered by foreigners becomes more attractive, increasing the government's desire to borrow more from foreigners. As reputation endogenously builds up, the value of letting more foreigners in becomes sufficiently high that the government allows flighty private investors into the domestic market. Importantly, the action of letting in private flighty investors itself increases the government's reputation, since it is a disproportionately expensive action to take for a government intending to impose ex-post controls.

Establishing reputation as an international currency issuer, like the U.S., is a slow and arduous process ([Eichengreen et al. \(2017\)](#)). Throughout modern history, many would-be contenders, like Japan or the Eurozone, have failed to displace the dominance of the dollar. [Sargent \(2012\)](#) stressed the importance and difficulty in building a reputation for the newly created United States in the 1780s and the newly created Euro Area in the 2000s. Whether or not the Renminbi will become a international currency is also uncertain. Our model offers a cautionary tale to optimistic views that China might quickly or straightforwardly emerge as an international currency provider. The stationary distribution of the model shows that countries endogenously spend most of the time at low levels of reputation and instituting policies that indeed confirm such low reputation is warranted. Governments that impose controls lose their reputation with investors, resetting their reputation cycle. At low levels of reputation, the cost of losing the existing reputation is also low, thus providing smaller incentives to building a better reputation.

Furthermore, reputation can only be built in the fire of a crisis. In normal times, when foreigners do not flee from the country's debt, the government is not tempted to tamper with foreign debt holdings. The lack of temptation also means that no reputation is built. Since crises are infrequent, so are opportunities to build reputation. In this respect, the behavior of a government during crises is a salient moment for investors to update their beliefs on the type of government they are facing. This updating is particularly strong for a country like China at the beginning of the internationalization process, because investors are unsure whether China will resist the temptation to impose controls on capital outflows in the face of a capital flight. As reputation builds, and investors assign higher probability that a government will not impose capital controls, it becomes more difficult to build it further and some governments decide that further gains in reputation are too small to justify not imposing capital controls in the next crisis.

Measuring reputation in the data is a notoriously difficult problem. Based on the model, we derive a sufficient statistic to track countries' reputation over time and estimate it in nearly real-time using micro data on foreign investors' portfolios. Intuitively, we track whether foreign investment funds that own RMB bonds are specialists in investing in emerging market or developed market bonds. Formally, we estimate at each point in time the correlation among investment funds between the share of the foreign portfolio invested in RMB bonds and the remaining share invested in a reference set of safe developed countries government bonds. We show that this measure can be estimated for all countries, not just China. Based on the model, a higher correlation points to a country's reputation closer to the reference set (countries of highest reputation). Consistent with the model, we find high positive correlations for countries such as the U.S. and Eurozone, and negative correlations for countries such as Brazil and South Africa. We find that China's reputation is in between emerging markets and developed countries. As predicted by the model, China's measured reputation increased as it opened up to flighty investors.

The model is tractable and can help make sense not only of new situations, like China's internationalization, but also the behavior of established players like the U.S. and their past trajectory. To better understand the interaction among countries competing to be a reserve currency, we develop a model of competition among issuing countries. Competition has a deep interaction with reputation building since countries' choices feature an interesting complementarity: if a country's competitors impose capital controls today and reset their reputation, then that country has higher incentives not to do so since tomorrow at a higher level of reputation it will capture a larger share of the market (face a better residual demand curve). We show that competition lowers the incentives to build a higher reputation by limiting the future benefits of becoming a reserve currency. In the extreme, committed governments could provide such high levels of competition as to deter any attempt by opportunistic governments to build reputation. More generally, we show that competition induces countries like China, currently at low levels of reputation, to spend more time (in a stationary distribution sense) at low levels of reputation. An established reserve currency issuer, like the US, can deter an up and coming competitor like China by issuing more safe debt to foreigners, thus satiating world demand more and leaving little space for the competitor (see also [Farhi and Maggiori \(2018\)](#), [Choi, Kirpalani and Perez \(2022\)](#)).

Finally, we extend the model to include two-way capital flows. Both gross foreign assets and liabilities grow in reputation, and crises with losses of reputation feature two-way retrenchment, a sharp contraction

in both gross assets and liabilities. A country like China can start as a large net foreign creditor at low levels of reputation. Even if the country has a high saving rate so that in equilibrium it is a net foreign creditor, its government chooses to borrow from foreigners while at the same time investing abroad in order to build reputation. Reputation is like a pledgable asset, it is valuable because one can borrow against it. The higher its value, the more the country wants to lever against it. As reputation builds, the net foreign assets position deteriorates and established reserve currency issuer tend to be net foreign debtors.

Related Literature. The internationalization of the Renminbi is an important global macroeconomic development that has attracted much policy attention but surprisingly little formal analysis, either empirically or theoretically. Our focus is related to the literature on China’s bond and currency market reforms like [Song and Xiong \(2018\)](#), [Cerutti and Obstfeld \(2018\)](#), and papers included in the handbook by [Amstad, Sun and Xiong \(2020\)](#).¹ [Xiong \(2018\)](#) and [Brunnermeier, Sockin and Xiong \(2022\)](#) focus on China’s gradualistic approach to managing the financial system and issues with local government financial leverage. [Song et al. \(2011\)](#) document a number of stylized facts about the nature of China’s economic growth strategy and provide a theoretical framework consistent with the observed patterns.

There is a recent theoretical literature on the international monetary system, mostly focusing on established international currencies like the U.S. Dollar and Euro ([Farhi and Maggiori \(2018\)](#), [He et al. \(2019\)](#), [Chahrour and Valchev \(2021\)](#), [Gopinath and Stein \(2021\)](#), [Drenik, Kirpalani and Perez \(2021\)](#), [Choi, Kirpalani and Perez \(2022\)](#)). An important exception is [Bahaj and Reis \(2020\)](#) who focus on the early process of jump-starting the Renminbi as an international currency. They focus on the unit of account and payments role of a currency and examine the role of the introduction of PBoC swap lines in leading the Chinese Renminbi to be adopted in the global payments system. We share a focus on competition among possible reserve currencies with [Choi, Kirpalani and Perez \(2022\)](#).

Our model of dynamic reputation is related to foundational work by [Kreps and Wilson \(1982\)](#), [Milgrom and Roberts \(1982\)](#), and [Barro and Gordon \(1983\)](#). [Diamond \(1989, 1991\)](#) mixes dynamic reputation and adverse selection to study the dynamics of reputation acquisition in financial markets and the choice between bond and loan financing. Our modeling of reputation builds on the strand of literature that considers changes in type over time ([Mailath and Samuelson \(2001\)](#), [Cripps et al. \(2004\)](#), [Phelan \(2006\)](#), and [Mailath et al. \(2006\)](#)).² Our paper is related to the literature examining how reputational incentives can help sustain debt repayment by governments as in [Amador and Phelan \(2021\)](#) and [Fourakis \(2021\)](#).

Finally, our focus on the temptation that governments face in imposing ex-post capital controls and the presence of stable and flighty investors is related to the literature studying fire sales, liquidity, and heterogeneous investor bases ([Caballero and Simsek \(2020\)](#), [Clayton and Schaab \(2022\)](#), [Coppola \(2021\)](#)).

¹See also: [Prasad \(2017\)](#), [Mo and Subrahmanyam \(2020\)](#), and [Lai \(2021\)](#).

²See also [Tadelis \(1999\)](#) and [Lu \(2013\)](#).

1 Background on China’s Bond Market

We begin by providing a brief overview of China’s bond market. For more comprehensive introductions to the market, see [Amstad and He \(2020\)](#) in [Amstad, Sun and Xiong \(2020\)](#), or [Schipke and Zhang \(2019\)](#). Today, China’s market is the third largest in the world, behind only the United States and the Euro Area. Appendix Figure [A.II](#) shows the remarkable growth in China’s bond market over the last 15 years, the value approaching nearly \$20 trillion at the end of 2020. In the last ten years, the size of China’s bond market surpassed that of the U.K. and Japan. The other large markets in Figure [A.II](#) are the closest to the textbook case of free capital movement, thus making China an interesting outlier due to the combination of market size and segmentation from the rest of world capital markets.

China’s central government had long been the largest issuer in domestic bond markets, with China Government Bonds (CGBs) used as the de facto proxy risk-free rate in local bond markets. The second most important category had long been policy-bank bonds, the bonds of the large Chinese state-affiliated policy banks (Agricultural Development Bank of China, China Development Bank, and the Export-Import Bank of China). The bonds of these banks are generally assumed to be implicitly guaranteed by the central government. Recently, both of these categories were supplanted by local government bonds ([Xiong \(2018\)](#)). The rest of the market, which is much smaller than the above three governmental or quasi-governmental set of issuers, is composed of bonds issued by firms, either State Owned Enterprises (SOEs) in the form of enterprise bonds, corporate bonds by private firms, or bonds issued by commercial banks.

Through much of its development, China’s bond market was essentially closed to foreign investors. That began to change in the early 2000s. Rather than open its domestic bond market to all foreign investors at once, China instead pursued a gradual liberalization policy. China’s policy of opening up began by allowing in foreign investors with strict limits on the size of investment via quotas and by regulating the type of investors that could enter through special programs with demanding application processes and often lengthy lock-up periods. Over the last 20 years, China reduced each of these barriers gradually, allowing larger investment scale, a greater variety of foreign investors, and increasingly allowing foreign investors to quickly take their money out of the country.

The liberalization process took a major initial step in 2002 with the introduction of the Qualified Foreign Institutional Investor (QFII) program.³ Under this system, following a fairly onerous registration and application process, investors could gain access to domestic stock and exchange-traded bond markets. However, most of the foreign investment via QFII was in the Chinese stock market as the exchange-traded bond market is a small share of the overall bond market.⁴ In these early stages, the quotas were small and only a narrow range of investors actually gained access to the market. Importantly, QFII investment was originally subject to a one-year lock up period. In 2009, this was lowered to three months for “pension funds, insurance funds, mutual funds, charitable funds, endowment funds, government and monetary authorities and open-ended funds” ([ASIFMA \(2021\)](#)).

³The Renminbi Qualified Foreign Institutional Investor (RQFII) was introduced in 2011, allowing investors to use RMB to enter the market rather than foreign currency. The programs were merged in 2020.

⁴[Amstad and He \(2020\)](#) note that 90% of foreign investment through these programs went to the stock market, with the small remaining share going to bonds.

In the 2010s, China significantly broadened direct access to the domestic bond market, allowing foreign participation in the China Interbank Bond Market (CIBM). The primary participants were central banks and other official investors, like sovereign wealth funds, and they could directly access the interbank market. In 2013, QFII and RQFII participants were allowed access to the interbank market (Guo (2019)). In 2015, the People’s Bank of China (PBoC) allowed full access without a quota to the interbank bond market for long-term investors such as central banks and sovereign wealth funds (Amstad and He (2020)).⁵ These reforms helped meet the requirements for the Renminbi’s inclusion in the SDR (Special Drawing Rights) basket in 2016. Quota restrictions were removed for all investors with the launch of CIBM Direct in February 2016 (Guo (2019)), but this form of access still required direct access to China’s bond markets with its accompanying regulatory and registration hurdles (Schipke et al. (2019)).

These hurdles were significantly lowered in 2017 with the introduction of Bond Connect. Unlike earlier programs, Bond Connect is based offshore in Hong Kong and can be accessed via standard trading platforms like Bloomberg without the registration requirements of QFII or CIBM Direct.⁶ The ease of access into the Chinese market via Bond Connect was seen as an important reform to facilitate China’s inclusion in global bond indices such as the Bloomberg Global Aggregate Index and the JP Morgan Government Bond Index - Emerging Markets (GBI-EM). In order to be included in these indices, bonds must be freely tradable, there cannot be substantial capital controls, and in some cases hedging instruments need to be available. In its 2018 press release announcing the inclusion of RMB bonds, Bloomberg wrote: “In order to be considered for inclusion in the Global Aggregate Index, a local currency debt market must be classified as investment grade and its currency must be freely tradable, convertible, hedgeable, and free of capital controls. Ongoing enhancements from the PBoC have resulted in RMB-denominated securities meeting these absolute index rules.” While these criteria could arguably have already been met for official sector investors investing through CIBM Direct prior to Bond Connect, it was only recently that private investors were deemed to reach that level of access. Indeed, whether the Chinese bond market is freely investable for most foreign investors today is still a matter of contention. FTSE only added Chinese bonds to its World Government Bond Index (WGBI) in October 2021 and following this decision, for instance, Japan’s Government Pension Investment Fund (the largest tracker of the WGBI) subsequently decided to track a version of the WGBI index excluding China, arguing that market access was still too incomplete

⁵The Chinese government was explicit that these relaxation of restrictions were only for long-term investors. PBC No. 220, July 14, 2015, the “Notice of the People’s Bank of China (PBC) on Issues Concerning Investment of Foreign Central Banks, International Financial Institutions and Sovereign Wealth Funds with RMB Funds in the Inter-bank Market” writes “With a view to enhancing efficiency of foreign central banks or monetary authorities, international financial institutions, and sovereign wealth funds (hereinafter referred to as relevant overseas institutional investors) investing in the Chinese inter-bank market... Relevant overseas institutional investors shall act as long-term investors, and conduct trading based on reasonable needs for preserving or increasing the value of their assets. The PBC will, in accordance with the reciprocity principle and macro-prudential requirements, regulate trading behavior of relevant overseas institutional investors.”

⁶In preparation for the launch of Bond Connect, PBC’s Announcement [2016] No.3 extended the category of foreign institutional participants eligible to access the interbank bond market from the Foreign Central Bank-Type Institutions (including foreign central banks or monetary authorities, international financial organizations and sovereign wealth funds), QFIIs and RQFIIs to all qualified foreign institutional investors, including “other medium and long-term institutional investors” and changed the tone from “investors shall act as long-term investors” to “PBC encourages an overseas institutional investor to make medium and long term investments”.

for them to invest ([Sano and Galbraith \(2019\)](#)).

While each step of these reforms has its own intricacies, one can understand China’s bond market liberalization as beginning by allowing in a subset of long-term investors with restrictions on investment amounts and withdrawals, loosening these restrictions for subsets of investors over time, before moving toward free access to a range of global investors. This gradualism is consistent with the philosophy of “crossing the river by touching the stones,” moving by incremental policy reforms to develop the economy while maintaining economic stability. As we document below, these reforms have overall been accompanied by inflows of foreign investment in Chinese bond markets, starting with official foreign investors and, more recently, growing amounts of private investment.

2 The Renminbi in International Portfolios

In this section, we document the rise of Renminbi-denominated bonds in international investment portfolios. From the beginning of 2014, foreign investment in onshore RMB bonds rose from under \$100 billion to nearly \$640 billion at the start of 2022. The largest increase came in 2020, when foreign holdings increased by nearly \$200 billion. Appendix Figure [A.III](#) plots the rise of foreign ownership of RMB-denominated bonds issued in onshore capital markets at a monthly frequency.

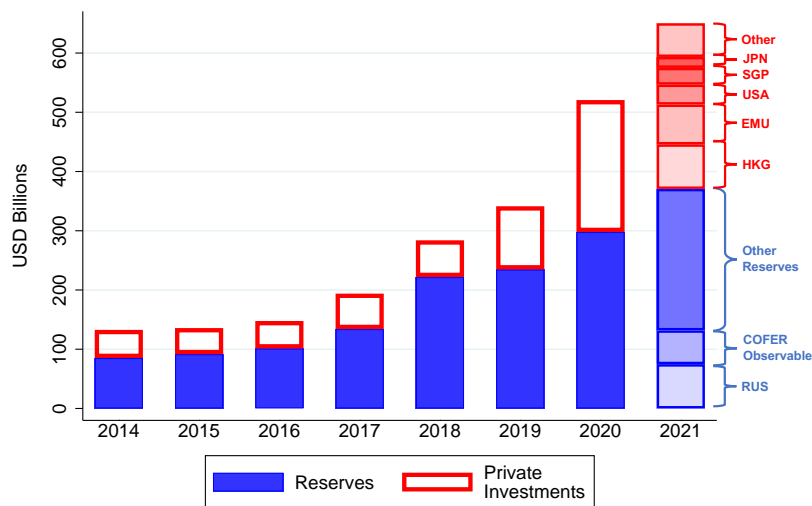
The process was gradual and featured some setbacks. There were two significant instances of foreign capital outflows over the last decade. The first occurred during the financial market turbulence of 2015–2016: between July 2015 and February 2016 the value of foreign holdings declined from \$128 to \$101 billion dollars, a 21% decline. This was a period of Chinese stock market volatility and depreciation of the Renminbi, and China intervened heavily in its financial markets. In particular, regulators introduced suspensions of share-trading following market drops and restricted domestic firms and investors from moving capital abroad. Despite the market turmoil and the sizable outflows, China did not introduce restrictions on foreign investors, including those in the bond market, from exiting the country.⁷ In fact, government officials at the time publicly reinforced China’s commitment to the opening up process and explicitly characterized capital controls as an unwanted regression in that process.⁸ Some market participants, however, still argued that the possibility of future restrictions acted as a deterrent to foreign investment in China.⁹ Inflows resumed and accelerated after this outflows episode. The most recent

⁷See, for instance, [Danese \(2016\)](#), who writes of the differential restrictions on outflows: “This is important since, as a result of capital outflows, Chinese authorities have been clamping down on all existing channels for moving capital out of the country. This has included suspending issuance of new quotas for outbound programmes, such as the qualified domestic institutional investor (QDII) scheme, as well as issuing window guidance to banks restricting how much foreign exchange (FX) corporates can remit out of the country. For CIBM, the rules did not include any such provisions, possibly in a bid to assuage concerns by index provider MSCI, which decided in June not to include A-shares in its emerging market index.”

⁸See [SAFE \(2016\)](#) or [SAFE \(2015\)](#): “(...) the policy orientation of foreign exchange administration to support the development of the real economy and promote trade and investment facilitation remains unchanged. (...) While controlling abnormal capital flows, the SAFE has been dedicated to prudential management by economic and market means, and will continue to do so in the future. This way of administration will continue for ongoing and ex-post regulation, so as to build a macro-prudential management framework, rather than the traditional capital control model.”

⁹See [Weinland \(2017\)](#), who writes in the Financial Times, “China’s restraints on capital outflows have started

Figure 1: Composition of Foreign Ownership of China-Issued RMB Bonds



Notes: Figure plots our estimated breakdown of foreign ownership of RMB denominated bonds into central bank reserves and private holdings. Data on reserves are from IMF COFER and private holdings are from IMF CPIS or from commercial data. See Appendix A.I.A for details.

period of outflows began in January 2022 and appears to be ongoing at the time of writing, with much of the data to analyze it still to be released.¹⁰

Figure 1 decomposes foreign ownership of Chinese Renminbi bonds issued by China-resident entities into two components, central bank reserves and private investment.¹¹ The initial rise in foreign investment is largely driven by central bank holdings. By far, the largest disclosed holder is the Central Bank of Russia. In 2017 and 2018, Russia dramatically cut its holdings of USD reserves and moved into RMB and EUR, apparently in response to U.S. sanctions and general wariness of relying on the dollar-based financial system. In particular, Russia increased its holding of RMB denominated bonds from under \$1 billion in the second quarter of 2017 to around \$67 billion in the second quarter of 2018. Reserve holdings themselves may also understate the true importance of the Renminbi as a reserve asset.¹²

It is only in 2019 and 2020 that we see a more substantial increase in private foreign investment in RMB bonds. For the latest year, 2021, the figure also displays the estimated private ownership of RMB bonds by investor country. We find that the investor base is broadly spread geographically with large private holdings of RMB bonds by the Euro Area, United States, Singapore, Japan, and Taiwan.¹³

to discourage inbound investment into the country, the opposite of the intended effect of the measures.”

¹⁰Market commentary mentions fears, after Russia’s invasion of Ukraine, of sanctions spillover to China, but also deterioration in China’s fundamentals and raising rates in the United States and other advanced economies.

¹¹See Arslanalp, Eichengreen and Simpson-Bell (2022) for an analysis of the changing composition of global foreign exchange reserves.

¹²As discussed in Bahaj and Reis (2020) and Bahaj and Reis (2021), China has opened a number of swap lines with central banks around the world. Therefore, even if central banks do not hold Renminbi in their current reserves assets, they may be counting on Renminbi liquidity in a crisis.

¹³Appendix Figure A.I reports our estimates of the geographic breakdown of holdings for the full period. See Appendix Appendix A.I.A for details on the estimates. We note that the private investment estimates are based in

The aggregate investment pattern raises the question of what investors are actually purchasing within the class of RMB bonds. Using data from China Central Depository and Clearing, the top panel of Appendix Figure A.IV shows that China Government Bonds (CGBs) account for 67% of of foreign investment in China, with 30% of investment in Policy Bank Bonds (PBBs), even though these two classes only account for a combined 62% of the total bond market. Importantly, these are the two categories that are either direct liabilities (CGBs) or assumed to be implicitly guaranteed (PBBs) by the Central Government. By contrast, only 3% of foreign investment goes to the 38% of the market with significant private credit risk. These patterns highlight that, conditional on investing in RMB, foreign investors mostly hold the safer assets denominated in that currency. In Appendix Section A.I.D, we decompose private investment flows into RMB and show that it was driven by actual investment decisions and that flows into RMB were largely accounted for by sales of developed currency debt.

Foreign investment in RMB bonds is, of course, not the only way that foreign investors can lend to China. In Appendix A.I.B, we document the changing importance of offshore bond issuance in both RMB and foreign currency by Chinese entities. In particular, we show that for foreign mutual funds the share of investment in Chinese bonds denominated in RMB issued offshore (the CNH market) compared to total holdings (onshore plus offshore) fell from over 90% in 2013 to under 10% by 2020. Despite this rise in the importance of onshore relative to offshore RMB financing, Appendix Figure A.V shows that throughout the full sample period mutual funds continued to invest more in China in foreign currency via international capital markets than they did in the onshore RMB market. See [Coppola, Maggiori, Neiman and Schreger \(2021\)](#) and [Eichengreen, Macaire, Mehl, Monnet and Naef \(2022\)](#) for a more detailed exploration of foreign investment in China via the offshore bond market.

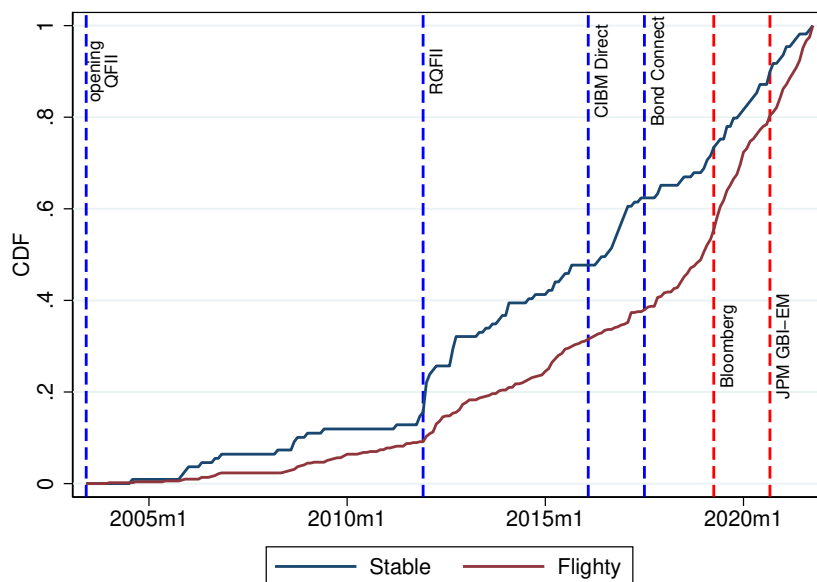
2.1 Selecting the Foreign Investor Base

In the previous subsection, we documented the holdings of RMB bonds in China by reserve managers and foreign private investors. Here, we turn to understanding how China selected which type of investors would be able to invest in its bond market over time. To do so, we create a new monthly dataset of the investor composition of the four access methods to the Chinese bond market discussed in Section 1: QFII, RQFII, CIBM Direct, and Bond Connect. For each of the programs, the regulatory agency either directly reports the investor name and the month that particular investor gained access to the program, or they release a series of monthly reports of investors with access, and we infer the month of access based on the first appearance on the regulatory filing. Based on investor name, we merge these investor lists with Factset to collect investor information, such as country of residency, nationality, and industry classification. We then classify them as “Stable” investors, “Flighty” investors, or “Banks.”¹⁴

Figure 2 displays the cumulative distribution function (CDF) of investors’ entry into the Chinese bond part on IMF CPIS data. These data exclude central bank holdings, but can include some public investment in the form of sovereign wealth funds, government pension funds, and state-owned enterprises. We confirmed, however, that for many countries the primary holders are mutual funds or insurance companies.

¹⁴“Stable” investors include central banks, legislative bodies, international organizations like the IMF, university endowments, non-profits, pension funds, and insurance companies. “Flighty” investors are those in the investment advice or portfolio management industry. “Banks” include investment banks, commercial banks, and broker dealers.

Figure 2: Entry into Domestic Markets



Notes: Figure plots the share of each investor type that had entered the market by a given date. The share is expressed as a fraction of investors by type that had entered by 2021.

market for Stable and Flighty investors from 2003 to 2021. It shows a striking difference between the entry pattern for the two types of investors, with Stable investors generally entering earlier in the sample period followed by a rapid increase in Flighty investors over the most recent years.¹⁵ At the launch of RQFII and CIBM Direct, we observe increased entry of the Stable investors. By contrast, in the wake of the introduction of Bond Connect and China’s inclusion in key bond indices, we observe a quicker entry of the Flighty investors.

We view these patterns as the result of conscious policy choices by the Chinese government that selected and grew its foreign investor base over the last two decades. As discussed above, the early entry and growth of the Stable investors was engineered via quota programs in which each investor separately applied for market access, while the later entry and growth of the Flighty investors is largely the result of more open and lightly regulated access programs like Bond Connect that allows access without any lock-up period. Our model, introduced in Section 3, both draws from this evidence in featuring two different classes of foreign investors, one stable and the other flighty, and provides an explanation of why China has followed this sequential opening up strategy to internationalize its bond market.

3 Reputation in the International Monetary System

We organize the empirical patterns documented above around stylized facts that inform our theory. First, the Chinese domestic bond market has progressively opened up to foreign participation. Second, this

¹⁵Appendix Figure A.VI repeats the exercise for each of the underlying categories. It shows the heterogeneous process followed by different sub-types of investors in entering this market. Appendix Figure A.VII breaks down Flighty investors into Mutual and Hedge Funds.

gradual opening up process was shaped by government policies aimed at selecting an investor base: starting with stable long-term investors and progressively letting in flightier private investors. We explain these facts via a dynamic model of a country internationalizing its bond market. We think of a country like China that has the potential to become the provider of a reserve currency, given its economic size or geopolitical importance, but that at an early stage does not have the reputation to provide a safe store of value. The model helps us think about how the country might build this reputation over time, the setbacks it might face, and the gradual policies it might choose.

3.1 Model Setup

The model is infinite horizon and time is discrete $t = 0, 1, \dots$. Each date t is divided into a beginning, middle, and end of the date. Within each date we develop a financial intermediation model with costly liquidations, across dates we develop a dynamic reputation model. There is a country with a government and a representative financial intermediary, both of which are risk neutral. There are foreign investors who reside outside the country.¹⁶ Investors live for one date and are risk neutral with a quadratic utility cost of lending to the country. There is measure one of *stable* foreign investors, $i = s$, and measure one of *flighty* foreign investors, $i = f$. Investor type is observable to the government and to intermediaries.

At the beginning of each date, the government's type is either *committed* or *opportunistic*. The government's type is not observable to foreign investors. We assume that the government controls all decisions within the country, so that we refer to the country level actions and objectives as if the government was implementing them directly. At the beginning of date t , governments make a financing decision for the country on behalf of its domestic intermediaries. Governments also make a strategic choice of whether or not to impose a capital control tax on outflows in the middle of date t , the tax has two levels denoted $\tau \in \{0, \bar{\tau}\}$. We assume that committed governments always choose $\tau = 0$.

We proceed as follows. We first describe payoffs to governments and investors. Next, we characterize the optimal strategy of the committed government. We then characterize strategies of opportunistic governments and study the dynamic reputation game. Figure 3 summarizes the timeline of date t and the actions taken at each point in time by each of the agents are described in detail below.

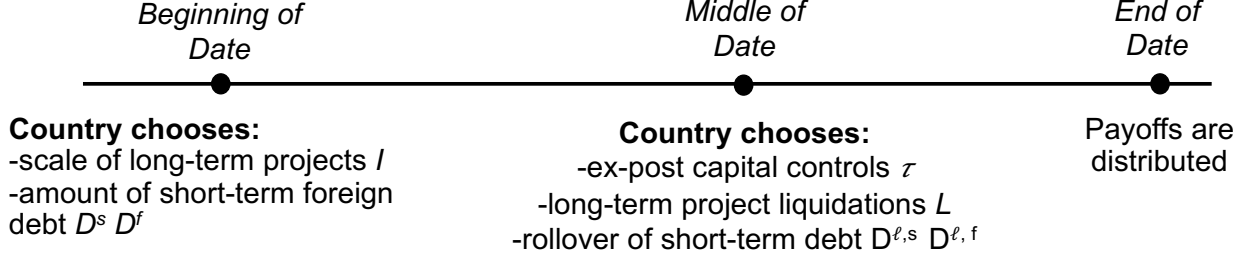
3.1.1 Payoff from Financial Intermediation

The government's payoff at date t is the final end of date equity payoff of the intermediary at end of t , denoted c_t . There is no consumption in the middle or beginning of the date. We derive this payoff below.

At the beginning of the date, the intermediary borrows short-term debt due in the middle of t denoted by amount $D_t^i \geq 0$, $i \in \{s, f\}$, from the two types of investors at endogenous interest rates R_t^i . Denote $D_t = D_t^s + D_t^f$ to be total foreign debt borrowed at the beginning of date t and $R_t = \frac{R_t^s D_t^s + R_t^f D_t^f}{D_t^s + D_t^f}$ the average interest rate on debt. The intermediary uses its debt D_t and an exogenous endowment of inside equity, $A \geq 0$, to undertake real projects of scale $I_t = A + D_t$.

¹⁶Our focus is on raising debt financing from foreign investors, we extend the framework to have a separately meaningful role for domestic investors/households in Appendix A.II.P.1 and Section 6.

Figure 3: Model Timeline Within Each Date



Notes: Figure displays the timing withing each date t of the financial intermediation model.

Real projects have a return $Q \geq 1$ if held to the end of the date. The projects yield no payoff in the middle of t , but can be liquidated at a discount $\gamma < 1$ per unit of final project payoff. Denote $L_t \leq QI_t$ the liquidations and γL_t the liquidation value that accrues to the intermediary.¹⁷ Since there is no consumption in the middle of the date liquidations only occur to repay foreign debt.

The government can choose to roll over or repay the intermediary foreign debt in the middle of t . Denoting $D_t^\ell = D_t^{\ell,s} + D_t^{\ell,f}$ to be total debt that is rolled over, the intermediary's middle of t budget constraint is

$$D_t^\ell + \gamma L_t = R_t D_t. \quad (1)$$

The intermediary cannot discriminate between investor types in the middle of t , that is the intermediary must deliver the same terms to all investors. Denote R_t^ℓ the common (endogenous) interest rate for debt rollover. We assume that debt rollover is subject to a collateral constraint,

$$R_t^\ell D_t^\ell \leq (1 - h_t)(QI_t - L_t), \quad (2)$$

where $h_t \in (0, 1)$ is the haircut for debt rollover.

Final intermediary payoff is given by $c_t = QI_t - L_t - R_t^\ell D_t^\ell$, that is final payoff of the remaining projects minus repayment of debt that has been rolled over. We assume that the collateral constraint binds in the middle of t . Thus we can substitute equations 1 and 2 into the final payoff to write

$$c_t = \underbrace{\frac{h_t}{\gamma - \frac{1-h_t}{R_t^\ell}}}_{\text{Net Worth Multiplier}} \underbrace{\left(\gamma QI_t - R_t D_t \right)}_{\text{Liquidation Value of Inside Equity}}. \quad (3)$$

The final payoff c_t can be written as the product of a net worth multiplier and the liquidation value of the bank's inside equity. The net worth multiplier falls when the haircut is higher and when the the rollover interest rate R_t^ℓ is higher, because both tighten the collateral constraint and force more liquidations.

¹⁷Liquidations in our model are an actual unwinding of the real projects, not a sale of the project to some second best holders. Early liquidations occurs at a value below the value the projects would have yield if held to maturity.

3.1.2 Investor Preferences and Interest Rate Determination

Date t foreign investors are risk neutral but have a quadratic cost of lending to the intermediary at the beginning of the date. In the middle of the date, their preferences are linear. Investors do not discount payoffs between the beginning, middle, and end of t and are myopic. Stable and flighty investors have identical preferences over (monetary) payoffs and only differ in collateral demands (equation 4).

Investors at the beginning of t have wealth w , which they allocate between lending to the intermediary, D_t^i , at promised interest rate R_t^i , and allocating to an outside asset with exogenous expected return $\bar{R} > 0$. In the middle of the date, investors choose to roll over or repatriate their debt based on the promised rollover interest rate and on whether a capital control tax on outflows has been imposed by the government.

The haircut required for debt rollover depends on which investor type the country has borrowed from at the beginning of the date. In particular,

$$h_t = \begin{cases} h^s, & D_t^f = 0 \\ h^f, & D_t^f > 0 \end{cases} \quad (4)$$

where $h^f \geq h^s$, that is the required haircut is higher when borrowing from flighty investors. All investors are treated pari-passu and offered the same haircut, so that the presence of flighty investors raises the haircut for the entire market.¹⁸

An investor of type i with due debt repayment $R_t^i D_t^i$ pays a tax τ on net outflows $\max(R_t^i D_t^i - D_t^{\ell,i}, 0)$, where $D_t^{\ell,i}$ is the new debt and $\tau \in \{0, \bar{\tau}\}$ depends on whether the government has imposed a capital control. Withdrawn funds can be stored in an outside asset with unit return until the end of the date and then consumed. Investor i receives payoff R_t^ℓ per unit rolled over in the middle of t .

We solve the investor problem backwards starting from the rollover decision in the middle of the date. If the intermediary offers contracts that violate the required haircut, then no debt is rolled over $D_t^{\ell,i} = 0$. For contracts that offer sufficient collateral, investors maximize end of date payoff $c_t^{*,i}$:

$$\max_{D_t^{\ell,i} \geq 0} c_t^{*,i} = (R_t^\ell - 1)D_t^{\ell,i} - \tau \max(R_t^i D_t^i - D_t^{\ell,i}, 0) + R_t^i D_t^i + \bar{R}(w - D_t^i)$$

The first order conditions imply: (i) indifference to any roll-over amounts $D_t^{\ell,i} \in [0, R_t^i D_t^i]$ if $R_t^\ell = 1 - \tau$; (ii) a corner solution at $D_t^{\ell,i} = 0$ for $R_t^\ell < 1 - \tau$; (iii) $D_t^{\ell,i} = R_t^i D_t^i$ if $R_t^\ell \in (1 - \tau, 1)$; (iv) indifference to any level of $D_t^{\ell,i} \geq R_t^i D_t^i$ for $R_t^\ell = 1$ (v) infinite lending for $R_t^\ell > 1$. Solutions (ii) to (v) cannot be an equilibrium, so that we restrict the attention to solution (i) and express the resulting interest rate schedule as:¹⁹

¹⁸This assumption helps us capture the market reforms that in practice allow a government to let in new types of investors. These reforms apply to the entire market, not just to the new investor type. We view this as capturing the spirit of the evidence in Section 1 and Section 2.1 documenting the gradual process by which China has progressively and selectively allowed different type of foreign investors into its domestic bond market, both by directly restricting the type of investors eligible for a given program, and by adopting policies like a fixed lock-up period which only certain types of investors can realistically agree to.

¹⁹Solution (v) in the aggregate violates the collateral constraint. Under solution (iv), both the intermediary and investors are indifferent between $D_t^{\ell,i} = R_t^i D_t^i$ and $D_t^{\ell,i} > R_t^i D_t^i$ for $R_t^\ell = 1$, and so we can rule it out by ruling

$$R_t^\ell = \begin{cases} 1, & \tau = 0 \\ 1 - \bar{\tau}, & \tau = \bar{\tau} \end{cases} \quad (5)$$

Thus, the capital control $\tau = \bar{\tau}$ reduces the interest rate for debt rollover. Each investor's total monetary payoff at the end of date t can therefore be written as

$$c_t^{*,i} = \bar{R}(w - D_t^i) + R_t^i R_t^\ell D_t^i = \bar{R}w + (R_t^i(1 - \tau) - \bar{R})D_t^i,$$

which, all else equal, is lower when the capital control is imposed, $\tau = \bar{\tau}$.

We can now turn to the investor maximization problem at the beginning of date t . Investors have beliefs $\pi_t \in [0, 1]$ that the government is committed at the beginning of t . We focus on strategies that are Markov in π_t throughout the paper. Investors have beliefs $m(\pi_t) \in [0, 1]$ that if the government is opportunistic it will not impose capital controls in the middle of date t . Therefore, investors believe that the government will not impose capital controls with probability $M(\pi_t) = \pi_t + (1 - \pi_t)m(\pi_t)$. We refer to $M(\pi_t)$ as the government's *reputation* and use the lighter notation M_t in the equations whenever the explicit reminder that M_t depends on π_t is not necessary for clarity.

At the beginning of t , investors take as given the promised interest rate R_t^i and their belief M_t and solve the following problem:

$$\max_{D_t^i \geq 0} \bar{R}w + (R_t^i E[1 - \tau] - \bar{R})D_t^i - \frac{1}{4} \frac{b}{\omega(M_t)} D_t^{i2},$$

where the first term is the expected monetary payoff at the end of the date $E[c_t^{*,i}] = \bar{R}w + (R_t^i E[1 - \tau] - \bar{R})D_t^i$ and $E[1 - \tau] = M_t + (1 - M_t)(1 - \bar{\tau}) = 1 - (1 - M_t)\bar{\tau}$. The last term is a utility holding cost of investing, with $b > 0$ a slope coefficient, and $\omega(M_t) > 0$ an exogenous cost/taste function that we assume to be continuous and weakly increasing in government reputation. For most of the paper, we think of $\omega(M_t)$ as being constant at 1, but an increasing function allows us to also capture the disproportionately higher demand faced by issuers of very safe bonds (high M). In Section 4, we show how $\omega(M_t)$ arises from aggregation in a model with investors with heterogeneous tastes for countries of different reputations.

Given R_t^i and M_t , investor i 's optimal choice of debt purchases D_t^i is given by the first order condition:

$$R_t^i = \frac{\bar{R} + \frac{1}{2} \frac{b}{\omega(M_t)} D_t^i}{1 - (1 - M_t)\bar{\tau}}. \quad (6)$$

This interest rate schedule has a lower intercept and slope the lower the probability capital controls are imposed ex-post (even when taking $\omega(M_t)$ to be constant). A higher reputation M_t corresponds to a interest rate schedules that start lower and increase slower as the amount of debt increases.

out $D_t^{\ell,i} = R_t^i D_t^i$. We can rule out (iv) by noting that (i) with $R_t^\ell = 1 - \tau \leq 1$ sustains $D_t^{\ell,i} = R_t^i D_t^i$ at lower borrowing cost to the intermediary. We can rule out (iii) by the same argument. Finally, (i) is weakly preferable to (ii) because the intermediary is indifferent between no rollover with $R_t^\ell = 1 - \tau$ and no rollover with $R_t^\ell < 1 - \tau$.

3.2 Optimal Debt Policy of the Committed Type

The solution of the model can be analyzed by first determining what the committed type of government optimally chooses to do in each date. Opportunistic types then decide to either mimic the committed type or deviate. Therefore, we start by analyzing the problem of debt issuance at the beginning of date t by a committed government.

The committed government chooses its debt policies at date t to maximize lifetime utility. As in much of the literature, the committed government chooses its policies taking the entire path of reputation $\{M(\pi_t), \pi_t\}$ as given, that is not internalizing the impact of its borrowing decisions on the behavior of the opportunistic government. The committed government's decision is therefore a repeated static problem of choosing policies at date t to maximize its date t payoff (with $\tau = 0$), taking current reputation M_t as given. The committed government internalizes the impact of its borrowing decisions on its interest rate schedule and required haircut.

Formally, the problem of the committed government at date t is to choose debt policies (D_t^s, D_t^f) in order to maximize its date t objective (equation 3 with $R_t^\ell = 1$, that is $\tau = 0$), subject to the interest rate schedules of stable and flighty investors (equation 6) and to the haircut determination (equation 4), taking its reputation M_t as given. The proposition below characterizes the optimal policy choices of a committed government.

Proposition 1 *There exists a unique opening up threshold $M^* \in [0, 1]$ such that optimal policies of a committed government are*

$$D^s(M_t) = \frac{\omega(M_t)}{b} \left[\gamma Q (1 - (1 - M_t)\bar{\tau}) - \bar{R} \right]$$

$$D^f(M_t) = \begin{cases} 0, & M_t \leq M^* \\ D^s(M_t), & M_t > M^* \end{cases}$$

and the resulting interest rate is $R(M_t) = \frac{1}{2} \frac{\bar{R}}{1 - (1 - M_t)\bar{\tau}} + \frac{1}{2} \gamma Q$, and $R(M_t) = R^s(M_t) = R^f(M_t)$.

The proof is in Appendix A.II.B. This proposition proves that there is a unique threshold M^* below which a committed government only borrows from stable investors, and above which it borrows from both stable and flighty investors.²⁰

The policy rules for debt and the resulting equilibrium interest rate are intuitive. Consider first the case of $M_t \leq M^*$, in which a committed government only borrows from stable investors. If the government acted as a competitive borrower, taking the interest rate as given, then the interest rate would equal the liquidation value of the project $R_t = \gamma Q$. Instead, the government takes into account the impact of its borrowing on the interest rate: it equates marginal benefit and marginal cost of borrowing. As a result, it borrows less than in the competitive case and faces lower interest rates. As is common in monopolist problems of this (functional form) type, it borrows half as much as in the competitive case and the

²⁰Appendix A.II.P.2 generalizes Proposition 1 by providing more general conditions on investor preferences under which this form of staggered opening up occurs.

equilibrium interest rate is an arithmetic average of the competitive rate γQ and the rate that would have been paid on the first unit of debt $\frac{\bar{R}}{1-(1-M_t)\bar{r}}$.

The key property of Proposition 1 is the opening up threshold M^* , below which the government does not borrow from flighty investors and above which the government borrows equally from both types. The intuition follows a typical fixed cost problem, which can be best visualized by taking the log of the government's date t payoff,

$$\log c_t = \underbrace{\log \frac{h_t}{\gamma - (1 - h_t)}}_{\text{Net worth multiplier}} + \log \left(\gamma Q I_t - R_t D_t \right).$$

Intuitively, the net worth multiplier enters the government's objective separably from debt. This means that an increase in the haircut from $h_t = h^s$ to $h_t = h^f$ is a fixed cost to the committed government from the reduction in its net worth multiplier. The committed government is only willing to pay this fixed cost if the benefit from doing so is sufficiently high. In particular, the benefit the committed government receives is the ability to borrow from a second class of investors without increasing the marginal interest rate. This means that the government can double its debt issuance by setting $D_t^f = D_t^s$ while maintaining the same interest rate. As reputation M_t increases, the interest rate schedules R_t^i shift downwards and flatten. This means that at higher reputation, the government can raise more debt at lower interest rates. This makes the benefit of borrowing from a second class of investors increase in the government reputation. The threshold is the point M^* at which the benefit of increasing the debt by letting in the flighty investors exactly equals the fixed cost of the higher haircut. Appendix A.II.C provides a graphical illustration of this tradeoff.

We are now ready to define the indirect utility function of the committed government over the date t payoff as

$$V(M_t) = \frac{h(M_t)}{\gamma - (1 - h(M_t))} \left(\gamma Q I(M_t) - R(M_t) D(M_t) \right) \quad (7)$$

which substitutes the policy functions from Proposition 1 into the objective function (equation 3) and sets $\tau = 0$. We have: $h(M_t) = h^s$ for $M_t \leq M^*$ and $h(M_t) = h^f$ for $M_t > M^*$; $I(M_t) = A + D(M_t)$; and $D(M_t) = D^s(M_t) + D^f(M_t)$.

3.3 Opportunistic Government Payoff and Strategies

An opportunistic government always mimics the debt issuance policy of a committed government at the beginning of each date to avoid revealing itself before any debt has been raised.²¹ However, an opportunistic government additionally chooses whether to impose capital controls in the middle of date t .

If the opportunistic government does not impose capital controls at date t its payoff at the end of the date coincides with that of a committed government given by $V(M_t)$ in equation 7. If instead the

²¹We assume that investors hold off-path beliefs $\pi = M = 0$ for any government that does not mimic the issuance of a committed government. Appendix A.II.D briefly verifies that these beliefs are sufficient in equilibrium to ensure the opportunistic type always mimics issuance.

opportunistic government imposes capital controls, then the payoff is given by $g(M_t)V(M_t)$ for $g(M_t) > 1$ a function derived below. We, therefore, define the end of date payoff for an opportunistic government as:

$$V^{Opp}(M_t, \tau) = \begin{cases} V(M_t), & \tau = 0 \\ g(M_t)V(M_t), & \tau = \bar{\tau} \end{cases} \quad (8)$$

where

$$g(M_t) = \frac{\gamma - (1 - h(M_t))}{\gamma - \frac{1-h(M_t)}{1-\bar{\tau}}}. \quad (9)$$

Where g is a decreasing function of $h(M_t)$, that is higher haircuts lower the proportional gains from imposing capital controls. Equation 9 is derived by substituting the policy functions from Proposition 1 into the objective function (equation 3) and considering separately the case of $\tau = 0$ and $\tau = \bar{\tau}$.

We study strategies of the opportunistic governments that are Markov in the beginning-of-period probability π_t that foreign investors assign to the government being the committed type. We define a strategy for the opportunistic government to be a probability $m^o(\pi_t) \in [0, 1]$ that it will not impose capital controls in the middle of the date when investors hold beliefs π_t and $M(\pi_t)$ at the beginning of that date. Values of $m^o = 0$ and $m^o = 1$ correspond to the pure strategies of deviating for sure (certainty of capital controls) or mimicking for sure (certainty of no capital control), respectively. Interior values of m^o correspond to mixed strategies. Within a date for given investor beliefs, the opportunistic government does not suffer from time inconsistency. It sets the strategy $m^o(\pi_t)$ at the beginning of the date and then randomizes accordingly when deciding whether to impose capital controls in the middle of the date.

Reduced Form Game. It is convenient to collect the results so far into a reduced-form representation of the date t game. Investors believe that the government is committed at the beginning of date t with probability π_t . Consider strategies that are Markov in π_t . Let $\tau \in \{0, \bar{\tau}\}$ denote a capital control decision by the government. A committed government sets $\tau = 0$ by assumption. Denote $m(\pi_t)$ to be investors' belief about the probability that an opportunistic government sets $\tau = 0$. Define $M(\pi_t) = \pi_t + (1 - \pi_t)m(\pi_t)$ to be the government's *reputation* for setting $\tau = 0$. A committed government follows an exogenous debt policy $D_t^i = D^i(M(\pi_t))$, $i \in \{s, f\}$, as given by Proposition 1. Given interest rate R_t , the payoff to the committed type is $c_t = n_t(QA + (Q - R_t)D_t)$, where $n_t = n^s > 0$ if $D_t^f = 0$ and $n_t = n^f$ (where $0 < n^f \leq n^s$) if $D_t^f > 0$. The opportunistic government mimics the debt policy of the committed government (see Appendix A.II.D). The opportunistic government receives payoff c_t if it sets $\tau = 0$ and $g_t c_t$ if $\tau = \bar{\tau}$, where $g_t = g^s$ if $D_t^f = 0$ and $g_t = g^f$ if $D_t^f > 0$, with $g^s \geq g^f \geq 1$. Investor i receives payoff from lending equal to $R_t^i D_t^i$ if $\tau = 0$ and $(1 - \bar{\tau})R_t^i D_t^i$ if $\tau = \bar{\tau}$, and her beginning of period expected utility is $\bar{R}w + (R_t^i E[1 - \tau] - \bar{R})D_t^i - \frac{1}{4} \frac{b}{\omega(M_t(\pi_t))} D_t^{i2}$. The interest rate is $R_t = R(M(\pi_t))$, given by Proposition 1. An opportunistic government's strategy is the probability $m^o(\pi_t) \in [0, 1]$ of setting $\tau = 0$.

3.4 Dynamics of Reputation Building

We now study the dynamic game of reputation building, and characterize optimal strategies and equilibrium. We assume that at the end of date t , after payoffs have been distributed, the government may be

dissolved. Committed governments are dissolved with probability $\epsilon^C > 0$ while opportunistic governments are dissolved with probability $\epsilon^O > 0$, with $\epsilon^C + \epsilon^O < 1$. Governments that are dissolved are replaced by the opposite type government, and place no value on their successor. Investors know these switching probabilities but actual changes in government are not observable to them. Let $\beta^* < 1$ be the government discount factor, then define $\beta \equiv \beta^*(1 - \epsilon^O)$ to be the effective opportunistic government discount factor that accounts for switching probability. We build on Phelan (2006) and Amador and Phelan (2021) by analyzing the implications of exogenous government type-switching. This plays an important role in the dynamics of reputation in our model even for small probabilities of types switching.

Investor posterior beliefs at the end of date t (i.e., prior beliefs at the beginning of $t + 1$) about the government type are formed from Bayes rule. If a government did not exercise the capital control in the middle of t , then

$$\pi_{t+1} = \epsilon^O + (1 - \epsilon^C - \epsilon^O) \frac{\pi_t}{M(\pi_t)}. \quad (10)$$

If on the other hand a government exercised the capital control, then $\pi_{t+1} = \epsilon^O$, reflecting that the government revealed itself as opportunistic but may have died and switched types.

It is natural in this model to index strategies and beliefs with respect to the number of dates passed without the capital control having been imposed, which we term “steps” and denote by n . Note that $\pi_0 = \epsilon^O$. Henceforth we will focus on steps n rather than calendar dates t .

At step n , the opportunistic government takes as given investor belief $M(\pi_n)$ and chooses its own strategy m^o . This decision is characterized by the Bellman equation,

$$W(\pi_n) = \max_{m_n^o \in [0,1]} m_n^o \left(V^{Opp}(M(\pi_n), 0) + \beta W(\pi_{n+1}) \right) + (1 - m_n^o) \left(V^{Opp}(M(\pi_n), \bar{\tau}) + \beta W(\pi_0) \right). \quad (11)$$

A mixed strategy $m_n^o \in (0, 1)$ requires indifference between exercising and not exercising the capital control, that is,

$$V^{Opp}(M(\pi_n), 0) + \beta W(\pi_{n+1}) = V^{Opp}(M(\pi_n), \bar{\tau}) + \beta W(\pi_0).$$

By contrast, a pure strategy of exercising the control, $m_n^o = 0$, requires a weak preference for the capital control, whereas a pure strategy of not exercising the capital control, $m_n^o = 1$, requires a weak preference for not exercising it. We can now define a Markov equilibrium of the model.

Definition 1 *A Markov equilibrium of the model is a path of debt issuance of the committed government $\{D_n^s, D_n^f\}$, a path of debt purchases of stable and flighty investors such that debt markets clear at interest rates $\{R_n\}$, a path of strategies $\{m^o(\pi_n)\}$ of the opportunistic government, and a path of investor beliefs about government type $\{\pi_n\}$ and strategies $\{m(\pi_n)\}$, such that:*

1. *Debt issuances are optimal for the committed government*
2. *Debt purchases are optimal for investors*
3. *$m^o(\pi_n)$ is an optimal strategy of the opportunistic government at step n*
4. *π_n is consistent with Bayes’ rule in equation 10 with $\pi_0 = \epsilon^O$*

5. *Investor beliefs are rational about government strategies: $m(\pi_n) = m^o(\pi_n)$*

Consistent with Phelan (2006), we conjecture and solve for an equilibrium that takes the form of a cycle, $n = 0, \dots, N$ for $N \geq 0$. Opportunistic governments play a mixed strategy, $m(\pi_n) \in (0, 1)$ at dates $n < N$. At N , opportunistic governments play a pure strategy of exercising the capital control, $m(\pi_N) = 0$. As in the previous literature, we refer to N as the “graduation step,” at which a *committed* type government gains the highest possible beliefs and reputation. Committed types that continue to each step $n > N$ either switch types and play the pure strategy $m(\pi_n) = 0$, or remain committed and continue at the constant beliefs and reputation, $\pi_n = M_n = 1 - \epsilon^C$. We refer to this form of equilibrium as a graduation step Markov equilibrium.

An important step in the cycle is the earliest step N^* at which the government lets in flighty investors, that is $M_n < M^*$ for $n < N^*$.²² We verify that $M_n \geq M^*$ for $n \geq N^*$, that is an economy that opens up stays open. We refer to N^* as the “opening up step”, since the government is opening up to a new class of investors.

3.5 Paths of Reputation Building

In our conjectured equilibrium, the government plays either a mixed strategy or a pure strategy of exercising the capital control at every step. Recalling the notation $M_n = M(\pi_n)$, we must have

$$W(\pi_n) = g(M_n)V(M_n) + \beta W(\pi_0), \quad (12)$$

for all n . Focusing in particular on the first step $n = 0$, we have

$$W(\pi_0) = \frac{1}{1 - \beta} g(M_0)V(M_0). \quad (13)$$

This condition says that the lifetime value that accrues to a specific opportunistic government at the beginning of the cycle under the optimal strategy is equal to the value it would achieve if it followed the strategy of imposing the capital control at every date forever.

As characterized above, a mixed strategy requires the indifference condition $V(M_n) + \beta W(\pi_{n+1}) = g(M_n)V(M_n) + \beta W(\pi_0)$. We can therefore substitute equations 12 and 13 into this indifference condition to obtain the representation

$$V(M_{n+1}) = \frac{g(M_n)}{g(M_{n+1})} \rho(M_n)V(M_n) + \frac{g(M_0)}{g(M_{n+1})} V(M_0) \quad (14)$$

where we have defined $\rho(M_n) = \frac{1}{\beta} \frac{g(M_n) - 1}{g(M_n)}$. Equation (14) characterizes the indifference path of our conjectured equilibrium in terms of indirect utility $V(M_n)$, rather than in terms of the value function W_n . It tells us, for a given initial reputation M_0 , opening up step N^* , and graduation step N , what

²²As long as $\epsilon^O \leq M^* < 1 - \epsilon^C$, such a step exists in the conjectured equilibrium of this form. Note that it is possible for $N^* = 0$, that is opening up happens immediately, or for $N^* = N + 1$, that is opening up happens after graduation.

the path of reputation M_1, \dots, M_N must be to sustain a mixed strategy by the opportunistic government up until the graduation step. This path is characterized by an AR(1) process in indirect utility $V(M_n)$. However, as we describe in detail below, the coefficients of the AR(1) process change when the government opens-up due to the change in investor composition. We build more intuition for this equation below as we decompose its dynamics in the different regions. To simplify notation, we denote $\rho^s = \rho(M_n)$ and $g^s = g(M_n)$ for $M_n \leq M^*$ so that $h(M_n) = h^s$. Correspondingly, we denote $\rho^f = \rho(M_n)$ and $g^f = g(M_n)$ for $M_n > M^*$ so that $h(M_n) = h^f$. Note that $\rho^f < \rho^s$ since $g^f < g^s$.

Equation (14) governs the dynamics for $n < N$. To complete the argument, a pure strategy of $m_N = 0$ requires that $V(M_N) + \beta W(1 - \epsilon^C) \leq g(M_N)V(M_N) + \beta W(\pi_0)$. An opportunistic government also plays a pure strategy at $n > N$, meaning that $W(1 - \epsilon^C) = g(1 - \epsilon^C)V(1 - \epsilon^C) + \beta W(\pi_0)$.²³ Combining these conditions with equation 12 yields

$$V(1 - \epsilon^C) \leq \frac{g(M_N)}{g(1 - \epsilon^C)} \rho(M_N) V(M_N) + \frac{g(M_0)}{g(1 - \epsilon^C)} V(M_0). \quad (15)$$

Equation (15) parallels equation (14). Intuitively, it states that graduation occurs once the required indirect utility V to sustain a mixed strategy exceeds the upper bound on indirect utility $V(1 - \epsilon^C)$ attainable in the conjectured equilibrium. Once the transition path exceeds this threshold, indifference can no longer be maintained and graduation occurs. Observe that graduation cannot occur at a prior point on the indifference path. If we conjectured an earlier graduation step, equation (14) implies there is an indirect utility $V \leq V(1 - \epsilon^C)$ that makes an opportunistic government indifferent between imposing and not imposing the capital control. But this means the opportunistic government strictly preferences continuation to reputation $1 - \epsilon^C$, rather than graduation, a contradiction.

3.6 Model Equilibrium

To build intuition for the model dynamics, we consider first the simpler case in which foreign investors are homogeneous.

Homogeneous Investors. We set $h^s = h^f$ so that the haircut is identical across the two investor groups. The transition dynamics of equation (14) simplify to:

$$V(M_{n+1}) = \rho^f V(M_n) + V(M_0). \quad (16)$$

²³If $N^* < N + 1$, then equation 15 is a sufficient condition for a pure strategy $m_n = 0$ for $n > N$ to be optimal. If $N^* = N + 1$, then the equilibrium also must satisfy $\left(1 - (1 - \beta)g(1 - \epsilon^C)\right)V(1 - \epsilon^C) \leq \beta g(M_0)V(M_0)$, which guarantees optimality of pure strategy after graduation. In general, we approach the model by solving for an equilibrium of the model not subject to this constraint, and then verifying that this constraint holds if the conjectured equilibrium has $N^* = N + 1$.

Finally, note that in the homogeneous haircuts case, $N^* = 0$ and therefore a pure strategy at N implies a pure strategy at $n > N$.

The transition path of indirect utility $V(M_n)$ follows an AR(1) with a constant coefficient, $\rho^f = \frac{1}{\beta} \frac{g^f - 1}{g^f}$. The rate of convergence decreases in the discount factor β , reflecting that as opportunistic governments become more patient they require smaller increases in reputation to be willing not to impose the capital control. It increases in the value g^f of imposing the capital control, reflecting that a higher value increases the foregone benefits of imposing the control today and so requires a larger increase in reputation to maintain indifference. Similarly, the analog of the graduation condition (15) is²⁴

$$V(1 - \epsilon^C) \leq \rho^f V(M_N) + V(M_0). \quad (17)$$

In our conjectured equilibrium, the graduation step N is determined, starting from the initial reputation M_0 , as the first step N at which condition (17) is satisfied.²⁵ The proposition below characterizes this equilibrium.

Proposition 2 *If investors are homogeneous $h^s = h^f$, there exists a unique graduation step Markov equilibrium.*

Proposition 2 (see proof in the Appendix) verifies that a graduation step Markov equilibrium does in fact exist, and that it is the unique equilibrium of this form. Intuitively, uniqueness arises because the path of reputation described by equation (16) and the path of beliefs described by equation (10) have different responses to a change in the initial government reputation M_0 . An increase in initial reputation M_0 means that all future reputations M_n must be higher to maintain the indifference condition. By contrast, a higher initial reputation means that posterior beliefs π_1 are lower, as more opportunistic governments are not imposing the capital control. This means that the future path of beliefs is also everywhere lower. In other words, the path of reputation M_n increases at every n in the initial reputation M_0 , whereas the path of beliefs π_n determined by Bayes' rule falls at every n in the initial reputation M_0 . This gives rise to a crossing point of these two paths at any conjectured graduation step N . The terminal condition of graduation, equation (17), then pins down the step N at which these two paths not only cross, but also graduation is feasible, giving rise to existence. At this point, a lower initial reputation would be required to graduate at a later step, due to the indifference path. However, a lower initial reputation implies that beliefs build faster, and so overshoot reputation. This gives rise to uniqueness. Appendix A.II.P.4 illustrates a numerical solution of this model.

Heterogeneous Investors. We now analyze the model with heterogeneous investor types. As discussed above, we assume that $\epsilon^O < M^* < 1 - \epsilon^C$, so that a committed government with reputation ϵ^O would not open up whereas a committed government with reputation $1 - \epsilon^C$ would open up. This ensures that our conjectured equilibrium has a well defined open up step $0 \leq N^* \leq N + 1$.

If $N^* = 0$, then the economy is always open and the transition dynamics and graduation condition are given by equations (16) and (17). We now characterize the case $0 < N^* \leq N + 1$. The transition dynamics

²⁴As noted above, equation 17 also guarantees that $m_n = 0$ is optimal for $n > N$.

²⁵If $\rho^f > 1 - \frac{V(\epsilon^O)}{V(1 - \epsilon^C)}$, the proof of Proposition 2 additionally shows that it must be the case that $N < \infty$.

of equation (14) can be written separately in two regions (some of which may be empty in equilibrium). As characterized below, there is a lower region of low reputation and a fast rate of convergence. There is an upper region of high reputation and a slow rate of conversion. At the boundary between the two regions, an upward jump occurs in the transition dynamics.

The lower region is the (possibly empty) set of cycle steps $\mathcal{N}_1 \equiv \{n | n + 1 < N^*\}$. For any $n \in \mathcal{N}_1$, the economy has not yet opened up to flighty investors at either n or $n + 1$, and so the haircuts are $h_n = h_{n+1} = h^s$. As a result, the transition dynamics in equation (14) reduce to

$$V(M_{n+1}) = \rho^s V(M_n) + V(M_0). \quad (18)$$

The dynamics in this region carry the same intuition as the dynamics in the homogeneous investor model.

The boundary between the lower region and the upper region is the step prior to opening up, $N^* - 1$. When $N^* > 0$, this step always exists in our conjectured equilibrium. This is the unique step n of our conjectured equilibrium such that the economy is not open to flighty investors at $n - 1$ but is open to flighty investors at n . This means that $h_{N^*-1} = h^s$ but $h_{N^*} = h^f$. Therefore if $N^* < N + 1$, the transition dynamics of equation (14) reduce to:

$$V(M_{N^*}) = \frac{g^s}{g^f} \left(\rho^s V(M_{N^*-1}) + V(M_0) \right). \quad (19)$$

The opening up step N^* has the same transition dynamics as before opening up, but is scaled by the relative value g^s/g^f of imposing the capital control before and after opening up. We have that $g^s > g^f$: for a given inside equity, imposing capital controls before rather than after opening up increases the government utility more. Intuitively, this occurs because flighty investors are more inelastic (require a higher haircut) in their debt rollover decisions, thus making imposing capital controls ex-post less advantageous for the government.

Opening up is a disproportionately expensive action for the opportunistic types to take. In reputation games, taking this type of expensive action comes with a jump up in reputation. Formally, this manifests as a larger increase in the indirect utility $V(M_{N^*})$ at opening up N^* relative to the dynamics before opening up. Capital inflows jump up on opening-up for two reasons: (i) flighty investors are let in for the first time and due to the fix-cost nature of this decision there is a lumpy capital inflow (see Proposition 1); (ii) both stable and flighty investors respond to the endogenous jump up in the country's reputation by increasing their lending.

The upper region is the (possibly empty) set of cycle steps after the economy has opened up but before graduation, $\mathcal{N}_2 \equiv \{n | N^* \leq n < N\}$. In this region, the economy is open at both n and $n + 1$, so that $h_0 = h^s$ and $h_n = h_{n+1} = h^f$. As a result, the transition dynamics of equation (14) reduce to

$$V(M_{n+1}) = \rho^f V(M_n) + \frac{g^s}{g^f} V(M_0). \quad (20)$$

Intuitively, a government that imposes the capital control at n also benefits from the higher proportional value of imposing the capital control when it resets to reputation M_0 . This leads to the scaling of $V(M_0)$

by g^s/g^f . The rate of convergence also shifts from ρ^s to ρ^f , reflecting that the smaller proportional value of imposing the capital control slows the required increases in reputation needed to make the government willing not to impose the capital control today.

Finally, opportunistic governments must be willing to graduate at N , that is equation (15) must hold at N . As in the one investor model, graduation occurs when reputation implied by the indifference path exceeds the highest possible reputation $1 - \epsilon^C$. If $N^* < N + 1$, then the graduation condition is

$$V(1 - \epsilon^C) \leq \rho^f V(M_N) + \frac{g^s}{g^f} V(M_0).$$

If instead $N^* = N + 1$, then the graduation condition is

$$V(1 - \epsilon^C) \leq \frac{g^s}{g^f} \left(\rho^s V(M_{N^*-1}) + V(M_0) \right).$$

Relating back to the intuition behind equation (19), the loss in value of the capital control may be sufficiently large that the opportunistic government cannot be incentivized to play a mixed strategy at the date prior to opening up. In this case, opening up occurs after graduation.

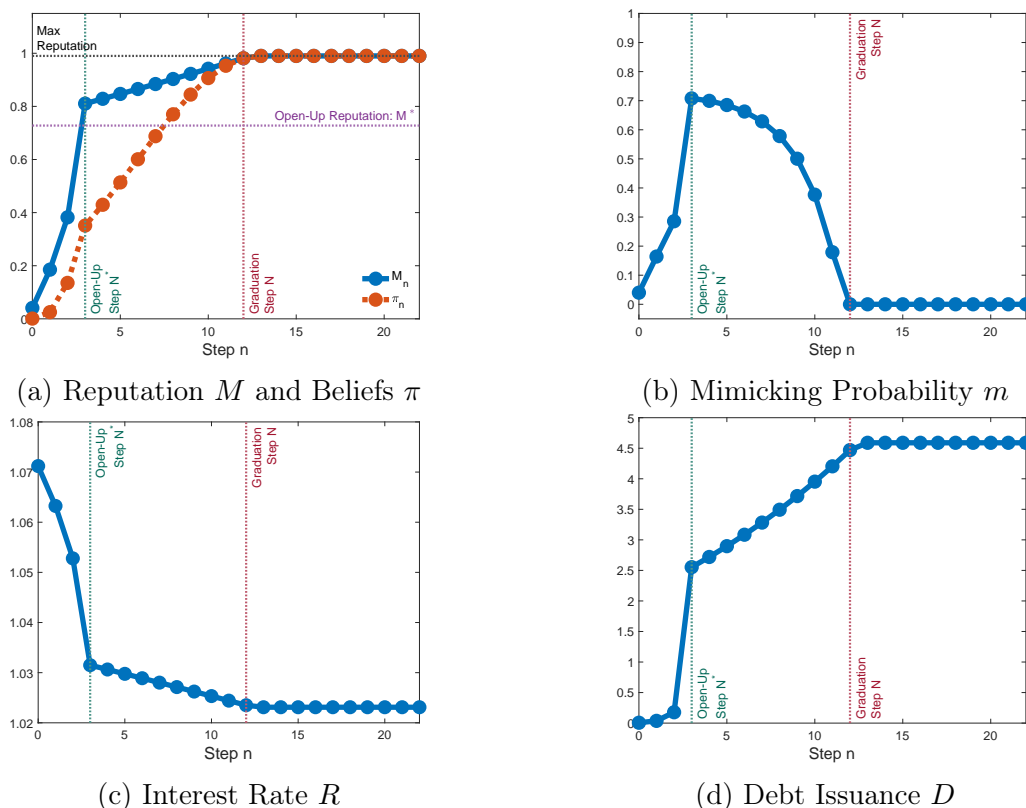
The proposition below characterizes this equilibrium.

Proposition 3 *There is at most one graduation step Markov equilibrium associated with an opening up step N^* .*

The model with heterogeneous investors might feature multiple equilibria with different opening-up steps, but given an opening-up step there is at most one equilibrium of this form associated with that step. In some sense, the logic of uniqueness of the equilibrium in the special case of homogeneous investors carries over to this set-up with multiple classes once the opening up step is fixed. The multiplicity, if present, arises from setting two different opening up steps. Technically, the possibility of multiple equilibria arises from the fact that reputation grows faster before opening up, but the jump up of reputation upon opening up is smaller the longer opening up is postponed. Intuitively, at a conjectured opening up date there might be two possible outcomes. The first is that the economy opens up and reputation experiences a larger jump according to equation (19), carrying it to $M_{N^*} > M^*$. This then rationalizes the decision of committed governments to open up at N^* . However, it can also be possible that if there were no jump and equation (18) governed the dynamics, we would have $M_{N^*} < M^*$. This in turn rationalizes the decision of committed governments not to open up.

Numerical Illustration. Figure 4 provides a numerical example of the equilibrium. Our model is intentionally stylized and qualitative, so all figures depicting equilibria of the model are to be taken as pure illustration without a quantitative focus. In this case, the economy opens up at $N^* = 3$ and graduates at $N = 12$. The upper left panel plots the evolution of reputation M_n and beliefs π_n . Beliefs and reputation start low at $n = 0$ because, at this point, investors are relatively sure that the government is opportunistic; in this example, prior beliefs at $n = 0$ are $\pi_0 = \epsilon^O = 0.001$. Intuitively, most governments at $n = 0$ are

Figure 4: Equilibrium Reputation Cycle: Heterogeneous Foreign Investors



Notes: Numerical illustration of the equilibrium of the model when foreign investors are heterogeneous. The N^* dashed-green and N dashed-red lines are the opening up and graduation steps, respectively.

those that exercised capital controls last period, thus revealing themselves to be opportunistic, and the only uncertainty about their type this period is due to the exogenous switching probability. At low levels of reputation letting in the flighty investors is sub-optimal since total desired borrowing is small. As reputation builds further and consequently the interest rate schedule shifts downwards, both because of the direct effect of reputation and because we set $\omega(M)$ to increase in M , desired borrowing increases to the point that the government decides to let in the flighty investors. As discussed above, the decision to open up endogenously causes a jump up in reputation since it is disproportionately expensive for the opportunistic governments to mimic this decision. Reputation build-up slows down substantially after opening up as seen in the top left panel of Figure 4. The bottom right panel of Figure 4 confirms the intuition that the government upon opening up to flighty investors wants to borrow a lot more. Part of the increase is due to the “fixed cost” nature of letting in the flighty investors, part of the increase is due to the endogenous jump up in reputation. The bottom left panel shows that the equilibrium interest rate falls together with the debt increase.

After opening up, foreign debt continues to increase and interest rates continue to fall, but the movements are much less pronounced since further build up of reputation occurs slowly. At higher reputation

the government contemporaneously sustains more foreign debt and lower interest rates, which is intuitive since higher reputation is a shift downward in the interest rate schedule. Eventually the economy reaches a level of debt and reputation at which further gains would be too small and all opportunistic governments decide to impose capital controls if a crisis occurs, thus restarting the reputation cycle. The presence of stable investors, rather than just one homogeneous class of flighty ones, allows the country to grow reputation faster before opening-up. After opening-up, the growth rate of reputation is the same as the homogeneous model. Appendix A.II.P.5, provides further numerical examples allowing for heterogeneous parameters in investor demand curves, a cap on the size of the stable investors, and variation in the taste for safe assets (the weights $\omega(M)$).

Discussion of Modeling Choices and Results. The model captures salient empirical features documented in Sections 1 and 2. Foreign entry into the Chinese market is a slow building process. In the model, investors “experiment” with this new market: they start with a cautious view ascribing a low reputation to the country. They then test the country commitment: they pull out their capital and pay attention to the reaction of the Chinese government and the well functioning of the bond market. If during these crises the Chinese government lets foreigners take their money out unimpaired, foreign investors positively update on the future prospects of investing in Chinese bonds. The model makes sense of the 2015-16 v-shape episode of capital outflows, visible in Appendix Figure A.III. In the midst of economic and financial turmoil in China, foreigners liquidated more than 20% of their Chinese bond holdings without the Chinese government locking the gates to foreign capital.²⁶ As the crisis passed, foreign capital flows returned to China with the overall foreign bond holdings increasing well past their pre-2015 peak.²⁷ In 2022 foreigners are again pulling out of China and it is an open question what the Chinese policy response is going to be.

The model highlights the importance of building the investor base, starting with stable investors, in the early phases of internationalizing the bond market of what could become an international currency. We think of the demand for the country’s bonds by stable investors even at low levels of reputation as a special characteristic of countries that could become a reserve currency, like China. Most other countries, like many emerging markets, do not have this option and instead open up directly facing flighty investors. At each point in history only a handful of countries are possible contenders for a reserve currency role and researchers have long debated these countries’ necessary characteristics such as size, importance in trade, military power, institutional quality, and fiscal capacity (Eichengreen, Mehl and Chitu (2017), Ilizetzi, Reinhart and Rogoff (2022)). The model captures this idea in reduced-form as the presence of these characteristics for China (e.g. size, and military power) is why the stable investors are demanding the bonds even at low levels of reputation, and instead focus on the endogenous build up of reputation.

The model captures the idea that reputation as an international currency issuer can only be built in

²⁶In fact, the Chinese government decided to intervene by blocking domestic savers from exporting capital. A decision that we view, in part, as being motivated by fears that restrictions on foreigners would have damaged China’s reputation in global markets at a time when China was actively pushing for internationalization.

²⁷The simplicity of the model implies that the level of holdings is purely a function of reputation. This can be relaxed by making the outside option \bar{R} or the slope of the demand curve b time varying, thus allowing for changes in the demand for Chinese bonds that do not depend solely on reputation.

the “fire” of severe crises. In normal times, there is little that investors learn about the government type and how it would behave in a future crisis. One can think of a step in our model as a crisis, with calendar time between two steps being “good times” of stochastic (potentially long) length. Appendix [A.II.P.3](#) makes this formal by introducing a high and low state within each date. No reputation is built in the high state. The model presented in the main text only features the low/crisis state.

Alternative Policies and Mechanisms. The model shows how hard it is to build a reputation toward being a reserve currency. At a basic level, the rule of law and financial market development are important characteristics, on which China still has much progress to make. But being an international currency goes even further, it is a promise to foreign investors of a store of value in a crisis. Many government actions, such as ex-post capital controls, but also currency depreciation and/or inflation, can impair such a promise without constituting a deviation from the rule of law per se. Investors buying an international currency do so for its safety and liquidity and we think of these characteristics as being very sensitive to the reputation of the government. This view drives the focus of the paper on foreign investment in domestic currency bonds, rather than equity or foreign direct investment (FDI) where there is no expectation of stable returns regardless of the level of financial development or reputation. China also opened up its equity (Stock Connect programs) and FDI markets to foreigners, and in many respects those liberalizations came earlier but do not load as heavily on policy commitments.

We focus on the uncertainty that investors face about a country like China and abstract from uncertainty that the country might have about investor behavior. In practice, we believe China can observe the behavior of large investors, like foreign central banks or large investment management groups, in many other countries that receive foreign portfolio investments. Investors, on the other hand, face the unique situation of a very large country beginning to open up its markets under the shadow of substantial political risk and a lack of transparency. Therefore, while China has a myriad of ways to learn about investors’ tendencies in related contexts, it is hard to see how investors can assess what the Chinese government is likely to do in a future crisis other than by observing how it acted in past and current crises. It is this uncertainty and learning that our model focuses on.

We chose to model the willingness to impose ex-post capital controls as the defining characteristic of an opportunistic government because it captures a salient feature of foreign investors’ fears about investing onshore in China: the ability to “get the money out” in a future crisis. Outright default, and inflation or exchange rate depreciation are other ways to alter repayments to foreign bondholders that also carry reputational losses. As detailed in Appendix [A.I.G](#), foreign investors in the Chinese bond market emphasize uncertainty over “repatriation risk” or whether China will “lock the gates” in bad times.²⁸ While of course there are the standard currency and interest rate risks of investing in RMB, a salient risk in the context of China is the possibility that investors will not be able to get their money out in bad times. We

²⁸For instance, a number of funds discuss concerns over the custodian or beneficial ownership arrangement of their bonds purchased via Bond Connect or CIBM Direct. With these untested markets, investors are not sure they will actually be able to sell the bonds they own in all market conditions. Another concern is generally referred to as a “suspension of trading.” Although adopted more frequently so far in equity markets, investors in Chinese bond markets report fears that in times of market stress, China will halt trading on the bond market, making them unable to repatriate their capital.

model this as the risk that China institutes an ex-post capital outflow tax, although it could be re-framed as a quantity restriction on outflows.

Allowing the committed type to take into consideration its market impact has two advantages for us. First, it connects to the economics of reserve currencies as special assets whose issuers receive an exorbitant privilege via monopoly rents and opens up the possibility of studying competition among issuers (Farhi and Maggiori (2018); Choi, Kirpalani and Perez (2022)), something we return to in Section 5. Second, it allows for some degree of ex-ante macro-prudential policy to have already taken place in the model, sharpening the difference between ex-ante prudential measures and ex-post capital controls. Ex-ante capital controls do not carry the same reputational stigma because they are known at the time of investment.²⁹ Intuitively, a competitive intermediary sector would issue too much debt and reach the competitive interest rate, not internalizing its impact on the equilibrium borrowing rate. The government behaves as a monopolist and imposes ex-ante controls on intermediary borrowing in order to force them to internalize the price impact of borrowing (Lorenzoni (2008); Bianchi (2011); Guerrieri and Lorenzoni (2017); Bianchi and Lorenzoni (2021)).³⁰

In general, governments have a number of other ex-post policies that would interact with ex-post capital controls. Bailout policy, either financed by ex-post taxes or ex-ante reserve accumulation, is a particularly relevant one since the government could prevent liquidations by bailing out the intermediation sector, formally bypassing the collateral constraint. Such bailouts have fiscal costs and can induce future moral hazard, so that there is a policy trade off. For example, one can think of the U.S. bailing out its financial intermediaries during the 2008 financial crisis while not tampering at all, and in fact supporting, the payoff and market access to U.S. Treasuries by foreigners. One possible extension of the model is to allow for reserve accumulation as a mechanism to “build” reputation.

Earlier Episodes of Countries Building a Reserve Currency Status. It is also interesting to reflect on how the model speaks to earlier episodes of countries building reputation toward becoming a global reserve currency. In this respect, we think of Alexander Hamilton’s policy, when he was the first U.S. Secretary of the Treasury, of having the newly created federal government assume the debt of the states. The policy aimed at building a solid reputation as a borrower for the newly created United States (Sargent (2012)).³¹ Similarly, we think of the later efforts by New York Federal Reserve Governor Benjamin Strong to build

²⁹In a paper reviewing the IMF policy stance on capital controls over time Ostry (2022) writes: “the poor reputation of outflow controls is widespread in both academic and policy circles (and is not confined to the IMF). Indeed, the bad name of capital controls historically stems more from the reputation of outflow controls than inflow measures. The former are often seen as tantamount to expropriation of foreign investors, of changing the rules of the game after the money has already entered the country. And those concerns are legitimate.”

³⁰In the model, liquidations happen at an exogenous price γ . If we made the price a decreasing function of the size of liquidation ($\gamma(L_t)$), then the model would feature pecuniary externalities in the spirit of the macro-prudential literature. In our baseline, instead, the desire of the government to limit borrowing ex-ante compared to the competitive equilibrium is driven by the monopoly rents.

³¹Hamilton (1790) extols the virtues of governments that maintain their promises to creditors: “States, like individuals, who observe their engagements, are respected and trusted: while the reverse is the fate of those, who pursue an opposite conduct. [...] The credit of the United States will quickly be established on the firm foundation of an effectual provision for the existing debt.” Chernow (2004)[pg 298] remarks: “With this huge gamble, Hamilton laid the foundations for America’s future financial preeminence”.

an investor base for the trade-bills (bankers acceptances) market in dollar in New York to rival the liquid and safe markets for these bills in sterling in London. Such efforts were instrumental into making the dollar a reserve currency (Eichengreen (2011); Broz (2018)). The need to maintain reputation was also a motivation behind England’s misguided return to the gold standard at the pre-war exchange rate level in the 1920s.³²

Countries have, at various times, suffered losses of reputation as providers of reserve currencies. England suffered a blow to its reputation with the sudden devaluation of the pound in 1931 and never recovered its role as a reserve currency provider. The U.S. went off gold in 1933 and then again in 1972. In particular, the Nixon administration in 1971 reneged on a promise of free convertibility of the dollar into gold, restricting this ability only to official (“stable”) investors and excluding the private (“flighty”) investors. Immediately after 1973 there was an attempt by foreign investors to diversify away from the dollar, but, perhaps due to the lack of viable alternatives, the dollar quickly regained and maintained its status.

4 Measuring Reputation

Measuring reputation empirically is a notoriously difficult task. In this section we derive a model-implied sufficient sufficient statistic for reputation. We then empirically implement this new measure of reputation with detailed micro data on foreign investors’ bond holdings. We begin by deriving the measure theoretically and then estimate it in the data.

4.1 Investor Specialization and a Theoretical Measure of Reputation

We generalize the reputation model considered so far to allow for investors who specialize in countries of varying levels of reputation. We assume that there is a unit continuum of identical countries. Countries are identical in the sense that they have the same fundamentals, but may be at different investor beliefs π and reputation levels M . In this section, to sharpen the focus on investors, we assume that a measure one of issuing countries play the reputation game while having no interactions with each other. Section 5 removes this simplification and studies competition in becoming a reserve currency among the countries.

We focus on the case of homogeneous investors in terms of haircut ($h^s = h^f$) but allow instead specialization in the cost function, $\omega(M_t)$. We return to calendar time t because countries are at the same date t rather than the same step n .

A unit continuum of countries $j \in [0, 1]$ are of equal measure. There are a set of investor specialists, $i \in \{1, \dots, \mathcal{I}\}$, with each specialist having a continuum of identical investors of total measure $\frac{2}{\mathcal{I}}$.³³ We refer to investors by their specialization. Investors have identical information sets and have identical beliefs π_{jt} about the probability that government j is committed at date t . We restrict attention to Markov

³²The Cunliffe Committee, charged in 1918 with studying the possible international monetary arrangements after WWI, stated in its interim report: “The uncertainty of the monetary situation will handicap our industry, our position as an international financial centre will suffer and our general commercial status in the eyes of the world will be lowered.” A strong dissenting voice was John Maynard Keynes (Keynes (1923)) who argued that these concerns were overblown compared to the economic cost of return to gold at a deflationary peg.

³³We assume total measure of 2 to maintain consistency with the baseline model.

equilibria that are symmetric in π_{jt} , that is committed and opportunistic governments j and k play the same strategy at date t if $\pi_{jt} = \pi_{kt}$. Denote M_{jt} the beliefs of investors that government j will not exercise the capital control at date t .

Investor i has identical preferences to the baseline model, except that she can invest in the entire portfolio of debt. Her holding costs are separable across countries, meaning her preferences can be written separably as³⁴

$$\bar{R}w_i + \int_j \left[E[R_{jt}(1 - \tau_{jt}) - \bar{R}]D_{jt}^i - \frac{1}{4} \frac{b}{\omega_i(M_{jt})} D_{jt}^{i2} \right] dj. \quad (21)$$

The weights $\omega_i(M_{jt})$ are investor specific and akin to taste (higher or lower holding cost) for particular assets of varying reputation levels. It is the heterogeneity in the function $\omega_i(M_{jt})$ that we refer to as specialization. For example, investors who specialize in high reputation debt have an increasing ω_i .

Given i 's beliefs M_{jt} and interests rates R_{jt} , investor i chooses her debt purchase D_{jt}^i to maximize her utility in equation (21). Since the investor's utility is separable across countries, optimal debt choice is also separable and given by

$$R_{jt} = \frac{\bar{R} + \frac{1}{2} \frac{b}{\omega_i(M_{jt})} D_{jt}^i}{1 - (1 - M_{jt})\bar{r}} \quad (22)$$

This demand curve is identical to that of the baseline model (equation (6)), up to the investor-specific reputation taste $\omega_i(M)$. For example, an investor i that specializes in reputation M has a higher taste $\omega_i(M)$, and hence has a flatter interest rate schedule for debt of that reputation level.

Representative Investor Aggregation. The model features a simple aggregation to a representative investor. Consider the problem of a committed government j with reputation M_{jt} . The decision problem of the committed government mirrors that of the baseline model. Since the haircut is identical across investors, the committed government borrows from every investor type. At the optimal issuance, the equalization of the demand schedules of investor 1 and investor $i > 1$ implies that relative issuance is given by $\omega_i(M_{jt})^{-1} D_{jt}^i = \omega_1(M_{jt})^{-1} D_{jt}^1$ for all i . A country of reputation M_{jt} raises different debt amounts from different investors only to the extent that their holding costs $\omega_i(M_{jt})$ differ. The total amount borrowed by a country of reputation M_{jt} is given by $D_{jt} = \frac{2}{\mathcal{I}} \sum_i D_{jt}^i$. Substituting in optimal relative issuance, we obtain for all i

$$\frac{1}{2} \omega(M_{jt})^{-1} D_{jt} = \omega_i(M_{jt})^{-1} D_{jt}^i. \quad (23)$$

where we define the average holding cost $\omega(M)$ among investors as

$$\omega(M) = \frac{1}{\mathcal{I}} \sum_i \omega_i(M). \quad (24)$$

³⁴The investor problem is analogous to our baseline model, including the effect of ex-post capital controls. In the interest of brevity we do not restate the entire solution by backward induction starting from the rollover decision. We assume that governments cannot discriminate between investor types.

Finally, we can substitute equation (23) back into the interest rate schedules to obtain an aggregate demand schedule relating aggregate debt to the interest rate,

$$R_{jt} = \frac{\bar{R} + \frac{1}{4} \frac{b}{\omega(M_{jt})} D_{jt}}{1 - (1 - M_{jt})\bar{r}}. \quad (25)$$

The aggregate demand schedule therefore is identical to the one studied in the previous sections when summed over investors but here we have provided a tractable disaggregation of the investor specialization in assets with different reputation M given by equation (24). Given the aggregate demand for debt, the decision problem of the committed government is identical to the baseline model, so we can use Proposition 1 to characterize the committed government's strategy. We can then also apply the existence and uniqueness results of Proposition 2.

A Rank Measure of Reputation. We now characterize what types of investors hold a country at a given point in its reputation cycle. From the demand curves derived above, we have $D_i(M_{jt}) = \frac{1}{2}\omega_i(M_{jt})\omega(M_{jt})^{-1}D(M_{jt})$. Consider a country j with reputation M_{jt} . The (infinitesimal) portfolio share of investor i in that country is given by

$$\alpha_i(M_{jt}) = \frac{\frac{1}{2}\omega_i(M_{jt})\omega(M_{jt})^{-1}D(M_{jt})}{w_i}.$$

We take the debt issued by countries with the highest reputation, \bar{M} , to be a reference set. We show below that the correlation of portfolio shares across investors between the portfolio share in debt j and the debt of this reference set \bar{M} reveals the correlation between investor taste $\omega_i(M_j)$ and $\omega_i(\bar{M})$. As long as investors are heterogeneous in this taste, i.e. they specialize in debt of varying reputation, the rank of these correlations reveals the issuers' reputation rank.³⁵ The proposition below formalizes this measure.

Proposition 4 *The correlation of investors' portfolio shares in the debt issued by country j of reputation M_{jt} with a reference set of debt issue by countries with reputation \bar{M} measured at a point in time across investors is*

$$\text{corr}_i(\alpha_i(M_{jt}), \alpha_i(\bar{M})) = \text{corr}_i(\omega_i(M_{jt}), \omega_i(\bar{M})).$$

Let $\omega_i(M_{jt}) \approx \phi_0^i + \phi_1^i(M_{jt} - M^r)$ be a first order Taylor approximation around point M^r and define $\sigma_0^2 = \text{Var}_i(\phi_0^i)$, $\sigma_1^2 = \text{Var}_i(\phi_1^i)$, and $\rho_{0,1} = \text{corr}_i(\phi_0^i, \phi_1^i)$. Provided a sufficiently small approximation error, if $\sigma_0^2 > 0$, $\sigma_1^2 > 0$, and $|\rho_{0,1}| < 1$, then we have for any two countries j, k :

$$M_{jt} > M_{kt} \iff \text{corr}_i(\alpha_i(M_{jt}), \alpha_i(\bar{M})) > \text{corr}_i(\alpha_i(M_{kt}), \alpha_i(\bar{M}))$$

Intuitively, Proposition 4 says that if investors specialize in the debt of issuers with different reputation

³⁵We assume that portfolio shares are invariant to the size of the fund w_i . In the model this can be done by assuming w_i to be constant across funds or by defining the taste functions ω_i up to a multiplicative constant w_i so that their ratio is independent of i . We also assume w_i is sufficiently high that there is positive investment in the outside asset.

and there is a set of issuers for which the reputation level is known to the the highest, then all other issuers' reputation can be ranked by checking how similar are the portfolio shares in those issuers compared to the reference set. We show below that this measure can be taken directly to the data. We note that the measure does not require knowing the parameters of the function $\omega_i(M)$, is valid even if the aggregate $\omega(M)$ is constant, and does not require observing the universe of investors or relying on market clearing.

This measure is particularly useful in the context of a new asset, like China bonds, for which time-series evidence on returns is of limited use or in situations when reforms or crises (like a default or imposition of controls) are likely to have changed the countries' reputation.³⁶ By using portfolio quantities among many heterogeneous funds, it provides a cross-sectional estimate of what the investors believe about the asset (see also [Kojien and Yogo \(2019\)](#)).

4.2 Empirical Implementation

The idea behind Proposition 4 is that heterogeneity in investor portfolios is driven by different relative preferences for investing in countries of various reputation levels. While we cannot observe this characteristic directly, if we know a set of countries to have a high reputation, then we can infer the relative ranking of other countries by seeing which other assets funds that own high reputation government debt also buy. In order to take this idea to the data we need: (i) a sufficiently large and heterogeneous (in terms of reputation focus) set of portfolio investors for which we observe their complete portfolio, and (ii) a choice of reference set. We take the reference set \bar{M} in Proposition 4 to be a set of developed countries (DM) government bonds denominated in their local currency.³⁷ We think of this reference set as having a high reputation \bar{M} .

4.2.1 Portfolio Holdings

We use micro-data on portfolio investment from foreign investors via mutual funds and ETFs from around the world. Investment funds are a useful set of investors for our purposes because: (i) they tend to specialize in specific markets, (ii) high quality data is available at the security level for many countries, and (iii) they are substantial private holders of foreign debt security.³⁸ Our data include global mutual fund and exchange traded fund (ETF) holdings provided by Morningstar for each fund at the security level. We supplement it with information on the asset class, currency, market of issuance, nationality and residency of the issuer and its ultimate parent company, and other security characteristics.³⁹

For each fund and currency, we calculate the share of the fund's total foreign currency bond investment in DM local currency bonds and the remaining share in a selected currency (with that currency omitted

³⁶Appendix [A.I.E](#) reviews the price-based evidence on Chinese bonds.

³⁷The complete list of countries is in Appendix [A.I.C](#).

³⁸For many large developed countries mutual funds and ETFs are the largest foreign bond investors, usually followed by insurance companies, pension funds, and non-financial corporations. Our focus is on keeping the type of investor constant across many domiciles, so we use mutual funds and ETFs for which high quality data is available for many countries.

³⁹See [Maggiori, Neiman and Schreger \(2020\)](#) and [Coppola, Maggiori, Neiman and Schreger \(2021\)](#) for details on the data and the many sources combined in assembling it.

from the DM calculation if relevant).⁴⁰ In our baseline sample, we omit holdings of domestic currency bonds and any equities from the calculations because equities do not have a clear nominal currency component and domestic currency bonds play a special role for each country (see [Maggiori et al. \(2020\)](#)). We measure the correlation between the share of a foreign-currency bond portfolio invested in that currency with the share of the remaining foreign-currency bond portfolio invested in DM currencies across the universe of mutual funds and ETFs. More formally, for each fund i and currency c , we compute the share of the foreign-currency bond portfolio in that currency:

$$\alpha_{c,i} = \frac{\sum_{b \in B_c} MV_{b,i}}{\sum_{c \in FC_i} \sum_{b \in B_c} MV_{b,i}},$$

where $MV_{b,i}$ is the market value of holdings (measured in USD) that fund i has in bond b , B_c denotes the set of bonds denominated in currency c , and FC_i the super-set of bonds in foreign currency from the perspective of fund i . The denominator, therefore, is the value of holdings of foreign currency bonds by fund i . In addition, for each fund i and currency c we compute the share of the remaining foreign-currency bond portfolio in DM currencies as

$$\alpha_{DM,c,i} = \frac{\sum_{d \in \{DM_i/c\}} \alpha_{d,i}}{(1 - \alpha_{c,i})}.$$

We exclude currency c if it is a developed currency, so that $\{DM_i/c\}$ is the set of developed currencies excluding c . We re-scale shares by $(1 - \alpha_{c,i})^{-1}$ so that they reflect the composition of the remaining portfolio excluding currency c .⁴¹ Finally, we compute the summary statistic of interest: the correlation across funds of the share invested in currency c and the remaining share invested in (other) developed currencies

$$\rho_{c,DM} = corr_i(\alpha_{c,i}, \alpha_{DM,c,i}), \quad (26)$$

where the notation $corr_i$ emphasizes that the correlation is cross-sectional over funds i at a point in time.

In bringing the model to the data, we make two further refinements. First, in our baseline analysis we restrict the focus to the government bonds⁴² of the country issuing each particular currency. For example, for the dollar we restrict the attention to U.S. government bonds and exclude bonds denominated in dollar but issued by other sovereigns. The focus on local-currency sovereign bonds in our baseline empirical analysis follows the rationale of our model since, as discussed above, these assets are the most directly sensitive to the reputation of a government (as opposed to corporate bonds and equity, for example). Appendix [A.I.C](#) provides more details on the procedure and highlights the impacts of expanding the types of assets included.

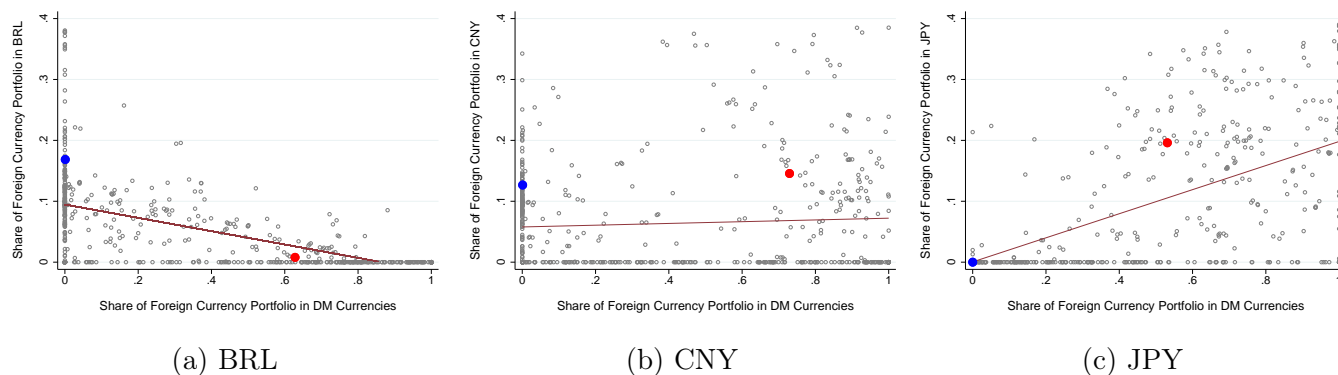
Second, we exclude from our analysis funds that specialize in any particular currency, which we define

⁴⁰We define domestic currency to be the currency of the country in which the fund is domiciled. In the Appendix we explore robustness of this choice by also excluding the currency in which the fund reports its returns.

⁴¹This re-scaling maps the estimates closer to the theory since there the composition of the residual portfolio is unaffected by the size of the share in bonds issued by country j given the assumption of a continuum of issuers each of measure zero.

⁴²In the case of China we classify Policy Banks' bonds as government debt, as these are assumed to be implicitly guaranteed by the central government.

Figure 5: Portfolio Shares by Currency, December 2020



Notes: In each panel, observations are the portfolio holding shares of a particular fund in December 2020. The vertical axis is the portfolio share in BRL in the left panel, CNY in the middle panel, and JPY in the right panel. The horizontal axis in all panels is the portfolio share of in developed markets currencies. In each panel, the blue dot represents the holdings of the PIMCO Emerging Markets Local Currency and Bond Fund and the red dot represents the holdings of the T. Rowe Price International Bond Fund.

as funds that have more than 50% of their foreign-currency bond portfolio in a single currency. We do so because these funds are most likely to have too specific a mandate to reliably contribute to the correlation estimation. We also leave out funds with a small foreign currency portfolio, i.e. less than \$20 million of foreign currency investment, since these small investments are more likely to be noisy and reflect residual positions. Based on our focus on foreign-currency bonds and sample cleaning, the resulting dataset includes approximately 600 investment funds, adding up to just over a trillion dollar of assets under management. As we show below, this is a large sample with substantial investment heterogeneity and Appendix A.I.C provides further sample summary statistics.

4.2.2 Heterogeneous Investment Portfolios and Country Reputation

Figure 5 illustrates our estimates of this correlation measure. We plot the portfolio shares for bonds in three currencies: the Brazilian Real (BRL) in Panel (a), the RMB in Panel (b), and the Japanese Yen (JPY) in Panel (c). Each observation represents the holdings of a particular fund in December 2020, with the share of the fund's foreign bond holdings invested in DM currencies on the x-axis and the share invested in the government bonds of the selected currency on the y-axis.

In Panel (a), we see a negative relationship between the DM currency share and the share in BRL. In Panel (c), we see precisely the reverse pattern for the Yen, with funds investing more in JPY putting a higher share of their non-JPY funds in other DM currencies. In Panel (b) China lies in the middle between these two extremes, with no strong relationship between the DM share and holdings of RMB. This shows that RMB-denominated Chinese government bonds are held together with developed and emerging market government bonds in global portfolios, while Brazilian government bonds are mostly held by EM focused funds, and Japanese mostly held by DM focused funds.⁴³

In each panel, we also highlight two specific funds to help illustrate how heterogeneity in investor portfolios is driven by different relative preferences for investing in countries of various reputation levels.

⁴³Appendix Figure A.VIII plots this underlying data for all currencies in our sample.

The first fund (red dot) is the T. Rowe Price International Bond Fund: it reports the Bloomberg Global Aggregate ex-USD Bond Index as its benchmark and it describes its investment objective as “seeking the above-average total return potential from international bonds.” This fund largely focuses on DM currency debt, with these bonds accounting for almost 65% of its FC portfolio. The second fund (blue dot) is the PIMCO Emerging Markets Local Currency and Bond Fund: it reports the J.P. Morgan Government Bond Index-Emerging Markets as its benchmark and it describes its investment objective as “tapping into opportunities for higher yields and currency appreciation through an actively managed portfolio of local currency-denominated emerging markets (EM) debt.” This fund has less than 1% of its portfolio in DM currencies. In Panels (a) and (c) these two funds are at opposite extremes, reflecting their different specializations, but in Panel (b) their holdings of RMB are somewhat similar.

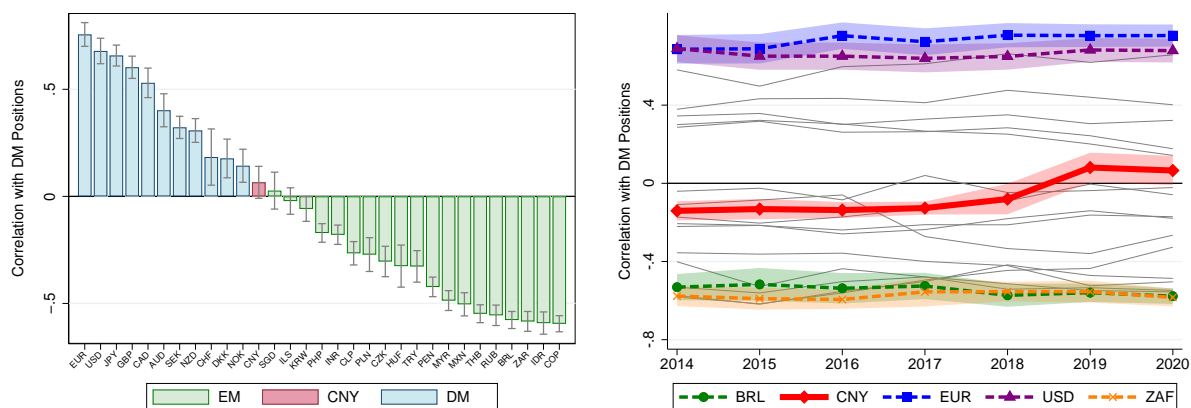
To illustrate more systematically the relation between DM currencies shares and holdings of each one of the currencies, Figure 6 Panel (a) reports the estimated correlations using December 2020 holdings data for all emerging and developed markets in our sample. We find that the Chinese RMB ranks in between emerging market and developed market currencies in terms of its correlation with DM bond portfolio shares. In particular, China ranks close to the most developed among emerging markets issuers: Singapore, Israel and South Korea. As one would expect, emerging markets’ currencies have low and negative correlation with DM shares. Similarly, major DM currencies, like the Euro and the U.S. Dollar, have a positive and high correlation. These patterns in the data reflect the specialization of investors, with some funds more emerging market and some funds more developed market focused.

Through the lens of our model, tracking the correlation measure over time allows us to infer the evolution of a country’s reputation rank. While the time series for China is relatively short, Figure 6 Panel (b) shows that China’s portfolio correlation with developed markets has increased and so has its reputation rank in our model-implied measure. This jump in reputation provides support for a key prediction of our model: a country that opens up to flighty investors should experience a (larger than normal) jump up in reputation. We see such an increase in 2019 for China, the year of the largest inflows from setting up the Bond Connect program, while there is little movement in the correlation measure for the US and Eurozone, both with high and stable correlations’ rank, and Brazil and South Africa, both with low and stable correlations’ rank. Appendix Figure A.XI provides the estimated correlations time-series for a broader set of countries.

In the appendix, we demonstrate that this pattern of China lying in between the EM and DM currencies broadly holds across specifications. We consider U.S. Treasuries as the sole high reputation reference set, weight the observations by fund assets under management, exclude index funds, consider different fund size and fund specialization thresholds and find the results are broadly similar to our baseline with the Chinese RMB lying somewhat in between EM and DM currencies.

We also show the result is robust to controlling for other typical determinants of fund-level portfolios. While our model is univariate, with country reputation the only relevant characteristic, in practice many other characteristics may influence funds’ allocations. In Appendix Table A.III, we control for other common drivers of portfolios, in particular so-called gravity variables such as the distance between the domicile of the fund and the issuing country, a common legal system between them, and the weight of the

Figure 6: A Rank Measure of Reputation: Sovereign Issuers in Local Currency



(a) Cross-Section of Estimates in 2020

(b) Time Series

Notes: Figure reports the correlation between the foreign-bond portfolio shares invested in government bonds in each currency and in a reference set of Developed Markets (DM) local-currency government bonds. Panel (a): reports cross-sectional estimates at the end of year 2020. Panel (b): reports time series for selected countries' estimates. Each line, including the ones in gray, corresponds to a specific currency. We label select currencies for ease of comparison. 95% confidence intervals are computed via bootstrapping.

issuing country in total exports/imports of the country's domicile and find similar results.

5 Reserve Currency Competition

An important feature of becoming an international currency is that a country at the beginning of the cycle faces competition from both other “aspirants,” those at the same low level of reputation, and from countries that are already established, those at high levels of reputation. For example, China is entering now, but faces competition from the U.S. as an established reserve currency issuer. Theoretically, the interaction between reputation building and competition is an interesting area due to complementarities. For example, the value to a country of future higher reputation increases if current competitors lose reputation but decreases if entrenched players issue more. Both occur because the actions of others affect the residual demand curve that the country faces for its debt at future levels of reputation.

Our theoretical framework allows us to study competition among potential reserve currency issuers in a simple and tractable manner. We maintain a set-up nearly identical to Section 4 and briefly outline the differences before formalizing them below. The main difference is that investors now have holding costs/tastes that are no longer separable across countries. This introduces a motive for competition among the issuers: issuance by one country pushes up holding costs for other countries' debt. For tractability, we also introduce an asset S that is in fixed supply \bar{S} and that is sold competitively. Its endogenously determined return is R_t^S . This asset serves as a common factor across investors.

5.1 Asset Demand and Aggregation

As in Section 4, there is a set of investor types, $i \in \{1, \dots, \mathcal{I}\}$, with a continuum of investors of type i with total measure $\frac{2}{\mathcal{I}}$. There is a unit continuum of countries $j \in [0, 1]$. Investor i forms beliefs (π_{jt}, m_{jt}) about country j 's type, strategy, and reputation at date t , with $M_{jt} = \pi_{jt} + (1 - \pi_{jt})m_{jt}$, and takes interest rates R_{jt} and the return R_t^S as given. She chooses her debt portfolio, D_{jt}^i , and asset holdings, S_t^i , in order to maximize her utility,

$$\bar{R}w_i + (R_t^S - \bar{R})S_t^i + \int_j E[R_{jt}^i(1 - \tau_{jt}) - \bar{R}]D_{jt}^i dj - \frac{1}{8}b \left(S_t^i + \int_j \omega_i(M_{jt})^{-1} D_{jt}^{i2} dj \right)^2 \quad (27)$$

Equation (27) is analogous to equation (21), except that investor i can now trade asset S , and i 's holding costs are no longer independent across its holdings. The entire cost function is raised to the power of 2, so that the marginal cost of holding any asset depends on the other asset holdings in the portfolio. This interdependency of holding costs across countries gives rise to interconnected demand curves and a role for issuer competition.

Demand Curves for Assets. The maximization of utility in equation (27) with respect to S_t^i is given by the first order condition:

$$R_t^S - \bar{R} = \frac{1}{4}b \left(S_t^i + \int_j \omega_i(M_{jt})^{-1} D_{jt}^{i2} dj \right).$$

Recall that market clearing for asset S is given by $\frac{2}{\mathcal{I}} \sum_i S_t^i = \bar{S}$. We sum this equation over all investors and impose market clearing for asset S to write

$$R_t^S - \bar{R} = \frac{1}{8}b \left(\bar{S} + \frac{2}{\mathcal{I}} \sum_i \int_j \omega_i(M_{jt})^{-1} D_{jt}^{i2} dj \right). \quad (28)$$

The above equation shows that at the optimal portfolio the average portfolio holding costs across investors equal $R_t^S - \bar{R}$. This common factor across investors induces much tractability, as it will become clear below.⁴⁴ For simplicity, we set $\bar{S} = 0$, so that asset S is in zero net supply. We define the average portfolio holding cost b_t^* to be:

$$b_t^* = 4(R_t^S - \bar{R}) = b \int_j \left[\frac{1}{\mathcal{I}} \sum_i \omega_i(M_{jt})^{-1} D_{jt}^{i2} \right] dj. \quad (29)$$

The maximization of utility in equation (27) with respect to D_{jt}^i is given by the first order condition:

$$R_{jt} = \frac{\bar{R} + \frac{1}{2}b_t^* \omega_i(M_{jt})^{-1} D_{jt}^i}{1 - (1 - M_{jt})\bar{\tau}} \quad (30)$$

⁴⁴An analogy might be drawn with money in the utility function frameworks and the cashless limit; a modeling tool that has proved very tractable in macro theory.

This demand curve has the same form as in equation (22), except that b_t^* replaces b as the slope of the demand curve.

As in Section 4, the model features a very tractable aggregation to a representative investor. By the same steps as in that section, we can define the average holding cost $\omega(M) = \frac{1}{T} \sum_i \omega_i(M)$ as in equation (24), and define total holdings of debt issued by country j as $D_{jt} = \frac{2}{T} \sum_i D_{jt}^i$. We substitute equation (23) into equation (29) to write:

$$b_t^* = b \int_j \frac{1}{4} \omega(M_{jt})^{-1} D_{jt}^2 dj \quad (31)$$

We finally obtain the representative investor demand curve:

$$R_{jt} = \frac{\bar{R} + \frac{1}{4} b_t^* \omega(M_{jt})^{-1} D_{jt}}{1 - (1 - M_{jt}) \bar{\tau}}. \quad (32)$$

Again, this is analogous to equation (6) and equation (22), but now the slope b_t^* is endogenous. When other countries increase issuance to the investors, the residual demand curve faced by a specific country for its debt worsens (steepens). The effect occurs through a common component, b_t^* , to which countries of varying reputation M_{jt} are heterogeneously exposed via the taste $\omega(M_{jt})$. Countries at levels of reputation that investors on average find less attractive, a high $\omega(M_{jt})^{-1}$, are more exposed to increases in b_t^* .

5.2 Equilibrium and Stationary Distribution

We restrict our analysis to Markov strategies of committed and opportunistic government that are symmetric in investor beliefs π_{jt} : governments j and k of the same type play the same strategy if $\pi_{jt} = \pi_{kt}$.

Committed Government. A committed government j at date t takes as given the entire path of its own reputation $\{M_{jt}\}$, the reputation paths and issuance strategies $\{M_{it}, D_{it}\}_{i \neq j}$ of all other countries, and the path of returns on the outside assets $\{R_t^S\}$. Because committed government j is small, it therefore takes the path of slopes $\{b_t^*\}$ as given. The path of $\{b_t^*\}$ is sufficient information on the issuance by other countries for the committed government to solve its decision problem at date t .

As in the baseline model, the decision problem of committed government j is a repeated static problem in which at date t it faces reputation M_{jt} and slope b_t^* . Proposition 1 with homogeneous haircuts applies to this set-up and characterizes the committed government's strategy, with b_t^* replacing b .

Opportunistic Government. As in the baseline model, an opportunistic government mimics the debt issuance of the committed government to avoid revealing itself at the beginning of date t . The opportunistic government strategy is the choice of probability $m_t^o(\pi_{jt})$ of not imposing the capital control and the end of date payoff is still given by equation (8), where indirect utility V now depends on both M_{jt} and b_t^* but is otherwise defined analogously.

The decision problem of an opportunistic government can be defined analogously to the baseline model,

$$W_t(\pi_{jt}) = \max_{m_{jt}^o \in [0,1]} m_{jt}^o \left(V^{Opp}(M_t(\pi_{jt}), b_t^*, 0) + \beta W_{t+1}(\pi_{j,t+1}) \right) + (1 - m_{jt}^o) \left(V^{Opp}(M_t(\pi_{jt}), b_t^*, \bar{\tau}) + \beta W_{t+1}(\epsilon^0) \right). \quad (33)$$

where the value function W_t now also depends on time t variables like b_t^* and their future evolution.

Definition of Equilibrium. We now define an equilibrium of the model with competition.

Definition 2 *An equilibrium of the competition model is a path of debt issuances of committed governments $\{D_{jt}\}$, a path of debt and outside asset purchases $\{S_t^i, D_{jt}^i\}$ of investor i such that debt markets and asset markets clear at interest rates $\{R_{jt}, R_t^S\}$, a path of strategies $m_t^o(\pi_{jt})$ of opportunistic governments, a path of investor beliefs about government types $\{\pi_{jt}\}$, opportunistic government strategies $\{m_t(\pi_{jt})\}$, and government reputation $\{M_t(\pi_{jt})\}$, and a path of slopes $\{b_t^*\}$ such that: (1) Debt issuances are optimal for the committed government; (2) Debt and asset purchases are optimal for investors; (3) $m_t^o(\pi_{jt})$ is an optimal strategy of opportunistic government j at date t ; (4) π_{jt} is consistent with Bayes' rule in equation (10); (5) Investor beliefs are consistent with the opportunistic government optimal strategy, (6) $m_t(\pi_{jt}) = m_t^o(\pi_{jt})$; (7) Slope b_t^* is consistent with equation (31).*

For given constant slope b^* , the equilibrium Definition 2 is identical to that in the baseline model with homogeneous haircuts (Definition 1).

Steady State Symmetric Equilibrium. We focus on characterizing a steady state of the model which features a symmetric graduation step Markov equilibrium. A steady state of the model is an equilibrium with a path of constant slopes: $b_t^* = b^*$.

We construct an equilibrium proceeding as follows.⁴⁵ First, consider the model of Section 3 with homogeneous haircuts. For any given b^* in the model with competition, define $b' = b^*$ to be the value of the slope of investor demand in the model without competition. Then by Proposition 2 there exists a unique graduation step Markov equilibrium of the model without competition. Imagine a unit mass of countries each separately in a Markov equilibrium without competition. Denote $\mathbf{M}(b^*) = \{M_0(b^*), \dots, M_N(b^*), 1 - \epsilon^C\}$ to be the reputation cycle associated with the unique graduation step Markov equilibrium without competition when the slope is $b' = b^*$. Parts (1)-(5) of the Definition 2 hold in this conjectured equilibrium. What remains to verify is that condition (6) also holds: given conjectured equilibrium issuance D_{jt} and reputation cycle $\mathbf{M}(b^*)$ the right hand side of equation (31) indeed equals the conjectured value of b^* .

Given the reputation cycle $\mathbf{M}(b^*)$, the steady state distribution μ_{b^*} over reputation levels $[0, 1]$ is atomic with atoms at each point in $\mathbf{M}(b^*)$ and with no mass at any subset of $[0, 1]$ that is disjoint with $\mathbf{M}(b^*)$.⁴⁶ We can rewrite equation (31) as

$$b^* = b \int_M \frac{1}{4} \omega(M)^{-1} D(M, b^*)^2 d\mu_{b^*}, \quad (34)$$

⁴⁵As in the baseline model, we restrict attention to cases where the collateral constraint binds. We provide a sufficient condition on primitives for the collateral constraint to bind in the proof of Proposition 5.

⁴⁶Appendix A.II.O provides a formal characterization of this stationary distribution μ_{b^*} .

where we employed a Lebesgue integral over μ_{b^*} and $D(M, b^*) = 2\frac{\omega(M)}{b^*} \left[\gamma Q(1 - (1 - M)\bar{\tau}) - \bar{R} \right]$ as in Proposition 1 with homogeneous haircuts. Thus, an equilibrium exists if there is a b^* such that the above condition holds. The proposition below formalizes existence of our conjectured equilibrium, which we refer to as a steady state symmetric graduation step Markov equilibrium.

Proposition 5 *There exists a steady state symmetric graduation step Markov equilibrium of the competition model.*

5.3 Effects of Competition

Competition affects the dynamics of the model both by affecting the optimal debt policy for a given reputation path and by affecting the path of reputation itself. Intuitively, competition lowers the value of becoming a reserve currency because, in the presence of competitors, the residual demand curve for debt is not as attractive (steeper) for the issuer. Most potential candidate countries stay at low levels of reputation, that is they do not become reserve currencies, and even those that emerge as reserve currencies find being one less valuable than in the absence of competition. To unpack these effects it is useful to consider some special cases before turning to the full effect of competition on the stationary distribution.

We consider first the special case of no inside equity, so that all projects are fully debt financed.

Proposition 6 *Assume that inside equity is zero, $A = 0$. Then, there exists a unique steady state symmetric graduation step Markov equilibrium of the model with competition. The reputation vector \mathbf{M} and distribution μ are the same as those in the unique graduation step Markov equilibrium in the model without competition and slope b . Competition lowers the optimal debt issuance but does not affect the evolution of reputation.*

In this limiting case, competition lowers equilibrium debt issuance but has no direct impact on the reputational dynamics. The reason is that absent inside equity, the entire value of the government comes from debt issuance. Because b^* has the same proportional impact on the demand curves of all reputation levels, it drops out of the transition dynamics absent inside equity, leading to the limiting result.

In the general case with $A \geq 0$, the transition dynamics are

$$V(M_n) = \rho v A \frac{b^* - b}{b} + \rho V(M_{n-1}) + V(M_0),$$

where V is the indirect utility function of the committed government in the model without competition and slope b , and where $v = \frac{h}{\gamma - \frac{1-h}{R^M}} \gamma Q$ is the marginal value of inside equity.⁴⁷ In the limiting case of $A = 0$, these transition dynamics collapse to those of the model without competition, as highlighted by Proposition 6. When $A > 0$, the above equation shows that reputation builds more quickly when competition is higher, that is b^* increases relative to b . Intuitively, the value of intermediation can be thought of as a combination of value from inside equity and value from external debt. As competition

⁴⁷See the proof of Proposition 6 in the Appendix for the derivation.

becomes more fierce, the value of external debt declines relative to the value of inside equity, making it less costly for a government to forego its current reputation level (all else equal). This means that a larger reputational gain is required to induce the opportunistic government to be willing to forego capital controls today, leading to a faster buildup of reputation.

The above observation gives rise to a second interesting limiting case: committed governments can provide sufficiently fierce competition to force immediate graduation by opportunistic governments.

Proposition 7 *There exists a threshold \bar{b}^* such that if and only if $b^* > \bar{b}^*$, there is a crowd out equilibrium of the competition model in which $\mathbf{M} = \{\epsilon^W, 1 - \epsilon^C\}$ and all opportunistic governments immediately graduate.*

Intuitively, competition in this case is sufficiently fierce that opportunistic governments cannot build sufficient value from reputation. As a result, they immediately impose capital controls and graduate. Proposition 7 expresses the result in terms of a threshold on the sufficient statistic b^* .⁴⁸

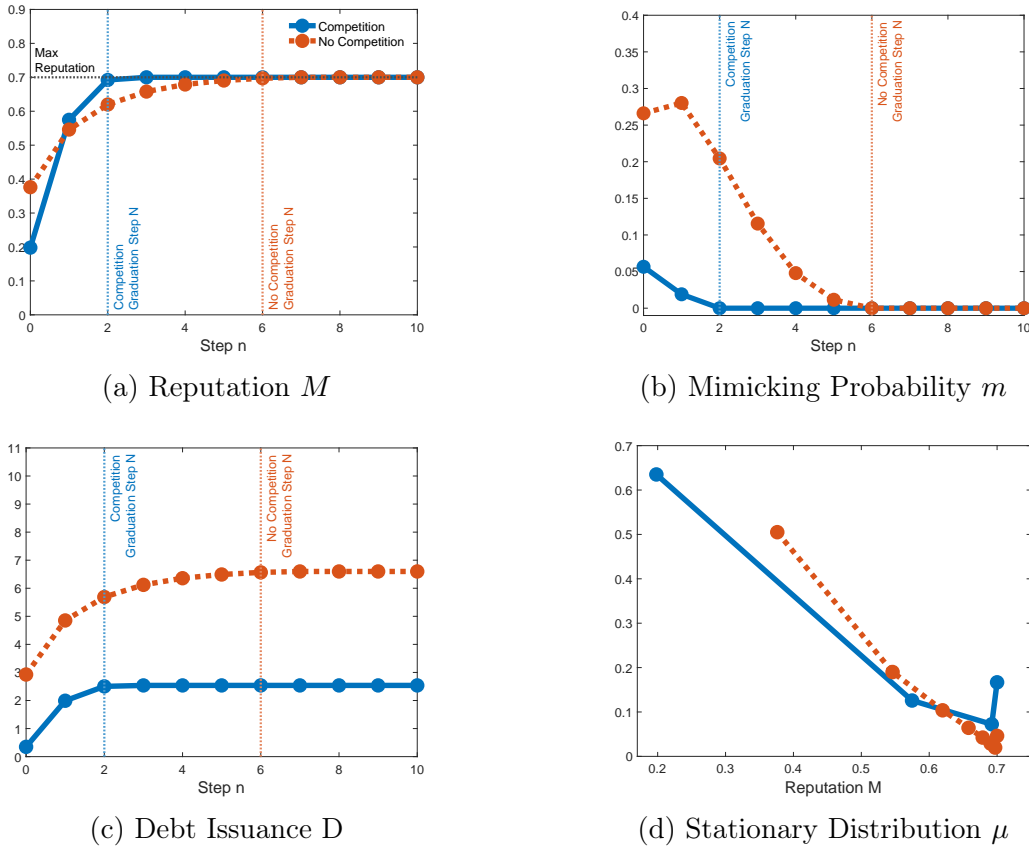
Numerical Illustration. We now turn to a numerical illustration of the general case. For simplicity, we assume $\omega(M)$ is constant in M . Figure 7 plots the equilibrium cycle and distribution of reputation for a country in the model under two configurations. This configuration is equivalent to the baseline model of Section 3.6, but with homogeneous haircuts. For this configuration, Figure 7 panel (d) plots the stationary frequency that the country spends at each level of reputation. The country spends most of the time at low levels of reputation highlighting how difficult it is to emerge as a reserve currency in the model.

In the second configuration, there is a unit mass of issuing countries. All parameters are otherwise identical to the first configuration, including b and $\omega(M)$. For this configuration, Figure 7 panel (d) plots the stationary frequency that a country, drawn at random ex-ante, spends at each level of reputation. Given the law of large numbers, this frequency also coincides with the stationary cross-sectional distribution μ . Compared to the first configuration, the country now spends more time at lower levels of reputation and graduates sooner.⁴⁹ Indeed, Panel (a) shows that reputation at $n = 0$ is lower under competition, but then grows faster leading to an early graduation. The faster growth is consistent with the lower mimicking probability at $n = 0$ under competition. A greater fraction of opportunistic types reveal themselves at $n = 0$ leading to a higher stationary mass point there (see Panel (d)). Panel (c) confirms that debt issuance per country falls due to competition. Overall, these features highlight that competition deters a country currently at a low level of reputation, like China, from building reputation up into being a reserve currency. Several of the key qualitative features of Figure 7 can be shown to be

⁴⁸A similar expression holds in the model without competition and provides a restriction on a set of parameters, including the slope of the demand curve b , to induce immediate graduation ($N = 0$). In particular, the model without competition requires that $(1 + \rho)V(\epsilon^O) \geq V(1 - \epsilon^C)$ for immediate graduation to occur. If the model without competition features immediate graduation, then the model with competition also features immediate graduation.

⁴⁹Both distributions feature an increase in mass at the highest reputation that is achieved after graduation. This level of reputation is identical in the two configurations and given by $1 - \epsilon^c$. The graduation step is an absorbing state for committed types, so that a mass of probability builds up in the model at that level of reputation.

Figure 7: Competition and the Stationary Distribution



Notes: Numerical illustration of the model with or without competition. Panel (a) plots the reputation cycle M . Panel (b) plots the mimicking probability m . Panel (c) plots debt issuance. In panels (a), (b), and (c), the dashed-blue and dashed-red lines are the graduation steps of the model with competition and no competition, respectively. Panel (d) plots the stationary distribution μ of the two models.

generic properties of the model with competition. Generically, higher competition leads countries to start at a lower reputation level at $n = 0$, eventually build to a higher reputation level, and graduate faster. Higher competition always leads opportunistic governments to mimic less early in the reputation cycle. Equilibrium debt issuance is lower for any given reputation level.

How Can the U.S. Deter China From Becoming a Reserve Currency? In the model of competition we studied above, countries take the reputation cycle and distribution as given, in the spirit of monopolistic competition models. It is interesting to extend this set-up to consider the incentives of a country to manipulate the cycle, and the impact such a country has on the outcomes for its competitors. We provide here a brief leading example, relegating most of the details to Appendix A.II.M. Suppose there was a large country known to be committed forever, so that its reputation is $M = 1$ and constant. Assume that this country chooses issuance taking into consideration its effect on the reputational cycle \mathbf{M} , distribution μ , and other countries' issuance, that is its effect on b^* .

In terms of the model developed in this section, it is analytically convenient to make this country (the U.S.) the issuer of the outside safe asset S which we previously took as being supplied exogenously at \bar{S} .⁵⁰ This country faces the demand curve in equation (28). As it increases issuance S , the first term in the demand curve leads to the usual monopolist effect: the country internalizes that its own interest rate goes up as it issues more debt. As R^S increases, further issuance also has the effect of pushing up the slope of the demand curve, b^* , faced by its competitors. In turn, competitors' issuance decisions, affect the second term in equation (28), $\sum_i \int \omega_i (M_{jt})^{-1} D_{jt}^i dj$, which falls if the competitors decrease their issuance. The country (U.S.) chooses higher issuance, all else equal, if this latter effect is indeed negative.

An interesting corollary of Proposition 7 is that this country (the U.S.) can choose sufficiently high issuance S such that all opportunistic competitors graduate immediately. Intuitively, the US flooding the market with safe assets diminishes the value of building reputation for an opportunistic competitor (say China) sufficiently to completely discourage it from building any reputation. More generally, we show that the probability that an opportunistic competitor, starting at the beginning of the reputation cycle (at step 0), goes through its next n crises without ever exercising the capital control declines for any $n > 0$ as the U.S. issues more safe debt. This means that the probability an opportunistic competitor builds to any reputation above the initial level declines. In this sense, increased issuance by the U.S. makes it harder for an emerging opportunistic competitor to establish itself as a competitor reserve currency. In practice, one important concern is that the U.S. issuing more debt to deter new entrants like China might risk a self-full-filling debt crisis in the U.S. itself (see Farhi and Maggiori (2018) and He et al. (2019)). This risk is absent here since we imposed common knowledge that the US is a committed type.

Formally, we define $\delta_n = \prod_{k=0}^{n-1} m_k$ to be the probability that a government that is opportunistic at step 0 and survives its next n crisis, does not exercise the capital control in any of those crises and reaches step n of its reputation cycle. We collect the result in the proposition below.

Proposition 8 *The probability that an opportunistic government (e.g. China) starting at step 0 reaches step n of its reputation cycle decreases in competition b^* for any $n \geq 1$, that is $\frac{\partial \delta_n}{\partial b^*} < 0$.*

In this set-up, the presence of an existing hegemon, like the U.S., makes it less likely that a multipolar international monetary system emerges. Much like in Stackelberg competition, the incumbent uses its dominant position to discourage entrance, in this case by oversupplying safe assets and shrinking the exorbitant privilege. To the extent that a multipolar system is desirable, this analysis opens up a role for multilateral policy agreements and points to the tools from the analysis of monopolies and competition as a way forward to analyze and reform the international monetary system.

6 Two-Way Capital Flows

The Chinese government is one of the largest holders of U.S. Treasuries and a major foreign investor in everything from direct financing of infrastructure projects to loans to emerging market economies. At the

⁵⁰Taking the U.S. as being known to be committed, while we think of China as opportunistic, is purely for convenience and sharpens the focus on the key forces we want to highlight.

same time, it is letting foreigners participate in its domestic bond markets. In the model considered so far, we have focused on the decision to borrow from foreigners. We now consider the interrelated decision of letting domestic savers invest abroad. These two-way capital flows are important in understanding China's motivation for internationalizing its currency because they distinguish the current account and net foreign asset position (net borrowing at the country level) from the gross assets and liabilities positions and changes in gross positions (see also Obstfeld et al. (2010) and Dooley et al. (2008)).

We show that, as reputation builds, increased investment by foreigners in the domestic bond market coincides with increased foreign investment by domestic households (savers). On the one hand, the model clarifies that internationalizing a currency is not about net-borrowing per se, i.e. the current account or net foreign assets, but more linked to gross positions. On the other hand, it draws an equilibrium connection between internationalization and, all else equal, the net desire to borrow. In net, as reputation builds, the country becomes more of a borrower (or at least less of a creditor) from the rest of the world. For example, starting from a large creditor position at low levels of reputation, like China's present situation, there is a tendency toward becoming a debtor as reputation increases. Intuitively, reputation is like a pledgable asset, it is valuable because one can borrow against it. The more it becomes valuable, the more the country wants to use it to lever up.

We return to the baseline model of Section 3.6 with heterogeneous investors. We generalize that model by assuming that domestic households have an endowment W of liquid wealth at each date t . Households also own the intermediation sector, where $E_t \equiv V_t$ is the total value of the intermediation sector equity at date t . Thus, their total wealth position is $W + E_t$. At the beginning of each date, households can invest an amount K_t in illiquid foreign assets, which pay out R^K at the end of the date. Households invest the remainder $W - K_t$ in illiquid non-intermediary investments, and we normalize the return of these assets to 1 for simplicity.⁵¹ In the main text we assume that shares in the intermediaries cannot be traded, since inside capital A is fixed and domestically held. In Appendix A.II.P.6, we relax this assumption and show that it generates a jump in both gross assets and liabilities that occurs at the opening up step.

Households have an adjustment cost for sending capital abroad based on their total wealth, given by $\Psi(k_t)(W + E_t)$, where $k_t = \frac{K_t}{W + E_t}$ is the fraction of their total wealth that they send abroad and where Ψ is increasing and convex. Given that households send a fraction k_t of their wealth abroad, their total welfare, including the value E_t of their intermediary equity, is given by: $\left(R^K k_t - \Psi(k_t) + (1 - k_t) \right) (W + E_t)$. The optimal private allocation of domestic savings to foreign investment k_t is constant, that is households always allocate a constant fraction of their total wealth to international investment. This optimal household allocation is given by $\Psi'(k) = R^K - 1$.

The government may encourage capital outflows by domestic savers to be higher or lower than the private optimum. On the one hand, the government may value investments that increase demand for the Renminbi as a global currency more so than individual households do, internalizing the benefits of a liquid market for its currency. The benefits might come in the form of a shift downward in the demand

⁵¹We assume that there is a very large penalty associated with $K_t > W$ and focus for simplicity on solutions in which this constraint does not bind.

curve of foreign investors, who have higher incentives to invest in Renminbi as a result of Chinese foreign investment. The benefits might also arise from gains in geopolitical importance or independence arising from building an international payment system in which the Renminbi is an accepted store of value and means of payment. On the other hand, individual savers may value exporting capital more than the government if they fear that capital held domestically will be captured by the government for its own private benefits. The government may have perverse incentives to restrict private outflows of capital if it can divert part of that capital to its private benefit.

To capture the wedge between private and government incentives, we assume that the government obtains a proportional benefit B from all savings kept at home, which yields a total benefit to the government of $B(1 - k_t)(W + E_t)$. A value of $B > 0$, can stand in for government corruption, or more benignly, benefits from keeping the savings domestic that are not internalized by households. A value of $B < 0$, help us capture the extra value attributed by the government compared to households to investments abroad that help build the currency globally. Given the government's objective, its optimal allocation is $\Psi'(k_t) = R^K - (1 + B)$. If $B > 0$, then the government chooses to send less capital abroad than households would have privately chosen, and it imposes limits on domestic capital flowing abroad concurrently with the limits on inflows by foreigners (this latter part has been the focus of our model so far).⁵²

Solving the model with two-way asset holdings follows the same steps as the model solution in Section 3.6. Since k_t is constant over time, the government's objective function is an affine transformation of $E_t = V_t$ generating similar dynamics. We further impose a realistic restriction that the marginal value of an additional unit of inside equity is less than two, so that the marginal return on an additional unit of inside equity is less than one hundred percent.⁵³ We summarize the dynamics in the proposition below.

Proposition 9 *In the model with two-way capital flows, both gross foreign assets and liabilities increase in reputation. The country's net foreign assets deteriorate as reputation improves.*

As reputation builds up, gross flows happen simultaneously: foreigners hold more of the domestic bond market and domestic capital flows abroad. Foreign assets, $K_t = k(W + E_t)$, increases in constant proportion ($k < 1$) to the equity value of the intermediation sector. Intuitively, as reputation builds, the equity value of the intermediation sector also builds, and so does household net worth, making it more attractive to send more wealth abroad. Foreign liabilities D_t increase faster than the value of intermediation (see proof of Proposition 9 in the Appendix). The country is leveraging to extract the highest possible value out of its reputation, and becomes more levered as reputation increases. The net foreign asset position, therefore, deteriorates as reputation increases.

⁵²In practice the government might simultaneously limit some forms of domestic capital outflows and incentivize others. For example, it might limit private holdings of foreign assets and, at the same time, invest abroad via state-owned entity projects that the government selects. In the case of China, for example, there are tight controls on private holdings of foreign securities, but at the same time entities like SAFE and AIIB make large investments abroad using domestic savings. This could be accommodated in our framework by introducing two types of foreign investments, one over which B is positive and one over which it is negative.

⁵³See the proof of Proposition 9 in Appendix A.II.L for discussion of where this condition applies.

The model can make sense of a country like China that is a net foreign creditor at low levels of reputation: imagine that W is much larger than E_t at low levels of M . Even at low levels of reputation, and while being a net foreign creditor, the country chooses to borrow some capital from foreigners in order to start building future reputation. As that reputation is built, the desire for borrowing increases faster than the desire to invest domestic savings abroad, leading to a net foreign asset deterioration. The model captures the tendency of countries that are established reserve currency providers, like the U.S., to be net foreign debtors and characterizes their dynamic adjustment toward this position.

7 Conclusion

This paper characterizes China’s strategy for internationalizing its currency through controlling the set of investors that can access its bond market. While the Renminbi has a long way to go to rival the U.S. Dollar as an international currency, China’s real economic size and the size of its capital market could make the integration of its capital market into global financial markets a major shift in the international monetary system. We explain China’s gradual approach to liberalizing capital inflows as balancing the desire to gain international currency status against the risks of sudden capital outflows that come with foreign investment. By beginning with allowing investment from more stable investors and only later allowing in flightier ones, China has put itself on a path towards becoming an international currency while trying to minimize the risks it faces on the transition path. Whether it is able to achieve this while avoiding costly episodes of capital flight and the imposition of capital outflow controls is an open question.

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