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Introduction

by Daniel Bob

In 2013, China announced it would establish the Asian Infrastructure Investment Bank (AIIB) to help meet the enormous demand for new infrastructure in Asia. In 2009, the Asian Development Bank (ADB) projected that such demand would reach $8 trillion between 2010 and 2020, vastly more than ADB and other existing multilateral development banks (MDBs) could finance.

Countries in the region responded positively to China’s proposal, with many pledging to join the bank. The United States and Japan, however, took a cautious approach. Despite the existing MDBs’ resource constraints, they viewed AIIB more as a challenge to the existing Bretton Woods institutions, than a complement.

As China moved ahead with its plans for AIIB, both the United States and Japan questioned China’s motivations and intentions as well as Beijing’s ability to create a high-standard, well-functioning international financial institution. The United States went further: it lobbied allies and partners against joining the bank.

To the apparent surprise of both Washington and Beijing, on March 12, 2015, George Osborne, the United Kingdom’s Chancellor of the Exchequer, announced that Britain would join AIIB. The UK decision opened the floodgates, and another two dozen European and other countries with close ties to the United States quickly signed up. By the April 15, 2015, deadline, a total of 57 nations had joined as prospective founding members. Fifty of those nations have since committed to full participation as founding members, while the remaining seven have until the end of 2015 to make a final decision.

China’s push to establish AIIB and the response by the United States and Japan are important, in and of themselves, given Asia’s need for infrastructure. The actions taken by all three also seem to illustrate many of the issues that attend China’s swift economic, military and diplomatic rise. Indeed, China’s reemergence as a major power, the extent to which it works within the bounds of existing international institutions and follows global norms, coupled with other nations’ willingness to accept and accommodate that reemergence, present some of the more difficult issues of 21st century geopolitics.

To get a sense of how those issues are playing out among Bretton Woods institutions, Sasakawa USA commissioned papers on AIIB’s creation and development by experts from China, Japan and the United States.

Dr. Masahiro Kawai, former head of the Asian Development Bank Institute, provides a view from Japan. He compares AIIB to existing MDBs in its governance, financial operations, scale, membership, capital subscriptions, voting shares and focus, concluding that the new bank parallels them in many respects.

He goes on to assess China’s mix of motivations in establishing AIIB, which included the goal of helping meet the large demand for infrastructure in Asia. He points to American, Japanese and European domination of existing international financial institutions. In large part, that domination results from the failure of the U.S. Congress to permit reforms at the International Monetary Fund that would give China and other countries voices in the Fund more commensurate with their increased economic power. China also saw the bank as a vehicle for expanding external demand to absorb domestic excess capacity and
a potential support for its foreign policy objectives and ambitious plans to build overland and maritime “Silk Roads” connecting and integrating China with Central Asia, the Middle East, Africa and Europe. Dr. Kawai then analyzes AIIB’s current weaknesses. Perhaps most important is its lack of a coherent vision, but the bank also has a governance structure and allocation of voting shares that China may overly dominate, lending policies that may neglect environmental and social standards or fail to follow best practices, potential difficulties attracting personnel with the requisite expertise and a possible unwillingness to coordinate with existing MDBs.

He explains the reasons behind Japan’s initial decision not to join AIIB, pointing first to a fundamental lack of trust between Tokyo and Beijing due to disputes over history and territorial issues. More directly, Japan had concerns over the new bank’s governance and lending standards, and suspicions that China would use AIIB primarily as an instrument for realizing its narrow economic and strategic goals. Finally, Dr. Kawai weighs the pros and cons of Japan joining the bank, and concludes that Tokyo should take a wait-and-see approach, though it should also encourage existing MDBs to engage and work with AIIB.

Yun Sun, a Senior Associate at the Stimson Center, examines China’s motivations in establishing AIIB. She argues that it fits into President Xi Jinping’s vision for the “great rejuvenation of the Chinese nation,” which includes establishing a new, “proper” international order reflecting China’s greater economic and political weight. AIIB was designed, in part, she says, to expedite the emergence of that new order.

Like Dr. Kawai, she cites such other motivations as China’s aim to help meet Asian demand for new infrastructure, provide financial and technical support for China’s Silk Road initiatives, further China’s strategic objectives, boost external demand to absorb excess capacity and give it a voice in an international financial institution focusing on Asia that corresponds to China’s economic influence in the region. She also notes that AIIB may help China achieve its aim of internationalizing the yuan.

Ms. Sun then examines how China’s plans for AIIB changed over time as a result of internal negotiations with members over the Articles of Agreement, the bank’s basic organizing document, as well as external pressure from the United States and Japan. China did not initially anticipate or encourage membership by non-Asian countries. However, as interest outside of Asia grew, China dropped its focus on establishing an exclusively regional bank, and it allotted 25% of capital shares to non-regional members. China also moved away from earlier proposals that the bank function as either an aid organization or a commercial bank, and clarified AIIB’s role as one close to that of existing MDBs.

In addition, China lowered its planned capital contribution to the bank – from a level that might have translated into absolute veto powers – and focused on a more circumscribed range of areas over which it could exercise dominance. Given such changes, Ms. Sun concludes that, while ultimate judgment must await the bank’s actual performance, AIIB’s development shows that, as China challenges the existing international system, those seeking to maintain the essential elements of that system may check China’s ambitions and push it closer to playing by the established rules.

Tobias Harris, Fellow for Economics, Trade and Business at Sasakawa USA, assesses the U.S. response to AIIB. He argues that it encapsulates problems in the Obama administration’s “pivot” to Asia, a set of policies designed to preserve and extend the U.S. diplomatic, economic and political position in the Asia Pacific. To counter widespread views within China and elsewhere that the pivot is a thinly veiled attempt to contain China, the administration has repeatedly denied it has any such intention, essentially reinvigorating the previous administration’s call for China to act as a “responsible stakeholder.”

However, rather than engaging AIIB constructively as a new multilateral opportunity to address the regional shortfall in infrastructure financing, the United States advocated against allies and partners participating in the new bank. Washington portrayed the bank as a threat to existing institutions by focusing on AIIB’s potentially lower standards.
Harris characterizes the rush of allies and partners in Europe and elsewhere to join the bank as an embarrassing failure of U.S. diplomacy. The U.S. arguments against AIIB focused on narrow, institutional standards within the bank, neglecting the larger strategic picture. Harris agrees with Yun Sun, however, that U.S. resistance to AIIB may have played a useful role in pushing China to improve the bank’s operating structure.

Harris goes on to explore the reasons for the imprudent U.S. response. Congressional opposition to the United States joining any new international financial institution, let alone meeting commitments to existing ones, fundamentally limits options for the United States. However, the U.S. response was also driven by an initial lack of information on AIIB, the administration’s preoccupation with Ukraine and the Islamic State, a predisposition within the Treasury Department to preserve the current Bretton Woods institutions’ position and a desire to maintain U.S.-Japan relations when Japan opposed the bank.

Harris concludes with his views on lessons learned for the United States in dealing with China and the development of new institutions in Asia. He maintains that the United States should offer its own solutions to regional problems rather than reflexively oppose new institutions offering fresh approaches. Moreover, Washington should recognize that agenda-setting and institution-building in Asia by China and others are not necessarily zero-sum games. Indeed, new initiatives may even potentially benefit the United States. He contends that Washington needs to address Beijing’s valid complaints over the governance of existing international financial institutions, which do not align voting powers for China and other members with their recently increased economic weight, or more fundamentally, allow China room to become a responsible stakeholder in the existing international system.

As of the summer of 2015, Japan has indicated that it may ultimately seek membership in the bank, while the United States is holding back but taking the position that it welcomes AIIB. Prime Minister Abe said at an April 28, 2015, joint press conference with President Obama that, “For Japan to participate in the AIIB is a decision that we have not taken yet.” At the same press conference, President Obama said in reference to AIIB, “To the extent that China wants to put capital into development projects around the region, that’s a positive. That’s a good thing.”

AIIB is scheduled to begin operations at the end of 2015, so both the United States and Japan will have to find ways to accommodate it. In the meantime, as these papers show, China is acutely aware of the international interest in the bank and appears likely to take the steps necessary to make the institution function appropriately. However, many operational details have yet to be worked out and many hurdles remain.
Asian Infrastructure Investment Bank in the Evolving International Financial Order

by Masahiro Kawai*

1. INTRODUCTION

In mid-April 2015, the Chinese Finance Ministry announced that 57 countries had signed the Memorandum of Understanding on Establishing the Asian Infrastructure Investment Bank (AIIB), thereby becoming prospective founding members of the China-led bank. The group was comprised of 37 Asian and 20 non-Asian nations, including the United Kingdom, Germany, France and Italy – four of the Group of Seven (G7) countries. They then negotiated the Articles of Agreement to Establish the AIIB (AOA), which 50 nations signed toward the end of June to become full founding members.1 AIIB is scheduled to start operating by the end of 2015.

The authorized capital stock for AIIB will be US$100 billion. China dominates the bank as its largest shareholder with a capital contribution share of 30% and a voting power share of 26%. In addition, the bank’s headquarters will be located in Beijing and its president will be Chinese, the most likely being Jin Liqun, a former vice minister of finance in China’s Ministry of Finance and a former vice president of the Asian Development Bank (ADB).

Given vast infrastructure investment needs, Asia’s developing countries have welcomed China’s push to establish AIIB. The United States and Japan, however, have viewed AIIB with caution and skepticism and stayed away. Indeed, both Washington and Tokyo have raised questions about China’s motivations in establishing AIIB, including the bank’s potential to challenge the existing international financial order, led by the Bretton Woods institutions, in which the United States and other G7 countries are dominant shareholders. Japan also views AIIB as a potential direct competitor to ADB, which Tokyo leads as the largest shareholder and the provider of presidents.

In addition to establishing AIIB, China has worked with other BRICS (Brazil, Russia, India, China and South Africa) countries to create a New Development Bank and a Contingent Reserve Arrangement. China has also promoted the internationalization of its currency, the renminbi (RMB), and actively pushed for the RMB’s inclusion in the basket of currencies upon which the value of the IMF’s Special Drawing Rights (SDR) is based.

With the economic weight of emerging and developing countries having risen quickly since the global financial crisis of 2008, the advanced G7 countries, alone, can no longer manage the world’s economic and financial

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1 Seven prospective founding members did not sign the Articles of Agreement in June but have until December 2015 to do so. They are: Denmark, Kuwait, Malaysia, Philippines, Poland, South Africa and Thailand.

* The author is grateful to Masatsugu Asakawa (Vice Minister of Finance for International Affairs, Japan’s Ministry of Finance), Jin Liqun (Secretary General, Multilateral Interim Secretariat, AIIB), Takehiko Nakao (President, ADB), Yang Shaolin (Director General, Department of International Economic and Financial Cooperation, China’s Ministry of Finance) and Zao Jiayi (Director General, Department of International Economic Relations, China’s Ministry of Finance) for their insights as background for this paper. He also thanks Daniel Bob (Sasakawa Peace Foundation, USA) for detailed comments and suggestions for improvements on earlier versions of the paper.
challenges. As a result, the Group of Twenty (G20), which represents the world’s 20 largest economies, has emerged as the most prominent forum for international policy coordination. Associated with this change, the international financial order appears to be in transition, from one dominated by the United States and the U.S.-led G7 to a multipolar system in which major emerging and developing countries also play an important role. The establishment of AIIB encapsulates that evolution.

This paper is organized as follows: Section 2 defines AIIB as a multilateral development bank (MDB) and compares it with major existing MDBs and the Andean Development Corporation in Latin America. Section 3 summarizes motivations behind China’s move to establish AIIB. Section 4 identifies issues for AIIB, including its vision, governance, lending policies and standards, human capital and expertise and coordination with other stakeholders. Section 5 explores options for Japan. Section 6 discusses challenges for China and the international community. Section 7 offers conclusions.

2. WHAT IS AIIB?

(1) AIIB as an MDB

AIIB will be a multilateral development bank – an international financial institution, formed by a group of nations, to provide financing for infrastructure investment and other forms of assistance aimed at spurring the economies of developing countries.\(^2\) MDBs usually finance projects in one of three ways – through long-term loans at quasi-market rates, very long-term loans at below-market rates (concessional loans) and grants. There are some 20 MDBs in the world (Linn 2014). Examples of MDBs include the World Bank, ADB, the African Development Bank (AfDB), the European Bank for Reconstruction and Development (EBRD) and the Inter-American Development Bank (IDB).

Unlike other MDBs, AIIB will focus exclusively on infrastructure and other physical investments in Asia’s developing countries. According to AIIB’s Multilateral Interim Secretariat (see Box 1), AIIB will provide financing in such areas as energy and power, transportation and

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\(^2\) An MDB is defined as an international organization that: (i) is established through international treaty by sovereign nations as its shareholders; (ii) promotes economic development in developing countries; (iii) provides loans largely (but not exclusively) to sovereign governments; (iv) has sufficient capital to be financially viable; and (v) raises funds primarily in the international capital market, with the guarantee of shareholding governments. See Humphrey and Michaelowa (2013).

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**BOX 1**

**What is the Asian Infrastructure Investment Bank?**

- The Asian Infrastructure Investment Bank (AIIB) is a multilateral development bank (MDB) conceived for the 21st century. Through a participatory process, its founding members are developing its core philosophy, principles, policies, value system and operating platform. The bank’s foundation is being built on lessons learned from existing MDBs and the private sector. Its modus operandi will be lean, clean and green: lean, with a small, efficient management team and highly skilled staff; clean, an ethical organization with zero tolerance for corruption; and green, an institution built on respect for the environment. AIIB will put in place strong policies on governance, accountability, finance, procurement and environmental and social frameworks.

- AIIB will be a modern, knowledge-based institution focusing on the development of infrastructure and other productive sectors in Asia, including energy and power, transportation and telecommunications, rural infrastructure and agriculture development, water supply and sanitation, environmental protection, urban development and logistics. The operational strategy and priority areas of engagement may be revised or refined by its governing boards in the future as circumstances warrant.

- AIIB will complement and cooperate with the existing MDBs to address the daunting infrastructure needs in Asia. The bank’s openness and inclusiveness reflect its multilateral nature. AIIB welcomes all developing and developed countries, both regional and non-regional, that seek to contribute to Asian infrastructure development and regional connectivity.

telecommunications, rural infrastructure and agriculture development, water supply and sanitation, environmental protection, urban development and logistics. AIIB will not provide assistance in health or education, nor will it provide concessional loans or grants, at least in its initial stage.

**Governance Structure**
A typical MDB determines voting powers of member governments largely based on their capital contributions. Capital contributions, in turn, are determined by the member countries’ capacity to contribute, generally as measured by their economic size. Additional basic votes are distributed to all members equally to compensate small members for limited voting powers. AIIB closely follows this approach.

A typical MDB has a governance structure illustrated by Figure 1. The highest decision-making body is its board of governors, consisting of officials (often finance ministers) of member countries. Day-to-day decisions, including approval or disapproval of individual loan projects, are delegated to a board of directors, which also has the responsibility for monitoring the management of the MDB (president and vice presidents). Although AIIB will largely follow this governance structure, its board of directors may have more limited powers than those of other major MDBs as discussed below in Section 3(2).

**Mode of Financial Operations**
The mode of financial operations for a typical MDB is presented in Figure 2. AIIB will function in a similar way, except that it will not make concessional loans – at least at the beginning of its operation. An MDB is financed by member countries' capital and grant contributions. Based on its capital base, an MDB issues bonds in the international capital market to raise funds, which are used for non-concessional loans to the MDB's developing country members. The credit rating of the MDB affects its funding costs, hence the interest rates it charges to borrowers. These rates generally exceed funding interest rates by 50-100 basis points. Grant contributions are sources of concessional loans, i.e., loans with zero or very low interest rates with long maturities, designed for low-income countries. The World Bank's International Development Association, ADB's Asian Development Fund and AfDB's African Development Fund provide such concessional loans.

A new MDB can expect to enjoy the same benefits as existing MDBs, including secure, solid institutional and capital foundations to raise funds and provide loans to member countries by leveraging capital subscriptions and generating a substantial multiplier effect in terms of fund mobilization. For any MDB to work effectively, it must maintain transparent governance and a high credit rating, and possess the human capital and expertise to manage capital, debt, loans and related risks. AIIB faces potential challenges in each of these areas as explored below.
(2) AIIB Versus Existing Major MDBs

The characteristics of AIIB can be best understood by comparing it with those of the existing major MDBs. Table 1 summarizes various properties of the major MDBs (the World Bank, ADB, AfDB, EBRD and IDB), the Andean Development Corporation (Corporación Andina de Fomento or CAF) and the International Monetary Fund (IMF) in comparison to those of AIIB. In five areas, notable differences are apparent.

First, AIIB is relatively large in terms of membership and capital subscriptions. It has 50 member countries and another seven prospective members, while IDB has only 48 members. AIIB’s authorized capital stock of $100 billion is larger than that of EBRD and AfDB at $39 billion and $81 billion, respectively.

Second, AIIB’s major shareholders come from Asia and represent more than 70% of capital subscriptions and voting powers. Japan and the United States are not members. In the case of other MDBs, such as AfDB and IDB, while developing countries hold more than 50% of capital subscriptions and voting powers, developed economies, including the United States, Japan and EU countries, are also major shareholders.

Third, unlike the existing MDBs, which have strong governance structures with resident boards of directors, AIIB will have no resident board. This could potentially weaken the role of shareholder governments at AIIB, while strengthening the powers of the bank’s management. China, as the dominant shareholder venue for the bank’s headquarters and country of origin for its president, will have the most influence over the bank’s operations and loan decisions.

Fourth, the share of paid-in capital as a portion of total capital subscriptions will be 20% for AIIB, substantially more than other MDBs, with the exception of EBRD and CAF. Since EBRD makes loans to the private sector, rather than to sovereign borrowers, it needs greater paid-in capital to maintain high credit ratings. Being owned predominantly by Latin America’s developing countries whose financial conditions are weak relative to those of developed countries, the paid-in capital ratio of CAF needs to be high to ensure a reasonably high credit rating. Similarly, with Asia’s emerging and developing countries being AIIB’s dominant shareholders, the bank will also need a large proportion of paid-in capital to obtain a satisfactory credit rating.

Fifth, while the major MDBs focus on poverty reduction, sustainable development and social development, AIIB will emphasize infrastructure investment and connectivity. And while sustainable development and social development are mentioned in the Articles of Agreement, AIIB is not expected to give priority to projects aimed at poverty reduction or social sector support in areas such as education and health. Major MDBs have concessional windows (the International Development Association at the World Bank, the Asian Development Fund at ADB and the African Development Fund at AfDB), providing very long-term loans at zero or near-zero interest rates to low-income countries. AIIB will not have a concessional window.

(3) AIIB-ADB Parallels to IDB-CAF Relations in Latin America

When considering the role of AIIB and its potential for competition and cooperation with ADB in Asia, some interesting parallels may be drawn to the relationship between IDB and CAF in Latin America.

The World Bank and IDB used to be the main MDBs supporting economic development in Latin American and Caribbean countries. The five Andean Community countries of Bolivia, Colombia, Ecuador, Peru and Venezuela founded CAF in 1970 with an initial capital subscription of $25 million. Headquartered in Caracas, Venezuela, CAF’s membership has grown to 18 countries in Latin America and the Caribbean, as well as Spain and Portugal, along with 14 private banks. Capital subscriptions have also grown to $7.8 billion, with plans for an additional $6.3 billion by 2017. CAF’s mission is to stimulate

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4 All major MDBs enjoy the credit ratings of AAA, while CAF’s credit rating is AA- according to Fitch Ratings. (CAF, Annual Report, 2013).
5 Sub-regional MDBs in Africa and Latin America and the Caribbean, such as the East African Development Bank, Eastern and Southern African Trade and Development Bank, West African Development Bank, Caribbean Development Bank (CDB), and Central American Bank for Economic Integration (CABEI), also have high paid-in capital ratios of more than 20%.

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6 Although IMF is not an MDB, it is listed for comparison.
<table>
<thead>
<tr>
<th></th>
<th>IMF</th>
<th>World Bank</th>
<th>EBRD</th>
<th>AIDB</th>
<th>ADB</th>
<th>IDB</th>
<th>CAF</th>
<th>AIIB</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Head</strong></td>
<td>European (Christine Lagarde)</td>
<td>American (Jim Yong Kim)</td>
<td>European (Suma Chakrabarti)</td>
<td>African (Akinwumi Adesina)</td>
<td>Japanese (Takehiko Nakao)</td>
<td>South American (Luis Alberto Moreno)</td>
<td>South American (Enrique García)</td>
<td>Chinese (Jin Liqun, expected)</td>
</tr>
<tr>
<td><strong>Member countries</strong></td>
<td>188</td>
<td>188</td>
<td>64 (Plus EU &amp; EIB)</td>
<td>80</td>
<td>67</td>
<td>48</td>
<td>18 (plus 14 private banks)</td>
<td>50 (June 2015)</td>
</tr>
<tr>
<td><strong>Capital subscriptions</strong></td>
<td>$368 billion</td>
<td>$283 billion</td>
<td>$39.4 billion ($29.7 billion)</td>
<td>$80.8 billion</td>
<td>$163.5 billion</td>
<td>$144.3 billion</td>
<td>$7.8 billion</td>
<td>$100 billion</td>
</tr>
<tr>
<td><strong>Paid-in capital ratio</strong></td>
<td>—</td>
<td>—</td>
<td>20.9%</td>
<td>4.9%</td>
<td>5.0%</td>
<td>3.7%</td>
<td>39.4%</td>
<td>20.0%</td>
</tr>
<tr>
<td><strong>Group institutions</strong></td>
<td>—</td>
<td>IBRD, IDA, IFC, MIGA</td>
<td>OCR, AIDF, NTF</td>
<td>OCR, ADF</td>
<td>IIC, MIF</td>
<td>—</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Major shareholders</strong></td>
<td>US, Japan, Germany, UK &amp; France, China</td>
<td>US, Japan, China, Germany, France &amp; UK</td>
<td>US, France, Germany, Italy, Japan &amp; UK</td>
<td>Nigeria, US, Japan, Egypt, South Africa</td>
<td>Japan, US, China, India, Australia</td>
<td>US, Argentina &amp; Brazil, Mexico, Japan</td>
<td>Peru, Venezuela, Colombia, Argentina, Brazil</td>
<td>China, India, Russia, Germany, Korea</td>
</tr>
<tr>
<td><strong>Developing country voting shares</strong></td>
<td>Developing and emerging countries: 42.1%</td>
<td>Developing and emerging countries: 42.1%</td>
<td>Transition economies: 13.8%</td>
<td>Regional: 59.5%</td>
<td>Regional: 65.1% (DMCs: 46.8%)</td>
<td>Regional: 50.015%</td>
<td>Regional: 95.5%</td>
<td>Regional: 75%</td>
</tr>
<tr>
<td><strong>Key decisions</strong></td>
<td>85% majority</td>
<td>80% majority</td>
<td>80% majority</td>
<td>70% majority</td>
<td>75% majority</td>
<td>75% majority</td>
<td>80% majority</td>
<td>75% majority</td>
</tr>
<tr>
<td><strong>Board of directors</strong></td>
<td>Resident</td>
<td>Resident</td>
<td>Resident</td>
<td>Resident</td>
<td>Resident</td>
<td>Resident</td>
<td>Non-resident</td>
<td>Non-resident</td>
</tr>
<tr>
<td><strong>Major task</strong></td>
<td>Macro-economic stability, response to financial crisis</td>
<td>Economic development, poverty reduction, and policy advice</td>
<td>Development of open and sustainable market economies committed to, and applying, democratic principles</td>
<td>Sustainable economic growth and reducing poverty</td>
<td>Economic development, poverty reduction, and policy advice</td>
<td>Economic and social development and regional integration</td>
<td>Sustainable development and regional integration</td>
<td>Infrastructure development and connectivity in Asia</td>
</tr>
</tbody>
</table>


Source: Author’s compilation of website information.
sustainable development and regional integration by financing projects in the public and private sectors and by providing technical assistance and other specialized services.

CAF has seen a rapid growth of its loans to Andean countries, especially since the mid-1990s. Its total loan portfolio and equity investment reached $18.2 billion in 2013, exceeding the $13.3 billion in loans approved by IDB that same year. One of the factors behind CAF’s loan expansion has been the rapid speed at which it approves loans, averaging three to five months as opposed to IDB’s 10 months and the World Bank’s 16 months (Humphrey and Michaelowa 2013). In addition, CAF has minimized bureaucratic procedures for loan approval; the World Bank has maintained a rigid and legalistic approach. CAF does not have formally defined safeguard policies and only a brief list of guiding principles. It imposes no binding constraints on the environmental and social aspects of projects, beyond national legislation. A final factor contributing to CAF’s growth has been its lack of a resident board of directors. Instead, loans are approved by senior management of the bank, which increases agility in the approval process.

Based on its economic evaluation of projects, CAF and the borrowing country agree on matrices of actions to be taken by the borrower. Failure to fulfill the agreed actions, however, does not necessarily preclude the disbursement of loans, as CAF may offer technical assistance to help the country meet its obligations (Griffith-Jones 2008). The fact that CAF approves loans quickly and provides flexible lending conditions helps explain why Andean member countries have increasingly borrowed from CAF – even though its loans are more expensive, due to its lower credit rating – rather than from IDB or the World Bank.

In the mid-1990s, as IDB recognized the competitive pressures produced by CAF and other banks in region, and CAF and the other banks recognized the limits of

3. MOTIVATIONS BEHIND CHINA’S MOVE TO ESTABLISH AIIB

China seems to have had four basic motivations in establishing AIIB: (i) closing the huge infrastructure investment gap in Asia, (ii) responding to dissatisfaction with the existing international financial institutions, (iii) meeting China’s domestic economic needs and (iv) achieving China’s foreign policy objectives.

(1) Infrastructure Investment Gap in Asia

Any country’s economic success depends, in part, on infrastructure investment. Such investment can provide higher standards of living through the provision of basic services (electricity, transport, water, sanitation and other social services); reduction in poverty by giving farmers, workers and small- and medium-sized enterprises

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In contrast, the World Bank and IDB require a series of procedures and measures above and beyond the national legislation of borrowing countries for their infrastructure projects. The reason is that their developed country shareholders are pressured by domestic environmental groups and legislatures to implement rigid safeguards in these projects (Humphrey and Michaelowa 2013).

7 These other sub-regional banks include CABEI, CDB and the Financial Fund for the Development of the River Plate Basin (FONPLATA).
expanded access to markets; improvement in the productivity and competitiveness of firms; increases in the density and scale of economic activity; and promotion of environmental sustainability and social inclusion. Infrastructure investment also tends to encourage private investment, including inflows of foreign direct investment (ADB and ADBI, 2009).

Asia has an enormous demand for infrastructure that developing country governments and existing MDBs, such as the World Bank and ADB, cannot meet. According to ADB and ADBI (2009), between 2010 and 2020, developing Asia needs to invest about $750 billion annually in energy, transportation, information and communication technology (ICT) and water and sanitation infrastructure.

Figure 3 provides estimates of infrastructure investment needs for individual developing countries in Asia. It shows that several countries (Tajikistan, Lao People’s Democratic Republic [PDR], Mongolia, Kyrgyz Republic, Afghanistan, Bangladesh and India) need to invest more than 10% of GDP in coming years, while others (Uzbekistan, Cambodia, Viet Nam, Nepal and Pakistan) need to invest more than 8% of GDP. Some economies need to invest heavily in transport, while others need to invest in electricity and/or ICT.

In most developing countries, the amount of actual infrastructure investment has fallen below needs. For example, Mongolia’s actual investment of 1.5% of GDP falls well below the 12.5% needed, while the infrastructure investments of both Sri Lanka and Nepal fall more than 1% short.

The World Bank and ADB have provided annually about $15 billion and $13 billion, respectively, for infrastructure investment in Asia, far less than the estimated need. Based on successful experience in national infrastructure development, China wants to take the lead in helping to cover some of the shortfall through AIIB.

**Figure 3**

**Estimated Infrastructure Investment Needs for Asian Economies**

(Annual Average from 2010-2020 as a Percent of GDP)

Source: Bhattacharyay (2012).
2 Dissatisfaction with the Existing Institutions and Willingness to Lead

The economic and financial power of China and other major emerging countries has grown rapidly, but their voice in existing international financial institutions has not kept pace. These countries generally view the existing institutions, including IMF, the World Bank and ADB, as dominated by the U.S.-led G7 countries and unwilling to make necessary reforms to reflect the increased economic clout of emerging nations. Even though developing countries could contribute more capital to these institutions and thereby attempt to raise their voting powers, they believe developed country members seeking to maintain their influence would block such actions.

A good example is the case of the IMF quota and governance reform package, which was approved in December 2010 by the Fund’s board of governors, the highest decision-making body of the institution. The package called for:

- Doubling IMF quotas, the institution’s principal source of financial resources, from SDR 238.4 billion to SDR 476.8 billion (about $755.7 billion); *
- Shifting more than six percentage points in quota share from developed countries and some oil producing countries to dynamic emerging and developing countries; *
- Shifting two seats on the IMF board of executive directors from advanced European countries to emerging countries to reflect the proposed change in quotas.

The reform would have made China the third largest IMF shareholder after the United States and Japan, and allowed three of the other BRICS countries – Brazil, Russia and India – to become top-10 shareholders. At the same time, the voices and voting shares of the poorest countries would have been maintained.

Ratification of the package, however, requires an 85% majority vote of the board of governors. Since the United States holds 17% of those votes and the U.S. Congress has not approved the IMF package, the United States has effectively prevented the reforms from going into effect for five years.

China and other emerging economies have come to believe that the United States opposes the IMF reforms in order to retain Washington’s dominant position, while simultaneously constraining a rise in China’s influence over the institution. Indeed, China seems to have concluded that any reform of the existing institutions that would allow it a larger voice will be difficult, due to U.S. intransigence.

The United States and developed European countries play dominant roles at IMF and the World Bank, while Japan takes the lead at ADB with U.S. support. Japan’s voting share in ADB is more than twice that of China’s, and a Japanese national has always headed the bank. China has no such influence at an existing international financial institution, despite the country’s status as the world’s second largest economic power, ahead of Japan and second only to the United States. That disparity and the effective veto wielded by the United States to correct it seem to have contributed significantly to China’s decision to create a new bank that would allow Beijing to lead in Asia’s economic development through infrastructure investment.

3 Domestic Economic Needs

After 30 years of double-digit GDP growth rates, China’s growth decelerated due to the global financial crisis of 2008. Indeed, China attempted to maintain high growth in the face of that crisis by raising public investment spending by CNY4 trillion and easing monetary policy. While China achieved its goals through 2011, growth rates have since fallen to 7-8%, due to domestic over-investment, excess credit, excess capacity and a shrinking labor force, coupled with stagnant economic conditions in developed economies. Excess capacity has become massive even by Chinese standards, particularly in materials-producing sectors, such as steel and cement. Financial vulnerabilities have also risen due to large borrowing by local...
governments, housing bubbles and the spread of shadow banking.

The Xi Jinping administration, inaugurated in 2013, has embarked on a plan to make structural reforms to reduce over-investment, excess capacity and excess credit, and achieve more balanced, sustainable economic growth. Xi has emphasized the decisive role of the market in resource allocation and aimed for less resource-intensive and more employment-intensive, services-sector-oriented and consumption-driven economic growth. China admits that it has entered a “new normal,” with permanently slower growth rates of 7-8%, which will require structural reforms to be maintained.

An important challenge for Chinese authorities is how to make a smooth transition to a stable economy. In several important sectors, such as steel and cement, output is well below capacity, a gap so large that exports cannot solve this problem given the relatively stagnant conditions of the U.S. and European economies. A slowdown in China’s infrastructure and property investment, which the Xi administration has pursued, would further aggravate the country’s already low capacity utilization. Significantly, stimulating aggregate demand would also go against Xi’s structural reform efforts.

In this context, expanding external demand through AIIB’s operations, rather than a cheap RMB, could be a useful way to support market-oriented reform of the Chinese economy. Infrastructure projects in AIIB member countries could provide them economic stimulus sufficient to offer export opportunities for manufacturing firms struggling with excess capacity. Similarly, infrastructure firms facing shrinking domestic opportunities could expand their activity abroad.

AIIB is expected to support China’s “One Belt, One Road” initiative to construct both overland and maritime “Silk Roads” (see AIIB Multilateral Interim Secretariat 2014). The Silk Road Economic Belt will connect China with Central Asia, West Asia and Europe through overland transport systems, while the Maritime Silk Road will connect China with the South China Sea, the Indian Ocean, the Middle East, Africa and Europe through maritime transport systems. The bilateral Silk Road Fund, established in November 2014 with $40 billion, will support these initiatives, and AIIB is expected to be involved as well. Construction projects could help China make use of its enormous infrastructure and industrial overcapacity and prod increased sales of Chinese products in regional markets.

(4) Pursuit of Foreign Policy Objectives

China could use AIIB as an instrument for realizing its major foreign policy objectives, which include: (i) political stability; (ii) sovereign security, territorial integrity and national unification; and (iii) sustainable economic and social development. In pursuing these objectives from the 1990s until recently, China abided by Deng Xiaoping’s famous approach on foreign policy: “keep a low profile and achieve something (taoguang yanghui)” (Chen and Wang 2011). Over the last several years, however, Deng’s approach has been replaced by a more confident and assertive posture. China now seeks to establish a new type of great power relations with the United States; it aggressively claims territories in the South and East China Seas; it attempts to connect China with Europe through two Silk Roads; and it leads initiatives to create new international financial institutions, such as AIIB.

The strategic use of economic incentives to pursue One Belt, One Road will assist China in fulfilling its foreign policy objectives of improving diplomatic relations with its Asian neighbors and expanding its regional and global influence. The One Belt, One Road initiative highlights China’s ability to use its enormous financial resources for infrastructure investment in Asian neighbors as an inducement for them to work with Beijing. If successful, the initiative will deepen infrastructure connectivity and economic integration by boosting cross-border trade, investment and financial flows. It will provide economic benefits for both China and other countries that use or form part of the new transport systems. Thus, the initiative will likely strengthen China’s importance as an economic partner for its neighbors and enhance Beijing’s diplomatic leverage in the region. Greater investment in energy and mineral resources, particularly in Central Asia, could also help strengthen China’s energy and resource security.

Beyond the pursuit of geo-economic interests, China
may also use AIIB as an instrument to realize its own geopolitical objectives, including expanding its sphere of political and security influence westward through the new belt and road initiative. Potential adversaries surround China, with Japan in the east (and the U.S. beyond it), the Philippines and Vietnam in the southeast and India in the south. Thus, China seeks closer ties with Central Asian countries through overland routes and with friendly Southeast Asian, South Asian and Middle Eastern countries through maritime routes. China may use AIIB in addition to the Silk Road Fund (and even the BRICS’ New Development Bank) to expand its geopolitical influence. Although Beijing has not yet imposed any preconditions, special commitments or requirements on the Silk Road nations with which it works, some nations believe that China has significant political, security and military motives underlying the initiative (Wang 2015).

For example, while India is the second largest shareholder in AIIB, it has yet to accept the One Belt, One Road initiative. India has not supported the Maritime Silk Road, nor has it welcomed the China-Pakistan plans for an economic corridor, both of which are part of the Silk Road Economic Belt project (Panda 2015). India seems to want to impede these Chinese projects from inside AIIB, as it can accept China’s rising economic clout but not Beijing’s play for geopolitical influence and the possible creation of a “China-centric” order in the region.

China’s recent, aggressive moves to reclaim land on disputed reefs in the South China Sea to build military facilities have led many observers to believe that it will be difficult to convince China to change its geopolitical behavior once it puts a policy firmly in place. China’s actions suggest that it is not interested in cooperating with neighboring countries on territorial issues and will pursue its strategic interests regardless of opposition by other countries.

4. MAJOR ISSUES FOR AIIB

AIIB faces several major issues, including its vision, governance, lending policies and standards, human capital and expertise and coordination with stakeholders.

(1) Vision

AIIB needs to develop its core philosophy and principles because it is unclear what the bank’s ultimate goal is or what sort of vision it seeks for Asia. Unlike the World Bank and ADB, AIIB does not seem to regard poverty reduction as its goal. While an MDB does not have to limit itself to poverty reduction, any new international organization should articulate its vision. Infrastructure development, reinforcement of infrastructure connectivity, regional economic integration and even economic development are only the means to achieving some ultimate goal.

Common challenges facing many Asian developing countries can inform AIIB in developing such a vision. For example, developing countries in Asia have experienced severe environmental degradation (deforestation and contaminated air, water and land) in the process of rapid economic development, and need to ensure that the environment is protected as economic development proceeds. In addition, although absolute poverty has been reduced by rapid economic growth, income and social disparities have widened in many Asian countries. This suggests that future economic development should aim to be broad-based and inclusive, providing equal opportunities for all.

Many developing countries in Asia have also faced inadequate delivery of public sector services and persistent corruption among officials and politicians. These problems suggest that those countries need to strengthen public sector governance, enhance public service delivery and curb corruption.

AIIB might aim to address these challenges by focusing on environmental sustainability, inclusive growth and better governance. China may want to add some Chinese flavor to these objectives. However, without a clear vision and well-articulated goals, AIIB will find it difficult to select and implement appropriate infrastructure projects. Worse, outsiders might fear that China’s ultimate
objective in forming AIIB is to create a China-centric Asia dominated by Chinese interests and influence.

(2) Governance

The governance structure of any MDB is key to its decision-making, operational efficiency and accountability to shareholder governments. In the case of AIIB, with its headquarters in Beijing, its first president a Chinese citizen and China holding a significant share of voting powers, one can expect its strong influence over AIIB governance. To ensure that the bank will function as a neutral international organization, the allocation of voting powers among member countries, which is basically determined by the allocation of capital subscriptions, should be balanced and the power of the board of directors should be strong.

Capital Subscription and Voting Shares

AIIB’s allocation of capital subscriptions across countries is determined by GDP. Reportedly, prospective founding members agreed to use a combination of current U.S.-dollar GDP (converted at market exchange rates) and current international-dollar GDP (converted at purchasing power parity rates) to calculate the economic size of individual members and, hence, capital subscriptions and voting powers. Table 2 summarizes the agreed and estimated shares of capital subscriptions and voting powers across member economies under three different scenarios. The first scenario is based on the assumption that all 57 countries will become founding members, even though seven countries had yet to sign the Articles of Agreement as of the end of June. The second scenario assumes Japan’s participation in AIIB. The third includes both the United States and Japan in the bank.

The first scenario is summarized in the first three columns of the table which show that, with the current membership, China has the dominant share of capital subscriptions at 30.3%, followed by India (8.5%), Russia (6.7%), Germany (4.6%) and the Republic of Korea and Australia (3.8%). The European member countries collectively have 20.7%. The allocation of voting powers follows the pattern of capital subscriptions shares: China has the largest voting share at 26%, giving it effective veto power over critical issues, followed by India (7.5%), Russia (6.5%) and the Republic of Korea and Australia (3.5%). Thus, no single country can challenge China. Even if the European countries, with a collective voting share of 22%, form a united position, they cannot rival China.

China’s voting share is far larger than any held by the largest countries at the existing international financial institutions with the exception of IDB. The United States holds a 16.8% share at the IMF and 16.5% at the World Bank, while both Japan and the United States hold 12.8% at ADB. At IDB, the U.S. share of 30% exceeds China’s share at AIB. It is well known that the United States exercises strong influence over IDB, which is headquartered in Washington, D.C., even though its presidents have always been Latin Americans. Given China’s dominant voting share at AIIB, together with the bank’s headquarters in Beijing and a Chinese national serving as its first president, one may conclude that AIIB will be strongly influenced by China.

The balance of shares would change if Japan joined AIIB. The next three columns of the table show the reallocation: Japan’s capital and voting shares would be 11% and 10%, respectively, while China’s shares would drop to 26% and 23%. Thus, Japan’s participation would effectively strip China of its veto power. Nonetheless Japan, alone, could not rival China in capital or voting shares, though it could challenge China by uniting with Europe, as the sum of Japanese and European shares would exceed those of China. Indeed, Japan and Europe could exercise veto power if they acted jointly. Essentially, Japan’s participation could block certain Chinese moves that might be contrary to the interests of the West.

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10 Specifically, a 60% weight is assigned to current U.S.-dollar GDP and a 40% weight to current international-dollar GDP.

11 Decisions on critical issues – such as changes in the Articles of Agreement, an increase in total capital subscriptions, election of the bank president and termination of bank operations – will require a supermajority vote of the board of governors, that is, an affirmative vote of two-thirds of the total number of governors, representing not less than 75% of the total voting power of the members (Article 28 of the Articles of Agreement).

12 Thus the United States has veto power at both the IMF and the World Bank, which requires 15% of total voting powers. Japan and the United States together have veto power at ADB, which requires 25% of voting powers as in the case of AIIB.
### TABLE 2
Shares of Capital Subscriptions and Voting Powers for AIIB Members

<table>
<thead>
<tr>
<th></th>
<th>Agreed amounts and shares</th>
<th>Estimated amounts and shares</th>
<th>Participation by Japan</th>
<th>Participation by Japan &amp; US</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Capital Subscr. ($ Bill)</td>
<td>Capital Share (%)</td>
<td>Capital Subscr. ($ Bill)</td>
<td>Capital Share (%)</td>
</tr>
<tr>
<td>Regional</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>China</td>
<td>29.8</td>
<td>30.3</td>
<td>26.1</td>
<td>29.8</td>
</tr>
<tr>
<td>Japan</td>
<td>--</td>
<td>--</td>
<td>--</td>
<td>12.8</td>
</tr>
<tr>
<td>India</td>
<td>8.4</td>
<td>8.5</td>
<td>7.5</td>
<td>8.4</td>
</tr>
<tr>
<td>Russian Fed.</td>
<td>6.5</td>
<td>6.7</td>
<td>5.9</td>
<td>6.5</td>
</tr>
<tr>
<td>Korea, Rep. of.</td>
<td>3.7</td>
<td>3.8</td>
<td>3.5</td>
<td>3.7</td>
</tr>
<tr>
<td>Australia</td>
<td>3.7</td>
<td>3.8</td>
<td>3.5</td>
<td>3.7</td>
</tr>
<tr>
<td>Indonesia</td>
<td>3.4</td>
<td>3.4</td>
<td>3.2</td>
<td>3.4</td>
</tr>
<tr>
<td>Turkey</td>
<td>2.6</td>
<td>2.7</td>
<td>2.5</td>
<td>2.6</td>
</tr>
<tr>
<td>Saudi Arabia</td>
<td>2.5</td>
<td>2.6</td>
<td>2.5</td>
<td>2.5</td>
</tr>
<tr>
<td>Chinese Taipei</td>
<td>--</td>
<td>--</td>
<td>--</td>
<td>1.7</td>
</tr>
<tr>
<td>Iran, Islam.R.of</td>
<td>1.6</td>
<td>1.6</td>
<td>1.6</td>
<td>1.6</td>
</tr>
<tr>
<td>Non-regional</td>
<td>25.0</td>
<td>25.0</td>
<td>26.7</td>
<td>25.0</td>
</tr>
<tr>
<td>United States</td>
<td>--</td>
<td>--</td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td>Western Europe</td>
<td>20.3</td>
<td>20.7</td>
<td>22.1</td>
<td>20.3</td>
</tr>
<tr>
<td>Germany</td>
<td>4.5</td>
<td>4.6</td>
<td>4.1</td>
<td>4.5</td>
</tr>
<tr>
<td>France</td>
<td>3.4</td>
<td>3.4</td>
<td>3.2</td>
<td>3.4</td>
</tr>
<tr>
<td>U. K.</td>
<td>3.1</td>
<td>3.1</td>
<td>2.9</td>
<td>3.1</td>
</tr>
<tr>
<td>Italy</td>
<td>2.6</td>
<td>2.6</td>
<td>2.5</td>
<td>2.6</td>
</tr>
<tr>
<td>Spain</td>
<td>1.8</td>
<td>1.8</td>
<td>1.8</td>
<td>1.8</td>
</tr>
<tr>
<td>Brazil</td>
<td>3.2</td>
<td>3.2</td>
<td>3.0</td>
<td>3.2</td>
</tr>
</tbody>
</table>

Note: (a) To estimate the capital subscriptions share when Japan and/or the U.S. participate(s), 2013 data for current U.S.-dollar GDP (converted at market exchange rates) and current international-dollar GDP (converted at purchasing power parity rates) are used. A 60% weight is given to the former and a 40% weight is given to the latter.

(b) To estimate the voting power shares, 600 shares are allocated to all prospective founding members, and 12% of total voting powers are equally divided and allocated to all members, including new (or ordinary) members.

(c) When both Japan and the United States join AIIB, the regional members’ capital subscriptions are assumed to rise by 20% so that the collective capital subscription share of regional members does not drop below 70%.

(d) Figures for China do not include those for Hong Kong SAR. When Japan participates, both Chinese Taipei and Hong Kong SAR are also assumed to join.

Source: Author’s computation using GDP data from the IMF World Economic Outlook database, April 2015 and information from AIIB (2015).
U.S. participation in AIIB would likely change the allocation of capital and voting shares for Asian regional members as well, even though the United States would be a non-regional member. U.S. participation would raise the share of non-regional members’ total capital subscriptions in a significant way, which could prompt an increase in capital subscriptions of regional members to keep their collective share at 70%. The final three columns of the table present a scenario in which both Japan and the United States join AIIB. They show that the United States would secure a 13.5% capital share and a 12% voting share, while Western Europe’s collective capital share would decline to 13% and its voting share to 15.5%. The participation of both the United States and Japan would make them the second and third largest shareholders of AIIB, with the sum of their voting shares roughly equal to that of China’s (20.5%). As a result, they could be vocal at AIIB and affect China’s behavior particularly when they work with the European countries, Australia and New Zealand.

One needs to be cautious, however, about such a possibility. First, there is no guarantee that the interests of Japan, the United States, Europe, Australia and New Zealand would align within AIIB. After all, several European countries – the UK in particular – decided to become founding members of AIIB out of economic self-interest, despite the G7’s united, cautious position toward the new bank. Second, the collective voting share of these western countries would be almost 40%, quite sizable, but far less than emerging Asian countries’ total voting share of more than 57%. China could join forces with Russia, Iran, Central Asian countries or members of the Association of Southeast Asian Nations to overrule a coalition of Japan, the United States and Europe (plus Australia and New Zealand). Essentially, AIIB is a bank owned and controlled by Asia’s emerging and developing countries, whether Japan and the United States join or not, and thus the developed countries’ influence could be limited.

13 It has been reported that China will ensure that the share of regional members’ capital subscriptions would not go below 70% in the future. If the share of capital stock held by regional members were to go below 75% of the total subscribed capital stock, a supermajority vote of at least 75% of voting shares would be required.

Board of Directors

The governance structure of AIIB is similar to that of other major MDBs – the World Bank, ADB, AfDB, EBRD and IDB. It will have a board of governors and a board of directors, which will make key decisions and monitor the management, headed by the president, to ensure that the bank operates in the best interests of shareholder governments. All powers will be vested in the board of governors, whose main responsibilities will be to: (i) determine changes in membership, (ii) elect the president, (iii) determine reserves and net income allocation, (iv) increase or decrease authorized capital and (v) amend the Articles of Agreement. However, unlike other major MDBs, the board of directors will be non-resident – not located in the headquarters. All current major MDBs have permanent resident boards of directors at their headquarters, with the power to approve or disapprove each loan and investment proposal. Instead, the powers of the AIIB board of directors will be limited to: (i) establishing policies, (ii) supervising the management and operations and (iii) approving the strategy, annual plan and budget (AIIB 2015). The plan seems to be for the board of directors to meet only several times a year, guide the bank’s strategic direction and leave routine operation to the management. The Articles of Agreement do not mention the power of the board of directors to approve or disapprove individual loan proposals. It is possible that such power may be delegated to the management.

The management will conduct daily business in accordance with AIIB’s delegated authority. It will be assisted by the credit and investment committee – consisting of management and senior staff of the bank – which will be responsible for investment decisions.

A resident board of directors would allow close information exchange among the board members and with the management and staff of the bank. Resident board members, as representatives of shareholder governments, would also be able to more closely monitor management and operations. The absence of a resident board has the advantage of reducing operating costs with regard to the board and accelerating decision-making as in the case of CAF. Speed is important, as the existing MDBs have been criticized for taking too long to make loan and investment decisions.
decisions and implement projects.

The downside risk is that management is left with too much power and discretion, particularly in deciding which infrastructure projects to finance and how they should be carried out. Infrastructure financing priorities and impact assessments of infrastructure projects could be different across member governments, and significant discussions among board members would be needed for contentious projects.

Without due consideration of governance issues, China could select only those projects it wanted to promote in friendly countries, thus using AIIB mainly to pursue its own interests. In addition, China might use AIIB to provide more assistance to a particular country, complementing its bilateral assistance. It would not help China’s reputation if the international community viewed Beijing as using AIIB to maximize its own economic and political interests. To avoid such negative perceptions, China should clearly demonstrate to the rest of the world that AIIB will maximize benefits for all members. Toward this end, China should forewear veto power and provide the board of directors with maximum powers and authorities.

(3) Lending Policies and Standards

Another important issue is the kind of lending policies and standards AIIB will adopt. As a bank, lending decisions must be made in a financially sound manner, considering the economic viability of projects and the borrowing countries’ ability to repay. Given the potentially significant impact of infrastructure projects on the environment and inhabitants within and nearby project sites, appropriate safeguards must be adopted in order to mitigate negative environmental and human consequences. In addition, a transparent procurement process is required to reduce project costs and eliminate corruption.

AIIB is expected to aim at instituting international best practices on these issues, but questions remain. Chinese Finance Minister Lou Jiwei, for example, often says that the practices of the World Bank and ADB are not always best suited to developing countries, suggesting that China may compromise on rigorous policies and high standards in favor of faster, less bureaucratic procedures or less stringent safeguards.

Sound Banking

Infrastructure investment is characterized by large initial capital commitments, long gestation periods, a variety of risks (project risk, market risk, commercial risk, political risk) and the presence of many stakeholders (potential users of infrastructure services, several levels of government, potential operators and creditors, affected inhabitants). Thus, the decision to lend for infrastructure investment requires expertise in developing bankable projects, conducting project screening and appraisals, managing risks and working with stakeholders. Such expertise cannot be acquired overnight. The question remains as to whether AIIB will have the requisite expertise to make financially sound loan and investment decisions.

China’s domestic banking system is dominated by large, state-owned commercial banks that extend loans largely to state-owned enterprises, without much due diligence on borrowers. The recent expansion of local government debt and shadow banking suggests that the financial market lacks expertise in the areas of credit analysis, financial risk assessment and risk management. Externally, China’s policy increased their exposure to high-risk borrowers, such as Ukraine, Venezuela and Zimbabwe, in the early 2000s. Some of these loans are now in arrears, with possible defaults on the horizon (Wihotol 2015). China’s lenders seem to be learning the importance of conducting due diligence, assessing risks of potential borrowers and monitoring borrowers’ financial conditions. It is essential that the AIIB will be backed by a strong culture of credit and banking.

When a developing country borrows from AIIB for infrastructure investment, external debt burdens pile up. Once a country’s external debt reaches a level beyond its capacity to repay on a sustainable basis, it may fail to make debt repayments not only to AIIB but also to other lenders, such as the World Bank and ADB. Thus, it is essential that AIIB’s lending decisions be based on sound credit and debt sustainability analysis. IMF conducts debt sustainability analysis of its member countries; AIIB should make use of IMF’s analysis in making decisions on infrastructure financing for its members.
Environmental and Social Standards

Concerns are often expressed over the environmental and social standards that AIIB will adopt in financing infrastructure projects. Low standards could encourage destructive development that leads to environmental degradation or threatens the human rights of inhabitants in or near a project site.

Existing major MDBs, such as the World Bank and ADB, consider the environmental and human impacts of infrastructure projects. Projects, particularly large-scale ones, can have significant, negative impacts on the environment and sometimes can require inhabitants to relocate. If an MDB handles these issues poorly, it may severely damage its reputation. Therefore, major MDBs, like the World Bank and ADB, tackle these issues from the start of a project by taking measures to mitigate risks, rather than only responding to problems when they arise. The major MDBs believe that such a cautious approach maximizes the probability of success and minimizes project risks. At the same time, it increases the procedures required for, and time devoted to, project preparation.

Developing countries tend to view the environmental and social standards adopted by the World Bank and ADB as overly rigorous, making compliance difficult for nations with institutional, capacity and financing constraints. Thus, some infrastructure projects desired by developing countries may not be implemented because the countries are unable to comply with the strict standards. If AIIB finds it useful to carry out such projects using lower standards, it should also provide technical assistance to help the borrowing countries improve their institutions and capacity, so they can comply with higher standards in the future. From this perspective, AIIB should consider establishing a trust fund for technical assistance to improve national environmental and social standards.

Procurement

Procurement for any publicly supported infrastructure project can be a breeding ground for corruption. To prevent corruption and maintain a level playing field for all firms concerned, it is critical that tender rules be highly transparent. Both the World Bank and ADB require such transparency as well as competitive bidding to limit resources flowing into the hands of corrupt people. Such practices also help to avoid waste and reduce project costs.

At AIIB, procurement will be open to all firms, whether they are from member countries or not. This is a commendable practice, but it would also be desirable that firms from non-member countries not face discrimination in collecting information and making tenders.

(4) Human Capital and Expertise

Human capital and expertise are essential for the success of any MDB. There is some concern that AIIB may not start with adequate human capital and expertise. It has been reported that AIIB has already recruited seasoned experts from the World Bank and other institutions on legal matters, integrity, safeguards and procurement. This is good news. But what matters is the quality of operational staff on the ground. Without high-quality staff it is hard to build bank creditworthiness and functional competence. For example, to raise sufficient funds at low cost in the international capital markets, AIIB would have to be rated highly by private credit rating agencies. For this purpose, experts are needed in portfolio and exposure management, risk management and mitigation and loan and investment quality assessment.

A typical lending cycle for any MDB consists of: (i) project proposal, (ii) internal assessment, (iii) bank authorization, (iv) project implementation and (v) post-project evaluation. At each step, expertise is required in project design, implementation, evaluation and environmental and social safeguards. A potential borrowing country first submits a detailed proposal to the bank, which includes: expected, positive developmental impacts; expected environmental risks and negative impacts on people (inhabitants, the poor, women and indigenous people); and proposed measures to mitigate such risks and impacts. The bank makes an internal assessment of the proposal, which takes into account the borrower’s capacity to carry out its financial obligations under the loan agreement and the relative merits of technical, economic and developmental impacts versus potential risks and negative consequences. Once a project proposal is deemed sound, bank authorization is sought by going to the board of directors (or the management in
some case). While the borrowing country implements the project, the bank reviews progress, monitors compliance with bank policies and ensures that funds are used as intended. An internal evaluation unit often conducts a post-project evaluation to determine the extent to which the project has or has not met its objectives, and the unit reports its evaluation to the board of directors or the management.

Experts are needed at every stage of the project cycle, but such expertise is not widely available and must often be procured in professional markets in the United States, Europe, Japan and other developed countries. Perhaps the best sources for human capital and expertise are the existing MDBs and financial firms engaged in project financing.

(5) Coordination with Other Stakeholders

To improve the effectiveness of financing assistance, the borrowing country should design and implement its own strategy for economic development, while seeking assistance from multilateral and bilateral development agencies. And all the development agencies should coordinate, as economic development requires a comprehensive national strategy as well as strategies for major sectors of the economy, such as transport, energy, water, sanitation, ICT, education, health and agriculture. A developing country government needs to decide which infrastructure projects are most productive in achieving the strategy for each particular sector. Such decisions require consultation and dialogue between the developing country government and development agencies as well as coordination among development agencies. Essentially, a single infrastructure project cannot add much value unless it is fully integrated into the strategy for the relevant sector. To that end, AIIB can avoid investment duplication and create synergies by working with other multilateral agencies (such as the World Bank and ADB) and bilateral agencies (such as the Japan International Cooperation Agency [JICA], the Japan Bank for International Cooperation [JBIC], Korea International Cooperation Agency and the Australian Agency for International Development).

China is not a member of the Organisation for Economic Cooperation and Development’s (OECD) Development Assistance Committee, which tracks the flows of official development assistance and coordinates development assistance policy across donor countries. China takes the position that, as a developing country, it defines its support for developing countries as “south-south cooperation,” rather than development assistance, and does not coordinate with traditional donors (Wihtol 2015). For AIIB to operate successfully, China will be under pressure to adjust its position. The European and Oceanic members are likely to push AIIB to participate in international mechanisms to coordinate development assistance.

Strengthening coordination with the existing MDBs, such as the World Bank ADB, would be particularly useful for AIIB. In its early stage of operations, developing a pipeline of its own projects will be a challenge. Indeed, AIIB would likely find it beneficial to participate in joint financing of projects already developed by the World Bank or ADB, so that AIIB could disburse loans while meeting the high environmental and social standards set by the existing MDBs. To the extent that the World Bank and ADB save funds as a result of co-financing, these institutions can develop more projects with high-quality standards.14

Such coordination between AIIB and the existing MDBs would prevent an unproductive race to the bottom in terms of standard setting. In this way, AIIB could support Asian developing countries’ efforts to achieve environmentally sustainable and socially inclusive development.

5. OPTIONS FOR JAPAN

(1) Reasons for Japan’s Decision Not to Join AIIB

Japan decided not to sign the Memorandum of Understanding on Establishing the AIIB, stayed away from Articles of Agreement negotiations, and did not consider signing the Articles of Agreement for at least three reasons: lack of trust and communication, concerns over governance and geopolitical misgivings.

14 At the same time, the World Bank and ADB may further strengthen their coordination in areas of support for middle-income countries, including policy advice and governance reform (Nehru 2014).

20 Asian Infrastructure Investment Bank: China as Responsible Stakeholder?
Lack of Trust and Communication

The two countries’ leaders – Japan’s Shinzo Abe and China’s Xi Jinping – have never held a bilateral summit since they assumed office in 2012 and 2013, respectively. Relations between the two countries have been poor since 2012 when Japan nationalized the Senkaku Islands (known as the Diaoyu Islands in China). The history issue has also been a negative factor. The two leaders met only briefly and informally in November 2014 at the Beijing Asia-Pacific Economic Cooperation (APEC) Summit and in May 2015 at the Bandung Conference, and Xi reportedly invited Abe to join AIIB in Bandung. But they have not had an opportunity to discuss details of AIIB, Asia’s development issues, the challenges Asia and the two countries face or their visions for the future of Asia.

The two countries’ finance ministers – Japan’s Taro Aso and China’s Lou Jiwei – have not held frequent meetings to exchange views on either AIIB or how the two countries can work together on economic and financial issues. It was in early June 2015 that the two ministers met for the first time to discuss issues of mutual interest and possible cooperation. They agreed to promote infrastructure investment in Asia, including through development financial institutions, and Lou reportedly said to Aso that the door was open if Japan wanted to join the new bank. However, the two seem not to have exchanged views over Japan’s deep doubts over the functions and roles of AIIB.

The lack of trust and communication has led the Japanese to believe that China might want to exclude Japan from AIIB. If there was any invitation from China at the ministerial level or higher, it came too late. Japan doubts whether AIIB will maintain transparency in its decision-making and operations or in its capacity to conduct adequate due diligence of loan projects. These concerns have also contributed to Japan’s indecisiveness about joining the bank.

Concern over Governance and Lending Policies and Standards

Finance Minister Aso has expressed his concerns over AIIB’s “uncertain nature of bank governance, environmental and social standards associated with infrastructure projects and considerations for debt sustainability in borrowing countries, which should follow internationally established best practices.” While not stated as directly, he seems to be concerned that AIIB might be controlled by China through its dominant voting powers and the absence of a resident board of directors, that AIIB might adopt low environmental and social safeguards, and that it might extend loans without sound appraisal of projects and countries.

In addition, Japan is concerned that, by adopting a lenient stance towards the financial viability of projects and environmental and social standards, AIIB could put itself in an advantageous position relative to the existing major MDBs, particularly the World Bank and ADB, as potential borrower countries would prefer fewer requirements and lower standards. Thus, potentially bankable projects developed by the World Bank and ADB might be taken away by AIIB, thereby putting pressure on the former to reduce their own standards. Japan does not want to see such a race-to-the-bottom competition on lending standards.

One way to push AIIB to adopt high standards would be for Japan to join AIIB and influence its decision-making from within. The problem is that Japan is not sure if it would have a sufficient voice to do so, given an estimated voting share of only 9%. Thus, Japan does not seem to wish to join AIIB unless it is confident that the bank will be well governed, financially sound and ready to adopt high environmental standards and social safeguards.

Geopolitical Concerns

A potentially more serious concern for Japan is that China may use AIIB as an instrument for realizing its own economic and geopolitical objectives, including expanding China’s sphere of influence westward through the New Silk Road initiative. AIIB may serve to create a Sino-centric economic and political sphere of influence, particularly in Central Asia and part of South Asia.

Japan’s concerns have been reinforced by China’s aggressive behavior in the East and South China Seas in recent years. In the East China Sea, the territorial issue surrounding the Senkaku Islands has made bilateral security relations unstable. In November 2013, China introduced the East China Sea Air Defense Identification Zone, covering the airspace of the Japanese controlled Senkaku
Islands, and imposed new air traffic restrictions. The new restrictions require any foreign aircraft in the zone to identify its flight plan, maintain radio communication with the Chinese authorities, display its nationality, and follow the authorities’ instructions. Japan views this as an attempt to impede freedom of flight in international airspace. In the South China Sea, Beijing has taken a firm stance on reclaiming land on disputed reefs and building military facilities. Despite increasing concerns expressed by the United States, the Philippines and other countries, China has not slowed its reclamation efforts. Many observers believe that China’s behavior is an attempt to change the status quo through coercion. The aggressive behavior has created mistrust and apprehension about Chinese geopolitical intentions. There is a growing sense in the region that China is not interested in resolving territorial issues in a peaceful manner, and that it will pursue its strategic interests regardless of views held by neighboring countries.

Through AIIB, China could direct its rising economic and financial power to help strengthen infrastructure development, cross-border connectivity and economic integration. But China’s aggressive behavior on territorial issues has led Japan to suspect that China’s true intention in establishing AIIB might be to expand China’s economic, political, security and even military spheres of influence in Asia.

(2) Pros and Cons of Japan’s Participation
Japan should decide to join AIIB based on careful consideration of the pros and cons of participation.

Benefits of Participation
Given that AIIB is an Asian MDB focusing on Asia’s infrastructure development, with a potential for setting its own standards, Japan as the second largest economy in the region has a natural interest in influencing the new bank. In addition, various members of AIIB, particularly ASEAN member states, want Japan to participate in the bank to help protect their interests by counterbalancing China’s influence. Moreover, if Japan does not join AIIB, Tokyo’s relative weight in Asia might diminish. Japan could also encourage China to pursue rules-based behavior in AIIB as China’s economic and financial power continues to grow.

From an international perspective, AIIB can provide an opportunity for China to play a leadership role in the provision of international public goods. As a rising economic and financial power, China is expected to assume a greater burden in supporting global and regional prosperity and stability. AIIB provides an excellent test case of China’s true intentions in helping to develop Asia’s infrastructure and of its willingness to collaborate with the international community and the existing international financial order.

More specifically, the benefits of Japan’s participation in AIIB would include:

- Limiting China’s voting power by coordinating with Europe, Australia, New Zealand and like-minded developing member countries, thus prodding China toward pursuing cooperative behavior;
- Raising AIIB’s quality of governance, credit and banking culture and environmental and social standards;
- Creating synergy with the existing major MDBs, such as the World Bank and ADB, in the form of co-financing and joint project preparation and supervision;
- Positioning Japan as a reliable partner in Asia’s infrastructure building and economic development;
- Ensuring adequate flows of information to Japanese businesses on infrastructure projects financed by AIIB.

Costs of Participation
The cost of Japan’s participation in AIIB would be greatest if China uses the bank mainly to pursue its own economic and geopolitical interests. In that case, Japan might not be able to constrain China’s behavior through AIIB’s decision-making process, as emerging and developing countries will essentially run the bank, and some of those countries will side with China. The second greatest cost would be incurred if AIIB were run in a financially imprudent manner, as the resulting non-performing loans would damage capital and lead Japan to lose tax revenue (about $2 billion as paid-in capital).

Other costs of Japan’s participation would result if
China uses AIIB:
- As an instrument of foreign policy to expand its geo-economic and geopolitical sphere of influence;
- To give its political leadership greater legitimacy, thereby winning diplomatically over Japan, as Tokyo would be a junior partner to Beijing at the bank;
- To reduce the relative importance of ADB as AIIB enters a similar area of operation;
- To support indirectly China’s One Belt, One Road initiative.

(3) Japan’s Choice
This analysis has shown that Japan’s decision to join AIIB should depend on the following considerations:
- Does AIIB have a clear vision for the sort of Asia it wants to realize, and is that vision consistent with Japan’s? More specifically, does China want to use AIIB to help provide international public goods and contribute to the prosperity and stability of Asia, or to achieve its own economic and geopolitical interests and expand its sphere of influence?
- With China’s unduly large voice in AIIB, can Japan secure an appropriately strong voice when it joins?
- Can the board of directors be made resident in Beijing with maximum decision-making powers, including powers to approve or disapprove major loan projects (and other projects judged important by the board)?
- Will AIIB be willing to set high standards on loan appraisals and project screening, environmental and social safeguards and procurement rules? If AIIB provides loans without high environmental and social standards, will it have a mechanism to offset the impacts in the medium term (for example, by providing technical assistance for capacity building through trust funds)?
- Will AIIB be ready to work with the existing MDBs, such as the World Bank and ADB, through co-financing and other joint activities?

To summarize, if China provides international public goods through AIIB, rather than pursue its own policy objectives, and if the bank is run in a financially prudent manner with sufficiently high environmental and social standards, Japan should join. However, if China uses AIIB mainly as an instrument to realize self-interested economic and geopolitical objectives, Japan should refrain from joining. If Japan cannot adequately assess these issues, it should wait and see how AIIB operates, while encouraging the World Bank and ADB to help AIIB become operationally sound.

Japan’s Recent Infrastructure Assistance Initiative
Prime Minister Abe is, indeed, taking such a wait-and-see approach. At the same time, Japan has launched a new infrastructure assistance initiative in collaboration with ADB to increase funding for “high-quality” infrastructure projects in developing Asia to $110 billion over the next five years (2016-2020), which would be a 30% increase relative to the previous five years. In addition to working closely with ADB, Japan will mobilize all forms of development cooperation and strengthen the role of JBIC. The Japanese government will also expand its assistance for infrastructure development in Asian countries in partnership with the private sector, providing more than JPY4 trillion ($33 billion) over the five-year period. JICA, in cooperation with ADB, will establish a new funding mechanism for private sector infrastructure projects. JBIC will actively take greater short-term risks associated with infrastructure financing, without requiring recipient governments’ sovereign guarantees.

6. CHALLENGES FOR CHINA AND THE INTERNATIONAL COMMUNITY

(1) Challenges for China
Once AIIB is established, Beijing will be under intense international scrutiny to deliver results. China cannot afford AIIB’s failure, as the country’s highest political leadership has driven the AIIB initiative. Indeed, if the
bank were to fail, China’s reputation and clout as an emerging global power would be seriously damaged. To be successful, China has to ensure that AIIB does not become a Chinese fiefdom, but rather conforms to international norms and standards of transparency (Acharya 2015).

Essentially, running an international financial institution requires transparency of decision-making, accountability to shareholders, coordination of different international stakeholders and consideration of the environmental and social dimensions of infrastructure projects. But these considerations are foreign to China’s political and social system. In addition, running a bank requires a strong credit and banking culture, which China’s state-bank-dominated financial system lacks.

Acharya (2015) argues that, for China to succeed with this venture, the country needs to make significant adjustments to its regional policy by abandoning its expansive territorial claims and enhancing its military and economic transparency. Absent such changes, it would be difficult to establish trust with the many other AIIB members who are apprehensive about Beijing’s geopolitical intentions. If this optimistic argument is correct and China adjusts its policies, any resulting success of AIIB would mean that not only China but also Asia and the West, including the United States and other countries which have invested in the current system of global governance, would all be winners.

This suggests that AIIB management must promote the transparency of its governance and effectiveness of operations, and that China’s highest political leadership has to take a more conciliatory approach to neighboring countries on territorial disputes and issues in the South and East China Seas.

(2) Reform of the Existing International Financial Institutions

The existing international financial institutions also need to reform themselves to serve their member countries more fairly. Indeed, ADB has introduced four major reforms.

First, it has decided to expand its financial capacity by merging its Asian Development Fund’s lending operations with its Ordinary Capital Resources. This innovative initiative is expected to increase ADB’s annual operations by 50%, from $14 billion in 2014 to $20 billion in 2017. The greater financial capacity will allow ADB to increase its support for sustainable development and poverty reduction in the region. With the United Nations’ post-2015 Sustainable Development Goals and a global pact on climate change (expected to be ratified this year), ADB will scale up support for sustainable infrastructure, education, health and actions to combat climate change.

Second, ADB has decided to make loan decisions faster, without compromising project quality and standards for safeguards and procurement. The average length of internal processing time for loan proposals has been two to three years. Through internal reforms, such as delegating more authorities to country offices where projects take place, the bank can halve the processing time for procurement contracts.

Third, ADB will double assistance for education and health in line with its Midterm Review of Strategy 2020. ADB will expand its support for quality education with an emphasis on higher education and vocational training. The bank will focus health assistance on improving the delivery and efficiency of health services and systems, including promotion of universal health coverage.

Fourth, it will strengthen its support for public-private partnerships (PPPs) to accelerate the flow of private funds to critical infrastructure projects in developing Asia. For example, ADB has signed a co-advisory agreement with eight global commercial banks to help developing country governments develop PPP capacity to deliver bankable transactions, without crowding out private sector advisors. Under the agreement, ADB and the eight banks will provide independent advice to governments on how to assess the future income flows of projects, structure PPPs to make them attractive to the private sector and manage the subsequent PPP bidding process.

In addition to these reforms at ADB, the existing international financial institutions should adjust voting shares to reflect the change in the economic and financial weight of emerging and developing countries; otherwise, the institutions’ legitimacy will be in doubt. As a first step,
the United States needs to agree to implement the 2010 IMF reform as soon as possible. ADB should also consider adjusting capital subscription shares and the resulting voting powers among its member countries. In the long run, such reforms will lead to a more stable international financial system in a way that is consistent with the rising importance of emerging and developing countries in the global economy.

7. CONCLUSION

This paper characterizes AIIB as a large MDB owned and controlled primarily by Asia’s emerging and developing countries. These countries are trying to mobilize their own resources to finance their own infrastructure investment on their own terms. This self-help approach is laudable, and the international community may find a good reason to support it.

The paper has argued that, even though emerging and developing countries own and control AIIB, the bank should strive to establish high standards and transparency in the areas of decision-making, credit and banking practices, environmental and social safeguards and procurement rules. Such high standards would help strengthen the ability of the emerging and developing members of the bank to address their domestic challenges of environmental sustainability, social inclusion and governance improvement.

Given that AIIB is heavily dominated by China in its decision-making and operations, the paper has also identified two views with regard to the role of the bank, one positive and one skeptical.

The positive view sees China-led AIIB assisting Asia’s developing countries in financing infrastructure development that not only benefits them but also has positive spillovers to firms and people outside of these countries. It finds value in China’s willingness to assume leadership, and use its growing economic and financial power, in providing international public goods in the form of strengthened infrastructure development and connectivity in Asia, and in the opportunity the bank provides for China to become a responsible international player.

The skeptical view sees China’s potential to use AIIB as an instrument for: undermining existing MDBs – particularly the World Bank and ADB – by adopting low standards in running the bank; alleviating its own economic problems of excess capacity, slow growth, and energy and resource insecurity; and expanding its geopolitical sphere of influence in Asia through the One Belt, One Road initiative.

From this perspective, it would be prudent for Japan (and, for that matter, the United States) to judge if AIIB will serve as a productive bank that facilitates the provision of international public goods, or as a bank that mainly serves China’s economic and geopolitical interests. Japan, together with the United States, needs to see if AIIB will be run as a financially sound bank, whose operations include adequate environmental and social safeguards.

Given the lessons from IDB’s collaboration with CAF and other sub-regional MDBs in Latin America, encouraging the World Bank and ADB to work with AIIB is the right course. It is in the best interest of the international community to pull China and AIIB into the existing international financial order and help make China a responsible international stakeholder.

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China and the Evolving Asian Infrastructure Investment Bank

by Yun Sun*

1. INTRODUCTION
Since Chinese President Xi Jinping proposed the establishment of an Asian Infrastructure Investment Bank (AIIB) during his trip to Southeast Asia in October 2013, China has dedicated significant political, economic and diplomatic efforts toward paving the way for a successful initiation of the new financial institution. China has made the AIIB a priority and pushed for its successful debut by rallying regional support, broadening the membership base, refining the bank’s role and assuaging doubts. These efforts led to the signing of a Memorandum of Understanding (MOU) on AIIB’s establishment by 21 Asian countries in October 2014 and applications by 57 countries to become founding members of the bank before the deadline of March 31, 2015. After five rounds of intensive negotiations, 50 countries signed the Articles of Agreement (AOA) for the Asian Infrastructure Investment Bank on June 29, 2015 in Beijing.

From the beginning, China has had multiple aims in establishing AIIB. The most important and seemingly altruistic one has been to help meet the region’s need for increased infrastructure development funds. In Chinese coverage of the issue, the creation of AIIB has also been closely related to China’s “One Belt, One Road” strategy, which aims to use infrastructure projects to export China’s excess capacity, promote trade and project influence abroad. In addition, AIIB represents part of China’s effort to “democratize” the international order, and has been described as Beijing’s “first serious challenge to the U.S.-led global economic order established at Bretton Woods 70 years ago.” Finally, AIIB could have important strategic implications for China’s relations with countries in the region.

China’s diverse goals in forming AIIB are not free of internal inconsistencies and external controversies. Indeed, since China’s October 2013 announcement of its plan to establish the bank, AIIB has raised many questions, touched on many sensitive issues and led to serious policy debates in and outside China. There is an intrinsic tension between China’s ambitious claims that AIIB will provide funding for necessary infrastructure projects, some of which may be financially risky, and the bank’s identity as a multilateral development bank rather than a foreign aid agency.

With China the largest shareholder in AIIB and Beijing clearly pursuing some of its national interests through the bank, questions have also been raised about the extent to which AIIB’s decision-making process and

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operations will be truly multilateral. China’s stated goals of maintaining high standards at the bank, and also making quick, practical decisions with a “lean” institution that does not even have a resident board for oversight, present other inherent challenges. Further uncertainties relate to the details of AIIB’s fundraising model, loan guarantee system and collaboration with existing multilateral institutions. The AOA has provided some answers, but many details have yet to be worked out.

The negotiation process that led to the AOA has made China keenly aware of the incompatibility of some of its goals, in turn leading Beijing to adjust its expectations and position in certain areas. The unexpected embrace of the bank by developed European countries, for example, created an opportunity to move AIIB toward prevailing international norms and standards. As a result, the AIIB reflected in the AOA today is quite different from the AIIB China envisioned before March 2015. In this sense, the evolution of AIIB may provide a model of how China’s behavior can be shaped by the collective efforts of the international community and how China’s ambitions can be accommodated without overturning the existing international order.

2. BACKGROUND

Since Xi Jinping assumed the presidency in 2013, his world vision and global agenda have greatly shaped the priorities of China’s foreign policy. In contrast to his predecessor, Hu Jintao, Xi has adopted a more ambitious and assertive foreign policy posture, as exemplified by the active pursuit of Beijing’s territorial, political and economic agendas. Within his grand vision of the “great rejuvenation of the Chinese nation," a key underlying component has been the establishment of a new, “proper” world order that reflects China’s elevated economic strength and political status. China has identified a list of tasks to expedite the inception of such a new world order. In the field of economics, the goal has centered on reforming the U.S.-led global economic order based on the Bretton Woods system founded 70 years ago. To establish the so-called “new international economic order,” other tasks include founding international financial institutions that better reflect China’s economic status, internationalizing the Chinese renminbi (RMB) and expanding China’s leadership and influence through trade and investment.

This vision has particular relevance and implications for Asia. In recent years, the escalation of tension between China and some of its neighbors over maritime and territorial disputes has heightened concern in Beijing about the deterioration of China’s regional image and relations. The Xi administration regards improved ties with Asian neighbors and the reinforcement of the concept of China’s “peaceful rise” as key challenges. Toward this end, Xi identified Asia as the highest priority for China’s foreign policy at the Periphery Diplomacy Working Conference in October 2013. In the economic arena, China has sought to leverage its ample economic resources to improve political ties with Asian countries and strengthen its status. China has also waged an economic charm offensive in the region since 2013. For example, in 2013, Xi proposed the 21st Century Maritime Silk Road to Southeast Asian countries, promising investments and trade through regional connectivity. In 2014, Chinese Premier Li Keqiang proposed a friendship treaty with Southeast Asian countries and offered $20 billion in loans.

To expedite the emergence of the new international economic order, China under Xi has also pursued policies to promote the creation of two multilateral financial institutions, AIIB and the New Development Bank (NDB). NDB was officially founded in July 2014 by Brazil, Russia, India, China and South Africa, the so-called BRICS countries. With initial capital of $50 billion equally distributed among the five members, the Shanghai-based NDB also created a Contingency Reserve Arrangement.

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$100 billion, funded primarily by China (41%), followed by Brazil, India and Russia (18% each) and South Africa (5%). In October 2014, the MOU on establishing AIIB was signed in Beijing by 21 Asian countries.

3. CHINA’S MOTIVATIONS IN ESTABLISHING AIIB

Within the context of China’s assertive foreign policy posture and its prioritization of Asian diplomacy, multiple factors motivated Beijing in its decision to establish AIIB. These include a seemingly altruistic attempt to address the region’s capital shortage for infrastructure projects as well as China’s economic, political and strategic self-interest in advancing the country’s policy agenda.

(1) Financing Regional Infrastructure Development

China has pointed to the funding shortage for infrastructure development in Asia as its primary motivation for founding AIIB. China has cited data from the World Bank and the Asian Development Bank (ADB) to support the need for infrastructure in the region. The World Bank estimates a $1 trillion infrastructure shortfall in low- and middle-income countries, and suggests that the demand for infrastructure will continue to grow as countries develop. According to a more Asia-specific report by ADB in 2009, between 2010 and 2020, Asia will need to invest $8 trillion in national infrastructure and an additional $290 billion in regional infrastructure projects in transport and energy. Indeed, AIIB will provide increased funding for infrastructure in such areas as energy, telecommunications and transportation, which are of particular importance for Asian countries undergoing rapid industrialization and urbanization.

In China’s own experience, despite some adverse consequences, increasing public spending on infrastructure has been a popular strategy to promote growth. For example, after the 2008 international financial crisis and the subsequent negative impact on Chinese export industries, Beijing introduced a 4 trillion RMB infrastructure-heavy stimulus package to encourage growth. Leaders in Beijing generally view that initiative as a success, as China’s economy continued to grow in the face of a prolonged, major global recession (though there have also been some negative consequences). China views infrastructure investment in Asia – especially projects focused on intra-regional transportation and communication – as having a similar potential for promoting regional growth and economic development. Given China’s own favorable experience with infrastructure investment, most Chinese officials and analysts genuinely seem to believe that AIIB will improve infrastructure in Asia and therefore represent a positive contribution by China to the regional demand for development financing.

(2) Promoting China’s “One Belt, One Road” Strategy

“One Belt, One Road” is one of the most important strategic initiatives that Xi has adopted since 2013. Focusing on trade promotion, infrastructure development and regional connectivity, China designed the new Silk Road Economic Belt to link the country with Central Asia, the Middle East and Europe, and the Century Maritime Silk Road to connect China with Southeast Asia and, later, Europe and Africa via the Indian Ocean. One Belt, One Road is regarded in China as an upgraded version of China’s “opening-up” policy, with key projects focused on national and intra-regional transportation, power and

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telecommunications infrastructure.

Since most of the countries along the planned routes have developing economies, China sees great potential in economic cooperation through a variety of tools, including traditional free trade agreements, sub-regional cooperation, economic corridors, special economic zones, connectivity projects, transnational transportation systems and financial cooperation. In particular, Beijing has identified One Belt, One Road as the most important mid- to long-term strategy to foster China’s economic restructuring and boost the country’s slowing economic growth.\(^\text{10}\)

Xi clearly believes that AIIB will help in the implementation of the One Belt, One Road strategy. Soon after the MOU on founding AIIB was signed, he said, “China’s inception and joint establishment of the AIIB with some countries is aimed at providing financial support for infrastructure development in countries along the ‘One Belt, One Road’ and promoting economic cooperation.”\(^\text{11}\)

The spokesperson for the National People’s Congress (NPC) reinforced Xi’s views during the “Two Sessions” of the NPC in March 2015, saying, “AIIB and the Silk Road Fund are both created for the better implementation of ‘One Belt, One Road’.”\(^\text{12}\) Some in China have even proposed that AIIB focus on the construction of a Beijing-Baghdad railway, key to the completion of the “Silk Road Economic Belt.”\(^\text{13}\)

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Indeed, most Chinese analysts and officials draw a close correlation between AIIB and the One Belt, One Road strategy, viewing AIIB as the government’s mechanism for providing financial and technical support in implementing the strategy.14 According to Nankai University scholar Liu Chenyang, “Although the AIIB is not completely equal to the ‘One Belt, One Road’ plan unilaterally promoted by China, they both focus on connectivity and infrastructure and AIIB provides a model for fundraising for such infrastructure development in the region.”15 Local governments and Chinese companies have demonstrated great enthusiasm for both One Belt, One Road and AIIB as positive indicators of massive, upcoming central government spending. Anticipation of this spending has created intense competition among local provincial governments and Chinese companies to participate in the projects necessary for the completion of One Belt, One Road.16

(3) Exporting China’s Excess Capacity and Capital

Analysis from China indicates that AIIB closely aligns with China’s economic priorities of addressing the problem of excess capacity and exploiting the country’s burgeoning foreign exchange reserves. The series of massive government stimulus packages since 2008 produced growth but also created excess capacity – initially in steel and construction, expanding more recently to photovoltaics, wind power and other industries. Given limits on domestic demand and sluggish recovery of exports to developed countries, the Xi administration has made it a top priority to stimulate foreign demand as a means of absorbing excess capacity.17 Meanwhile, China’s enormous and growing foreign reserves – the world’s largest at the end of 2014 at $3.84 trillion – are another concern for Beijing.18 After a long-standing debate, a general consensus has emerged in China that the country should diversify its investment portfolio beyond U.S. securities and other dollar assets.

The combination of excess capacity and capital led to the creation of what has been termed a “Chinese Marshall Plan.”19 This plan envisions large-scale capital investment in the infrastructure of emerging economies along the One Belt, One Road, thereby turning foreign reserves into practical assets, while a growing Asian infrastructure market absorbs excess capacity. The plan would have the additional benefit of generating jobs for Chinese laborers.20

The most cited wisdom in China on AIIB’s economic utility reflects the strategy, in that the bank can become a channel for China to invest in Asian infrastructure projects, while creating business opportunities for Chinese manufacturers and contractors. Chinese analysts also hope that such investments will diversify China’s foreign investment portfolio and expedite the export of Chinese capital.21 Such a China-centric mission, however, inherently conflicts with AIIB’s stated goal of becoming a multilateral financial institution.

(4) “Democratizing” the International Economic Order

As discussed above, China aspires to reform the existing international financial system in order to accommodate its own expanding economic power and influence. Many Chinese believe that the Bretton Woods institutions – the World Bank, International Monetary Fund (IMF) and ADB – which are dominated by the West under U.S. leadership, unfairly disadvantage China in the international economic system.

14 Interviews with Chinese analysts, Beijing, January 2015.
16 Interview with a Chinese analyst, Beijing, January 2015.
While China has supported (and maintains that it will continue to support) the current system, Chinese leaders have been particularly frustrated by the existing multilateral financial institutions’ governance structures, which have not evolved to reflect the new distribution of power in the global economy. With gross domestic product (GDP) of $10 trillion in 2014, China’s economy is projected to surpass that of the United States within a decade, becoming the world’s largest.\(^2\) However, China’s voice in multilateral financial institutions has not kept pace with the country’s economic stature. The United States retains 16.75% of the votes in the IMF, while China holds only 3.81%.\(^3\) As a Financial Times article explains, the IMF’s “quota system, which determines what each country pays in and how many votes they are given, fails to reflect the reality of a changing world. The BRICS nations, which account for more than a fifth of global output, have a quota of just 10.3%. European countries, by contrast, are allocated 27.5% for 18% of output. To add insult to injury, the IMF presidency is reserved for a European, while that of the World Bank routinely goes to an American.”\(^4\)

While the need for reform is generally recognized, proposed changes face an uncertain future.\(^5\) IMF member countries struck an agreement in 2010 to boost the combined voting power of emerging markets, including China, Brazil and Turkey, from 42.1% to 44.7%.\(^6\) Despite the modesty of the proposed adjustment, the U.S. Congress has repeatedly failed to sanction the agreement due to concerns that the deal would weaken U.S. influence in the IMF – despite the fact that the United States would retain veto power at the institution. As Brookings Scholar David Dollar aptly explains, China is “frustrated with the lack of governance reform, slow pace of project implementation and reluctance to expand lending on the part of the existing development banks [and thus is] starting its own.”\(^27\)

Since announcing its plan to establish AIIB, Beijing has had to address how the new bank will handle relationships with existing multilateral development banks (MDBs). Most Chinese officials and analysts have downplayed competition, instead emphasizing the potential for mutually complementary relationships among AIIB, the World Bank and ADB. Highlighting complementarity, however, fails to address the reality of the market for infrastructure finance. While the demand is large enough to accommodate all three banks, the competition for good quality projects is steep. Unless AIIB intends to fund projects that the World Bank and ADB reject (for legitimate commercial or non-commercial considerations), it must inevitably compete with the World Bank and ADB over “fundable” projects in Asia.

Many Chinese and foreign analysts do not see such competition as a bad thing.\(^28\) AIIB could induce existing institutions, such as the World Bank and ADB, to improve operations, enhance efficiency and reform current management structures. Alternatively, analysts in China have also discussed the possibility of AIIB collaborating with the World Bank and ADB on certain projects. For example, Professor Xi Shiqing from Peking University has argued that AIIB and ADB could complement each other in terms of funding, functional expertise and infrastructure project specialties.\(^29\) However, since AIIB has yet to clarify fully its operating and fundraising models, the likelihood of collaboration remains uncertain.

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\(^27\) Interviews with Chinese and American scholars, Beijing and Washington DC, January 2015.

**(5) Internationalization of the Chinese Renminbi**

China sees the status of the U.S. dollar as the main reserve currency in international trade and finance as the basis for American “financial hegemony,” which hinders the expansion of Chinese economic influence. The internationalization of the RMB is part of China’s broader strategic goal of democratizing the global order, which requires, in part, a decrease in the dollar’s influence.

Since 2009, China has actively sought to internationalize the RMB, largely by establishing the so-called “dim sum bond market” and the Cross-Border Trade RMB Settlement Pilot Project, which established pools of offshore RMB liquidity. China hopes AIIB will strengthen these efforts through increased and diversified channels. Most important, infrastructure development financing by AIIB could popularize the RMB as a traded currency, thereby boosting its position.

Suggestions for improving the structure of AIIB have touched upon the RMB’s status, as well. As Simon Tay writes in *The Asia Weekly*, “Another key to making a better AIIB is to float public bonds and other market instruments for infrastructure funding… For China, such moves would also further the internationalization of the Yuan.” Ultimately, the internationalization of the RMB depends on its attractiveness “as a unit of trade, a store of value and for portfolio investments.” As countries with development and infrastructure needs in Asia increase their trade and investment relations with China, many of their central banks will consider investing part of their foreign currency reserves in RMB. Many in China hope that AIIB strengthens and expedites this trend.

**(6) Strategic Aspirations**

While China may have created AIIB primarily based on economic considerations, strategic considerations also played a significant role. Beyond China’s goals of improving its regional and global status and reforming the international system, Chinese foreign policy officials hope that China’s financial contribution toward regional infrastructure and economic development through AIIB will immediately assist and improve China’s overall relations with countries on its periphery.

China believes that the regional transportation network and trade promotion facilitated by AIIB will tighten recipient countries’ economic ties to China, which China believes will naturally translate into strategic influence throughout the region. Since Xi’s inauguration, heightened tensions over territorial and maritime disputes have damaged China’s reputation and relationships. However, many in China believe that AIIB’s economic impact will help reverse this trend, improve the country’s image and provide incentives for otherwise unaccommodating nations to cooperate with Beijing.

Some in China argue that AIIB will have a dual strategic utility. It could be used, as one influential Chinese media outlet put it, to “strengthen ties anchored on interests among Asian countries and ease the current geopolitical tension in Asia, especially in the East Asian region. For China, this is conducive to the periphery diplomacy guideline to ‘be benign partners of our neighbors’ and promote the joint development in the East and South China Seas.”

AIIB could also be employed to discourage countries from adopting China-unfriendly policies. In addition, some Chinese foreign policy experts have privately commented that, given the Philippines’ approach toward China over disputed territory in the South China Sea, it would be difficult for the Philippines to receive favorable consideration by the two financial institutions that China dominates (AIIB and the Silk Road Fund).

Some Chinese analysts trace the original motivation for One Belt, One Road and AIIB (as One Belt, One Road’s supporting institution) to Peking University.

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33. Interviews, Beijing, January 2015.
35. Interview with a Chinese official, Beijing, January 2015.
Professor Wang Jisi’s “Westward” strategy proposal in late 2012.36 Wang recommended that China pivot to avoid confrontation with the United States in the Asia Pacific and seek an alternative sphere of influence in the vast area west of China. The Westward strategy included an important national security component aimed at fighting terrorism, religious extremism and separatism in the volatile Xinjiang Uyghur Autonomous Region.37 In this sense, AIIB may also aim to improve China’s national security and external environment through stronger and better ties with Central Asian and Middle Eastern countries. The speculation that AIIB’s first project will be the Beijing-Baghdad railway or Pakistan-China economic corridor seems to confirm this strategic orientation.

It is worth pointing out that not all Chinese analysts agree with this geopolitical, strategic explanation for the creation of AIIB. Particularly in the trade, financial and business communities, most experts emphasize that the primary goal of AIIB is anchored in economic and commercial considerations. These analysts do not necessarily reject the strategic utility of the bank, but stress that AIIB should function, first of all, as a commercial bank and be treated as such. In this sense, there is a demonstrated reluctance to allow political consideration to interfere with AIIB’s decision-making.

4. AIIB BASICS
(1) Date of Launch
October 24, 2014: Ceremonial launch with 21 countries signing on to a memorandum of understanding (MOU).

(2) Formal Establishment
June 29, 2015: Signing Ceremony of the Articles of Agreement (AOA) of AIIB.38

The AOA will remain open for signature by Prospective Founding Members (PFM) until December 31, 2015. PFMs that sign the AOA will have until December 31, 2016, to provide their ratification, acceptance or approval of the AOA.

(3) Headquarters
Beijing, China.39

(4) Preparatory Group and Its Leadership
The AIIB preparatory group – the Working Group for Establishment of Asian Infrastructure Investment Bank – was established in early 2014. Chinese participants are comprised mainly of officials and experts from the Ministry of Finance and the National Development and Reform Commission (NDRC), with the Export-Import Bank of China as its technical advisor.40 The group’s director is Jin Liqun, who formerly served as chairman of the board of supervisors at the China Investment Corporation, China’s sovereign wealth fund. The deputy director, Chen Huan, is the former director-general of the Ministry of Finance’s China Clean Development Fund Management Center. Jin was elected on October 24, 2014, as secretary-general of the Multilateral Interim Secretariat for Establishing the AIIB. The Representative Meeting for the Negotiation on the Establishment of the Asian Infrastructure Investment Bank is co-chaired by Shi Yaobing, China’s deputy minister of finance, and Dinesh Sharma, India’s assistant minister of finance.41

(5) Original Signatory Countries (21)
Bangladesh, Brunei, Cambodia, China, India, Kazakhstan, Kuwait, Laos, Malaysia, Mongolia, Myanmar, Nepal, Oman, Pakistan, Philippines, Qatar, Singapore, Sri Lanka, Thailand, Uzbekistan and Vietnam.42

36 Interview with a Chinese analyst, Beijing, January 2015.
40 Interviews with World Bank officials, Beijing, January 2015.
(6) Prospective Founding Members (57)
Australia, Austria, Azerbaijan, Bangladesh, Brazil, Brunei, Cambodia, China, Denmark, Egypt, Finland, France, Georgia, Germany, Iceland, India, Indonesia, Iran, Israel, Italy, Jordan, Kazakhstan, Kuwait, Kyrgyz Republic, Laos, Luxembourg, Malaysia, Maldives, Malta, Mongolia, Myanmar, Nepal, Netherlands, New Zealand, Norway, Oman, Pakistan, Philippines, Poland, Portugal, Qatar, Republic of Korea, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sri Lanka, Sweden, Switzerland, Tajikistan, Thailand, Turkey, UAE, United Kingdom, Uzbekistan and Vietnam.

(7) Signatory Countries of AOA on June 29, 2015 (50)
Fifty of the 57 PFMs signed the AOA on June 29, 2015. The seven countries that chose to defer signing the document are the Philippines, Denmark, Kuwait, Malaysia, Poland, South Africa and Thailand.

(8) Capital
AIIB’s authorized capital stock will be $100 billion, divided into one million shares having a par value of $100,000 each. The original authorized capital stock will be divided into 20% paid-in shares and 80% callable shares. The authorized capital stock may be increased by the board of governors.

As a regional bank, AIIB’s Asian members will hold the majority of capital stock – a minimum 75%, except as otherwise agreed by the board of governors. This shareholding arrangement reflects the commitment and ownership of regional members. Schedule A of the AOA shows unallocated shares totaling about $1.6 billion for regional members and $234 million for non-regional members in anticipation of additional members joining each category. These numbers may change, depending on actual subscriptions by PFMs. Unallocated shares would be available for subscription by new or existing members as determined by the board of governors.

The basic parameter for allocating capital stock to each member is the relative share of its global economy (based on GDP) within the regional and non-regional groupings, with the understanding that GDP share is indicative only for non-regional members. (According to Chinese vice finance minister Shi Yaobin, the allocation of the capital stock was calculated following the formula of 60% nominal GDP and 40% GDP purchasing power parity of member countries.)

In addition to the capital provided by members, AIIB will raise funds primarily through the issuance of bonds in financial markets as well as through inter-bank market transactions and other financial instruments. AIIB may also raise funds, through borrowing or by other means, in member countries or elsewhere, in accordance with relevant legal provisions. AIIB will seek to obtain the highest credit rating possible to facilitate borrowing in capital markets.

(9) Governance Structure
AIIB will have a board of governors, board of directors, president, one or more vice presidents and other officers and staff as needed.

Each member of AIIB will appoint a governor to represent it on the board of governors. All AIIB powers are vested in the board of governors. The board of governors can delegate any of its powers to the board of directors, except certain reserved powers. The board of governors meets annually.

AIIB will have 12 directors on its board of directors: nine elected by regional members and three elected by non-regional members. Each director will have an alternate director, and directors elected by more than a specified number of members may appoint an additional alternate director. The board of directors will function on a non-resident basis, except as otherwise decided by the board of governors. The board of directors is expected to meet regularly in physical
meetings and to have electronic meetings as needed.

The board of directors will be responsible for the direction of AIIB’s general operations and, for this purpose, will exercise all the powers delegated to them by the board of governors.

It is worth noting that AIIB’s governance structure is largely in line with what the Chinese government had stated before the negotiation of the AOA. For example, as early as October 2014, the Chinese finance minister had stipulated that the governance structure would be composed of three tiers: the board of governors, the board of directors and the president and bank management. He also indicated that the board of directors would be non-resident, a rather controversial arrangement that could potentially weaken the actual power and authority of the bank’s operation.

5. CHINA’S EVOLVING POSITION

After the initial, overwhelming focus on China’s strategic intentions in setting up AIIB and its implications for the existing global balance of power, observers’ attention rapidly shifted toward questions about the bank itself. In particular, observers have been keen to know the extent to which the bank will be used to carry out China’s own political and economic aims, and how much China will honor its commitment to making AIIB a truly multilateral development institution, rather than its own policy instrument. The essential questions around AIIB are all embedded in its presumed Chinese identity. The negotiation process and the AOA revealed China’s evolving positions and helped answer some of these questions, but significant issues remain to be addressed.

For example, China’s position on AIIB’s membership, especially non-regional members, has undergone a significant shift. Originally, China had not planned for non-Asian countries to join AIIB. Prior to the wave of European countries’ applications, there were clear indications that China was not optimistic that non-regional members would join early. As late as March 6, 2015, the Chinese finance minister stated at the National People’s Congress that “the relative consensus among the 27 current Prospective Founding Members (PFMs) is that the Prospective Founding Membership is open to countries from the region first and applications from countries outside the region are not considered for now.” The statement was made six days before the United Kingdom submitted its application to become a PFM, raising questions about the wisdom of the minister’s statement.

The expectation among Chinese scholars and officials that, initially, AIIB would only be open to countries

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within the region was based on the assumption that most developed countries would not welcome the bank, since they would likely perceive it as a challenge to the existing international financial institutions. In addition, in light of Washington’s clearly stated “opposition” to the bank and to its allies joining the bank, the calculation was that China would avoid international embarrassment by targeting regional countries, rather than by soliciting Western nations.  

The enthusiasm demonstrated by advanced economies, including 14 countries from the Group of 20, to join AIIB was a welcome surprise for China. Beijing rapidly adapted its position to welcome European countries as well as African and Latin American countries as PFM s. The focus on regionalism was dropped and replaced by a distribution of capital shares between regional (75%) and non-regional (25%) members. The surge in the membership base, with a total of 57 PFMs, greatly strengthened AIIB’s legitimacy and enhanced China’s leadership image regionally and globally. Further, China’s success in winning over developed country members, especially U.S. allies such as the United Kingdom and South Korea, has been perceived as a major diplomatic victory for China over the United States.

Another significant change in China’s approach to the bank is that it clarified and confirmed AIIB’s nature and identity as an MDB. This represents a change from early 2015, when the bank was discussed as either an aid agency or a commercial bank. The “aid” argument made by many foreign policy analysts was that, since many, if not most, AIIB members would be less-developed countries in Asia, and they would be unlikely to contribute substantially toward the bank’s capital, China might be required to make a contribution of as much as 50% of the bank’s total. With such an overwhelming contribution by China, AIIB would essentially amount to another Chinese channel for financing Asian infrastructure development, hence blurring the difference from Chinese aid. Among financiers, commerce and finance officials holding opposing views – perhaps to defuse the “aid agency” argument – contended that AIIB would be a market-oriented, profit-seeking commercial bank that specializes in financing infrastructure projects, and that “China did not found the bank to lose money, but to make a profit.”

The final configuration of AIIB avoids both extremes and reflects a middle-way approach that had not been particularly popular in China, early on. As stipulated by the AOA, AIIB will be a new MDB designed to provide financial support for infrastructure development and regional connectivity in Asia. In the view of many Chinese analysts, this differentiates AIIB from both commercial banks and policy banks. Some, therefore, perceive AIIB as a “quasi-commercial bank,” meaning its investments must generate returns.

Simple as it sounds, the need to generate returns raises a key question regarding how the bank will balance funding infrastructure projects with practical concerns over the fundability and profitability of those projects. Infrastructure development is known for long funding cycles, low interest rates and potential for waste and corruption. If AIIB were to grant loans that other banks reject for commercial reasons, it would assume major risks. Especially in less-developed Asian countries with volatile domestic economies and unstable governments, how the recipient will repay the loans is a major question for any bank, including AIIB. China has traditionally adopted a “resources for infrastructure,” bilateral lending model through which the recipient country repays Chinese loans with natural resources or other contracts. Given how controversial and widely criticized that model has been, particularly among Western members of the bank, AIIB could not employ that method of repayment.

Despite the rosy original blueprint it developed, China has been forced to face the inherent conflict.

50 Ibid.

between funding potentially loss-making infrastructure projects and seeking profits. Multiple conferences dedicated to the issue were held in Beijing in the first half of 2015. Most analysts agree on the risks in the Asian infrastructure market and the need for AIIB to avoid them.\(^{54}\) In search of a solution, a consensus emerged among experts that the bank would need to be particularly cautious and commercially minded in its lending decisions, and that it temper earlier unrealistic hopes of funding all types of infrastructure projects, while generating high returns. Perhaps the most representative declaration was made by Zhang Jianping, director of the Office of International Economic Cooperation of the Academy of Macroeconomic Research in the National Development and Reform Council (NDRC), when he said, “The operation of the AIIB will definitely not seek high returns but rather to break even or earn minimal profits.”\(^{55}\)

The conflict between profits and fulfilling needs has two important implications. First, the scope of projects AIIB can support will be more limited than what was implied by China’s ambitious claim to “fill the funding gap in the Asian infrastructure market.” Second, the loans provided by AIIB may not be as generous as borrowing governments originally expected, in order for the bank to invest responsibly and earn “minimal profits.” Indeed, some Chinese finance officials have commented that AIIB will have to follow high economic standards, despite the high demand, and that such standards will be very similar to those of existing MDBs, such as the World Bank and ADB.\(^{56}\)

Over time, China lowered its capital contribution to the bank, thereby limiting its veto powers. When the MOU was first signed in October 2014, China planned to contribute 50% of the bank’s capital, which many assumed would translate into absolute veto power on any issues that require a simple majority. However, as more countries joined AIIB, China scaled back its share to 30%. Meanwhile, a more sophisticated formula for voting rights was adopted that combines voting shares based on capital shares, basic voting rights and PFM voting rights. The formula grants China 26.06% of the voting power.

Therefore, as the AOA stipulated, China will have veto power on issues that require a supermajority vote. As defined by the AOA, a supermajority vote of the board of governors will require an affirmative vote of two-thirds of the total number of governors, representing no less than three-fourths of the total voting power of the members.\(^{57}\) The AOA cites 12 issues that would require a supermajority vote:

- An increase of authorized capital stock of the bank (Article 4.3);
- The initial number of shares for future members or the changing number of shares for existing members that could reduce the capital stock held by regional members below 75% of the total (Article 5.2 and Article 5.3);
- Provision of assistance to non-regional recipients (Article 11.1-b);
- The total amount of outstanding loans, equity investments, guarantees and other types of financing (Article 12.1);
- Allocation of the bank’s net income to purposes other than reserves, retained earnings and distribution to members (Article 18.1);
- Changes to the size and composition of the board of directors (Article 25.2);
- Functioning of the board of directors on a non-resident basis (Article 27.1);
- Election, suspension or removal of the president (Article 29.1, 29.2);
- Suspension and restoration of membership (Article 38.1);
- Termination of the bank’s operation (Article 41.1);
- Distribution of assets to members based on their capital subscriptions (Article 43.1);
- Amendment of the AOA (Article 53.1).

\(^{54}\) Interviews, Beijing, June 2015.


\(^{56}\) Interviews, Beijing, June 2015.

In addition, at the level of the board of directors, a minimum of three-fourths of the vote is required for:

- Decisions on major operational and financial policies and delegation of authorities to the president under the bank policies (Article 26.ii);
- Delegation of authorities to the president regarding actual bank operations (Article 26.iii)

China’s veto power reflects China’s determination to retain control over key aspects of the bank. Its desire to maintain veto power and certain privileges was apparent from the beginning. When *The Wall Street Journal* reported in late March 2015 that China would forego veto power to gain the membership of key European countries, for example, the Chinese vice finance minister denied the report later the same day.

Chinese analysts acknowledge that China would like to maintain some privileges at the bank because “China is the original advocate and the largest shareholder of the bank after all and deserves the veto power,” and “being the largest shareholder in the bank, China is unlikely to give up its influence in it.” They further argue that China’s total share and voting rights were the natural result of openly negotiated formulas, rather than China’s manipulation. However, critics have pointed out that the negotiated formulas were, themselves, the result of China’s negotiating position and manipulation.

Although China’s veto power is controversial, it is more symbolic and may not be as threatening as it appears. Issues such as the acceptance of new members do not require a supermajority. And having veto power does not equal the power to force the board to approve whatever China wants. Further, how often China will exercise its veto power remains to be seen. It is highly unlikely that, on any of the critical issues mentioned above, the rest of the bank’s members will unanimously oppose China and so necessitate Beijing’s use of its veto. Given China’s advantageous position at the bank and the many other channels at China’s disposal to influence the bank’s decision-making (including through the many Chinese senior staff at the bank and countries with close ties to China), Beijing may not need to use a veto at all.

Meanwhile, a general consensus has emerged among analysts that China must be particularly cautious in exercising unilateral veto power. China has been trying to promote the bank as a multilateral institution, rather than its own bank. Exercising veto power would inevitably undercut those efforts and reinforce suspicions and criticism by countries such as the United States and Japan. The bank will not be free from China’s special status and privileges, but how China chooses to use its influence will be a key indicator of China’s true intentions for the bank.

International scrutiny and pressure, combined with China’s concern for reputation and its desire to gain recognition, will likely have a strong impact on China’s actions.

What is more important is the extent to which China will use AIIB to advance its own national interests and agenda. As discussed above, export promotion of Chinese products and services, support for China’s One Belt, One Road strategy and an attempt to gain strategic influence were all motivations for China to set up the bank – leading to criticism of China’s intentions. While the bank will help aid regional development and may enhance China’s international stature, the extent to which China lets its own commercial and political considerations take priority in the operation of the bank will elicit the most scrutiny in the years to come.

Thinking inside China on this issue has also been evolving. Indeed, there has been a debate in the Chinese policy community over the extent to which China should exploit AIIB to pursue Beijing’s goals of export promotion and progress on One Belt, One Road. In an encouraging sign, one of China’s most controversial goals in launching AIIB – promoting exports to absorb excess capacity – has gradually disappeared from government statements and media reports. Promoting exports of Chinese goods to absorb excess capacity runs the risks of encouraging anti-dumping lawsuits by trading partners.

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60 Interview, Beijing, June 2015.
62 Interview, Beijing, June 2015.
Moreover, if China’s traditional industries simply switch their focus from domestic to foreign markets, without making structural changes, much-needed economic reforms that the Xi administration seeks may be undercut. More important, AIIB as a multilateral development bank is fundamentally different from a Chinese trade-promotion agency; running the bank as the latter would inevitably undermine AIIB’s legitimacy and credibility. With more than 50 PFMs, including traditional Western donor countries such as the United Kingdom, France and Germany, it would be difficult and problematic for AIIB to favor Chinese exports. Indeed, the Chinese Ministry of Finance and the Chinese leadership of the AIIB preparatory group have repeatedly made statements to this effect.63

The relationship between AIIB and the One Belt, One Road strategy seems less direct and less controversial in China, perhaps because Beijing sees both endeavors as aimed at Asian infrastructure development and regional connectivity. Analysts in China generally view the two initiatives as complementary. If AIIB chooses – based on merit and in compliance with the bank’s governance regulations – to support suitable regional projects that happen to fall under the One Belt, One Road strategy, the bank’s actions will be harder to criticize.

China realized that the issue of upholding standards and regulations governing AIIB, while making practical decisions, presents another important issue. China has vowed from the beginning that AIIB will deliver funding more efficiently and effectively than the World Bank and ADB, but the Chinese have also gradually realized that high-quality rules and regulations are required for a variety of practical reasons. Good governance will guard against bad lending decisions, benefitting both the bank and the borrowers. High standards and vigorous oversight and management are preconditions for a good credit rating, which directly determines the viability of AIIB’s plan for fundraising on the international market (ADB’s rating is AAA). Moreover, given all the early concerns regarding AIIB’s governance, transparency and accountability, any missteps in this area will dramatically undermine the bank’s credibility and legitimacy.

Official statements regarding AIIB’s standards and oversight have, at best, been broad and vague, but the level of commitment to high standards and strict oversight is unprecedented for China. China has repeatedly promised that AIIB will be “lean, clean and green.”64 For example, on the issue of compliance, the official website states that, “The bank will ensure that each of its operations complies with the bank’s operational and financial policies. These policies would be based on international best practices and would include, among others, environmental and social frameworks, disclosure, procurement, debt sustainability and operations in disputed areas.”65 It also promises that, “The board of directors will establish an oversight mechanism to supervise the management and operation of the bank in line with the principles of transparency, openness, independence and accountability.”66 The bank’s actual practices and operations will be the true arbiter of AIIB’s performance in these areas. However, questions from opposing countries and scrutiny by the international community played a key role in shaping China’s preferences regarding the rules of the bank.

6. CONCLUSION

Despite early speculation, China did not initiate AIIB merely as a strategic endeavor to expand its political and security influence. China has had a long list of goals in pursuing AIIB, most of which are centered on China’s economic interests. These include expanding China’s regional influence, “democratizing” the international economic order, diversifying China’s investment portfolio, promoting China’s exports, assisting China’s One Belt, One Road strategy and internationalizing the RMB.

What China did not anticipate was the positive...

63 It is worth noting that this position has prompted disagreement inside China. Many domestic interest groups, such as local governments and companies, argue that China should not be completely altruistic, and that AIIB should advance China’s own economic agenda. More specifically, they expect China, at the minimum, to use its influence to favor domestic bidders in AIIB’s projects.


66 Ibid.
reception from most of the international community. Non-regional countries, including more than a dozen advanced economies, applied to become PFMs. Their enthusiasm belied China’s assumption that the developed countries would reject the new institution, and the bank’s membership would consist overwhelmingly of Asian developing countries, with China playing the dominant role. The participation of Western and other developed countries has greatly boosted AIIB’s credibility and legitimacy, a result that, in light of U.S. opposition, China views as a diplomatic victory over Washington.

At the same time, the negotiations establishing AIIB provide an example of how China’s behavior can be influenced by the international community. Upon joining the bank, the PFMs, including developed country members, were able to use their bargaining power to negotiate, guide and shape the bank’s AOA from within and enmesh China in a network of international norms and standards. Opposition and criticism from the United States and Japan also played an important role in reining in China’s ambitions and advocating for its own agenda. Although many details have yet to be worked out, AIIB today is very different from the bank China envisioned before March 2015. China adapted its expectations and position to meet changing realities. That flexibility, by itself, has been a positive development. Countries may still perceive AIIB as a case of China challenging the existing international system, but the development of AIIB also demonstrates that the existing system has the power to balance and shape that challenge, check China’s ambitions and make China play by the rules.

AIIB must continue to address the challenges and contradictions posed by the ambitions the bank has in Asian infrastructure development. A balance must be struck between the vast demand for Asian infrastructure funds and the high standards the bank has pledged to follow, as well as between building a high-quality multilateral development bank and accommodating China’s own goals. While the AOA has been published, many details have yet to be finalized and disclosed. Observers will pay special attention to these details as they are determined over such issues as China’s exercise of veto power, AIIB projects’ links to China’s export promotion efforts and broader policy agenda, the bank’s governance practices and compliance policies, its fundraising models and the loans it makes. China has successfully completed the first stage of AIIB’s establishment, but many important challenges lie ahead. Ultimately, the bank will be judged by its actual performance.
The U.S. Response to the Asian Infrastructure Investment Bank

by Tobias Harris

1. INTRODUCTION

On April 28, 2015, U.S. President Barack Obama held a joint press conference with Japanese Prime Minister Abe Shinzo in the White House Rose Garden. Asked about the strategic significance of the Asian Infrastructure Investment Bank (AIIB), President Obama sought to dispel the notion that the U.S. government opposes the creation of AIIB, saying:

Asia needs infrastructure. There are a lot of countries that have difficulty financing infrastructure, but if they got that infrastructure put in place and developed, they can grow much more rapidly. And that’s good for everybody. It’s good for that country. It’s good for the world economy. It’s good for us. We want more markets to be able to get our goods in and sell our services that are some of the best in the world. And China has got a lot of money. It’s been running a big surplus for quite some time. So to the extent that China wants to put capital into development projects around the region, that’s a positive. That’s a good thing.

Obama then went on to stress the importance of high-quality governance and lending standards for AIIB. “Let’s just make sure that we’re running it based on best practices,” he said, adding that he looks forward to collaborating with the new bank on development projects. In his remarks, Obama signaled that his administration was prepared to move past hostility towards the bank and is willing to recognize that, with AIIB taking form, the U.S. government should try to push it in more constructive directions.

Unfortunately, this shift in the Obama administration’s perspective came only after the U.S. government suffered an embarrassing defeat when the United Kingdom’s decision in early March to join AIIB led to a stampede of other U.S. allies, including France, Germany, Italy, South Korea and Australia, into the bank, ahead of the March 31st deadline to sign up as founding members. And even then, the administration was slow to recognize that it had to change its tone on AIIB. After the UK joined, an anonymous senior official told the Financial Times that the decision was another example of the UK’s “constant accommodation” of China.

The Obama administration’s response to the AIIB initiative encapsulates the problems with the political and economic dimensions of its Asia rebalance strategy. Confronted with China’s proposal, the administration struggled to see the upside of AIIB. Beijing was not only seeking a multilateral solution to an important regional problem, but also actively pursuing technical assistance from experts with long experience in managing existing development banks, including the Asian Development Bank (ADB). Instead, Washington focused entirely on


the threat to existing international financial institutions, the risks to borrowers and the broader threat to the U.S.-led international economic order. For these reasons, as China’s initiative took shape, the U.S. government devoted more energy to dissuading its allies and partners from participating than seeking a way to engage AIIB constructively or offering alternatives for addressing the region’s infrastructure gap.

Ultimately, the Obama administration’s Asia “rebalance” will require subtlety above all else. The United States will have to find ways to accommodate China’s desire to wield greater power in Asia, particularly when China pursues multilateral solutions to regional problems. The United States cannot afford to take a relentlessly oppositional stance when China offers to work with others, not least because – as this episode shows – the sheer size of China’s economy means that Washington cannot assume that its allies and partners in Asia and worldwide will share its approach. The mishandling of AIIB also illustrates the need for a genuinely “whole-of-government” approach to Asia, not only within the executive branch but also including the U.S. Congress.

This paper explores how the Obama administration responded to the AIIB initiative, focusing on interagency debates and outreach to U.S. allies as they considered China’s proposal. It then considers whether the United States could have responded differently and the factors that led the Obama administration to react defensively. It concludes with lessons learned from the administration’s handling of the issue.

2. THE REBALANCE AND CHINA’S RISE

The Obama administration has made strengthening U.S. leadership in Asia a top priority of its foreign policy. Through its Asia “rebalance” strategy – also known as the “pivot to Asia” – the Obama administration has sought to preserve and extend the U.S. position in the Asia-Pacific region, correcting the imbalance that resulted from two protracted wars in Central and Western Asia. As then-Secretary of State Hillary Clinton explained, “One of the most important tasks of American statecraft over the next decade will therefore be to lock in a substantially increased investment – diplomatic, economic, strategic, and otherwise – in the Asia-Pacific region.”

However, from the inception of the rebalance, the administration has had to counter accusations that its Asia strategy is actually a containment strategy aimed at China. Critics have stressed that, by strengthening ties with old allies and forging new security partnerships with China’s neighbors, the United States has risked triggering Chinese fears of encirclement. As a result, the United States has had to engage in high-level diplomacy to reassure China that the administration sees it as an important partner, while reassuring East and Southeast Asian partners and allies that U.S. security commitments remain ironclad, even in the face of Chinese assertiveness in territorial disputes. The point is not that the United States has succeeded in assuaging Chinese fears or reducing tensions between China and the United States and its allies, but that the administration believes it is important to avoid the impression that it seeks to contain China.

Accordingly, President Obama and other senior officials have repeatedly stated that the United States does not aim to contain China’s rise. In fact, Obama did so in a joint press conference with Chinese President Xi Jinping during the Asia Pacific Economic Cooperation (APEC) summit in Beijing in November 2014, shortly after two major U.S. allies decided not to join AIIB. The president said, “I have repeatedly reiterated and displayed through the actions of our administration that we want China to succeed. And we actively encourage our


friends and allies in the region to foster a strong and cooperative relationship with China.\textsuperscript{7}

U.S. officials have, for years, called upon China to act as a “responsible stakeholder,”\textsuperscript{8} a country that, in then-Deputy Secretary of State Robert Zoellick’s words, “[recognizes] that the international system sustains their peaceful prosperity, so they work to sustain that system.” However, the United States has not been as sensitive when it comes to multilateral political and economic institution building. Instead, Washington has, at times, seemed content to permit the emergence of “rival regionalisms.”\textsuperscript{9} Rather than welcome a greater Chinese role in regional institutions, challenging Beijing to act as a responsible stakeholder, the United States has seemed, at best, resigned and, at worst, hostile to China’s efforts to create its own institutions outside the existing regional architecture. While China has its own reasons for wanting to build new regional institutions, Washington has failed to use multilateral organizations as a means to give China a greater stake in the existing order and to counter the argument that the United States seeks to contain or otherwise limit China’s power in Asia.

It is, to some extent, understandable that the United States is defensive about the China challenge to existing institutions. The existing system of international financial institutions, built and sustained by the United States and its allies, is an important pillar of the global economy and a tool by which the U.S. wields global influence. As John Ikenberry, professor at Princeton University’s Woodrow Wilson School of Public and International Affairs, has argued, liberal, multilateral institutions have enabled the United States to signal its benign intentions and bolster its position by tying its own hands, taking the time to listen to weaker states and providing global public goods.\textsuperscript{10} But the United States does not strengthen its position in the region by forcing Asian countries to choose between U.S.-led institutions or newcomers initiated by China.

Washington needs to prepare for an era in which Asia is governed by overlapping clusters of institutions, some led by the United States and its allies, some led by China, still others spearheaded by the Association of Southeast Asian Nations (ASEAN), all of which can contribute to resolving disputes and promoting regional integration. The failure of officials across the U.S. government to recognize this emerging reality lies at the heart of the Obama administration’s mishandling of AIIB.

3. THE U.S. RESPONSE TO AIIB

The defensiveness of the Bretton Woods institutions can be seen in a January 2015 op-ed by Nathan Sheets, U.S. Under Secretary of the Treasury for International Affairs, which was essentially the first official statement by the Obama administration in response to AIIB. Sheets explained the value that U.S.-led multilateral development banks (MDBs) have provided since 1945, noting their high standards in terms of transparency, debt sustainability, the environment and project procurement. After making the case for the incumbent MDBs, Sheets addressed the newest institutions, AIIB and the BRICS countries’ New Development Bank. “The United States stands ready to welcome new institutions into the international development architecture,” he wrote, “provided that they share the international community’s strong commitment to complementing the existing institutions and maintaining time-tested, and ever-improving, principles and standards.”\textsuperscript{11}

The article’s tone can be best described as “grudging.” Sheets accepts that AIIB will exist, but focuses mainly on explaining the United States’ conception of best practices for MDBs. There is no acknowledgement of Asia’s infrastructure gap or appreciation that China is seeking to shrink the gap through multilateral means, rather than investing money through bilateral mechanisms. In short, after nearly a year of deliberations about how to respond to AIIB, in January 2015 the U.S. government


\textsuperscript{8} This phrase, first used during the Bush administration by Deputy Secretary of State Robert Zoellick, was also used repeatedly by former Secretary of State Clinton, though not by Secretary of State John Kerry.

\textsuperscript{9} Ellen Frost, Rival Regionalisms and Regional Order: A Slow Crisis of Legitimacy, NBR Special Report #48 (December 2014).


was still more focused on citing the shortcomings of the nascent, China-led MDB than offering a constructive response to Asia’s need for infrastructure investment. Sheets alluded to ways in which existing institutions “continue to evolve to meet global challenges, to enhance their efficiency and efficacy,” but offered no concrete proposals for how the United States and U.S.-led institutions intend to address the infrastructure problem.

The formula used by Sheets in his article – the United States welcomes AIIB but with extensive caveats pertaining to standards – remains the U.S. position, despite the more positive overtones in Obama’s joint press conference with Abe. As Under Secretary of State for Political Affairs Wendy Sherman said in a speech at the Carnegie Endowment for International Peace on February 27, 2015, “The United States welcomes new initiatives, such as the China-proposed Asian International [sic] Infrastructure Bank, provided its founding documents and practices uphold the high standards of other development institutions.”

It took more than a year for the Obama administration’s position to evolve only marginally from the grudging disapproval in the Sheets’ article to what can be described as “grudging acceptance.” The United States has arrived at this position only after ignoring AIIB, debating whether there were any way for the administration to kill the proposal and dissuading allies from joining. The U.S. focus has been narrow and negative – problems with the bank, its membership, its relationship with other institutions – instead of offering a response that addresses the issues raised by China’s proposal.

For six months following Chinese President Xi Jinping’s announcement in October 2013 that China intended to create AIIB, the Obama administration simply ignored the proposal. U.S. diplomats and officials in the region, who were watching AIIB take shape, have said that they were unable to get much of a response from Washington. In the words of one analyst, the administration was “asleep at the switch.” It was not until late spring 2014, when Chinese officials began fleshing out the proposal and enlisting founding members that the U.S. government began to react.

When the Obama administration did react, the first instinct of international economic policymakers at the White House and the Treasury Department was, according to one official involved in the initial discussions, to ask whether there were a way to prevent the bank from coming into existence. Concluding that there was probably nothing the United States could do to prevent China from establishing AIIB, the administration’s approach shifted from trying to block its creation to trying to limit its influence and prevent wealthy, democratic U.S. allies from joining and providing it with greater legitimacy.

Questioning China’s plans for AIIB’s governance and lending standards has been central to this approach. As noted previously, on the handful of occasions that U.S. government officials have spoken publicly about AIIB, they have voiced concerns that the bank would not be sufficiently transparent, particularly over its procurement decisions, and that its social, labor and environmental standards would be weaker than those of other MDBs. They have also expressed concerns that AIIB would be redundant with existing MDBs, including the Asian Development Bank (ADB) and the World Bank.

U.S. participation in AIIB appears to have not been considered. Even had the Obama administration wanted to join, it would have struggled to convince the U.S. Congress to allocate funds to enable the United States to participate in a Chinese-led development bank. Rather, the focus of U.S. policymakers was on U.S. allies that China approached about joining. While both the U.S. and Australian media reported that the United States explicitly asked its allies not to join AIIB, an official involved in the policy process suggested that the administration’s response was more measured. The administration did not “twist arms,” according to the official, although that approach was admittedly considered. Instead, when


13 For a different view, see John Kehoe, “We didn’t veto Asia bank: U.S.” Australian Financial Review, January 24, 2015. Kehoe says Evan Medeiros, senior director for Asia at the National Security Council, denied that the United
approached by allies about AIIB, the United States discussed whether the institution would have adequate safeguards, noting that, “The worst thing would be to build lots of highways and dams but ignore labor, the environment, and human rights.” By articulating concerns about AIIB standards, the U.S. government was able to provide U.S. allies with questions to ask China when they were invited to join.

Australia and South Korea were targets of extensive Chinese lobbying regarding the bank and were the allies with which the United States had the most extensive discussions. Bringing either country into AIIB would have immediately bolstered the bank’s legitimacy, as eventually happened when the UK’s decision to join cleared the way for Australia and South Korea to reverse earlier decisions to stay out.

Canberra appeared to have been leaning towards joining until the final weeks before the memorandum of understanding was signed on October 24, 2014. Prime Minister Tony Abbott has, at times, referred to himself as an “infrastructure prime minister,” and the Abbott government made global infrastructure investment a priority for its 2014 leadership of the G20. The Australian government struggled to balance its economic priorities and its relationships with China on the one hand and the United States and Japan on the other. The Abbott government resolved the tension between these positions by asking China pointed questions about AIIB in a “non-paper” drafted by the Australian treasury and delivered to Beijing in June 2014. In the non-paper, which echoes many of the U.S. government’s concerns, the Australian government asked for clarity on AIIB’s:

- Purpose and functions;
- Types of infrastructure projects in which the bank intended to invest;
- Membership and governance structure and distribution of power on the bank’s board;
- Capital structure and intentions regarding its credit rating;
- Borrowing, lending and investment procedures.

The non-paper also posed difficult technical questions, but it appears to have been written with a view towards eventual Australian participation. While the Abbott government eventually decided not to sign on to the memorandum of understanding in 2014, reports suggest that the Australian government conducted an extensive internal debate over whether it was better to join and shape the institution from within, or whether it should refrain from legitimizing a new institution that seems aimed at challenging incumbent institutions dominated by the United States and Japan. It is possible that U.S. and Japanese pressure tipped the balance in the Australian debate, but the non-paper suggests that, even without U.S. outreach, the Australian government would not join AIIB lightly. Nevertheless, Australia’s decision not to join proved controversial domestically, and it is not surprising that Australia reversed course and decided to join once the United Kingdom signed up as a founding member.

Despite growing economic and political ties with China, South Korea shared both U.S. and Australian concerns regarding AIIB, although it is possible that had Australia joined, South Korea would have joined as well. South Korea was not subjected to the same amount of lobbying by U.S. officials as Australia, which may reflect both greater Australian interest in AIIB and the perception that Australian participation would be a bigger victory for China. One of the few public statements by a U.S. official regarding AIIB was made in an interview by the Yonhap News Agency with Sydney Seiler, then-director for Korea at the National Security Council (NSC). Seiler offered a defense of the existing development institutions, especially ADB, questioning the need for AIIB when high-standard institutions already exist. Seiler’s intervention, days after China asked South Korea to join, appeared to have

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14 Interview, February 2015.
16 Both President Obama and Japanese Prime Minister Abe may have explicitly urged Abbott not to join AIIB. Philip Coorey and Greg Earl, “China bank: Abbott held talks with Abe,” Australian Financial Review, November 1, 2014.

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convinced Seoul to delay participation.

It is worth noting, however, that, although the Obama administration was initially able to convince Japan, South Korea and Australia to remain out, the ten ASEAN countries and India joined – countries that stand to gain the most from new infrastructure investment. In short, even though the United States has convinced China that AIIB needs to have higher standards (see Yun Sun’s contribution in this volume) the United States ceded ground in Asia by failing to pitch its response to the region’s emerging economies.

4. MISSED OPPORTUNITY FOR U.S. LEADERSHIP

Despite the prevailing impression that the Obama administration’s response to AIIB was badly mishandled, it cannot be characterized as a total failure. AIIB is gradually evolving in a manner that conforms to the U.S. government’s emphasis on high standards. U.S. pressure, whether explicit or implicit, convinced key allies to withhold participation – and thereby the legitimacy that participation would confer – until China offered concessions on the bank’s architecture. And AIIB, far from trying to unseat the World Bank and ADB, is looking to both for guidance, personnel and technical assistance. In fact, China has been receptive to criticism and eager to work with rich countries and incumbent institutions to ensure that AIIB performs its job well. In addition to naming a former ADB vice president, Jin Liqun, as the bank’s first president, the bank has looked to hire other former ADB officials and reached out to ADB for technical assistance.

However, even if AIIB develops into a high-quality international financial institution that complements existing institutions, by focusing solely on the bank’s technical aspects the Obama administration missed an opportunity to advance the U.S. strategic position in Asia. The United States would have looked more serious and engaged in the region if the Obama administration had met the challenge posed by AIIB by outlining new initiatives to tackle the infrastructure gap or by reforming ADB and other development institutions by granting greater stakes to China and Asia’s other emerging economies. Its actions would have lived up to the vision, outlined in the rebalance strategy, of U.S. leadership committed to solving regional problems. Instead, the U.S. government conveyed the impression that it is more interested in having the United States and its allies take the lead in writing rules for Asia in the twenty-first century than in solving widely recognized problems. President Obama reinforced this impression when making the case for the Trans-Pacific Partnership (TPP) in his 2015 State of the Union address, when he said, “But as we speak, China wants to write the rules for the world’s fastest-growing region. That would put our workers and our businesses at a disadvantage. Why would we let that happen? We should write those rules.”

Demanding that Chinese-led institutions conform to high standards and safeguards seems consistent with the U.S. government’s longstanding insistence that China act as a “responsible stakeholder.” However, the innate hostility to China’s AIIB proposal and the argument that the United States and China are engaged in a race to build Asian institutions and write the rules of regional economic governance suggest that the positive-sum approach may be giving way to a zero-sum worldview in which any measure to exercise regional economic leadership comes at the expense of U.S. leadership. From the U.S. response to AIIB, Beijing could reasonably conclude that “responsible stakeholder” actually means being a passive member of organizations in which China holds stakes incommensurate with its economic power. As Australian academic Peter Drysdale has written, “The Chinese can do whatever infrastructure financing they wish unilaterally, but they have chosen to offer multilateral partnership in this initiative. It should take no more than a nanosecond to conclude that countries such as Australia, Korea, Japan and the United States should partner in this enterprise.”

In short, by focusing on institutional standards instead of on the larger strategic picture – welcoming China’s intention to contribute to the provision of regional public


goods—the United States disregarded the principles of its own Asia strategy and contributed to the impression that it seeks to contain China. Contrast this with World Bank President Jim Yong Kim’s response to AIIB. Asked about AIIB while visiting China in July 2014, Dr. Kim said:

We think that the need for new investments in infrastructure is massive and we think that we can work very well and cooperatively with any of these new banks once they become a reality.

In fact we have been going through a reform process at the World Bank Group over the past year, precisely because we knew that there would be new entrants in the business. We feel that our advantage is that we have 70 years of experience and we have the best technical knowledge, knowledge not just of papers and evidence and data, but we have experience of putting together actual solutions to problems. So we’re now prepared with our global practices and cross-cutting solutions areas to work very closely with the BRICS Bank or the Asian Infrastructure Investment Bank and provide them with the kind of knowledge and solutions that would help them be more effective in building infrastructure in developing countries.

So for us, our competition is poverty, our enemy is lack of economic growth. Another enemy is a growth that’s not inclusive. So as long as we’re clear on what we’re doing and what we’re battling, we have actually no choice but to welcome any new entrants, because every new entrant will help us battle poverty and help us to share prosperity.20

While the United States could not respond in the same terms as the World Bank, Dr. Kim’s remarks suggest that the Obama administration lost sight of the problem that needs to be addressed. To the extent that ASEAN countries, the primary beneficiaries of AIIB, believed that the United States was ignoring their interests and forcing them to choose between the United States and China on this issue, Washington’s response handed China a victory in the battle for hearts and minds in Asia.

This is not to say that standards and best practices for multilateral institutions are unimportant. The MDBs have spent decades learning how to balance poverty alleviation, debt sustainability and environmental and social responsibility in their projects.21 High standards are necessary if China is to be a responsible stakeholder. But the United States should offer advice and assistance out of a good-faith belief that the region will be better if China seeks to wield power through multilateral institutions, even imperfect institutions, than if China acts unilaterally. If the United States is to continue to play a leadership role in East Asia and to be involved in shaping the region’s institutional environment—as the rebalance strategy envisions—it cannot just seek opportunities for the United States to write the rules. It has to find and welcome opportunities for China to participate as well. The Obama administration may gradually be moving in this direction when it comes to AIIB, particularly as AIIB’s standards evolve and as wealthy democracies join the institution.

5. WHY THE U.S. ERRED

The key questions going forward are why the U.S. government’s initial reaction was defensive and whether it is possible to learn from this experience to avoid repeating the same mistakes in the future. Perhaps the most important thing to note about the Obama administration’s AIIB policy is that, rhetoric notwithstanding, it would be a mistake to conclude that the response to AIIB was the product of a deliberate plan to contain China. Instead, the administration may have opted for a policy of undermining AIIB because it was the path of least resistance—and institutional factors made it more difficult to opt for a subtler, accommodating response to the bank.

First, devising a more nuanced approach may have taken time and energy that policymakers simply did not have. Beijing’s campaign to enroll members into AIIB coincided with the deepening crisis in Ukraine and the emergence of the Islamic State of Iraq and the Levant (ISIL). Both crises may have made the Obama administration acutely sensitive to perceived threats to the global order, priming the U.S. government to react defensively to what it perceived as a Chinese challenge to...
Policymakers may have also reacted defensively in part because they had limited information about China’s plans for AIIB, which China was slow to provide. Had China been more deliberate in its rollout proposal and reached out to the United States earlier in the process, it might have forestalled some of the acrimony with which the Obama administration greeted the proposal. It was only in September 2014 that Jin Liqun, the incoming AIIB president, visited Washington to reassure U.S. experts and officials that China was trying to address criticisms about the bank’s structure, well after the United States had decided to lobby allies not to join the organization.

Additionally, the U.S. international economic policymaking apparatus may have predisposed the U.S. government towards a defensive reaction to China’s proposal. The Treasury Department and Treasury officials working at the NSC dominated the U.S. government’s formulation of a response. The Treasury view was heavily influenced by a belief in the sanctity of the Bretton Woods institutions, including MDBs like ADB, and as a result, it instinctively sought to uphold the primacy of the incumbent institutions when confronted with a challenge.

U.S. economic policymakers reacted similarly in 1997, when, in the midst of the Asian financial crisis, Japan argued for the creation of an Asian Monetary Fund (AMF) that would provide an Asia-led response to balance of payments crises. Indeed, the arguments made by U.S. Treasury officials against Japan’s AMF proposal in 1997 were similar to the arguments U.S. officials would later make in 2014 against AIIB. They stressed that an AMF would duplicate the function of existing institutions; they argued that it would have lower standards than existing institutions (in this case that its lending would lack conditionality, the requirement that borrowers implement structural reforms); and they argued that it was a Trojan horse by which a regional power sought to marginalize the United States and claim hegemony for itself.

Participants in the debate over AIIB suggest that there were officials in Treasury’s Office of International Affairs who welcomed China’s determination to contribute to solving a regional problem, but who argued for a more nuanced response, believing the United States should have laid out its concerns publicly, early in the process. However, the debate was dominated by a small number of players, and officials advocating for a more subtle response, whether at the Treasury Department, the NSC or the State Department, struggled to push the administration in this direction. The State Department’s Economic and Business Affairs and East Asia and Pacific Bureaus, which may have wanted to ensure that the administration’s response was consistent with the broader goals of the rebalance strategy, played, at best, a marginal role in formulating policy. Some observers have suggested that the Treasury view prevailed, in part because the NSC has expanded in size – according to David Rothkopf, CEO and editor of The FP Group, it now has nearly 400 people, “twice as large as during the early Bush years” – limiting its ability to craft an approach that defends global standards for multilateral institutions while still accommodating a greater role for China in global economic governance.

The Japanese government’s opposition to AIIB may also have shaped the U.S. government’s defensive response. Both because the Japanese government wants to ensure that ADB, in which Japan is the largest shareholder along with the United States, remains Asia’s preeminent development bank, and because the Japanese government is acutely sensitive to the contest with China for influence in Southeast Asia, the Abe government was, if anything, even less favorably disposed to AIIB than the Obama administration. As noted previously, Tokyo may have been even more explicit than Washington in urging Canberra to stay out, leveraging Prime Minister Abe’s personal rapport with Prime Minister Abbott. This is not to say that the U.S. government simply followed Japan’s lead on AIIB, but opposition from the leading U.S. ally in Asia likely made it more difficult for officials in favor of a more accommodating response to win the debate. After all, by trying to limit the influence of AIIB and preserve ADB’s

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predominance, the U.S. government would not just be defending ADB, it would be upholding a leadership role for Japan.

Finally, as former Federal Reserve Chairman Ben Bernanke and others have argued, the Obama administration may have been constrained by the U.S. Congress. There is no evidence that members of Congress expressed any interest, positive or negative, in China’s AIIB proposal. However, Congress is not only responsible for authorizing U.S. contributions to MDBs and other international financial institutions but must also approve any changes to the governance and structure of MDBs. It is noteworthy that, even as China was pledging tens of billions of dollars to stand up AIIB, the U.S. Treasury has struggled to get Congress to meet the U.S. commitments to ADB and the Asian Development Fund (ADF), which makes concessional loans for poverty alleviation. U.S. arrears to ADF totaled $326.7 million at the end of FY2014 and could eventually affect the U.S. share in the fund.

In light of Congress’s inability to fund existing commitments to Asian development assistance, the Obama administration may have been unable to offer concrete proposals to counter AIIB – for example, by reforming shares at ADB or increasing the bank’s support for infrastructure lending. For the same reason, U.S. membership in AIIB is unthinkable for the foreseeable future, despite the decision by U.S. allies to join the bank. As the prolonged debate over Trade Promotion Authority and the Trans-Pacific Partnership (TPP) in Congress suggested, while individual members of Congress from both parties recognize that Congress has an important role to play in ensuring that the United States has the resources with which to exercise leadership in Asia, Congress as an institution struggles to make decisions that advance the strategic interests of the United States.

6. LESSONS LEARNED

This analysis suggests that there are four lessons the U.S. government should draw from its confrontation with China over AIIB.

First, the U.S. government’s first response to China’s efforts to create new institutions or otherwise write the region’s rules should not be “how do we stop this?” AIIB will not be the last time that China proposes a new institution. The United States by no means has to accept or participate in every institution China proposes, but when the institution is designed to address a widely acknowledged problem, the U.S. government needs to offer its own solution rather than defending the status quo for its own sake.

Second, the United States must avoid zero-sum thinking when it comes to agenda setting and institution building in Asia. Legitimate U.S. leadership in Asia requires not just trumpeting U.S. values and interests but also listening to the concerns of other countries in the region, especially the region’s small and medium-size powers. The United States is competing with China not over who gets to write the rules in the twenty-first century but over whose position in the region is seen as most legitimate and respectful of the sovereignty and national interests of all countries in the region. As an offshore power with a long history of sustained bilateral and multilateral engagement in Asia, the United States actually enjoys a considerable advantage, whereas China is locked in protracted territorial disputes with the same countries it is trying to pull into its orbit through trade and investment. The United States must be careful not to squander this advantage by pressuring its allies and partners to choose between the United States and China or by letting the “great game” with China take precedence over regional problem solving.

Third, as the United States has learned through its own experience with multilateral institutions – especially multilateral development institutions – it is difficult to run them well. The United States could, therefore, afford to be more sanguine towards China’s multilateral initiatives. As China has already discovered with AIIB, a genuinely multilateral institution is difficult for a single country to dominate. Essentially, China’s pursuit of
multilateral institutions could work in favor of the United States, regardless of how the institutions turn out. If the institutions succeed, it means that China has accepted the constraints that come with participation – that, in effect, China has accepted the logic of Washington’s “responsible stakeholder” argument. If the institutions fail because China has alienated other participating countries, the incumbent multilateral institutions will look even better by comparison.

Finally, the United States and its allies should take seriously China’s complaint that its role in international financial institutions is incommensurate with its wealth. The United States cannot be surprised that China, India and other emerging economies want to create new institutions, when the incumbent institutions have not shifted to reflect the new global distribution of wealth. If the United States wants China to be a responsible stakeholder within the existing order and not create new institutions, it has to give China an appropriate stake in the existing order. While the domestic and international politics of reallocating shares in international financial institutions are complicated, if the United States wants the Bretton Woods system to endure, it has to exert political capital to ensure that the system evolves with the global economy.
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