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China's AIIB: Competition for Bretton Woods or an opportunity for Asia?

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China has initiated a new multilateral development bank. But it is different from the bank that Beijing originally planned. Viewed with scepticism by the USA and Japan, it is being increasingly welcomed in Asia and Europe. Its geopolitical impact could be huge.

The deadline for potential members of the first multilateral development bank – a bank initiated by an Asian emerging country and which has largely been led by it ever since – ended on the evening of 31st December 2015. The signing ceremony of the Asia Infrastructure Investment Bank (AIIB) was held on 29th June 2015. The 57 countries which were members at that time had up until New Year's Eve to ratify the document or submit any change requests. The beginning of the new year went without a hitch. Seven nations delayed signing, but by the time the Philippines agreed to join, it was the last country to give the go-ahead on 31st December. Following a ceremony, the organisation was officially opened for business on 16th January. It is led by Jin Liqun. This experienced banker and former Deputy Finance Minister for China has taken on the office of President of the AIIB for the next five years.

China came up with the idea of the institution on its own initiative. In 2013, China's leaders officially proposed the concept of establishing a new Asian development bank for the first time. It has been a subject of debate ever since: Does China wish to challenge the Bretton Woods system, along with the World Bank and the International Monetary Fund (IMF), which has dominated since the end of the Second World War? Is Beijing trying to cement its own claims to power in the region using the AIIB and boot out undesirable competition such as the USA and Japan? Or can the new bank be a welcome and necessary addition to the existing institutions? Is it China's next step towards integration in a number of nations that determine global order?

A concept that in its initial planning phase showed signs of being a pure instrument of Chinese foreign policy has developed into a multilateral development bank which is to be taken seriously. China still plays a dominant role in the institution, but one which is far more low-key than numerous critics initially feared. As a result, there is now a wide consensus that the bank has the potential to close the necessary gaps in infrastructure financing. Conversely, there are still feelings of resentment and major challenges which need to be faced immediately by both the new bank and Beijing.

About the AIIB

According to its Articles of Agreement, the AIIB is a multilateral development bank (MDB) based on the model of organisations such as the World Bank, European Investment Bank (EIB), African Development Bank (AfDB), Inter-American Development

Bank (IDB) and European Bank for Reconstruction and Development (EBRD).

As an MDB, it is founded, formed and led by a group of countries. MDBs generally work in three ways: They (co-)finance development projects in developing and emerging countries via loans with long and very long terms or using low-interest loans, also known as soft loans. The interest rates for long-term loans are generally based on market rates. Very long-term loans have considerably lower rates. Soft loans generally have very beneficial interest rates for the borrower, but are tied to other regulations.

Unlike many other development banks, the AIIB was set up to focus primarily on infrastructure projects. These include, for example, the energy, transport, telecommunications, agriculture and water supply sectors, as well as urban development. Development projects in areas such as reducing poverty, education and healthcare are not intended to be at the top of the agenda. Likewise, the AIIB does not want to grant soft loans, at least at the beginning. As its name suggests, the bank also aims to focus on Asia. However, Beijing has not ruled out projects in other parts of the world such as Latin America and Africa.

China's concept of a regional bank is also similar to existing MDBs in terms of set-up and structure, although there are some key differences. The voting rights within a multilateral development bank are mainly distributed according to contributions made by the member countries. These, in turn, are generally based on the members' economic and financial capacities. In addition, it is common for every member to have a specific number of additional basic votes in order to compensate for the differences between large and small members. In the case of the AIIB, the share of these basic votes is 12 per cent – corresponding to 2430 votes. The Asian members of the new bank are set to receive a total of 75 per cent of the votes. This should ensure that the AIIB is not dominated by financially strong countries from Europe or the USA. Furthermore, each member receives a vote for each share of the AIIB's basic capital. The founding members also receive 600 votes each. The weighting of members from a specific region is therefore extremely high for an MDB. As it stands, with the current 57 members, China will hold a 30.3 per cent share of the capital and 26 per cent of the voting rights. It is followed by India with 7.5 per cent of the votes, Russia with 5.9 per cent, Germany with 4.2 per cent and South Korea with 3.5 per cent. Germany is contributing around 4.5 billion U.S. dollars.

The bank is typically led by a Board of Governors which comprises official representatives of the member states. Below this is a Board of Directors which is responsible for day-to-day decisions and for monitoring top-level management, comprising a President and a Deputy President of the organisation. The AIIB is essentially based on this structure. The Board of Directors should comprise 12 directors, of which nine should be elected from the regional members of the bank and three from the non-regional members. The directors should, however, meet regularly and hold meetings via video conferences. However, there is no requirement for them to permanently reside at the bank's headquarters, as is the case at the

ADB. This could result in much lower expertise within the Board of Directors than is the case at other large MDBs, according to an analysis carried out by the Washington-based Paul H. Nitze School of Advanced International Studies (SAIS). This would be in line with the Chinese requirement to make the management of the bank as lean as possible, i.e. with fast decision-making processes, and thus to make it different from other banks. At least, this is how it is viewed in Beijing, where organisations such as the World Bank are criticised for being slow.

The AIIB also expects to grow over the next three to five years. According to a report by the Japanese business journal, the Nikkei Asian Review, the bank will start off operating from office space in Beijing covering roughly 30,000 m² and employ around 700 members of staff. But AIIB President Jin Liqun anticipates that this figure will soon grow to 5000 employees who would be accommodated over an area of more than 200,000 m². He claimed that this would then need to be sufficient for the next 100 years. The World Bank currently has around 17,000 employees.

According to the Nikkei Asian Review, the AIIB has received further membership requests which it did not manage to deal with before the deadline. With these "sleeping beauties" on the waiting list – as Jin Liqun is said to have referred to them – the number of bank members could soon increase to 80 or 90.

Evolution of a bank

The multilateral character of the AIIB was not planned as such at the start. In fact, it was initially planned more as a development agency or commercially oriented bank. This would have been everything the critics – predominantly from the West – had feared: A new tool for implementing China's international interests.

So while the West viewed the plan with scepticism for a long time, a number of Asian countries expressed their interest in joining the initiative at an early stage. The situation finally changed when the UK announced its intention to also join the bank on 12th March 2015. The deadline for prospective members to indicate their interest was 31st March 2015. This number reached 21 before the start of the month and the AIIB ended up with 57 prospective members. London's support for the bank opened the door for a number of other European countries which had been delaying up until then. These included Germany, France and Italy. The fact that Washington's closest allies decided in favour of the AIIB counteracted the previously high level of scepticism of the Western countries which were in fact interested in joining, but may have been influenced by strong opposition from the USA and Japan. In Beijing, this was seen as a victory.

The decision by the UK and other leading European countries to join the bank was also made on the assumption that they would only be able to shape the future of the AIIB, and thus have an impact on an otherwise "Chinese" bank, through active participation. In fact, these countries joining prompted Beijing to make a few basic changes to the organisation. China had originally planned to restrict membership to regional countries, according to Asia expert

Yun Sun at the Stimson Center, a Washington-based think tank. She claimed that there was little optimism that countries outside the region would even be interested. At the start of March 2015, the Chinese Minister of Finance said that there was a consensus among the 27 prospective members at that time to keep membership open for extra-regional countries per se. However, nobody thought that such a scenario would actually arise. After London indicated its interest, however, Beijing quickly changed its stance to welcome European and African countries as well, according to Yun Sun. Among other things, Beijing gradually changed the rules regarding the voting rights and subsequently reduced its own capital contribution, which should have been 50 per cent temporarily. Beijing thus also voluntarily accepted a restriction on its own veto powers. Even the *de facto* veto power that China continues to hold with its current number of votes (26 per cent) has been restricted. According to the Articles of Agreement, it is restricted to circumstances requiring a supermajority. In other words, when at least two-thirds of all directors on the Board of Governors and more than three-quarters of all votes are required for a decision. This would, for example, be the case if the bank's basic capital were to be increased, if decisions relating to supporting non-regional borrowers were to be made or if changes to the size and composition of the Board of Directors were on the agenda. The veto power could also be over if the number of members were to increase in the future, particularly if members which are still financially strong, such as the USA or Japan, were to join. However, Yun Sun thinks that China's options for blocking decisions have in any case now become more symbolic in nature. She claims that, ultimately, a situation in which China is the only country out of over 50 that is against a decision is, although feasible, an unlikely scenario – especially as Beijing maintains very close relations with a number of AIIB member states.

In any case, the key interests that China is prioritising using the AIIB could be more likely to result in a consensus than originally feared. These include closing the infrastructure gap in Asia, the internationalisation of the yuan, as well as the reduction of imbalances in international financial institutions such as the IMF. Whether China really (still) sees the bank as a key tool for implementing its "One Belt, One Road" infrastructure strategy is the question being raised by an increasing number of observers.

Major consensus: Infrastructure financing

The highest common denominator among the other members of the AIIB is likely to be closing the infrastructure gap. The new bank has been set up to help meet the massive demand for infrastructure financing in Asia. It is aimed at promoting private investments by selecting necessary and promising projects, remedying problems relating to preparation and reducing risks during implementation. The ADB anticipates that in the Asia-Pacific region alone, there is a deficit of around 800 billion U.S. dollars a year in terms of investment in infrastructure. The IMF stresses the importance of such investments for the economic growth of emerging countries: It claims that governments can expect a growth effect which equates to 1.6 dollars for each dollar invested. For China, this means future sales markets and production sites. With increasing wage costs within the country, even China is increasingly dependent on low-cost labour in these emerging countries. This priority objective is in the interests of all members of the bank.

Against unbalanced financial institutions

The concern that China could and wants primarily to compete with existing multilateral financial institutions using the AIIB is based in particular on China's vocal criticism of the IMF and the World Bank. For a long time now, Beijing has – of its own doing – been a passenger, or even sat in the back seat, when decisions about the global financial system have been made. The international financial architecture – in Asia too – is still largely based on the Bretton Woods system at present. The dollar is the most popular and the strongest currency. But as their economies have developed, Asian countries have gained self-confidence and are striving for self-determination. It is not just Beijing that considers the distribution of influence in the World Bank and the IMF to be unfair. Together with other emerging countries, China has increasingly tried to change this since the financial crisis of 2008/2009. An important decision on the expansion of IMF resources could not be ratified because the Congress in Washington blocked it. Doubling the capital would have resulted in more voting rights for countries such as Brazil, Russia, India, China and South Africa (BRICS). Two seats on the IMF's Board of Directors would have been passed from developed European countries to emerging countries. China would have become the third largest stakeholder in the International Monetary Fund after the USA and Japan. Brazil, Russia and India would have been pushed up into the top 10. According to data from the World Bank, the BRICS countries account for around 20.5 per cent of the global economy and comprise 42.2 per cent of the world's population, but they only have an 11 per cent share of the votes in the IMF. The USA and Japan together account for 29 per cent of the global economy, but comprise just 6.2 per cent of the world's population. They have 23 per cent of the votes in the IMF. This figure is 31.3 per cent in the ADB. From the point of view of some other members, both nations have in the past opposed overdue changes to the distribution of voting rights and quotas.

Internationalisation of the yuan

The AIIB is also seen as a tool with which China can push forward the internationalisation of the yuan. Up until now, the currency has played a minor role as an international means of payment compared to the dollar and the euro, even though it has now become the world's fourth most used currency. However, with a share of around 2.8 per cent of all global payments, it only occupies a weak fourth place.

This is why China has for some time now tried various means of investing its extensive currency reserves of roughly 3.7 trillion dollars intelligently and effectively. This includes the BRICS Contingent Reserve Arrangement worth 100 billion dollars which came into force in 2015 and the Chiang Mai Initiative costing 240 billion dollars, as well as a range of bilateral currency swap agreements worth a total of just under 590 billion dollars.

Foreign economic interests

The extent to which the AIIB is aimed at providing Beijing with a means of supporting its One Belt, One Road strategy (OBOR) – a new cornerstone in China's Foreign and Security Policy – is a controversial issue. With OBOR, China wants to develop a "new Silk Road" which connects it with Central Europe via Russia, South Asia, South-East Asia and North Africa. Through huge investments in infrastructure, the intention is to build ports, roads, railway tracks and industrial parks along key routes between the Atlantic and the Pacific. OBOR is also intended to provide a means for the Chinese economy to reduce surplus production capacities built up over the past few years in some industries, i.e. to "export" them. Infrastructure projects along the "new Silk Road" identified and initiated by Beijing as part of the initiative could then also be financed by the AIIB, i.e. also using non-Chinese money in the bank, according to China's alleged calculations. The contracts for implementation could then, in turn, be placed with Chinese companies.

However, there has been a rise in the number of observers who think that instrumentalisation of the bank in this way to benefit China is unrealistic. Yun Sun reports, for example, that this belief is gradually disappearing from statements by the Chinese government and from media reports. David Dollar, Senior Fellow at the Brookings Institution think tank, questions whether the theory of exporting these Chinese overcapacities, funded by the AIIB, even makes sense. If the bank is successful, it could grant loans of up to 20 billion dollars a year over the next five years. However, China's steel sector alone would need roughly an additional 60 billion dollars to absorb surplus capacities, not to mention other sectors such as concrete and mechanical engineering. In addition, other mechanisms are available to finance the OBOR strategy, such as the Silk Road Fund, which was initiated especially for this purpose, or the China Development Bank (CDB).

Is it a "race to the bottom" by the development banks?

Regardless of these issues, the U.S. and Japanese media in particular are reporting fears that China is challenging institutions such as the IMF, World Bank, ADB and EBRD . The EU is also remaining cautious. As a paper by the European Political Strategy Centre (EPSC) highlights, with the AIIB and the New Development Bank (NDB), it is "significant" that China is operating two banks whose capital strength would only be exceeded by the EIB, World Bank and ADB. The decision to found the development bank led by the BRICS countries – the NDB – was made on July 2014 – with a major contribution from China. This bank has also been set up to focus on investments in infrastructure and development projects, and has a similar starting capital of 100 billion U.S. dollars. Often referred to as the "BRICS Bank" for short, this institution moved into its offices in the summer of 2015 – likewise in Shanghai. However, it clearly focuses on investments in the member states of Brazil, Russia, India, China and South Africa.

Over the next three to five years, the capital volume of the two institutions could grow to a combined value of 300 to 500 billion dollars, according to the EPSC. It also anticipated that in the next three to five years, the two banks could be responsible for 40 per cent of all loans granted by the present-day MDBs in emerging economies (a total of around 693 billion dollars). In Asia, this figure could even be as high as 90 per cent, equating to roughly 328 billion dollars. In any case, the EPSC is certain that the AIIB will rapidly extend its economic and global influence.

It also fears that competition could have a negative impact on the work of the World Bank and other institutions, and questions whether the AIIB, under China's "leadership", will meet international standards for granting loans to developing and emerging countries. China has often been criticised in the past for not giving enough consideration to the negative impact of its bilateral development assistance, for example the effects on the local civilian population or on protection of the environment. Critics feared a "race to the bottom", in which the AIIB would finance projects which were rejected by other banks. Ultimately, under pressure from the competition, this could result in institutions such as the World Bank and the ADB lowering their requirements for granting loans too. The fact that China declared itself in favour of "lean" management of the AIIB from the beginning with a Board of Directors which has less power than in the ADB, for example, adds to these doubts. The same applies to China's reluctance to offer soft loans.

However, according to the SAIS newspaper, some borrower countries could be very happy to endorse this approach of non-intervention. Soft loans, which require additional services from the countries' governments, are often seen as interfering in national affairs. And some borrower countries find that too many security mechanisms can cause projects to take longer unnecessarily. Japan has also been practising the approach of non-intervention in national affairs in matters of development projects in Asia for decades. For a long time, Tokyo was the biggest donor of bilateral development assistance in the region and has always kept to this principle.

The newspaper claimed that the competition between the development banks might be reduced so much that the estimated demand for infrastructure investments of several trillion dollars by 2020 can barely be covered by the existing institutions. For example, the World Bank and the ADB – as the two largest MDBs active in Asia – invested 24 billion dollars in 2014 (World Bank) and 21 billion dollars in 2013 (ADB). Both would rapidly turn away from infrastructure projects, according to Andrew Elek, Research Associate at the Australian National University. He states that in five out of the ten years leading up to 2012, the net sum of the loans for these types of projects granted by the two banks fell. They have focused more on soft loans and knowledge exchange with developing countries and thus left an important niche unfilled, according to the academic. Even if we take into account investments made by national development banks and private investors, it will be a major challenge to meet the demand. In 2013, private investments in the Asia-Pacific region, for example, totalled just 36 billion U.S. dollars compared to 58 billion the year before.

Instrumentalisation would contradict open door policy

The birth of the AIIB is injecting new dynamics into the international financial system, and into the complex interests and relationships in Asia. It appears to be highlighting the gaps between China on the one side and Japan and the USA on the other. The bilateral relationships between China and Japan have been tense for a long time, and the competition for dominance in the region is dealt with openly. Japan did not take long to decide not to join the bank, for reasons including doubts about transparency and compliance with international standards in the practice of awarding contracts. In addition, Masahiro Kawai, former Head of the Asian Development Bank Institute, reports that there is simply a lack of trust between the two countries at present. In Tokyo, China's geopolitical interests are seen as the primary motivation for setting up the bank. In June 2015, the finance ministers of both countries met for the first time to discuss the possibility of Japan joining. Reports claim that China's Minister of Finance Lou told his Japanese counterpart Aso that the door would continue to remain open for Japan. However, according to Kawai, if China had offered Japan an invitation of this kind at ministerial level, it would have been received much too late.

The situation looks very similar in the case of the USA. In Washington, there are fears that a strong AIIB under China's leadership would cause the USA to lose its influence in Asia. China's endeavours and the resulting NDB and AIIB are seen as a symbol of the development of a new Asian financial system with geopolitical and economic consequences. June Teufel Dreyer, Asia expert at the U.S. Foreign Policy Research Institute, claims that China responded to the USA's "hostile attitude" towards the AIIB with concern. She stated that instead of rejecting the initiative, Washington should be welcoming it. Lastly, she said that President Obama himself has described China in the past as a "free rider in the international system". Robert Zoellick, former President of the World Bank, said that the behaviour of the United States government was wrong – both the policy itself and the way it is implemented.

According to Hanns Günther Hilpert and Gudrun Wacker from the Berlin-based Stiftung Wissenschaft und Politik (German Institute for International and Security Affairs), there is reason to fear that the successful conclusion of negotiations on the TPP regional free trade agreement could widen these gaps even further. The planned trade agreement between the USA and the EU – the TTIP – could take the same line. However, instead of the potential competition between the AIIB and the TPP, David Dollar also sees possible synergies. According to Dollar, infrastructure is the necessary "hardware". He claims that partnership agreements such as the TPP are the "software" for this. When used together, this could have positive effects for the region. If, however, China and the USA pursue their own projects with the AIIB and TPP respectively in the future regardless of the opposition, this could in the worst case scenario lead to the formation of blocs in the region.

If a number of leading European countries such as the UK and Germany were to join the AIIB, this would significantly increase the complexity of this constellation. However, it also sped up the development of the AIIB into a multilateral bank in which it would be more difficult for China, from a purely structural point of view, to instrumentalise the institution for its own benefit, even if Beijing has guaranteed core rights and veto options in order to ensure that the bank does not develop in a direction it does not consider to be desirable, and that there would still be various ways to exert influence on the bank's work, for example by ensuring that a large proportion of the operational staff and the management are Chinese.

Beijing itself is increasingly emphasising the multilateral character of the bank. Kawai is convinced that for China, the AIIB has become one of its most important means of increasing its own soft power and thus gaining international prestige, trust and influence. He claims that the high level of openness with which multilateral development banks generally operate will prevent China from trying to instrumentalise the AIIB in a manner which lacks consideration. Hilpert and Wacker from the SWP (Stiftung Wissenschaft und Politik) also agree that to being in this kind of negative international spotlight contradicts the "recent open door policy". Finally, since 2012, Beijing is said to have "developed a noticeable activism in foreign policy and foreign trade."

While at first there was still a great deal of resentment towards and concerns about China's ambitions in relation to the AIIB – including within the region – with few exceptions, a consensus now seems to have been established that the bank may represent an opportunity. The ADB has indicated its willingness to cooperate. The same applies to the World Bank and the IMF, whereby the Managing Director of the latter, Christine Lagarde, has stressed that there is no competition with the new bank anyway. The head of the AIIB, Jin, called himself a close friend of the current World Bank President Jim Yong Kim and denies any ambitions to replace the institution.

Officially, Japan is not ruling out joining in the future either, provided that the new bank meets Tokyo's requirements for good governance. According to Teufel Dreyer, there are fears behind the scenes in Japan that Japanese companies could miss out on the opportunity to conduct lucrative business if Tokyo continues to shy away from joining the AIIB.

The Philippines's decision to ratify the Articles of Agreement of the AIIB on 31st December just before the expiry of the deadline was significant as this ASEAN member had been seen as a wavering candidate. Ultimately, the relations between Manila and Beijing are also tarnished due to territorial tensions. However, this should not affect cooperation at an economic level, according to the capital of the Philippines.

Whether Tokyo, and possibly even Washington, will follow this philosophy in the future could have a major influence on the work and significance of the new development bank.

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