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The Asian Infrastructure Investment Bank: Multilateralism on the Silk Road

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ABSTRACT

Initial English-language media coverage of the Asian Infrastructure Investment Bank (AIIB) was framed in terms of strategic rivalry between China and the United States and China's frustration with slow reform to existing multilateral development banks (MDBs). But the United States, not China, turned the AIIB into a battle for global influence, which the United States lost when key allies joined the bank.

China had a positive agenda for establishing the AIIB, particularly as part of its flagship 'one belt, one road' regional initiative. By establishing a multilateral lender for Asian infrastructure, China can de-politicize what can be fraught bilateral financing deals as well as boost its image in the region. This requires the AIIB being a truly multilateral institution.

The AIIB will have to meet the standards of other MDBs, particularly for safeguards, procurement and transparency. The bank will be under international scrutiny and AIIB shareholders should build the bank cautiously, initially focusing on co-financing with other MDBs. The AIIB need not mirror existing lenders, but can learn from their experience and improve on their efficiency. The AIIB will be a learning experience for China and could boost its credentials for future multilateral leadership.

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Introduction

China's first attempt to establish a multilateral financial institution was met with some suspicion and caution in the west. According to one interpretation, China is frustrated with the United States' reluctance to cede it power at the International Monetary Fund (IMF) and the World Bank, and so is attempting to usurp the United States' economic leadership by creating its own institutions to rival the Bretton Woods institutions, starting with the Asian Infrastructure Investment Bank (AIIB). The AIIB, according to its critics, will not be a true multilateral institution committed to common objectives. Instead it will be a vehicle for China to advance its own unilateral strategic objectives in Asia at the expense of the US.

Framing the AIIB in terms of rivalry between the United States (US) and the People's Republic of China makes for a compelling narrative. It plays into strategic ambitions

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and suspicions on both sides of the Pacific. Undoubtedly there are Chinese policy-makers who are frustrated with the United States and want China to play a larger role in international institutions. And the rest of the world has been calling on China to play a role in the international economic community more commensurate with its weight in the global economy.

The United States' handling of the AIIB, built on this premise, was poor and damaged its credibility. No doubt China was delighted that Washington could not keep many of its G7 allies, who focused on the potential of economic engagement with China. For Australia and Korea, hitched economically to China but necessarily sensitive to the United States' strategic concerns, the policy process that led to joining the AIIB was particularly tortuous.

But Beijing has its own reasons for making sure that the AIIB functions as a genuinely multilateral institution. And this is more than just contributing to meeting Asia's infrastructure needs.

The AIIB is an important vehicle for delivering Xi Jinping's signature foreign economic policy—the 'Silk Road economic belt' and the '21st century maritime Silk Road' (one belt, one road) initiatives. While the branding may not clearly convey the intent of the initiative, the underlying economic logic of integrating markets within Asia and to Europe, is both good for China in expanding its export markets, and good for the region. It is especially timely, as the economies of the North Atlantic remain drifting in the wake of the 2008 global financial crisis. The 'one belt one road' undoubtedly serves strategic goals for China, but by and large these are common goals for others in the region. Both APEC and ASEAN have been promoting similar agenda—known as 'connectivity'—for years.

China already has many existing avenues to finance infrastructure projects in Asia, including its new 'Silk Road fund' and traditional bilateral financing. Viewed in isolation, voluntarily committing resources to formal governance strictures and external oversight associated with a multilateral body appears to limit China's freedom of action. But multi-lateralizing financing decisions can also insulate China from bilateral political tensions. For example, China has good economic reasons for connecting its rail network with India, but the critical link through Myanmar might not be build if the 'Paid for by China' tag is too prominent. The countries in Asia may be more accepting of financing coming from a multilateral institution, even if China-led, than directly from China. In this context, the AIIB expands China's options to pursue its Silk Road initiative. When viewed in this light, it is very much in China's direct interest to ensure that the AIIB truly is a multilateral bank.

The biggest risk to the bank, however, is Beijing's instinct to retain control over all significant Chinese institutions. Indeed, compared to the charters of the Asian Development Bank and the World Bank, China has a larger veto power over decisions in the AIIB than the major shareholders have in these other multilateral banks. Nobody expects the major shareholders of multilateral institutions to come to the board room table in a completely disinterested fashion, but the arts of patience, persuasion and consensus are more helpful to the long-term multilateral character of the institution than flexing one's voting power. This is something China will experience. This paper unpacks these themes in more detail. After providing a brief sketch of the bank and its membership, it explores China's proactive motivations in proposing the AIIB and considers the reaction of other countries to the initiative. Given the importance of formal governance arrangements in defining the multilateral character of the bank, the

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paper reviews the Articles of Agreement for the AIIB, including how they compare with those of other multilateral development banks. Finally, to assist China and its fellow shareholders in the bank to help establish the AIIB as a genuinely multilateral institution, some suggestions are offered with regard to getting the bank operational. Leading a multilateral institution will be an important learning opportunity for China. But it also represents an opportunity for other countries to assist China in this endeavour, for all will benefit from the AIIB being a success.

A brief sketch of the AIIB

On a State visit to Indonesia in October 2013, Chinese President Xi Jinping proposed the establishment of a new multilateral bank, focused on the development of infrastructure in Asia. Just over a year later, after five formal consultation meetings with interested parties, 21 Asian countries signed a memorandum of understanding supporting the establishment of the bank on 24 October 2014. Nine months after that, following five chief negotiators' meetings, the Articles of Agreement for the bank were signed in Beijing by Finance Ministers or their representatives. Over that time the number of prospective founding members of the bank had almost tripled to 57 (Figure 1). By October 2015, 53 countries had signed the Articles of Agreement. The AIIB is scheduled to become operational before 2016. While fast, this time frame is comparable to the gestation of the ADB, which was designed between 1963 and 1965, and launched in August 1966 a little more than a year after United States President Johnson adopted the proposal (Dutt 2001).

The US$100 billion capital base makes the AIIB a medium-sized multilateral bank (Figure 2). The AIIB will be smaller than both the World Bank (the International Bank for Reconstruction and Development has a capital base of more than US$250 billion) and the

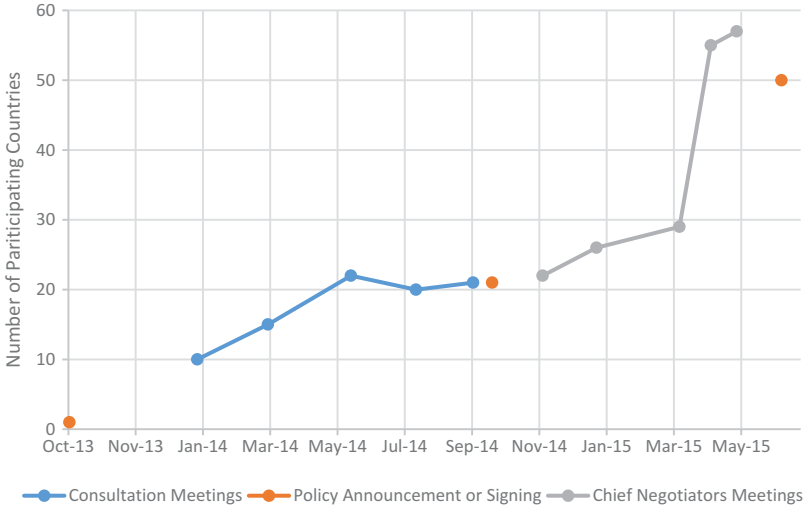

Figure 1. Rapid progress from proposal to signing of articles. Source: Authors' chart constructed based on press releases from Chinese Ministry of Finance, Department of International Economic Relations (国际经济关系司) http://wjb.mof.gov.cn/

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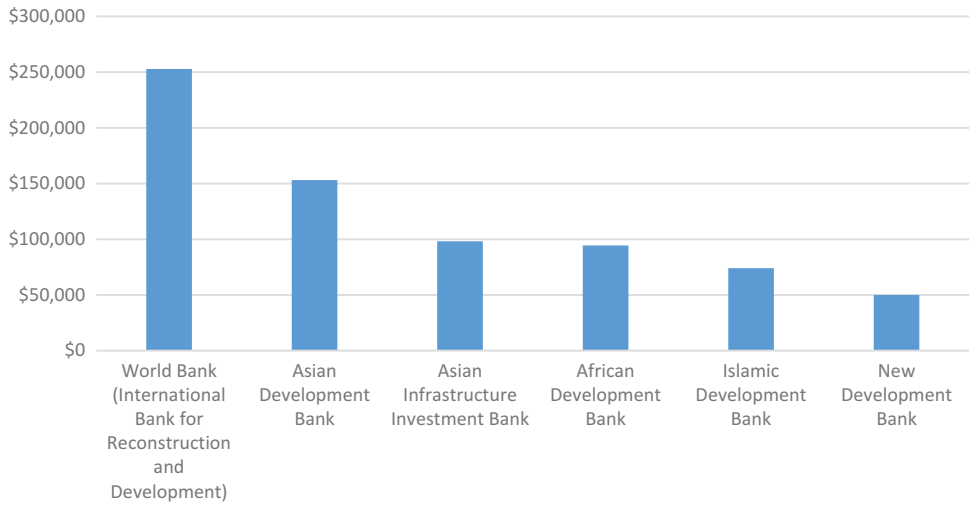

Figure 2. Multilateral banks' subscribed capital (USD million). *Source: Authors' calculations based on 2015 and 2014 annual reports of multilateral development banks.*

ADB (with capital of more than US$150 billion). It will be slightly larger than the African and Islamic development banks. By contrast, the other multilateral development bank initiative involving China, the BRICS' New Development Bank, has an authorized capital base of US$100 billion, but is only presently subscribed to US$50 billion.

All members of the AIIB have experience with multilateral banking, as members of the World Bank. The inclusion of all the BRICS members extends the membership of the AIIB to South America and Africa.

More than half of the members of the ADB are members of the AIIB. The ADB also includes non-IBRD members Hong Kong, and Taiwan (as Taipei, China). Timor-Leste, Papua New Guinea and the Pacific island states are members of the ADB but have not joined the AIIB. Afghanistan is not a member, despite being the centre of the United States' New Silk Road initiative (Clinton 2011). Ireland and Belgium are the only two European ADB members not to join the AIIB.

China's motivations and international reactions to the AIIB

China's motivation behind the AIIB proposal is best explained in the context of its 'Silk Road economic belt' and '21st century maritime Silk Road' (together, 'one belt, one road') initiatives. Chinese President Xi Jinping proposed a Silk Road economic belt on a visit to Kazakhstan in September 2013, and a 21st century maritime Silk Road in Indonesia the following month, simultaneously with the AIIB proposal. In his capacity as chair of China's leading economic policy group,[1] Xi Jinping has explicitly instructed policymakers that the 'primary task' of the AIIB is to provide capital for these initiatives ('Xi Stresses Implementing Central Economic Policies,' *Xinhua*, February 10, 2015). In addition to the AIIB, China has created a new $40 billion 'Silk Road fund' ('China to Speed up Construction of New Silk Road,' *China Daily*, November 6, 2014) and injected a further

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$31 billion in China's policy banks to support the initiative ('Policy Banks Linked to 'Belt and Road' Plans Said to Get US$ 31 Bln,' Caixin Online, July 21, 2015).

While some scholars regard the Chinese initiative as a reaction to the United States' 'new Silk Road' initiative to create a regional market for Afghanistan (Fallon 2015), China's proposal has its own economic roots, particularly in the wake of the global financial crisis and recession in the North Atlantic which had limited China's potential for continued export-led growth. In 2009, the Asian Development Bank Institute published a working paper calling for a modern or restored 'Silk Road' to help Asia meet its potential. The article was translated into Chinese and published in a journal edited by the Chinese Academy of Social Sciences (Bhattacharyay and De 2009a).

The crux of the Silk Road proposal was that transport costs and connectivity, not tariffs, had become the major impediment to intra-regional trade. Asian highway and railway networks were advocated as a means of reducing this impediment. A trans-Asian rail network depended on completing rail links from China to South and Southeast Asia through Myanmar and Laos, and to Central Asia through Kyrgyzstan. The highway network would connect central and southern China with the rest of Asia. What was lacking, particularly in the wake of the global financial crisis, was financing for that investment (Bhattacharyay and De 2009b).

The strategic implications of a Silk Road strategy for China were outlined by a Chinese academic (Gan 2010) as involving: expanding markets for Chinese exports, improving security for China's energy imports via overland routes, increasing China's soft power through greater cultural and tourism exchanges, contributing to regional economic integration, and improving China's regional security. Some of the obstacles for the initiative as outlined by Gan included: China's geography, the reality that some of the key countries on land routes were poor and required financial assistance, and the fact that over the previous two decades many organizations had encouraged the revitalization of the Silk Road, but there had not been a decisive platform through which to coordinate and resolve key issues.

A joint action plan issued in March 2015 by China's National Development and Reform Commission, the Ministry of Foreign Affairs, and the Ministry of Commerce ('Vision and Actions on Jointly Building Belt and Road,' *Xinhua*, March 28, 2015) provided the authoritative plan for developing the Silk Road, which includes, but is broader than hard infrastructure. In addition to physical connectivity (including transport networks, but also energy and communications), it encompasses policy coordination (including intergovernmental macro policy exchange), behind-the-border trade and investment facilitation, financial integration and people-to-people bonds. Additionally, it is linked to detailed development strategies for each of China's regions. The AIIB is one of more than a dozen financial integration initiatives by China aimed at promoting the Silk Road initiative, which encompasses regional bond markets, bilateral currency swaps and the internationalization of the renminbi.

Asian savings for Asian infrastructure investment

The ADB scholar who had suggested in 2009 the development of a modern 'Silk Road' also estimated that Asia needed US$776 billion in annual infrastructure investment to underpin its economic growth to 2020 (Bhattacharyay 2010). But while Asia had such a

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large infrastructure deficit, the irony was that the region had surplus savings—particularly foreign exchange reserves—which were invested in developed economies, particularly the United States.

The idea of expanding facilities for Asian infrastructure finance had, however, been popular in the region for some time. A United Nations agency had encouraged India to champion a US$300 billion special-purpose-vehicle for this purpose in 2007 ('Raising Funds for Infrastructure,' *The Hindu*, April 2, 2007). Malaysia spear-headed the creation in 2011 of a US$476.3 million ASEAN Infrastructure Fund under the auspices of the Asian Development Bank (ADB) (Asian Development Bank 2015). Expanding infrastructure investment in the region was also a key theme of Indonesia's APEC year in 2013.

At the Bo'ao Forum in April 2009, the Vice Chairman of a newly created, but politically influential think tank, the China Center for International Economic Exchanges (CCIEE), proposed three initiatives to combat slumping confidence and global output. Firstly, the US should peg its sovereign debt to the rate of inflation so as to protect China, India, Japan and other large holders of foreign exchange reserves from loss in the face of quantitative easing. Secondly, Asian countries should use Special Drawing Rights, not the US dollar as a reserve currency. Finally, 'to step up the development of Asian countries, he suggested establishing the Asian Infrastructure Investment Bank and Asian Agriculture Investment Bank' (China Center for International Economic Exchanges 2009)

According to the CCIEE proposal, the banks would seek higher returns for Asian reserves by investing in infrastructure and agricultural development in Asia, rather than low-yielding US debt. They would be commercial banks, with shareholdings held by other countries, and they would compete with the ADB to improve efficiency. The demand for equipment and raw materials generated by infrastructure spending would contribute 'to global economic recovery and prosperity and development of Asia.' (China Center for International Economic Exchanges 2009).

While the proposal received little comment other than from the author and his colleagues, it resurfaced spectacularly when President Xi Jinping proposed the AIIB in Jakarta in 2013. He offered the Indonesian president 'financial support for infrastructure construction in developing countries in the region, including members of the Association of Southeast Asian Nations' and stressed that the AIIB would cooperate with existing multilateral development banks ('China Vows to Build Community of Common Destiny with ASEAN,' *Xinhua*, October 3, 2013). To the Indonesian Parliament, Xi emphasized the role that the AIIB would play in ASEAN's agenda for connectivity in the region, and China's 'win-win cooperation' with the bloc ('China Proposes an Asian Infrastructure Investment Bank,' *Xinhua*, October 3, 2013).

The CCIEE Vice Chairman was at hand when Xi proposed the AIIB, and he explained that this was not 'just about speeding the development of Asian countries, it's also about promoting the global economic recovery' and recycling Asian savings within Asia (Wang, L. 2013). His colleague Wang Jun (2013) described it as a 'once in a millennium opportunity to build a multilateral Asian Financial Institution' which would not only finance infrastructure at lower cost, but place China at the centre of ASEAN connectivity and act as a vehicle for the internationalization of the renminbi.

The proposal was warmly received in Southeast Asia. Xi continued with a state visit to Malaysia, followed later by visits by Premier Li Keqiang to other ASEAN members including Brunei, Thailand and Vietnam. A finance vice minister was despatched to

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Thailand and Singapore in November 2013 (China Ministry of Finance 2013a) and later to a meeting in Laos with Cambodia, Laos, Myanmar, Thailand and Vietnam (China Ministry of Finance 2013b). The first multilateral consultation meeting for the establishment of the bank was held on 24 January 2014, with more than ten prospective Asian members participating (China Ministry of Finance 2014).

China's BRICS partner, India, was not included in the initial round of countries consulted for the project, but press reports in June cited diplomatic sources as indicating that India had been invited shortly after the inauguration of President Modi and India also became a signatory to the memorandum of understanding ('China invites India to join Asian Infrastructure Investment Bank,' *The Hindu*, June 30, 2014).

Neighbouring Bangladesh, Nepal, Pakistan and Sri Lanka joined from South Asia. From Central Asia, Kazakhstan—where Xi had announced the Silk Road economic belt—and Uzbekistan joined the initial group. Kuwait, Oman and Qatar joined from the Middle East. With the exception of Kyrgyzstan, which only applied to join the following April, all of the key players needed to realize China's Silk Road initiatives were in place as AIIB members in this first round of Chinese diplomacy in support of the new bank.

Why a new multilateral bank?

While the prospect of significant Chinese funding no doubt smoothed the reception in the region to a Chinese infrastructure initiative, the fact that China proposed to establish a multilateral bank has been the focus of much of the response from other countries. China already has significant capacity for policy-lending through the China Development Bank and the China Eximbank, as well as a history as a bilateral aid donor, particularly for hard infrastructure projects. Moreover, shortly after the initial memorandum of understanding on establishing the AIIB had been signed in October 2014, China's top policymakers established a $40 billion Silk Road fund as a vehicle for directly financing Silk Road projects ('习近平：加快推进丝绸之路经济带 (Xi Jinping, Accelerate the Silk Road Economic Belt),' *Xinhua*, November 6, 2014).

A multilateral development bank, like a domestic development bank, can serve a role in financing socially productive investments that may not be financed by the private, profit-seeking banking sector. It can also provide a mechanism to leverage and coordinate financing from multiple sources for recipient countries, including dealing with projects that spread across national borders. The provision of network infrastructure—such as establishing pan-Asian railway, highway and energy networks that form the backbone of Silk Road initiatives—falls easily into this category.

However to garner the voluntary membership of both borrowing and lending countries, multilateral banks adopt detailed governance structures which are deliberately designed to constrain the scope of leading shareholders to dominate the activities of the bank (Stone 2008). At first glance, this raises the question why a potential donor with a range of alternative financing options would choose to operate through multilateral channels. In part, the answer lies in the ability of a multilateral institution to depoliticize relations between countries, especially surrounding policy conditions attached to loans (Rodrik 1995). Independence from direct donor control strengthens the capacity of the bank (Kilby 2006) and its credibility amongst recipient countries. The shareholder of a multilateral bank

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accepts external constraints on how its capital is used, but these constraints open up opportunities for financing operations to deploy capital that may not have been through available bilateral channels (McKeown 2009).

The objectivity of financing decisions by a multilateral bank is particularly important for the Silk Road project. For example, Myanmar—a critical link in the southern Silk Road economic belt—had previous bad experiences with large scale infrastructure projects funded by China, and Vietnam was dubious about China's strategic intentions ('China's World: Bank Softens Beijing's image,' *Wall Street Journal*, March 25, 2015). This made them potential holdouts from broader network plans which require construction on their territory to connect China to third-country markets. The AIIB device also gave the Philippines room to separate its participation from its territorial disputes in the south China sea ('Aquino Urges World to be Vocal,' *Kyodo News*, November 4, 2014).

As noted further below, part of the initial international reaction to China's proposal to establish the AIIB was that it was an attempt by China to develop a rival institution to the US dominated World Bank and Japanese controlled Asian Development Bank. It was argued that the AIIB would not truly be a multilateral bank but rather a vehicle to directly pursue China's interests. However, as outlined above, there is a strong case that a multilateral lending institution was very much in line with advancing China's Silk Road initiative.

United States and Japan share strategic concerns

While Asia welcomed new financing for its infrastructure needs, the United States was suspicious of Chinese intensions. For example, the *Washington Post's* coverage of the 2009 Bo'ao forum speech where the AIIB was unofficially suggested summarized in one line that it was a call for 'a new Asian development bank to compete with Western-dominated institutions' ('China uses Global Crisis to Assert its Influence,' *Washington Post*, April 23, 2009).

Despite the 2005 invitation from the US Deputy Secretary of State Robert Zoellick for China to become a 'responsible stakeholder' in an 'open, rules-based international economic system' (Zoellick 2006), the United States has been ambivalent about this aspect of China's economic rise. An underlying strategic suspicion is that, coupled with other financial initiatives such as the internationalization of the renminbi, China might eventually undermine US supremacy in global finance, and therefore erode the strategic benefits that accompany such a position ('AIIB: America's Influence in the Balance,' *The Straits Times*, October 29, 2014). The Washington-based World Bank and IMF were a 'critical part' of US national security, US Treasury Secretary Jack Lew told Congress ('US Warns of Credibility Threat,' *Financial Times*, March 17, 2015).

China's maritime Silk Road initiative was interpreted by some foreign commentators as a 'string of pearls' strategy to displace the United States' strategic dominance over key energy and trade routes through Southeast Asia and the Indian ocean ('Beijing Eyes Closer Ties,' *The Korea Herald*, July 3, 2014). One senior Obama administration official was reported as saying that Xi Jinping's approach to Asia—including at the AIIB—was 'raising serious questions about whether the US vision and the Chinese vision are fully compatible' ('With One Eye on Washington,' *Reuters News*, July 3, 2014). One

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unnamed Chinese official told reporters that the AIIB proposal is 'political, political, political (sic): never forget that. It's the extension of a new policy under President Xi to dominate the South China Sea and to dominate Asia. We are confusing soft- and hard-power policies' ('AIIB Struggles for Lack of Investment,' *Euromoney*, October 9, 2014).

At its crudest level, the AIIB was seen as a war chest to 'bribe leaders from Dili to Ulaanbaatar' ('Buying Countries for Influence,' *Korea JoongAng Daily*, May 12, 2014), although the strength of this argument is blunted by the existence of alternative, much less transparent, channels than for China to trade aid for policy support. More subtly, the concern that AIIB funds would be used to pursue China's strategic objectives was at least one of the objections put by Australia's foreign minister in arguing against Australia's early participation in the bank ('Division Over Bank,' *The Conversation*, October 19, 2014).

The idea that a Chinese dominated institution could provide an additional channel for Chinese influence on the policies of its neighbours has some support in the history of World Bank and the ADB. Internal US government assessments over decades concluded that its position in multilateral institutions was a source of political influence (McKeown 2009). Likewise Lim and Vreeland (2013), based on quantitative evidence, suggest that Japan has at times leveraged its informal influence at the ADB, particularly over the office of the President, to garner support for Japan's candidacy for temporary positions at the United Nations Security Council.

Even in the absence of malign strategic intent, there was also a concern that a Chinese-led institution would 'promote a version of China's state capitalism, not transparent markets' ('China Trounces U.S.,' *Wall Street Journal*, March 20, 2015) among its borrowers. Through bitter experience, the ADB and World Bank had learned over decades that their development projects could be undermined by poor domestic economic institutions. Under this view, Asia's infrastructure deficit was not a financing problem, but rather could be explained in terms of a weak institutional environment for investment. The concern with the AIIB was that offering an alternative window to the ADB and World Bank would weaken the formers' capacity to enforce their own policy conditionality, and therefore eroding their influence.

Reflecting these concerns, the United States argued that the AIIB may not have the transparency, good governance and standards consistent with existing multilateral lenders. Consistent with the theory of policy conditionality in multilateral institutions (Stone 2008; McKeown 2009), stronger governance would restrict the ability of China to rely on informal mechanisms to meet its strategic goals that might not be common with other shareholders. The United States' emphasis on consistency with the standards of other multilateral banks was intended to reduce the scope of the AIIB to compete with the ADB and WB, while allowing reservations regarding the AIIB to be made in terms of the impact on developing countries, rather than being contrary to US strategic interests.

The AIIB was also seen as a response to Chinese frustration at the slow process in getting a larger say in the existing multilateral development banks and the IMF, one that was more in keeping with China's growing weight in the global economy. In particular, China's motivation for founding the bank was portrayed as a consequence of the failure of the US Congress to pass reforms that would give China a greater say in the IMF. An Obama administration official blamed Congressional failure to pass IMF

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governance reform as having 'created an opportunity (through the AIIB) for China to assert itself' ('How Europe and the U.S.,' *Reuters News*, March 22, 2015). China is clearly frustrated over the slow progress in governance reform in the multilateral institutions, including in particular the United States continuing to block reforms which would increase China's weight in the IMF. However as outlined previously, the AIIB proposal is an integral part of China's multi-pronged Silk Road initiative. Even if the reforms to IMF governance arrangements had been approved by the United States Congress and China's quota share moved to number three in the IMF, it is highly likely that China would still have proposed the establishment of an institution like the AIIB.

Given the United States' concerns over the adequacy of governance arrangements in the AIIB, the most direct way it could influence those standards would be to join as a founding member. The United States could have provided balance to Chinese influence from within. However, the unwillingness of the United States Congress to pass legislation involving governance reform at the IMF that would make China the third-largest shareholder, meant that appropriating United States taxpayer's money to join a new Chinese-led multilateral bank was not politically possible. Rather, the United States needed to work through allies who were potential members to meet its objectives. Only once it became clear that the United States could not keep its G7 allies from joining the bank did its position shift from demanding high standards to proposing cooperation between the AIIB and the existing international financial institutions ('U.S. Changes Tack,' *Reuters*, March 23, 2015).

Japan's response to the AIIB was similar to that of the United States, although Japan's strategic interests in international financial institutions are more concentrated in its leading position at the ADB. Japan's Foreign Minister questioned the 'additional value' of the AIIB, and noted that its governance and lending conditions were unclear ('Japan's Kishida Questions,' *Jiji Press*, August 9, 2014). When the deadline passed on signing the initial non-binding memorandum of understanding on the AIIB, Japan's vice minister of finance said Japan still needed to 'clarify the structure, or the governance, of this new bank.' That said, there were competing views in Japan with some focusing on the commercial opportunities for Japanese business ('Japan and the AIIB,' *Nikkei Report*, March 21, 2015). Japan officially remains open to joining the bank at some future time ('Japan Says Could Join,' *Reuters*, March 20, 2015), but remains cautious until the governance structure is clear ('Japan Still Cautious,' *Reuters*, March 26, 2015).

Commercial opportunities: West meets East

The first 'western' country to apply to join the bank was New Zealand. Prime Minister Key expressed his country's interest in time for Xi Jinping's state visit in November 2014 ('New Zealand PM Eye,' *Xinhua*, November 12, 2014). President Xi applauded New Zealand's 'independent voice,' while the *Financial Times* later dismissed its 'vassal state' policy ('China Will Not Thank,' *Financial Times*, March 17, 2015).

For decades, the United States had coordinated its multilateral aid policy with its G7 partners (McKeown 2009). The AIIB was discussed amongst the G7 although there are conflicting public reports on whether G7 members would only join if there was a consensus to do so ('UK Move to Join,' *Financial Times*, March 26, 2015), or

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whether talks were 'inconclusive' ('How Europe and U.S. Stumbled,' *Reuters*, March 22, 2015). In contrast to the founding of the ADB in the 1960s, which had critically depended both on United States political leadership and European financial capital (Dutt 2001), the establishment of the AIIB did not depend on European support. In fact, many European countries thought they needed the AIIB as a means of engagement with China more than China needed them to establish the bank.

Although China's initial efforts at encouraging countries to join the AIIB focused on its Asian neighbours (Huang and Chen 2015), China had engaged European G7 members since the middle of 2014, and in early 2015 China offered to lower its own share in the bank to encourage the United States and European countries to join ('China Woos Australia,' *The Australian Financial Review*, February 14, 2015). By March 2015, the Chinese Finance Minister confirmed that major European countries had expressed an interest in joining the bank ('AIIB Offer Still Open,' *Xinhua*, March 6, 2015). The first mover was the United Kingdom, which applied for membership shortly after informing G7 members of its decision ('UK Wants in on China's,' *Nikkei Report*, March 13, 2015). The United Kingdom's interest in attracting Chinese finance to London rather than Frankfurt ('China Will Not Thank,' *Financial Times*, March 17, 2015) meant that it acted without waiting for France, Germany or Italy, which coordinated their own applications a few days later ('France, Germany, Italy to Join,' *Agence France Press*, March 17, 2015). A dozen other smaller European nations rushed in the last days before applications closed on 31 March 2014 to become founding members.

While the official US position was that entry into the AIIB was a decision for sovereign states ('UK to Join,' *Reuters*, March 12, 2015), off the record the White House lambasted Britain's 'constant accommodation of China' made with 'virtually no consultation' ('US Attacks UK's,' *Financial Times*, March 12, 2015). A personal entreaty from the US Secretary of State to Germany was ignored ('France, Germany and Italy Say,' *New York Times*, March 18, 2015). The United States' apparent inability to enforce a common G7 position led the *Wall Street Journal* to describe the episode as 'routing the US in economic diplomacy' ('China Trounces U.S.,' *Wall Street Journal*, March 20, 2015). The Chinese nationalist newspaper, the *Global Times*, welcomed the 'precedent whereby would-be US allies can begin to dissent from US hegemonistic demands' ('AIIB Dissent May Mark Shift Away from Compliance with US Hegemony,' *Global Times*, August 14, 2015). Canada was the only G7 partner, which did not join but says it continues to actively considered the issue ('Canada Actively Considering,' *The Globe and Mail*, April 14, 2015).

Australia and Korea make the China choice

The two countries most influenced by US and Japanese strategic concerns, namely Australia and Korea, are not in the G7. Both countries share similar strategic circumstances, in that they are trying to maintain and expand strong trade and investment relationships with China while maintaining strong bilateral security alliances with the US.

According to press reports, the Australian government had been internally divided since March 2014 on whether to join the AIIB ('Govt Divided on Asia Bank,' *Australian Associated Press*, October 25, 2014). At a press conference in Beijing in June 2004 the

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Australian Treasurer welcomed the significant role that the AIIB could play in the Asian region and indicated that Australia was prepared to engage in discussions and looking forward to seeing more detail. Australia also wanted a common position with allies, with press reports suggesting that Australia's participation depended on 'an assurance that all regional players, including Japan, are involved' ('Beijing's Plan for New Bank,' *Australian Financial Review*, June 25, 2014). The Australian Treasurer emphasized the importance that 'everyone participate as much as possible' ('Treasurer: Sino-Aussie Ties,' *Shanghai Daily*, July 3, 2014).

China reportedly offered Australia 'a senior role' if it signed the Memorandum of Understanding in October 2014, and India, Indonesia and Singapore reportedly encouraged Australia to join early ('Australia Was Offered Top Role,' *The Australian Financial Review*, November 3, 2014). But US officials were reportedly lobbying their Australian counterparts against signing ('China Bank: Abbott Held Talks,' *The Australian Financial Review*, November 1, 2014). This escalated to the political level, with the US President and Japanese Prime Minister both raising their concerns over the AIIB with the Australian Prime Minister ('Australia was Offered Top Role,' *The Australian Financial Review*, November 3, 2014). In opposition to the Treasurer, the Prime Minister and Foreign Minister reportedly opposed Australia's entry to the AIIB at a national security committee meeting of Cabinet in October 2014 ('Australia Was Offered Top Role,' *The Australian Financial Review*, November 3, 2014). The cabinet decided not to sign the initial memorandum of understanding, although the Prime Minister held the line with US policy that Australia would be 'happy to join up with [the] sort of transparency and governance' as the World Bank ('We'll All Have a Voice,' *The Australian*, March 26, 2015).

By December 2014 Australia's Minister for Trade and Investment was publicly saying that it was 'the wish of everyone in the Cabinet, from the Prime Minister down' ('Australia Will Join,' *The Australian*, December 8, 2014) that Australia would join the bank. But Australia applied for membership after the United Kingdom's surprise announcement in March 2015, and so appeared to be playing catch-up. While Australia applied for membership, the Australian Treasurer outlined five conditions before Australia would formally join the bank—'open membership, high levels of transparency, no restriction on procurement of goods or services, sound banking principles and merit-based recruitment' ('Tony Abbott and Joe Hockey Say $100b,' *The Sydney Morning Herald*, March 25, 2015). The admission of New Zealand, and the United Kingdom's application to join, was presented as a public signal of the AIIB's institutional quality ('Australia Shifts Stance,' *The Financial Times*, March 16, 2015).

South Korea's entry into the bank followed a similar course to that of Australia. Seoul was initially non-committal, despite lobbying from Xi Jinping during a state visit ('S. Korea Weighs Offer,' *Yonghap*, June 30, 2014). Press reports in Korea noted the United States' 'deep concern' about South Korea participating in China's effort 'to reshape the global financial architecture' ('Asian Infrastructure Investment Bank and Korea's Position,' *The Korea Times*, August 4, 2014). In October 2014, Korea's official line reflected the 'high standards' argument of the United States—Korea's Minister of Strategy & Finance left opened the possibility of joining the bank 'as long as the disagreements over its governance structure are resolved' ('Korea Willing to Take Part,' *The Korea Economic Daily*, October 23, 2014). But off the record, a

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Korean official framed the decision in terms of the 'deep dilemma on what strategic choices [Korea] has to make as China challenges the U.S.-led (sic) international order' ('Korea Bails Out,' *Korea JoongAng Daily*, October 23, 2014). According to an Australian press report, Korea looked to Australia for guidance on whether or not to join ('Australia Was Offered Top Role,' *The Australian Financial Review*, November 3, 2014). One academic argued that Korea's economic interests, particularly for Korean construction companies, had been overshadowed by a US threat that Korean participation in AIIB would undermine strategic trust between the two countries ('Korea Should Join,' *Korea JoongAng Daily*, November 11, 2014).

US influence in the Korean decision-making process appeared even more involved than with Australia. Press reports described negotiations between Korea and the US ('Korea Still Mulling,' *Korea JoongAng Daily*, March 19, 2015) ('Negotiations Picking Up Speed,' *Maeil*, March 11, 2015). Korea delayed a decision on whether it would be a founding member, referring to an ongoing process of internal coordination and 'checking political situations in neighbouring countries' ('S. Korea to Make Decision,' *Yonhap*, March 15, 2015) and further talks with the US. But like Australia, the announcement by the Europeans that they were joining the bank was the catalyst for Korea applying before the end March deadline. Korea was concerned that Europe would end up with a greater say in the bank as founding members than Korea ('Korea to Join China-led Bank,' *Korea Times*, March 22, 2015). It was accepted as a prospective member, along with Australia and Spain, on 11 April 2015.

While Australia and South Korea had been keen for economic reasons to join the bank, they both delayed their decision to enter out of consideration to the United States. Although both countries may have been more influential had they been directly involved in the process of drafting the bank's Articles from the outset, it is possible that that the uncertainty about their entry may have given them slightly more leverage in negotiations with China in relation to governance at the bank. However, as with the European G7 members, neither Australia nor Korea were indispensable to China's proposal. Moreover both Australia and Korea appeared reactive to the views of others, namely the US and Japan in an initial reluctance to join the new bank, and a last minute application to join following the decision by the UK and other European countries.

The AIIB's governance structure

Given that the major public concerns of the United States and others surrounding the AIIB were about governance and standards at the bank, there will be close scrutiny whether the AIIB truly is a multilateral institution, or a vehicle that primarily pursues Chinese interests. Which category the AIIB is seen as will color not only the legitimacy of the bank, but also influence how future Chinese initiatives are received.

Unveiling the details of the AIIB proposal for the first time in March 2014, Chinese Finance Minister Lou Jiwei insisted that the AIIB would be modelled on the style and function of existing multilateral development banks (China Ministry of Finance 2014). The final AIIB Articles draw extensively on those of other multilateral development banks (MDBs), which may also reflect the fact that China engaged former officials from those banks to draft the AIIB Articles.

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The negotiation of the AIIB's Articles of Agreement was impressive, both in terms of speed and China's ability to appease the concerns of other countries. While many countries indicated a willingness to join the bank, a number (including Australia) added the proviso that this was contingent on being satisfied that the bank's governance arrangements were compatible with those of a multilateral institution. China successfully satisfied these concerns without forgoing significant control over the bank. This was a successful negotiating performance by China.

Similar to other regional development banks, there are special entitlements for regional members which will firmly establish the AIIB as a regionally dominated institution, even if it is not a Chinese dominated institution. The definition of the 'region' in the AIIB Articles is similar to that used by the ADB, and is based on the UN country classifications for Asia and Oceania. In the AIIB, regional members will always hold at least 75 per cent of the total capital stock (unless agreed by the members with 75 per cent of total capital stock). And nine of the 12 members of the Board of Directors will represent regional members. Of the 57 prospective founding members of the AIIB, 37 are from the region. By way of comparison, there are 67 members of the ADB with 48 from the region.

Unlike the other MDBs, the AIIB Articles allow for non-sovereign members from countries that are members of the AIIB. This leaves the door open to Taiwan to join the bank. While its initial application to join was rejected, the mainland remains open to Taiwan joining under an acceptable name ('Mainland Welcomes Taiwan Joining AIIB,' *Xinhua*, April 13, 2015). This provision allowing non-sovereign members also leaves opens the possibility of Chinese (and other countries') institutions becoming a member of the AIIB.

Capital allocations (Figure 3) are based on 'the relative share of the global economy of members (based on GDP) within the regional and non-regional groupings, with the understanding that GDP share is indicative only for non-regional members' (Asian Infrastructure Investment Bank Interim Multilateral Secretariat 2015a). This means that should Japan decide to join the AIIB, it would be a regional member and its share of the capital stock would be based on Japan's relative GDP. By contrast, should the United States join, its relative GDP would only be an indicative guide.

The voting arrangements for the AIIB will consist of: basic votes (12 per cent of total votes will be shared equally between members, a similar arrangement exists in the other MDBs to boost the voting power of small members); founding members votes (each founding member will be allocated 600 Founding Member Votes); and votes aligned with each members share of the capital stock in the Bank.

As the largest shareholder in the AIIB, China has by far the largest voting share at 26.06 per cent, followed at a distance by India (7.51 percent); Russia (5.93 percent) and Germany (4.15 percent). China's voting power in the AIIB is currently significantly larger than the United States' 15.02 percent voting share in the World Bank and Japan's 12.84 per cent voting share in the ADB.

While China does not have a formal veto power over project-level decisions, its 26.06 voting share in the AIIB gives it effective veto over major decisions requiring a super majority of 75 per cent. This is similar to the US veto over World Bank decisions requiring an 85 percent super majority. The decisions in the AIIB where China has a veto power include: increasing the bank's capital; increasing the capital subscription of a

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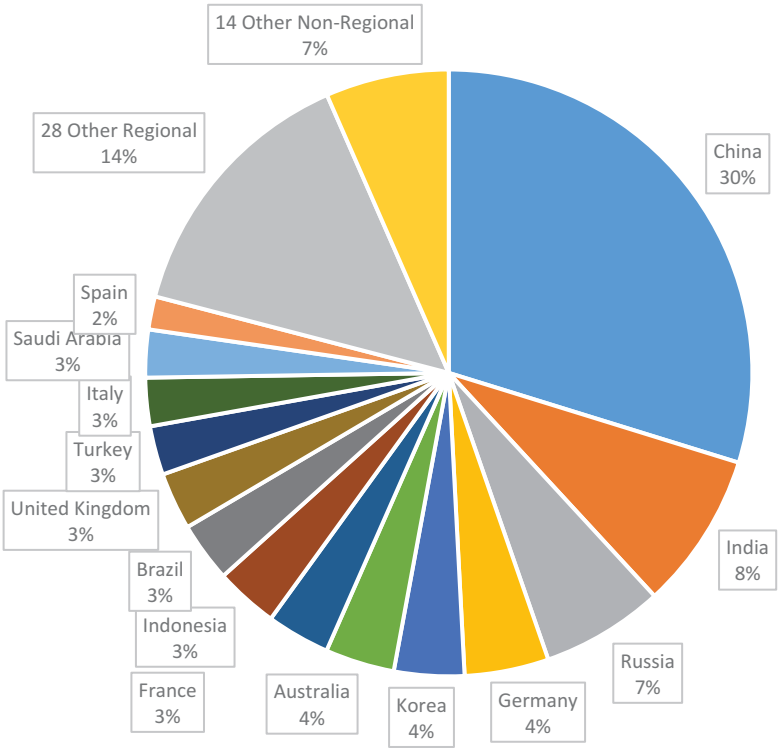

Figure 3: Prospective founding members' proportion of allocated shares. Source: Authors' calculations, based on Articles of Agreement (Asian Infrastructure Investment Bank Interim Multilateral Secretariat 2015a).

member; expanding the operations of the bank; changing the size of the board of directors; changing the structure of the board; appointing or removing the president; suspending a member; terminating the bank and distributing its assets; and amending the Articles. Thus notwithstanding reports that China offered to give up veto powers in exchange for European participation ('China Forgoes Veto Power,' *Dow Jones*, March 23, 2015), it enjoys veto power that goes beyond that enjoyed by major shareholders in other MDBs.

In particular, China has more control over the appointment of the President of the AIIB than the US has in the World Bank and Japan in the ADB. China has a veto power over the appointment of the AIIB President whereas the influence of the US in the World Bank and Japan in the ADB depends on informal arrangements. Given the angst among emerging markets and developing countries over the convention that the President of the World Bank is always an American and the head of the IMF always is a European, China could have taken the moral high ground by highlighting that the appointment of the AIIB President should be based on merit, regardless of nationality. However China followed the ADB precedent and the AIIB Articles say that the President must be a national of one of the bank's members.

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At the sixth Chief Negotiators' meeting in August 2014, negotiators considered formal nominations from China and Russia to serve as the President-designate of the bank. Mr. Jin Liqun, the former Chinese Vice Minister of Finance and state-owned financial executive, who had fronted the negotiations for the bank was the consensus choice (Asian Infrastructure Investment Bank Interim Multilateral Secretariat 2015b).

China's ability to garner significant veto powers may be a reflection of its negotiating skill. It could also mean that for some prospective members, governance considerations were not their primary consideration, notwithstanding their public comments. That China has sought extensive veto power may also suggest that it does not yet fully appreciate that its influence does not depend solely on its voting power combined with veto provisions. As has been evident in the World Bank and the ADB since their inception, the major shareholder can have a significant influence informally. This can be more effective than the blunt instrument of vetoing decisions that are supported by the bulk of the membership. China's exercise of influence and persuasion in this way may become more important.

China has maintained significant flexibility in the Articles in terms of the future direction of the AIIB. Despite its name, the bank is not restricted to infrastructure investment. Its formal role is to use its resources to promote public and private investment in the region and support 'harmonious economic growth,' in particular but not exclusively through investment in infrastructure.

While the AIIB's authorized capital is US$100 billion, it can also accept 'special funds' to increase its resources as well as administer funds held in trust for other parties. This is broadly consistent with the arrangements for the MDBs. The AIIB can also administer trust funds that are separate from its balance sheet. Its methods of operation are wide ranging and the recipients of its financing need not be members of the bank. As such, the Articles do not limit China's capacity to use the AIIB to directly pursue its economic and political interests—should this be its motivation.

But the important question is whether the bank's internal governance arrangements will provide a check on its dominant shareholder.

Similar to the MDBs, the AIIB will have a three-layer governance structure involving a Board of Governors, a 12 member Board of Directors and management/staff. The most distinguishing aspect, and one that could either enhance the efficiency of the bank or alternatively be a weak link in its governance arrangements, is the absence of a full-time, resident board of directors. The issue of whether international institutions should have resident or non-resident boards is by no means new. It was the topic of a major debate in 1944 between the founding fathers of the IMF and the World Bank—John Maynard Keynes and Harry Dexter White (Steil 2013). Keynes wanted high-level, part-time non-executive boards to focus on the strategic direction of the institutions. But White (and the United States) prevailed and the World Bank and IMF were established with full-time, resident executive boards to act as a political check on every decision.

Notwithstanding the advances in travel and communications, most of the subsequent multilateral institutions have followed the Bretton Woods model with full-time boards. The exceptions are the European Investment Bank, and now the AIIB. Prospective members of the AIIB who had doubts over its governance arrangements and feared it would largely be a vehicle for promoting China's interests would have supported a full-time resident board for the same reasons the United States insisted on full time boards

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in the World Bank and IMF, namely to be a political check on every decision taken. But such an arrangement confuses the role of the board and management and a board deeply involved in the detail of the banks day-to-day operations does not have the capacity to consider the strategic direction and overall performance of the institution. The staff of international institutions also know that the best way to nullify a board is to swamp the directors in detail.

The AIIB adoption of a non-resident board opens the possibility of a more effective board that provides strategic oversight and direction to the bank, as well as holding management accountable for its performance. If this is achieved, it will be a major advance on the arrangements in the World Bank and ADB. But for a part-time, non-executive board to be effective, the roles, responsibilities and expectations of the board and management has to be clearly articulated. Management should have operational freedom and discretion, but must be fully accountable to shareholders through the board for its performance. But the potential downside of the non-resident board is that it can take an excessively hands-off approach to the performance of the bank. It will be critical for every director to take their responsibilities seriously and play an active role in oversighting the performance of the bank. All shareholders in the AIIB will have the responsibility of ensuring that the non-resident board does provide effective oversight of the institution.

Making the AIIB operative—the hard part

China wants to maintain its impressive pace with the AIIB initiative and have the bank operating by the end of 2015. However there is a very big step between drafting the Articles, which is a broad high level document, and establishing the detailed processes and procedures that guide actual operations. China and the other countries that have backed it in joining the AIIB need to get these fundamentals right. The way the bank is initially financed, staffed and the first projects it supports will determine whether it is truly lives up to its promise as a multilateral institution, or is just a cover for a Chinese dominated body. The international community—particularly the United States—will be quick to criticize any misstep in order, if only to confirm initial suspicions as to China's motivations.

The most important aspect that the AIIB needs to resolve is its business plan—who will be the bank's clients, what will be its main activities and on what terms will it lend? There remains a lack of clarity as to what will be the precise role of the AIIB, not only in terms of how it will relate to the MDBs, including the BRICS New Development Bank, but also its role with respect to Chinese institutions, including the Silk Road Fund.

Is the AIIB a development bank, comparable to the MDBs? The word 'development' is not in its name and while its Articles state that its purpose is to promote investment in the region and to have regard to the needs of less developed members, it does not have a specific objective to reduce poverty. Nor does it have a concessional window to provide grants and low interest loans to developing countries. The AIIB Articles have, however, a similar provision to that in the ADB Articles, which provides that in considering an application for financing, the bank will take into consideration the ability of the recipient to obtain financing on terms and conditions the bank considers reasonable. The AIIB needs to resolve at the outset whether its focus will be primarily

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on assisting the development of low income countries in the region and help them reduce poverty, or whether it will have a broader remit and focus on the 'development' of all countries in the region.

If the AIIB is truly a multilateral institution, the projects it finances should not be selected on the basis of promoting China's interests, but rather the best interests of the borrowing countries. Much has been made of the prospect that the AIIB will be a more efficient, leaner and faster dispenser of loans compared with the MDBs, which are considered slow, bureaucratic and risk-averse. However, there has been considerable pressure on the MDBs which has made them risk averse. The same, if not greater, external pressure will be on the AIIB. While the AIIB should be seeking to be as efficient as possible, and certainly there is considerable scope to improve on the performance of the ADB and World Bank, its lending strategy cannot be primarily based on the approach that it offers 'faster loans with fewer questions.' The AIIB will have to negotiate a balancing act between ensuring that its operations are efficient, including loan disbursement times, and is a bank which is acceptable to all its members and civil society, particularly in terms of handling environmental and social issues.

The challenge for the AIIB in negotiating this balancing act is increased with the expectation that it will focus on 'big-ticket' investments, such as power plants, toll roads, seaports, airports. This could be described as the 'old' ADB model, when the bank's acronym was known as 'Asian Dams and Bridges' and it concentrated on financing hard infrastructure with a 'get it done' approach. In the early period of the ADB's operations, the ADB controlled the bidding, procurement, contracting and oversight of the project while the recipient country was responsible for all environmental and social aspects of the operation. But those days are long gone for MDBs. If the AIIB is to focus on major infrastructure projects, it will be immersed in dealing with environmental and social issues. These are matters that have not always been at the forefront of China's approach to infrastructure development.

The staffing of the AIIB will be a major factor in deciding whether the bank is an international or Chinese institution. To truly be a multilateral bank, the AIIB must have an international workforce. It cannot be predominantly staffed by Chinese nationals. This is necessary not only to avoid perceptions that the bank is Chinese dominated body, but to ensure that the new bank has the skills that it needs. China may have expertise in building infrastructure projects, but the AIIB needs the skills and expertise to run a multilateral bank, and this includes expertise in sound credit analysis, the maintenance of rigorous and transparent accounting functions, and ensuring that all loans and financing arrangements are in line with the organization's policies. These are skills that may not be readily available in China.

The AIIB would be wise to 'go global' in staffing the bank with the focus on gaining the required skills rather than the nationality of recruits. It should seek to recruit among the current and former staff of the MDBs, particularly the World Bank and ADB. This would not only benefit the AIIB, it would be good for the other institutions and their future relations with the new bank. Strong personal links between the staff of the MDBs and the AIIB will greatly facilitate cooperation between these institutions.

The operating language for the AIIB is English and, in consequence, it will be important that all staff, including administrative and support staff, are fluent in English. An advantage of having the headquarters of the ADB in Manila is that it has

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ready access to an English speaking workforce. Indonesia lobbied for the headquarters of the AIIB to be in Jakarta ('Jokowi Asks More of China,' *The Jakarta Post*, November 10, 2014), but China decided on Beijing. This may reflect China's desire to brand the bank as Chinese initiative, and also for the same reason the US insisted that the headquarters for the Bretton Woods institutions be in Washington, to keep a close eye on their operations (McKeown 2009). If the headquarters of the AIIB were in Jakarta, this may not have increased access to an English speaking workforce, but it would have reduced concerns that the bank will be dominated by Chinese nationals. With the headquarters of the AIIB being in Beijing, care needs to be taken from day one that the culture of the organization is internationally minded. That said, it is significant that the headquarters of a multilateral institution is in China. It is a symbolic demonstration that China is playing an active role in contributing to global economic governance.

The AIIB will need to establish and adhere to rigorous procurement procedures and safeguard policies. Opponents of the AIIB raised the fear that the bank would 'lend to dictators, despoil the environment and trample human rights' ('A Bank Made in China,' *Financial Times*, May 27, 2015). It was also suggested that the AIIB would primarily be a vehicle to promote China's narrow commercial interests. These concerns stem not simply from experience with China's bilateral lending arrangements, but also from the past and current performance of the MDBs.

Much criticism has been directed at the infrastructure projects supported by the other MDBs, particularly their impact on the environment and on people in the recipient countries, including dislocating communities and causing social upheaval. In response, the MDBs have established detailed environmental and social safeguard policies. These policies introduce more procedure, time and expense to the MDBs operations and can sometimes be seen as intruding into the domestic affairs of countries. Nevertheless, such safeguard arrangements are now considered essential for the MDBs. The scrutiny, particularly from civil society, that has been directed towards the environmental and social aspects of the operations of the MDBs has resulted in their expanding their workforce from engineers, financiers and economists to include specialists in social protection, governance, environment, gender and communication. The AIIB will have to recruit similar specialists.

To deflect criticism that the AIIB will not meet the environmental and social standards espoused by the World Bank and ADB, China's President Xi Jinping gave assurances that the new bank would adhere to the 'good practices' of existing international lending institutions (Rodney and Junio 2014). The AIIB has made a very good start by putting out for public consultation a draft Environmental and Social Framework. The first test it will face in terms of the priority it places on such issues is how it responds to the comments it receives on this framework, particularly from civil society representatives. To ignore all comments would give the impression that the AIIB is going through the motions on safeguard policies. However it is one thing to have a robust set of safeguard policies, and it is another thing to put them into practice. In March 2015, the World Bank admitted that it failed to follow its own rules for protecting the poor swept aside by dams, roads and other big projects that it had financed. This followed after the International Consortium of Investigative Journalists identified 'systematic gaps' in the bank's projections for people who lose homes or jobs

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because of development processes. The World Bank admitted that it was not following its own policies after an internal audit, with the World Bank President stating 'We took a hard look at ourselves on resettlement and what we found caused me deep concern' (World Bank 2015). In response, the World Bank has indicated that it will tighten its safeguard standards.

The AIIB will come under intense scrutiny over the social and environmental implications of its lending operations and given the extent of concerns that this will be a weakness of the bank, it may not have the same leeway as the World Bank and ADB to say that there are 'problems.' Not only will the AIIB require rigorous safeguard policies, it will also need thorough oversight and audit processes to ensure that they are implemented. But should problems arise, China will have to be prepared for the AIIB to accept that there was a mistake, open itself to an independent review and quickly take steps to ensure that the bank's future performance will be better. More generally, the AIIB will have to have a robust internal and external audit function and an independent evaluation process.

The AIIB's procurement policies will have to be watertight. Infrastructure projects financed by the AIIB will have to be based on international competitive bidding, as followed by the other MDBs. The AIIB cannot follow the path of China's bilateral funding arrangements where infrastructure loans have been tied to Chinese engineering firms gaining construction contracts. The international credibility of the AIIB would be severely damaged if there was any suggestion that it was being used merely to favour China's commercial interest.

If the AIIB is to be a multilateral bank, it will need a treasury function that allows it to borrow on international capital markets. The funding structure for the new bank cannot simply be based on financing from Chinese institutions. It would be embarrassing for China if the AIIB did not have the same AAA credit rating as the ADB or World Bank. However the AIIB will depend on the robustness of its internal processes, including governance arrangements, project selection and credit analysis processes, lending policies, management structures and oversight, and review procedures.

Will the AIIB facilitate countries accessing private financing?

A major strategic decision that the AIIB will have to take is whether it will concentrate on financing specific investment projects in the region, or whether it will focus on facilitating the capacity of countries to access private financing in order to meet their infrastructure needs. One of the rationales for the establishment of the AIIB was the contribution that it could make to fill the USD8 trillion infrastructure gap in Asia (Bhattacharyay 2010). The ADB finances less than two per cent of Asia's infrastructure needs and at best the AIIB could only match this amount from its direct lending operations. The problem, however, is not inadequate saving to finance Asia's infrastructure needs, but the challenge of intermediating available saving into infrastructure investments. Direct lending by the AIIB will only make a small contribution. It has the potential to have a larger impact if its business plan focused on how to catalyze private investment flows into infrastructure.

To achieve this, the AIIB would have to concentrate on countries in the region identifying a pipeline of 'bankable' projects, enhancing their project selection processes

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and improving their investment climates. This will include helping countries introduce rigorous cost-benefit procedures in order to select and prioritize projects, maintain the rule of law along with stable regulatory and taxation environments, develop skills to manage public-private partnership projects, and ensure a sound and stable economic environment. However many of these aspects are features that China itself has to develop, and it could be a major indirect beneficiary of the AIIB's concentrating on helping countries in the region to access private sector financing to meet their infrastructure requirements.

It is important that the AIIB positions itself as complementing rather than competing with the other MDBs. Competition is healthy if it is directed at improving the internal processes of the organizations, but it would be unhealthy if it was viewed in terms as a race to the bottom in terms of lending standards and the quality of the projects being financed. With one eye on the importance of the institutions cooperating and the other eye on the intense scrutiny the AIIB is likely to come under in terms of the initial projects it finances, there would be merit in the AIIB initially concentrating on co-financing arrangements with other investors, including the MDBs. This would also help counter concerns that the AIIB will be a Chinese dominated operation, as well as providing the opportunity to draw on the skills and expertise of the other banks. It would also help position the AIIB as a multilateral institution.

In terms of cooperation with the MDBs, the AIIB should become an active participant in the Global Infrastructure Facility (GIF). The GIF is a platform, based in the World Bank that coordinates and integrates the efforts of the MDBs, private sector investors and financiers, and governments interested in infrastructure investment in emerging markets and developing countries. Not only would the AIIB's involvement in the GIF help improve collaboration in dealing with infrastructure projects, it will help the AIIB gain from the experience of other lenders and not attempt to 'recreate the wheel.'

Conclusion

China has clearly been a winner to date with its initiative to establish the AIIB. Despite the cold water from the United States, 56 other countries have agreed to be founding members of the bank—an outcome that probably surprised China. In addition, China has successfully negotiated the Articles of Agreement for the bank and appeased concerns over the governance arrangements for the AIIB. In contrast, the US handling of the AIIB has been poor and it has lost credibility. In opposing the AIIB, it has appeared petulant and hypocritical, particularly since the US Congress continues to block reforms to the IMF which would increase the role of the emerging markets, particularly China.

While China has demonstrated that it could lead multilateral negotiations constructively in concluding the Articles for the bank, and no doubt gained valuable experience in doing so, in many respects that was the easy part. Getting the AIIB successfully up and running will be more difficult and all the credit China has received over the initiative to date would be quickly lost if there was any suggestion that the concerns of those who opposed the AIIB were realized and it was a Chinese dominated institution that did not meet the lending standards of

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the MDBs. Not only would China lose credibility if this eventuated, so would all the other founding members in the bank who have responsibility for how the AIIB develops. Moreover it is directly in their interests to help ensure that the AIIB is a success. China, along with all the other members, have to ensure that a non-resident board of directors is effective and provides effective oversight of the bank's operations. In particular, the shareholders should not seek to shape the AIIB as a mirror image of the existing MDBs, but use the AIIB as a catalyst to improve the efficiency of these institutions.

Given that the AIIB will be under intense scrutiny and the international tolerance for missteps is likely to be low, China would be wise to tread carefully with the establishment of the bank, both in terms of ensuring that it has through processes and procedures, an international and appropriately skilled workforce, and focuses its initial activities on co-financing. If such care is taken, the downside is that it may take longer than China wishes for the AIIB to be a significant player in the region. But China would gain significantly if there is no question that the AIIB is a multilateral institution which compares more than favourably with the other MDBs. It would demonstrate that China can make an effective contribution to providing global public goods and may provide the encouragement to be more active in multilateral leadership. Moreover the areas of the AIIB's operations where time and care should be taken—such as rigorous credit assessments, careful project selection, careful attention to environmental and social issues, strong accounting and transparency arrangements—are ones where China has a great deal to learn. Indeed, there are a number of indirect benefits that China can gain from the careful establishment of the AIIB.

Note

1. The Central Leading Group on Financial and Economic Affairs.

Disclosure statement

Paul Hubbard is on leave from the Australian Treasury as a Sir Roland Wilson PhD Scholar. Mike Callaghan is a former Executive Director the Australia Treasury, and at the time of writing was the Chairman of the Northern Australian Insurance Premiums Task Force based in Treasury. In both cases, these are the authors' personal views based on the sources cited in the text, and should not be construed as representing the view of the Australian government or the Department of the Treasury. This research paper was commissioned to inform the Australia-China Joint Economic Report which is a joint project of the East Asian Bureau of Economic Research at The Australian National University and the China Center for International Economic Exchanges, but does not represent the views of either institution.

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