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INDO-PACIFIC INSIGHT SERIES

What does China want from the Asian Infrastructure Investment Bank?

The AIIB is a controversial addition to Asian economic regionalism. It is the first multilateral development bank (MDB) dedicated to infrastructure, and the first international economic institution created by China. However, critics have alleged it is a vehicle for Chinese geostrategic goals, may dilute good governance initiatives, and compete with other MDBs working in Asia. During membership negotiations in 2015, China had to strike a balance between its own goals and its partners' desire for a transparent and commercially-oriented bank. To ensure the bank's legitimacy, China has compromised with member states to create an institution which conforms to international best practices in development financing, and works with – rather than against – the existing MDBs to help close infrastructure gaps in Asia.

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EXECUTIVE SUMMARY

- The establishment of the AIIB in 2016 was a landmark development in Asian economic regionalism. It is the world's first multilateral development bank (MDB) dedicated to infrastructure, and the first international organisation created by China.
- It has also proved very controversial. Critics of the AIIB have alleged it is a vehicle for Chinese geostrategic agendas, may dilute good governance initiatives, and compete with other MDBs working in the region.
- In creating the AIIB, China has had to strike a balance between its own national economic goals and the desires of its partners for a transparent and commercially-oriented bank.
- China's AIIB strategy has changed over time. To ensure the bank's legitimacy, it has compromised with member states to create an institution which conforms to international best practices and cooperates with the existing MDBs.
- Thus far, there is little evidence that AIIB loans are being used to advance Chinese strategic agendas.

INTRODUCTION

The Asian Infrastructure Investment Bank (AIIB) is a landmark development in Asian regionalism. Launched by the Chinese government in 2013, it is arguably the most significant economic institution to be established in the region for over a decade. The AIIB's core mission is to help fill infrastructure gaps – the underdeveloped transport, energy and communication links which many agree are holding back Asia's economic potential – by providing a new development bank specialising in infrastructure funding. It has already attracted wide support, counting seventy members from governments both within and without the region, who have contributed an initial capital stock of $100 billion. It is also the first international organisation conceived, initiated and led by China, marking the country's recent maturation to become a provider of regional public goods.

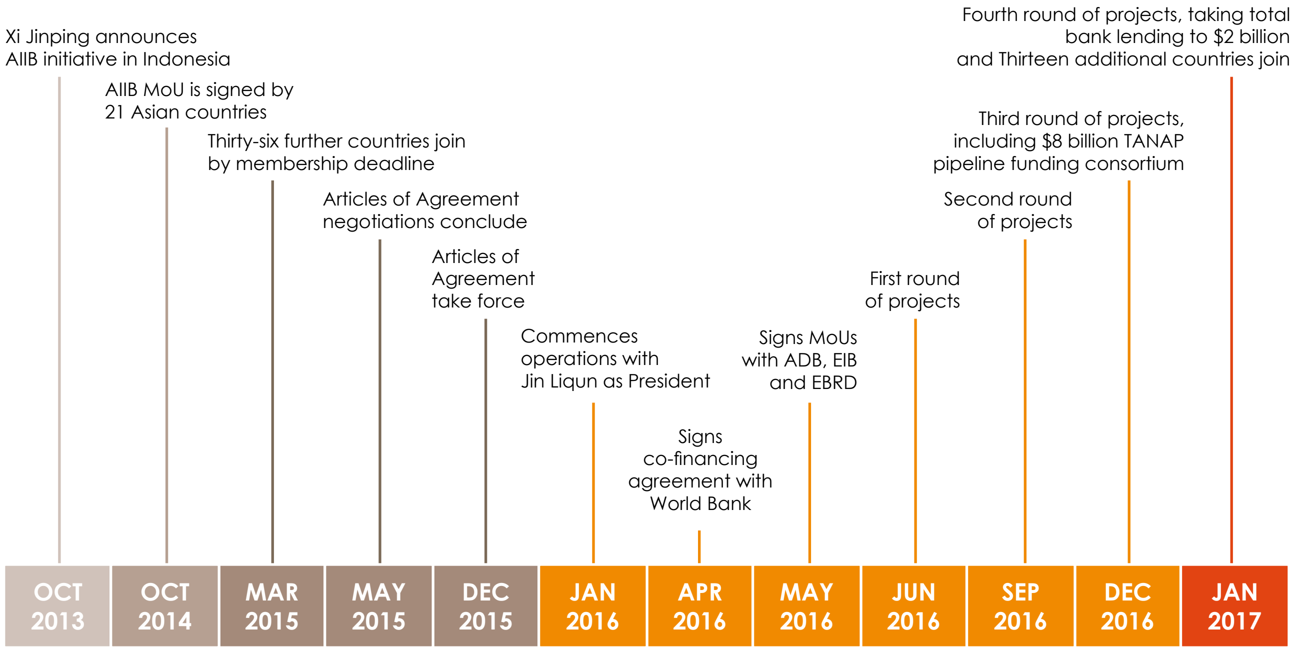
However, the establishment of the AIIB has not been without controversy. Critics have alleged it is not simply a provider of infrastructure finance, but a strategic vehicle to advance several of the Chinese government's economic and strategic agendas. Others fear it will compete with the existing multilateral development banks such as the World Bank and Asian Development Bank (ADB), and may undermine their efforts to promote good governance in development projects. While China and the AIIB leadership have strenuously rejected these claims, both the US and Japanese governments have declined membership invitations citing such governance concerns. As the AIIB begins to ramp up its lending activity in 2017, these controversies pose a significant question: *What does China want from the AIIB?*

In building this new international institution, China has needed to balance two competing imperatives. One on hand, as the AIIB's leader and principal financier, Chinese policymakers expect the institution to help advance several strategic objectives – particularly its concomitant One Belt One Road regional connectivity project. On the other, the need to achieve legitimacy and a sense of 'Asian' rather than 'Chinese' ownership has meant that compromises with the interests, goals and agendas of other players has been required. As the initiative progressed, Chinese thinking on how this balance should be struck has evolved. An early emphasis on strategic goals has progressively given way to a focus on legitimacy objectives, resulting in an AIIB which is radically different from that which was initially proposed.

CHINA'S FIRST FORAY INTO INTERNATIONAL INSTITUTION BUILDING

The proposal for the AIIB – and its rapid two-year progress from plan to reality – was decidedly China-led. The AIIB initiative was first announced by Chinese President Xi Jinping in October 2013[1] , in a speech to the Indonesian parliament during the first foreign tour of his Presidency. Following 12 months of preliminary negotiations, a Memorandum of Understanding (MoU) to establish the bank was signed by twenty-one Asian governments, and by March 2015 fifty-seven countries had signed onto the Chinese initiative. The AIIB's legal foundation (the Articles of Agreement) entered into force in late 2015, and the bank began operations of 17 January 2016 with Jin Liqun elected as its inaugural President. Wasting little time, the AIIB quickly began financing activities, and has now approved $2 billion of loans for twelve infrastructure projects in member states (Table 3).

Figure 1: Timeline of the AIIB



Per its *Articles of Agreement*[2], the AIIB is a multilateral development bank (MDB) dedicated solely to financing infrastructure projects. Memberships is open to all current members of the World Bank and/or ADB, which are grouped into 'regional' and 'non-regional' blocs. It has a tripartite governance structure which is fundamentally similar to all other MDBs: featuring a Board of Governors, a Board of Directors and a Senior Management team[3]. The primary difference from other MDBs is its part-time and non-resident Board of Directors, designed to give the Senior Management team a greater degree of autonomy in operational decision-making[4]. The AIIB has an extensive range of policies[5] which govern its funding activities, including Codes of Conduct for officials and personnel; procurement, financing, public information and loan pricing policies; and an Environmental and Social Framework for analysing the societal impact of its projects.

One unique features of the AIIB is its special status as an Asian institution. This is reflected in its bifurcated approach to membership. It defines its 'regional' members as those from the fifty-three United Nations Asia-Pacific Group of countries[6], labelling all others as 'non-regional' members. Regional members must always retain at least 75 percent of the subscribed capital stock. As Board of Director votes on governance decisions require a 75 percent super-majority to be carried, this membership system creates an asymmetry in veto powers: if Asian members vote as a bloc, they will always be able to carry a governance measure, whereas non-Asian members will be unable to exercise a veto. It also means that China – which holds 32.4 percent of the capital stock and 28.8 percent of the voting shares – currently enjoys an informal veto power over all governance matters.

Table 1: AIIB Capital subscription and voting shares, February 2017

	Capital Subscriptions		Voting Shares
	USD millions	Share	
China	29780	33.41%	28.79%
India	8367	9.38%	8.31%
Russia	6536	7.33%	6.56%
Korea	3739	4.19%	3.88%
Australia	3691	4.14%	3.84%
Indonesia	3360	3.77%	3.52%
Other regional	14487	16.27%	21.84%
Regional members	**69960**	**78.49%**	**76.74%**
Germany	4484	5.03%	4.59%
France	3375	3.78%	3.53%
United Kingdom	3054	3.42%	3.23%
Other non-regional	8255	9.27%	11.9%
Non-regional members	**19168**	**21.50%**	**23.25%**

Source: AIIB (2016), 'Subscriptions and Voting Power of Member Countries', https://www.aiib.org/en/about-aiib/who-we-are/membership-status/.content/index/_download/20160930035841674.pdf

The AIIB has a three-fold significance for economic cooperation in Asia. First, it is experimental as the only MDB which is solely dedicated to infrastructure projects. By functionally specialising in a single area, it intends to concentrate expertise and knowledge to improve infrastructure lending practices[7]. Second, it promises to kick-start institution-building in Asia. It is the first economic body established in the region since the East Asia Summit of 2005; and the first financial organisation since the formation of the ADB in 1966. Third, it is the first time the Chinese government has proposed, led the negotiations for, and subsequently hosted the headquarters of an international organisation. The AIIB not only reflects a rapid and successful learning process for Chinese diplomats, but also marks China's emergence as an institution-builder rather than just -follower in global economic governance[8].

WHY ANOTHER MULTILATERAL DEVELOPMENT BANK?

Given China's leadership of (and veto power within) the AIIB, there is considerable interest in its goals for the new bank. The global economy already has some twelve major MDBs[9], all of which provide development finance for infrastructure projects. The Asia-Pacific also has its own regional MDB – the Asian Development Bank – which since 2008 has actively targeted infrastructure in its financing programs[10]. Questions have therefore been raised over why the Chinese government has inserted yet another institution into the currently-crowded MDB landscape, rather than working through existing global and regional bodies? While China has emphasised infrastructure development and promoting regional interconnectivity as its principal aims, many commentators have alleged a range of more 'strategic' motives are at play. As a result, there is a heated debate over what precisely is China's AIIB agenda.

The official answer – stressed by both AIIB[11] and Chinese officials[12] – is that the bank's primary aim is to help close Asia's 'infrastructure gaps'. As a public good, infrastructure is frequently under-supplied, due to a lack of incentives facing private investors and coordination problems facing cross-border projects. The ADB has quantified the infrastructure investment needed in the region between 2010-20, estimating that $8 trillion is required for national projects and a further $290 billion for cross-border linkages[13]. The Chinese government argues the AIIB can help close this gap by (1) earmarking $100 billion for infrastructure and (2) providing an MDB which specialises solely in infrastructure projects[14]. By marshalling capital and concentrating expertise, the AIIB could more efficiently support infrastructure projects than the other (non-specialised) MDBs.

However, critics have questioned whether the AIIB will indeed contribute to closing the regional infrastructure gap. Three criticisms are made. First, it is widely acknowledged the cause of under-investment is not a shortage of capital, but rather a lack of 'bankable projects' which MDBs could fund[15]. Second, many of the existing MDBs already have considerable expertise and capacity in infrastructure projects, particularly the ADB[16]. Third, it is feared that rather that creating technical capacity, the AIIB might simply cannibalise the infrastructure expertise of existing MDBs and compete for what few bankable projects are available[17]. The creation of a new Chinese-controlled MDB will thus only make a marginal impact on the region's infrastructure deficit. These criticisms have led some to suggest the primary Chinese motive for creating the AIIB was instead one of several geostrategic objectives.

One suggestion is that the AIIB is part of a revisionist push to reform global economic governance. China has for many years been frustrated by its lack of representation in international economic institutions, particularly the International Monetary Fund and World Bank[18]. However, repeated attempts to increase the voice of developing economies such as China – particularly through voting system reforms – have been stymied by the US government keen on protecting its veto powers. By creating a new financial institution, in which Asian economies hold the majority of votes and China has an informal veto, the Chinese government is able to realise governance and leadership aspirations otherwise impossible within the existing global architecture[19]. President Jin Liqun has described the AIIB as a "*progressive*" institution, which will be led by developing countries and does not give veto powers to western country members[20].

Another has been the allegation that the AIIB initiative is an attempt to export China's excess industrial capacity. Since the fiscal stimulus following the global financial crisis, the Chinese economy has accumulated large industrial production overhangs, particularly in the steel, machinery and construction sectors. As much of this can be put to use in infrastructure, many analysts have noted that AIIB funded projects may help absorb China's surplus industrial capacity[21]. Indeed, many Chinese officials have claimed that increased exports to regional partners was one of the major benefits the AIIB would carry for China[22]. These suggestions have raised concerns about the transparency of project governance, particularly the fear that China could use its large voting bloc to ensure construction contracts would be preferentially channelled to Chinese firms.

It has also been suggested the AIIB is designed as vehicle for China to gain geopolitical influence with Asian countries. Some commentators have alleged China will use AIIB loans as a diplomatic side payment for friends[23], which Reisen has labelled a form of *"shadow global diplomacy"*[24]. It has also been suggested it will preferentially direct finance to projects associated with China's 'One Belt, One Road' (OBOR) strategy. Both Xi Jinping[25] and the National Development and Reform Commission[26] indicated that the AIIB was designed to support the OBOR program. This has led to concerns it will not finance the region's most economically-justified infrastructure projects, but rather those which suit China's geopolitical agendas, diluting the good governance practices promoted by the World Bank and ADB. Much of the opposition to the AIIB in western countries[27], and the decision of the US and Japanese governments to decline membership invitations[28], was based on these concerns.

What unites these differing criticisms is the suggestion that there is more to China's AIIB agenda than simply closing infrastructure gaps in Asia. As the voting rules are explicitly designed to deny western countries veto powers, and informally give such powers to China, the fear is that the China will use bank loans to further its own economic and diplomatic ends. Rather than function as an 'Asian' bank, cynics view the AIIB as a Chinese plaything to buy off regional governments and win business for Chinese firms. Chinese actors have frequently denied these allegations, with Jin Liqun bluntly arguing the *"[the] AIIB is a bank, not a political organisation or political alliance"*[29]. Despite this, the controversy over Chinese intentions have persisted , and are now the single greatest challenge to the perceived legitimacy of China's first international economic organisation.

GROWING MEMBERSHIP AND EVOLVING AIIB GOVERNANCE ARRANGEMENTS

Much of this legitimacy debate is premised on the notion that the AIIB is 'owned by China', and that China has a clear agenda to advance its own strategic goals. This assumption is problematic, because it ignores the fact that the AIIB is a multilateral institution controlled by all its members. While China proposed the AIIB and led the establishment process, complex negotiation with the other member states necessitated bargaining and compromise. To secure signatories and ensure the perceived legitimacy of the bank, Chinese diplomats had to strike a balance between their own strategic agendas and the interests and preferences of the other players. As a result, the AIIB changed quite dramatically between proposal and establishment.

The initial AIIB template, proposed by China during diplomatic negotiations in 2014, naturally reflected China's own policy preferences. There was little emphasis on extra-regional members, with the focus instead on creating a bank compose primarily of Asian economies[31]. The Bank President was to have significantly more authority over operational decisions than in other MDBs, with a reduced role governance roles for the Directors and Governors[32]. There was little in the way of environmental, social or transparency safeguards[33]; and a clear preference to use Chinese construction contractors[34]. To help aid the internationalisation of the RMB, the AIIB was to issue at least some of its loans in RMB- rather than USD-denominated form[35]. Finally, China intended to contribute 50 percent of the capital stock, and hold a formal veto power over all investment decisions[36].

However, the involvement of several western economies changed the approach. China's proposal was initially successful in attracting developing countries seeking infrastructure investment, and by the signing of the initial AIIB MoU in some twenty-one Asian economies had agreed to join. But as the March 2015 membership deadline approached, several western countries – including Australia, Korea, and fourteen EU states – began actively negotiating membership. While supportive of a dedicated infrastructure bank, these governments had governance concerns with the initial Chinese proposal. These included a desire to ensure the AIIB would be commercially-oriented, have rules-based lending practices, be transparent in its operations, and uphold existing best practices through environmental and social safeguards. Attracting these countries as members would greatly improve the perceived legitimacy and technical capacity of the AIIB, but would require compromise on many elements of China's initial proposal.

Table 2: The AIIB's evolving membership structure

	AIIB MoU Signatories (October 2014)	AIIB Founding Signatories (March 2015)	First membership expansion (March 2017)
Regional members	Bangladesh, Brunei, Cambodia, China, India, Kazakhstan, Kuwait, Laos, Malaysia, Mongolia, Myanmar, Nepal, Oman, Pakistan, the Philippines, Qatar, Singapore, Sri Lanka, Thailand, Uzbekistan, Vietnam	Australia, Azerbaijan, Georgia, Indonesia, Iran, Israel, Jordan, Korea, Kyrgyzstan, Maldives, New Zealand, Russia, Saudi Arabia, Tajikistan, Turkey, UAE	Afghanistan, Armenia, Fiji, Hong Kong, Timor Leste
Non-regional members		Austria, Brazil, Denmark, Egypt, Finland, France, Georgia, Germany, Iceland, Italy, Luxembourg, Malta, Netherlands, Norway, Poland, Portugal, South Africa, Spain Sweden, Switzerland, United Kingdom	Belgium, Canada, Ethiopia, Hungary, Ireland, Peru, Republic of Sudan, Venezuela

Note: As of February 2017, Brazil, Kuwait, Malaysia, South Africa and Spain are still completing ratification.

The process for negotiating these compromises was complex, based on bilateral and plurilateral bargaining between the key players. However, when the final shape of the AIIB emerged by the end of 2015, it was clear that the western countries had a decisive impact on governance arrangements. The key compromises included the following:

- Non-regional members: The AIIB would ultimately include 29 members from outside the region, which received three of the twelve Board of Governors positions
- Commercial behaviour: The AIIB would only issue USD-denominated loans, which were to be made at commercial rather than concessional rates[37].
- International best practices: The AIIB developed a formal set of transparency and social safeguard policies[38]; and adopted an open and competitive procurement policy[39] which emphasised efficiency, value-for-money and transparency.
- Voting structure: China relinquished its claim to a formal veto power; and reduced its shareholding to 28.9 percent.

These governance compromises fundamentally altered the character of the AIIB. Far from being a China-controlled institution, it is now a broad-based MDB which draws members from a diverse range of countries within and without the region. It adopted governance practices and policies fundamentally like the other MDBs, emphasising transparency, competitive tendering and commercial loan activities. While China retains an informal veto[40], representative Boards of Governors and Directors ensure a wide range of voices will shape decision-making. These limit the ability of China to manipulate AIIB loan activities to advance its own strategic agendas. They have also gone a long way to assuaging many of the governance criticisms which were initially levelled at the bank.

WORKING WITH THE EXISTING DEVELOPMENT BANKS

Another common criticism of the AIIB was that it was little more than a China-backed competitor to the existing MDBs. Noting that many other MDBs already have expertise and established programs for infrastructure financing, critics have suggested the AIIB will duplicate the function of already-existing bodies, particularly the ADB and World Bank[41]. There are also fears the AIIB will compete with these banks for the few 'investment-ready' projects in the region, simply redistributing financing options rather than creating new infrastructure[42]. As The Economist has argued, if China genuinely wanted to close regional infrastructure gaps it might have just offered resources to the ADB's existing infrastructure programs, instead of the laborious task of creating a new MDB from scratch[43].

To allay these fears of competition, the AIIB has worked hard to build cooperative relations with the other MDBs. In a speech to the Asia Society Policy Institute in early 2016, Jin Liqun declared the AIIB would actively work in partnership with other MDBs by adopting a joint-venture strategy for project financing[44]. The AIIB moved quickly to sign cooperation agreements in its first year of operations. The first was an agreement with the World Bank in April 2016, where the two institutions agreed to co-finance projects under the supervision of World Bank policies. Similar MoUs were signed with the ADB, European Investment Bank (EIB) and European Bank for Reconstruction and Development (EBRD) in May[45]. Building on the expertise of these institutions, many of the AIIB's initial staff were drawn from the World Bank and ADB[46].

Indeed, the AIIB has largely worked with – and in many cases for – the other MDBs. During its first year of operation, the AIIB financed twelve infrastructure projects in its regional member economies (Table 3). Of these, only three relatively small projects were AIIB-led. In most cases the AIIB simply joined an existing project of the ADB, EBRD or World Bank as a minority financing partner. These were initiative and managed by the other MDBs, whose status as lead lender saw their governance and procurement policies applied. Even the AIIB's financial contribution was modest, which provided only 15 percent of the total cost of the projects. Thus far, the AIIB has largely loaned under policy the supervision of more established MDBs.

Table 3: AIIB funded projects, April 2016

Funding Date	Country	Name	Lead Lender/s	AIIB involved at outset?	Total Loans	AIIB Loans
Jun 2016	Bangladesh	Power distribution system upgrading	AIIB	Yes	262	165
Jun 2016	Indonesia	Slum upgrading project	WB	No	1743	216.5
Jun 2016	Pakistan	Shorkot-Khanewal M-4 Motorway upgrade	ADB	No	273	100
Jun 2016	Tajikistan	Dushanbe-Uzbekistan road improvement	EBRD	No	106	27.5
Sep 2016	Pakistan	Tarbela-5 Hydropower extension	WB	No	823	300
Sep 2016	Myanmar	Myingyan CCGT power plant	IFC, ADB	No	137	20
Dec 2016	Oman	Railway system preparation planning	AIIB	Yes	60	36
Dec 2016	Oman	Duqm Port commercial terminal	AIIB	Yes	353	265
Dec 2016	Azerbaijan	TANAP Pipeline	WB	No	8600	600
Mar 2017	Indonesia	Dam Operational Improvement and Safety	WB	No	300	125
Mar 2017	Indonesia	Regional Infrastructure Development Fund	WB	No	406	100
March 2017	Bangladesh	Natural Gas Infrastructure upgrade	ADB	No	453	60
Total					**13516**	**2015**

Source: AIIB (2017), 'Approved Projects', https://www.aiib.org/en/projects/approved/index.html

There is little evidence of Chinese 'strategic' behaviour in these early loan activities. In the main, the AIIB has simply piggy-backed on the work of others rather than developing its own projects. None are explicitly connected to the Chinese OBOR program, preferentially give contracts to Chinese suppliers, nor undermine or dilute the existing good governance practices. Indeed, while the AIIB relies on other MDBs for a supply of loan-ready projects, it has no capacity to be used as a tool for Chinese diplomatic manoeuvring. In part, this stems from the fact the AIIB is currently in a start-up phase; and as it builds capacity in coming years will likely begin to develop its own independent projects. But thus far, the AIIB has done little more than channel a small amount of additional capital into existing infrastructure financing mechanisms.

REVISING OR REINFORCING THE REGIONAL ECONOMIC ARCHITECTURE?

The AIIB which has emerged is a far cry from a strategic Chinese attempt to redraw the regional economic architecture. Rather, it closely conforms to existing practices. The AIIB is a broad-based multilateral institution, which has borrowed international governance practices and adopted a commercially-oriented approach to infrastructure financing. It has established cooperative rather than competitive relations with its peer MDBs, and currently relies on them to supply bankable projects. While China holds the largest voting share it does not control the bank, and its governance arrangements allow little scope for China to manipulate funding for strategic ends. Thus far, its principal impact has been to establish the world's first specialist infrastructure bank, and make a modest though much-needed addition to the regional pool of infrastructure financing.

It is also clear that China's AIIB strategy changed over time. The initial proposal looked very different, promising an institution under Chinese control and designed to advance its own economic and diplomatic agendas. But as a wider range of developed countries joined the negotiations in early 2015, external pressure was brought to bear on the design of governance arrangements. The Chinese government faced a choice: to persist with the initial model favouring its strategic interests at the cost of facing stiff foreign opposition, or adopt more transparent and commercial governance practices which would ensure it gained international legitimacy. In a welcome act of 'responsible leadership' the Chinese architects of the AIIB chose the latter.

Of course, it is still early days. The AIIB has so far issued $2 billion of loans, only a tiny fraction of its $100 billion subscribed capital. As it accumulates technical capacity and funding experience in coming years, it will surely begin financing infrastructure projects of its own. This will prove the test of the quality of the AIIB governance rules, and China's longer-term intentions for the bank. In the absence of the influence of MDB partners, will the AIIB continue its commitment to a transparent and commercial approach to infrastructure financing? And will China use its large shareholding, informal veto power and control of the bank presidency to revise its behaviour in years to come? Only time will tell. But the early indicators all suggest that China wants to contribute a transparent and legitimate institution to the Asian economic architecture. Given recent headwinds facing the region, this is a welcome development.

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