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AT THE CROSSROADS OF NEW GLOBAL GOVERNANCE CHINA'S AIIB AND THE WESTERN WORLD

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As emerging powers voice growing demands for reform of existing global governance structures, and Western powers try to resist the change, China's new infrastructure investment bank, the AIIB, could offer the opportunity to ease the impasse. New and old powers alike face today a crossroads. China should demonstrate that its initiative could contribute to global provisions of public goods, while positively integrating within the present system. Western powers, and above all the US, should comprehend that change *per se* is neither good nor bad, and that it may indeed be inevitable; therefore, they should closely examine new projects and pressure for them to uphold high standards of implementation and decision-making processes. The convergence of important actors on such a path could effectively become the first step towards more equally shared responsibilities on the global level, that is, a 'New Liberal Order'.

The paper concludes with a number of policy prescriptions for major actors, whose objective should be to find a viable way towards an enhanced and more balanced global governance.

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Introduction

Rising economic powers pose increasing challenges to the Washington Consensus and the corresponding ‘Western Liberal Order’. Bretton Woods institutions – notably the IMF – seem to stand on shaky ground. This has given rise to copious studies and analyses, but academic literature seems hardly able to keep up with the pace of announcements. The Asian Infrastructure Investment Bank (AIIB) is a crystal-clear example of such dynamics, also in view of its potential as a paradigm-shifting process.¹

China’s launch of the AIIB comes as no surprise, for existing multilateral institutions – including Western/Japanese-dominated international organizations such as the Asian Development Bank (ADB) – do not properly mirror today’s international balance of power. BRICS countries, and above all China, appear frustrated at the lack of significant reforms, and all the more so after the global financial crisis, which called into question the legitimacy and sustainability of the current international system. By launching their own initiatives, emerging countries seek to align global governance structures to changing international equilibria. Nonetheless, implications are far from unambiguous. Despite the much-voiced complementarity narrative,² emerging countries are yet to prove whether and how new institutions can effectively contribute to existing multilateral actors for the provision of “global public goods”,³ those very goods that enabled them to emerge in the first place.

In this context, the AIIB could mark a milestone on the path towards more balanced global governance, although the bumpy road to its establishment risks setting the international community on the wrong – or at least suboptimal – direction. First, the failure by the US to anticipate the Bank’s attractiveness to non-regional actors, coupled with domestic disagreement on how to face China’s rising ambitions on the global stage, proved to be nothing short of detrimental. Second, as European countries rushed to join the AIIB, it remains to be seen whether they will be able to substantially contribute to shaping the Bank’s model of governance, improving its political accountability and economic viability.⁴ Finally, the pressure building up around the project places China in the spotlight. It is

¹ See e.g. R. Biswas (2015), “Reshaping the Financial Architecture for Development Finance: The New Development Banks”, LSE Working Paper, 2/2015, in which the AIIB is still described as an exclusively Chinese initiative whose members are only Asian countries.

² Xinhua News (2015), “AIIB complementary to ADB, World Bank: China’s Finance Minister”, 31 March 2015; also see the Chinese Prime Minister Li Keqiang’s statements in China Daily (2015), “AIIB complementary to existing institutions”, 17 April 2015.

³ On “global public goods”, see A. Villafranca (2014), “Reforming the Global Economic Governance: ‘Public Goods’ and the Balance of Power”, ISPI Working Paper, 54.

⁴ The Guardian (2015), “Asian Infrastructure Investment Bank: France, Germany and Italy said to join”, 17 March 2015.

now Beijing's turn to prove the Bank's potential and its sincere objective of integrating it into the existing international framework.

Against such background, the first section of this paper reviews the Bank's creation process in the context of China's evolving international role. The second section evaluates the AIIB's viable prospects, offering a twofold analysis. From a practical standpoint, current plans for the Bank's structure shed some light on its future functioning, and allow a preliminary comparison with existing institutions – the World Bank and the ADB – and their long-standing 'best practices'. From a political perspective, the study will explore whether and to what extent the Bank may integrate into the West-led international liberal order, or pose a threat to it. To conclude, the paper outlines a number of policy prescriptions for major actors involved in the run-up of the AIIB, whose success – as Chinese President Xi Jinping puts it – will ultimately hinge upon its ability to provide “more public goods for the Asia-Pacific region and the world”.⁵

1. The AIIB: Not Out of the Blue...

The launch of the AIIB well depicts Beijing's new regional activism. Indeed, traditionally China was a rather passive international actor, but Deng Xiaoping's "keeping a low profile" has gradually been replaced by a more proactive attitude in the international arena⁶, though mainly focused on the country's immediate neighborhood.⁷ Building on these initial efforts, Xi Jinping now seems to be leading China towards even greater international engagement, as shown by initiatives such as the Xiangshan Forum, the Silk Road Economic Belt, and the 21st Century Maritime Silk Road.⁸ While China further expands the scope of its initiatives, the AIIB has become a case in point, possibly exceeding initial Chinese intentions aimed at establishing a regional investment bank. Recent accession of European countries to the AIIB may imply that the initiative cannot be reduced to yet another Chinese charm offensive and rather represents a more nuanced exercise of soft power (ever more US-style).

Indeed, the AIIB differs from China's other recent efforts in the fields of financing development and infrastructure. Neither the Chinese-only Silk Road Infrastructure Fund (\$40 bln, November 2014) nor the BRICS-only

⁵ Chinese President Xi Jinping declared that the AIIB specifically aimed at providing “more public goods for the Asia-Pacific and the world”, *China Daily*, 9 November 2014.

⁶ G. Wacker (2015), “The Irreversible Rise. A New Foreign Policy for a Stronger China”, in A. Amighini, A. Berkofsky (2015), *Xi's Policy Gambles: The Bumpy Road Ahead*, ISPI, p.65.

⁷ A prime example is the launch of the Shanghai Cooperation Organization in 2001.

⁸ C.C. Kuik (2015), “An Emerging 3rd Pillar in Asian Architecture? AIIB and Other China-led Initiatives”, *Asia Pacific Bulletin*, 305. On Silk Road-related initiatives, see W. Yiwei (2015), “China's 'New Silk Road': A Case Study in EU-China Relations”, in A. Amighini, A. Berkofsky (2015), *Xi's Policy Gambles: The Bumpy Road Ahead*, ISPI.

New Development Bank (\$50 bln, \$100 at full capacity, July 2014) could match the AIIB's potential impact. From an economic standpoint, Asian countries (including China and India) suffer from massive infrastructural gaps, which lower medium-to-long-term growth potential.⁹ ADB indicated in 2009 that Asia needs to invest 8 trillion on infrastructure between 2010 and 2020. The yearly investment need is about 750 billion per year and should be targeted to infrastructure capacity (68%) and for maintaining and replacing existing infrastructure (32%). Moreover, recent studies show that South Asia investment needs amount to \$1.7-\$2.5 trillion, which would require annual investments equal to 6.6%-10% of regional GDP between 2014 and 2020.¹⁰ But the Chinese recipe also include a political ingredient, as the Bank poses an implicit challenge to US-dominated institutions and, even more so, to the Japan-dominated ADB. European participation gave a helping hand as it contributed to changing the project both in scope and in aims.

This may have profound implications, given American opposition to the project in the context of its general resistance to reforming existing international institutions.¹¹ Indeed, by interpreting the AIIB as yet another unilateral project to expand Chinese influence against the international status quo, the US urged partner countries to disregard the initiative. However, within a month (likely following the usual behind-the-scenes negotiations) the UK joined the Bank; arguably, Mr Cameron seemed to temporarily forget the 'special relation' with the US as he deemed it more important to secure a role for London as an international hub for financial transactions in renminbi.¹² The move triggered a domino effect that led to the participation of most European

⁹ The IMF expects the "emerging and developing Asian" grouping to grow by 6.6% in 2015 and 6.4% in 2016. See IMF (2015), *World Economic Outlook*, April 2015, <http://www.imf.org/external/pubs/ft/weo/2015/01/pdf/text.pdf>. For recent studies on the Asian infrastructural gap, see D. Ding et al. (2014), "Future of Asia's Finance: How Can it Meet Challenges of Demographic Change and Infrastructure Needs?", IMF Working Paper, n. 14/126.

¹⁰ L.Andrés et al. (2014), "Infrastructure Gap in South Asia", World Bank Policy Research Working Paper, n. 7032.

¹¹ As 2014 closed with the US Congress still unable to pass the 2011 IMF reforms - which have already been approved by almost every other IMF member -, high-level officials at the IMF itself threatened to launch a "Plan B" in order to advance reforms without the US. Although this threat is void given the fact the the US currently exercises *de facto* veto power within the IMF, the threat has a considerable relevance on the international political stage; see AFP (2015), "IMF 'Plan B' on reforms could slash US power", 25 March 2015.

¹²HM Treasury (2014), Chancellor welcomes landmark agreement on London renminbi clearing and settlement arrangements. Indeed, China's new international efforts are concurrent to the steady increase in importance of the Chinese currency, the renminbi, in international trade.

<http://www.ft.com/intl/cms/s/3/e1a337d6-0ac6-11e5-98d3-00144feabdc0.html>

countries (including all European G7 members), plus South Korea, Australia and numerous others.¹³

Meanwhile, China fostered such domino effect by repeatedly stating its eagerness for multilateral negotiations regarding the Bank's articles of agreement. Initially, this may have simply amounted to a legitimation strategy. Conversely, however, the rapid rise in the number of founding members and the participation of many advanced economies offers an opportunity to enhance economic public goods provision in Asia and the world – namely, to scale-up countries' growth potential by fostering investment in infrastructure.

2. ...and in Search of a Fair Role

When the AIIB's articles are released, they will reveal much of the Bank's internal structure, both in terms of its foreseen governance/decision-making processes and with regard to investment selection and implementation monitoring. For the time being, *ex-ante* analysis may shed light on possible outcomes of ongoing negotiations, and especially on how and to what extent the Bank could fit within the current international system and interact with existing institutions. In this perspective, two key aspects of the AIIB will define its place and weight in the international context. Firstly, the Bank's governance structure and implementation practices will determine its success in contributing to the global provision of public goods. Secondly, the AIIB's relations with other multilateral economic institutions will shape its broader and perhaps more important influence over the current global economic governance predicament.

Political and diplomatic decisions by major actors – China, the US and European states – will steer the international community in one of two directions, determining the fate of future global governance.

2.1. Chinese Governance or Chinese Dominance?

When it comes to governance and decision-making processes within the new Bank, two Institutions stand out as major counterparts and precedent-setters for the AIIB: the Asian Development Bank (ADB) and the World Bank (WB).¹⁴ These institutions adopted decision-making rules that, while being quite different in some respects, tend to follow some standard practices:

¹³ As of June 2015, Japan remains ambiguously undecided and will likely wait for the Bank's establishment in late 2015 and its actual functioning before taking any final commitment.

¹⁴ We use the term WB to refer specifically to the International Bank for Reconstruction and Development, the main institution out of the five that make up the World Bank Group. Other institutions within the WB Group may be governed by different decision-making rules.

- Capital contributions from each member country predominantly determine voting shares assigned to that country, thus defining the relative political weight of each member in governing decisions. Each institution also puts in place a mechanism to redistribute some voting power to smaller members;
- Important decisions (such as admitting new members, increasing the capital stock, or deciding upon the collaboration with other international organizations), generally require a qualified majority. This has allowed the US to wield *de facto* veto power in the WB (as well as the IMF), while in the ADB, the veto power is effectively held by Japan and the US jointly (together they hold over 25% of total voting power, and important decisions require a 75% qualified majority);
- A restricted board controls the general operating of the institution and takes important decisions, while it delegates ordinary (non-sensitive) decisions to management. In the WB this is called the Executive Board and is composed of 25 members (out of 188 countries), while in the ADB it is the Board of Directors which is composed of 12 members (out of 67 countries)¹⁵.

As China launched the AIIB, increasingly trying to lure Western countries and US allies in the Asia-Pacific region, negotiations seemed to indicate the fact that China may be willing to give up veto power within the Bank. However, early in the negotiating process Chinese officials already started to backtrack, keeping all options open.¹⁶ Moreover, news surfaced that China is, in fact, actively operating to keep veto power,¹⁷ which would make the AIIB's decision-making process a stark example of China embracing a widely criticized practice to its own advantage.

Moreover, if rumors are to be believed, China might be even leaning towards an "unpaid, non-resident board of directors".¹⁸ This would be all the more troubling, given that international institutions traditionally

¹⁵ It is worth noting that, as mentioned above, there are, respectively, 25 and 12 board seats, grouped by constituencies, whereby only the largest shareholders have an exclusive Board seat and the others are grouped in constituencies of approximately similar voting power, with an alternation of the largest shareholders in one constituency in holding the Executive or Alternate Director position. So, strictly speaking, all shareholders are represented, but not all of them directly.

¹⁶ In late March, China's vice Finance Minister said that assumptions that "China had either sought or given up veto power in the AIIB are untrue", Yang C. (2015), "Bank to be based on collective negotiations: experts", Global Times, 25 March 2015.

¹⁷ M. Magnier (2015), "How China Plans to Run AIIB: Leaner, With Veto", Wall Street Journal, 8 June 2015.

¹⁸ *Ibidem*.

have a resident Board approving major decisions and thus representing an important direction-setting body of the institution.

2.2. 'Best practices': Not Only Words

Long-standing efforts in international development and infrastructure financing, as well as prolific academic research, have established an ample set of proven working standards. This body of work is often referred to as "best practices".¹⁹ Indeed, the AIIB will have to prove its worth vis-à-vis existing institutions and the international community with regard to upholding such high international standards.²⁰

Although Beijing seemingly accepted – if not actively pursued – this undertaking, Chinese intentions may diverge from Western expectations. In this regard, Chinese officials seem to send unclear signals. Most recently, Lou Jiwei, China's Minister of Finance, reportedly declared that he does not acknowledge "so-called best practices".²¹ The Chinese Vice-Minister of Finance echoed this in April, when he declared that "there is no 'best practice', only 'better practices'".²² While such statements might simply mean that the Chinese government does not want to be seen as bending the knee to well-established "Western" practices, while complying in practice, they could also be evidence of a political and diplomatic rift that might put the effectiveness of investments' selection by the Bank at risk.

Taking as "benchmark" current major institutions, the ADB and the WB have very similar safeguard policies. Their objective is to ensure that investment projects are conducted only after a thorough environmental impact assessment, and that project-affected people are compensated for adverse effects and relocated if they lose their residences or places of business. Both institutions also have a recourse process, whereby people adversely affected by projects funded by the multilateral Banks can seek redress if the Banks have not followed their policies (including consultation and public disclosure) during project preparation or implementation. Finally, both Banks have stringent procurement guidelines and exert ex-ante or ex-post controls, requiring rebidding or denying financing for components or entire projects which do not meet these requirements.

¹⁹ See especially: J. R. Barth et al. (2004). "Bank regulation and supervision: what works best?." *Journal of Financial Intermediation*, 13, 2, pp. 205-248; and W. Easterly, T. Pfitze (2008), "Where does the money go? Best and worst practices in foreign aid", *Journal of Economic Perspectives*, 22, 2, pp. 29-52.

²⁰ At the 2015 German-led G7, Western leaders called for the AIIB to uphold high standards.

²¹ P. Pennay (2015), "China says Western rules may not be best for AIIB", *Business Spectator*, 23 March 2015.

²² Zheng Y. (2015), "AIIB to operate in 'transparent way'", *China Daily*, 16 April 2015.

The ADB's evaluation program is carried out by its Independent Evaluation Department (IED). This body conducts systematic assessments of policies and programs, examining their design, implementation and results to determine relevance, efficiency, and sustainability.²³ The Department is an essential component of the ADB, and has proven to be independent and able to heavily criticize investment efforts. Additionally, the ADB discloses its top contractors/suppliers involved in goods, works, and related services contracts, in order to increase transparency and accountability towards officials, media, and the public. This system lies within a wider international "best practices framework". Indeed, the IED is based upon the Independent Evaluation Group (IEG), which acts as the independent evaluator of the four Banks of the World Bank Group. The IEG conducts project-level evaluations, portfolio reviews, country case studies, structured interviews and surveys of staff and stakeholders, and impact evaluations. Over the decades, the World Bank's independent evaluation system seems to have proven its worth in enhancing the viability, sustainability and effectiveness of financed projects.²⁴

In order to function properly, however, independent evaluators require a highly structured environment. Given Chinese President Xi Jinping's current focus against top-down, bureaucratic-heavy structures, 'Western best practices' could be discarded in favor of new 'Chinese standards'.²⁵ In such a scenario, the Bank could fall short of addressing issues arising from lighter controls of investments, leading to diminished, if not jeopardized, impact, potential corruption and disregard for environmental issues and social impacts of the projects it funds. Similarly, a strong stand against proven best practices could have political consequences, endangering cooperation between China and the West.

2.3. The Place of the New Bank on the Global Stage

The AIIB will confront the reality of international economic institutions as increasing demands from emerging countries underline the need to rework an unbalanced system. Should opposition grow between Western powers, especially the US, and emerging powers, especially China, the AIIB could become a venue for political clash. Down this path, were the US to oppose the Bank's new international role, and were China to use it

²³ ADB, *Independent Evaluation*, <http://www.adb.org/site/evaluation/methods-guidelines>.

²⁴ L. A. Ika et al. (2006), "Critical success factors for World Bank projects: An empirical investigation", *International Journal of Project Management*, 30, 1, pp. 105-116.

²⁶ Wilson Center (2015), "Do Western Values Threaten China? The Motives and Methods of Xi Jinping's Ideology Campaign", Conference: <http://www.wilsoncenter.org/event/do-western-values-threaten-china-the-motives-and-methods-xi-jinping%E2%80%99s-ideology-campaign>

solely to pursue foreign policy goals, contrasts would endanger the production of global public goods rather than enhance it.

For some time, Washington has resisted demands by emerging powers, as Congress continued to vote against the 2011 IMF reform – in spite of its all-but-revolutionary scope – and lobbied against internationalisation of the renminbi.²⁶ Despite this opposition, changes to the status quo may not be *per se* negative, and indeed continued opposition to possibly inevitable dynamics may endanger American global leadership.

Similarly, China should bear in mind the risk of letting down Western countries by turning the AIIB into a tool for unilateral foreign policy. Right now, then, China's priority should be to continue to integrate the new Bank into the existing international order, complementing it rather than undermining it. Direct confrontation would hinder China's cause for a more balanced system, and most likely fail to convince Western partners of the urgency of proceeding with the reform of the Bretton Woods institutions.

3. Conclusions: Two Paths after the Crossroads

Global public goods provision could benefit from the AIIB. The Bank may enhance regional and global growth potential, while fostering further cooperation between the main powers in the current international system and supporting positive reform of existing global and regional regimes. This is a unique chance, as dynamics surrounding the AIIB's first steps opened up an important window of opportunity. It could also create beneficial competition with more established multilateral development banks, spurring them to adopt additional reforms that would speed up their processes and enhance their efficiency and effectiveness

The changing economic and political balance of power is inevitably poised to affect the 'Western Liberal Order', and Bretton Woods institutions in particular. In this perspective, Western powers and emerging countries alike are today at a historical crossroads. One path leads to improved cooperation and enhanced support for global public goods, especially higher potential growth potential in the medium-to-long run. The other path leads to confrontation, discord, and the demise of a system that – despite its present shortcomings – has largely contributed to growth and prosperity since the end of the Second World War.

All in all, in terms of the AIIB's impact on global governance, Western actors should acknowledge that change *per se* is neither negative nor positive. At the same time, emerging powers should acknowledge that they share with advanced countries the responsibility for reshaping the

²⁶ R. H. Wade (2011), "Emerging world order? From multipolarity to multilateralism in the G20, the World Bank, and the IMF", *Politics & Society*, 39, 3, pp. 347-378.

current system without undermining it. The AIIB could facilitate the convergence of Chinese and Western narratives, setting a positive precedent for China-led initiatives. If well-coordinated, such efforts could set the international community in the right direction towards a ‘New Liberal Order’, which would see better calibrated international institutions and enhanced multilateral provision of global public goods.

In a narrower sense, China and Western actors should figure out how to deal with potential overlaps between the AIIB and other institutions. Here, cooperation could evolve on two levels. Horizontally, healthy competition among regional and global development banks, the ADB, the AIIB and potentially the New Development Bank, could improve the viability and feasibility of selected projects. Asian development banks could establish a cooperation model based on joint initiatives, particularly for cofinancing of regional megaprojects that require some risk diversification, combined with a functional diversification process. Particularly, the ADB may focus more on development projects (and achieving the MDG and the forthcoming Sustainable Development Goals), while the AIIB may contribute more to financing infrastructure needs.²⁷ Vertically, regional development banks could coordinate with the World Bank for qualitative investment diversification, pooling resources into larger projects or selecting a larger number of smaller projects.

In light of all this, the following are specific policy recommendations:

To China and the AIIB

- The AIIB should embrace a fair and equitable governance system and adopt established best practices, especially concerning environmental and social standards, investment monitoring, and independent evaluations, that have proven to be key to efficient implementation of development financing;
- As the main shareholder and dominant country in the AIIB, China should pursue positive integration of the Bank within the existing international framework (WB, ADB), and interact with major international institutions to improve multilateral production of global public goods – namely, supporting long-term economic growth;
- Following high standards of implementation and balanced internal governance policy, China should present the AIIB as a precedent-setting institution for broader reform of the current liberal order, aiming at gradual reforms from within and shying

²⁷ Indeed, rumors seem to point at such developments, see B. Otto (2015), “China-Led Bank to Focus on Big-Ticket Projects, Indonesia Says”, *The Wall Street Journal*, 10 April 2015.

away from direct confrontation.

To the US and the EU

- The US should acknowledge the growing importance of emerging powers and particularly its inevitable implications for the existing international economic institutions, i.e. the Bretton Woods system. In order to preserve its leading role on the global stage, the US should strive to avoid an isolationist temptation and embark on active collaboration to reform the current system. There is still room and need for the US to be back at the wheel and re-launch the reform of the global governance;
- European states are now offered an unprecedented opportunity. On the one hand, they bear the responsibility to show that they can help China gain a proper role in the international community, while defending well-established western values and best practices. On the other hand, they have to re-engage the US by intensifying contacts and opportunities both bilaterally (i.e. through the troublesome TTIP) and multilaterally (not only through existing Institutions but also exchanging views – and possibly find common ground – on the new ones);
- European states should commit to act together as much as possible as a cohesive bloc, so as to maximize their relevance by avoiding to “cherry-pick” Chinese offers solely based on national self-interest (e.g. by avoiding favouring certain projects just because of national economic objectives).