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China's AIIB challenges by Yun Sun

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Since Chinese President Xi Jinping proposed the establishment of an Asian Infrastructure Investment Bank (AIIB) during his Southeast Asia trip in October 2013, China has dedicated significant political, economic, and diplomatic effort to ensuring a successful launch of the financial institution. These efforts culminated in the signing of a Memorandum of Understanding on the establishment of AIIB by 21 Asian countries in October 2014. China has extended the deadline for countries to join as a founding member to March 31, 2015: six more countries have since joined and more are being lobbied, including Australia and South Korea. In discussions about AIIB outside China, most analysts have focused on the *external* implications of the bank, such as AIIB's challenge to the Bretton Woods system, China's desire to use AIIB to advance its strategic interests, and diplomatic skirmishes around the AIIB. However, more attention should be paid to the *internal* challenges posed by the running of the AIIB. Ensuring that the bank functions effectively may actually undercut China's ambitious goals.

First, the AIIB's identity is problematic for China. Early on, China emphasized the "$8 trillion gap in the Asian infrastructure market" to justify the need for AIIB, implying that the bank was necessary because of a lack of funding for these projects by institutions such as the World Bank (WB) and Asian Development Bank (ADB). The readiness to fill the gap strengthened the legitimacy of the Bank, especially among less developed countries in Asia.

But, Beijing has also emphasized that AIIB must be a multilateral commercial bank rather than a development aid agency. How then will AIIB balance the competing imperatives of funding infrastructure projects and getting paid back? Infrastructure projects have long funding cycles, low interest rates, and potential for waste and corruption. If AIIB aims to grant loans that other banks reject for commercial reasons, it would assume major risks, especially in less developed Asian countries with volatile domestic economies and unstable politics. China has a "resources for infrastructure" bilateral lending model where the recipient country repays Chinese loans with natural resources. Controversial and widely criticized as the model is, it would be politically unwise and economically risky to use it in the AIIB.

Some Chinese financial experts note that even if this concern is valid, China's goal for AIIB is not beyond reach; the bank simply needs to be cautious and commercially minded in its lending decisions. This has two implications. First, the scope of projects AIIB can support will be limited compared to China's ambitious claim to "fill the funding gap in the Asian infrastructure market." Second, AIIB loans may not be as generous as borrowing governments anticipate.

Moreover, Chinese officials have realized that it will be impossible for China to dominate AIIB's decision-making, even if China is the largest shareholder. According to Chinese Finance Minister Lou Jiwei, AIIB will have a three-tier management structure: a Board of Governors, a Board of Directors, and a President/Bank Management. The Board of Governors, as the highest decision-making body, will elect a non-resident Board of Directors, which will determine budgets and projects. Even if China has more members on the Boards than do other countries, it will not be able to treat AIIB as a Chinese policy bank and dictate decisions. Indeed, if China tries to push for unpopular loan or procurement decisions to advance its own economic or strategic agenda, an unbiased Board of Directors is likely to push back.

The multilateral nature of the AIIB has already become clear in the negotiations to establish the bank. The second chief negotiators' meeting on the establishment of the AIIB, held in Mumbai in late January 2015, was chaired by Chinese Vice Finance Minister Shi Yaobin and Indian Assistant Finance Minister Dinesh Sharma. While the AIIB preparatory group consists mostly of Chinese officials at this stage, it is understood in China that the eventual leadership and staffing of AIIB will be multinational and diverse.

The multilateral (and potentially democratic) decision-making process of the AIIB provides an explanation for diminishing enthusiasm within China about the Bank. This evolution is familiar. Frustrated by competition among BRICS countries over the BRICS' New Development Bank (NDB) funding structure, headquarters location, leadership composition, and other issues, China shifted its enthusiasm to the AIIB. However, after President Xi announced the set-up of the Silk Road Fund, a unilateral $40 billion endowment by China to fund regional infrastructure development, attention in China shifted to this new Fund. Indeed, some Chinese analysts have observed that the AIIB is taking much longer to create, and decision-making is more cumbersome than expected. In comparison, bilateral lending through such channels as the Silk Road Fund is easier to negotiate, quicker to implement, and more favorable to China's policy interests.

Standards and regulations governing the AIIB pose another dilemma, one between upholding high standards and making practical decisions. China has vowed that AIIB will deliver funding more efficiently and effectively than the WB and the ADB, but the Chinese also realized that high-quality rules and regulations are required for a variety of practical reasons. Good governance at the Bank guards against bad lending decisions, both for the sake of the Bank and for borrowers. High standards and vigorous oversight and management are preconditions for a good credit rating, which determines the viability of AIIB's international fundraising. (The ADB has an AAA rating.) Also, given the early international concerns regarding the AIIB's governance, transparency and accountability, any missteps will result in a significant loss of support and undermine the AIIB's credibility and legitimacy.

In China, there are disagreements about how vigorously China should pursue the governance and standards issue. The Ministry of Finance has called for a high-quality institution with first-class standards and operations. The senior leaders agree in principle. In fact, the head of the preparatory group, Jin Liqun, was a vice president of ADB. However, disagreements persist. Domestic interest groups counter that the AIIB should advance China's economic agenda, especially by promoting the export of Chinese products and services related to infrastructure development along the One Belt, One Road, Xi's most important regional development strategy. Some foreign policy strategists further contend that the AIIB should support China's strategic goals, with a result that countries disrespectful of China should receive less favorable consideration at AIIB. This debate will continue and the most likely result will be a compromise among different agendas.

Finally, and most importantly, there is not yet a firm plan for AIIB's fundraising model. At the early stage, China could use its foreign exchange reserves or issue special treasury bonds, but other member countries do not have the same financial flexibility. Some have speculated that China may have to lend money to some members for them to meet their initial pay-in. While intra-bank lending, private-public partnerships (PPPs), and Asia's large private savings have all been discussed as future fundraising options, the lack of a strong credit rating and a loan guarantor system severely inhibit the Bank's near-term capability.

Despite these challenges, Beijing will continue to pursue the AIIB as a high priority because the bank serves China's national interests: it expands Chinese influence, "democratizes" the international economic order, diversifies China's investment portfolio, promotes exports, and elevates the top leaders' prestige. Nevertheless, both Chinese and outside observers should have a more realistic assessment about how much earlier, ambitious expectations will be fulfilled.

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