



## **China and the Changing Asian Infrastructure Bank** by Yun Sun

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On June 29, China and 49 countries signed the Articles of Agreement (AOA) of the Asian Infrastructure Investment Bank (AIIB). The event signifies the successful establishment of the bank, moving the institution one step closer to the launch of operations before the end of 2015. There has been abundant research on China's motivation behind the AIIB and how Beijing intends to use the bank to serve its political, economic, and strategic agendas. How successful has China been in achieving those goals?

Close examination of China's evolving positions on the AIIB in 2015 shows how China's behavior can be shaped by collective efforts of the international community. The AIIB today is very different from the AIIB China envisioned before March 2015. This is reflected in a series of issues including the membership, capital contribution, veto power, and the linkage between AIIB and China's own economic agenda, as well as its governance and standard issues.

First, China's position on the AIIB's membership, especially on non-regional members, has undergone a significant shift. China had not planned for non-Asian countries to join in the early stage of the bank. As late as March 6 this year, China's finance minister was stating that "the Prospective Founding Membership is open to countries from the region first and applications from countries outside the region are not considered for now." Six days later, the UK submitted its application.

The enthusiasm of European countries to join the AIIB was a welcome surprise for China. Beijing rapidly adapted its position to welcome European countries as well as African and Latin American countries as Prospective Founding Members (PFMs). Beijing dropped the focus on Asia and replaced it with a distribution of capital shares between regional (75 percent) and non-regional (25 percent) members in exchange for enhanced international support.

Second, another significant change in China's approach to the bank is the nature of the AIIB as a multilateral development bank (MDB), which is very different from previous perceptions in China that the bank will either be China's aid agency or a commercial bank with a policy portfolio. The "aid" argument was that, since the majority of Bank members would be less-developed Asian countries and China needs to make a dominant contribution, the AIIB would essentially be just another channel for China to finance Asian infrastructure development. Financiers and finance officials

held the opposing view that the AIIB would be a market-oriented, profit-seeking commercial bank and that "China did not found the Bank to lose money, but to make a profit."

The final configuration of the AIIB avoids both extremes and reflects a middle of the road approach. As stipulated by the AOA, the AIIB will be a new MDB with China playing a large but not dominant role. In the view of many Chinese analysts, this differentiates the AIIB from both commercial banks and aid agencies, making it a "quasi-commercial bank" that has to generate returns.

The need to generate returns raises a key question regarding how the bank will balance funding infrastructure projects with practical considerations. Infrastructure development is known for long funding cycles, low interest rates, and the potential for waste and corruption. If the AIIB is to grant loans that other banks reject for good reasons, it would assume major risks. Especially in less-developed Asian countries with volatile domestic economies and unstable governments, how the recipient will repay the loans is a major question for any bank, including the AIIB.

Doubts from international society and developed country PFMs have forced China to face the inherent conflict between funding potentially loss-making projects and seeking profits. While most Chinese analysts agree on the risks in the Asian infrastructure market and the need for the AIIB to avoid them in its operation, a consensus emerged that China needed to abandon unrealistic hopes of funding all types of infrastructure projects while generating high returns. A senior researcher at the National Development and Reform Council (NDRC) offered perhaps the most authoritative opinion that "the operation of the AIIB will not seek high returns but rather to break even or earn minimal profits." This is echoed by private comments by Chinese finance officials that the AIIB will have to follow high financial standards despite the high demand, and that such standards will be more similar to those of the Asian Development Bank than anything else.

Concerns about China's veto power at the AIIB have been ameliorated. When the MOU was first signed in October 2014, China planned to contribute 50 percent of the bank's capital, which many assumed would translate into absolute veto power over issues that require a simple majority. However, as more countries became PFMs, China scaled back its capital share to about 30 percent and its voting rights to 26.06 percent. As the AOA stipulates, China will have veto power on issues that require a supermajority vote, such as the board, the president, the capital, as well as the major operational and financial policies. Retention of a veto reflects China's determination to retain control on key aspects of the bank.

Annoying as the veto power is for many, it may not be as threatening as it appears. Issues such as the acceptance of new members and ordinary loan decisions do not require a super

majority. And having a veto power to block things China doesn't want does not mean Beijing can make the board approve whatever it wants. Furthermore, how often China will exercise its veto power is unclear. It is highly unlikely that, on critical issues, the rest of the bank's members will unanimously oppose China and necessitate Beijing's use of its veto. Given China's advantaged position at the bank and the many other channels it has to influence decisions, Beijing may not need to use a veto at all. Meanwhile, there is a consensus among analysts that China must be cautious in exercising a unilateral veto, which will undermine China's efforts to promote the bank as a multilateral institution and reinforce suspicions and criticism. The bank will not be free from China's special influence and privileges, but international scrutiny and pressure, combined with China's concern for reputation and desire to gain recognition have a strong impact on China's actions.

What is more important is the extent to which China will use the AIIB to advance its national interests, such as export promotion. On this, only the future operations of the AIIB will tell, but there has been a debate in the Chinese policy community over the extent to which China should exploit the AIIB to pursue Beijing's economic goals. In an encouraging sign, one of China's most controversial goals in launching the AIIB – promoting exports to absorb excess capacity – has gradually disappeared from government statements and media reports. Promoting exports of Chinese goods to absorb excess capacity runs the risks of encouraging anti-dumping lawsuits, undermining Xi's economic restructuring campaign and, more importantly, undermining the AIIB's legitimacy and credibility. With more than 50 PFMs, it would be difficult and problematic for the AIIB to favor Chinese exports, which has been repeatedly acknowledged by Chinese officials.

Upholding standards and regulations governing the AIIB while making practical decisions is another conflict that Beijing has had to address in light of international criticism. While the AOA's reference on this issue is broad and firm, China's level of commitment is unprecedented. Beijing has promised that the AIIB will be "lean, clean, and green." The AOA made many pledges to honor international best practices on the environment, society, disclosure, procurement, debt sustainability, and oversight mechanism in line with the principles of transparency, openness, independence, and accountability. The bank's actual practices and operations will be the true arbiter of AIIB's performance in these areas. However, the education and concerns from the international community have shaped both China's behavior and the rules of the Bank.

The key reason that China adapted its positions and accepted an AIIB different from its earlier design is the role of the international community. The pivotal event was the decision by leading European economies in late March to join. Upon joining the Bank, the PFMs, including developed country members, were able to use their collective bargaining power to negotiate, guide, and shape the bank's AOA from within and enmesh China in a network of international norms and standards. China adapted its expectations and positions to meet changing realities. That flexibility, by itself, has been a positive development. Suspicion and opposition by countries

like the United States and Japan also played an important role in reining in China's selfish ambitions and making Beijing tread carefully when advocating for its own agendas. The world still perceives the AIIB as a challenge to the existing order, but the evidence suggests that the existing system also has the power to balance, influence, and shape that challenge, to check China's revolutionary ambitions, and to make China play by the rules.

The AIIB game is only beginning. A lot of the devils of the AOA lie in the details, yet such details are simply not available before the bank starts operation. The essential questions around the AIIB are embedded in its presumed Chinese identity and how China might use it as its own policy instrument. The world will continue to observe, critique, and shape its future.

*PacNet commentaries and responses represent the views of the respective authors. Alternative viewpoints are always welcomed.*