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The Asian Infrastructure Investment Bank

A New Multilateral Financial Institution or a Vehicle for China's Geostrategic Goals

Potential Economic Game Changer

Starting with a capital base of $100 billion – more than twice as large as the European Bank for Reconstruction and Development – the Asian Infrastructure Investment Bank has the potential to be a game changer in multilateral development finance.

Europe's Response Uncoordinated and Ad Hoc

14 EU Member States have signed up for the AIIB but not in a coordinated manner and without ensuring representation for European institutions such as the European Investment Bank or the European Commission.

A Vehicle for Geostrategic Interests

Early signs point to China using the vehicle not only for economic development but also for the pursuit of geostrategic interests, for example accelerating its plans for reviving the 'Silk Road' between Asia and Europe.

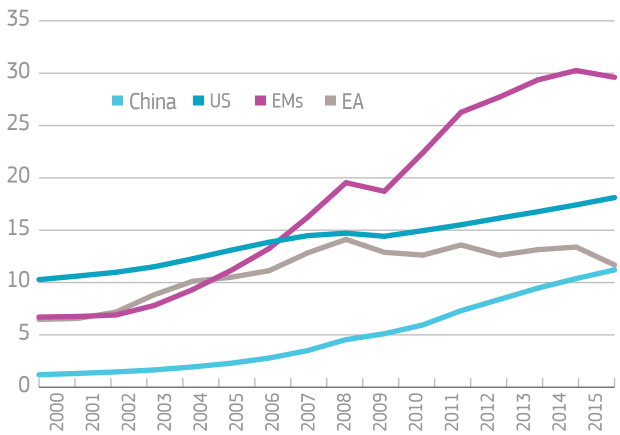
Not too Late to Ensure Cohesive and Coordinated EU Representation

The European Commission should lead in facilitating a loose coordination of EU Member States that are joining the AIIB, while also ensuring that European institutions are represented and an 'early warning mechanism' is launched to prevent slow and uncoordinated decision making in the future.

The creation of the Asian Infrastructure Investment Bank (AIIB) reflects the greater economic importance of Emerging Markets (EMs) in general and China in particular. The AIIB, together with other China-led initiatives, such as the New Development Bank (NDB) and Contingent Reserve Arrangement (CRA), has a combined capital base of $250 billion. This represents significant financial firepower roughly on par with the World Bank. The creation of these new institutions partly reflects China's growing dissatisfaction with the existing global multilateral financial frameworks where the country (rightly) feels underrepresented, since it is now the second largest national economy worldwide, similar in size to the entire euro area (see Graph 1). China, along with other emerging market economies, complains about its limited clout in bodies like the IMF, and over the slow pace of reform in addressing this imbalance.[1] Thus, the AIIB is only partially an economic vehicle,

Graph 1: Nominal Gross Domestic Product

Trillion US Dollars



Note: 2015 data are forecast.
Source: World Economic Outlook Database, IMF

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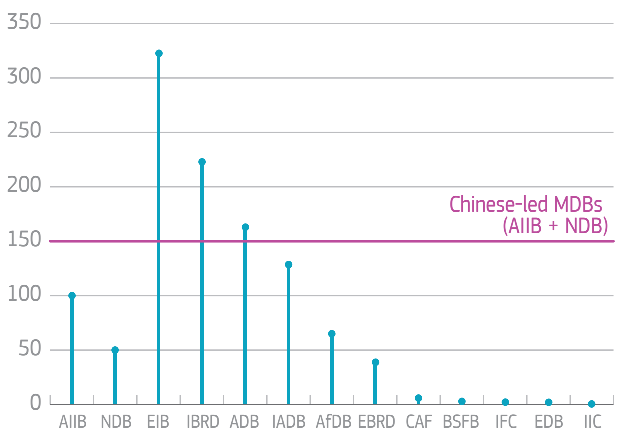
which, in reality, may be used for the pursuit of China's wider geo-political interests in the region and the world. This concern is reflected in the refusal, to date, of the United States and Japan to join the AIIB.

A New Major Player in the World of Multilateral Development Finance

The expected size of the AIIB's subscribed capital, at $100 billion, is roughly 30% that of the European Investment Bank (EIB) but is already more than twice that of the European Bank for Reconstruction and Development (EBRD). Most other multilateral development banks are well-established institutions, in some cases with several decades of existence and several rounds of capital increases. Tellingly, the subscribed capital of the AIIB and the New Development Bank (NDB) would make the joint capital of those two Chinese-led Multilateral Development Banks (MDBs) larger than all other global and regional MDBs, except for the EIB, the World Bank and the Asian Development Bank (see Graph 2).

Graph 2: Large Subscribed Capital For Chinese-Led MDBs in Relation to Other MDBs

Billion US Dollars



Sources: All the individual websites of the MDBs.

Based on the leverage of other Multilateral Development Banks, the AIIB's subscribed capital of $100 billion could support lending operations of between $200-500 billion, depending on how the institution raises funding and operates its lending business.[2] Adding the (China-led) NBD would increase these amounts by 50%. If the AIIB opts to increase its capital structure through international capital markets, the pace of building its loan portfolio is likely to be measured – probably three to five years – and will follow conservative practices to ensure the quality of loans. This would suggest that, in the medium term, lending totals would be closer to the lower-bound estimate of $200 billion. In addition, conservative lending practices will be necessary for a high credit rating, resulting in low-cost borrowing and, in turn, an expansion of its lending operations.

However, even in the slow-growing, three to five year scenario, a joint amount of $300 billion additional financing by the AIIB and the New Development Bank (NDB) would be equivalent to over 40% of the current stock of MDB loans to emerging markets (estimated at $693 billion) and over 90% of the current stock of MDB loans to Asian emerging markets (worth around $328 billion). Clearly, even in the most modest growth scenario, the AIIB – and therefore China – will quickly accelerate economic reach and global influence.

Chinese Domestic Development Banks Add Financial Firepower

Beyond the AIIB, China also has the largest domestic development banks (DDBs) among emerging markets. These DDBs have a joint capital base of over $100 billion, larger than most global multilateral development banks and worth almost 70% of the total capital base of the BRICS domestic development banks. Along with funds originating from the multilateral development banks, they are also used to finance external infrastructures by supporting the investments of Chinese companies abroad. For example, the Chinese 'Silk Road' initiative, which aims to create land and sea transport infrastructure linking Asia to Europe, will be largely financed via the China Development Bank (CDB). Not only is the CDB already the largest Chinese domestic development bank, but it is also due to receive a capital increase to the tune of $30 billion to support the 'Silk Road' initiative.

Table 1: Chinese DDBs compared to other DDBs

Billion US Dollars

Country	Entity	Total Capital	Total Assets
China	China Development Bank (CDB)	92	1,352
	Agricultural Development Bank of China	11	433
Other BRICS DDBs	BNDES (Brazil), VEB (Russia), IDBI (India), others	48	494
	Total	**151**	**2,280**

Sources: All the individual websites of the DDBs.

Making further use of its $3.7 trillion in hard currency reserves, China participates in several frameworks that provide very large amounts of international short-term, IMF-like liquidity. These include the $100 billion BRICS Contingent Reserve Arrangement, the $240 billion Chiang Mai initiative facility and a range of bilateral currency swap arrangements – mostly within the Asian region – with an estimated cumulative total of around $589 billion. **Adding up these three facilities implies an amount of financing close to the total that the IMF could provide to all emerging markets.**

The Asian Infrastructure Investment Bank: Key Facts and Figures

The Asian Infrastructure Investment Bank (AIIB) has a mandate to foster the development of infrastructure and other productive sectors on the Asian continent. Chinese President Xi Jinping announced its creation during a tour of Southeast Asia in **October 2013.** The initial subscribed capital of the AIIB is to be **$100 billion,*** and Beijing is to host its headquarters. Jin Liqun, a former Chinese Deputy Minister of Finance and previous Vice-President of the Asian Development Bank (ADB), was appointed as its Secretary-General. As of April 2015, there are 57 prospective founding members, including 14 EU Member States: Austria, Denmark, Finland, France, Germany, Italy, Luxembourg, Malta, the Netherlands, Poland, Portugal, Spain, Sweden and the United Kingdom. The IMF, World Bank and Asian Development Bank also indicated they would cooperate with the AIIB.

The creation of the AIIB follows other, similar Chinese-led initiatives to influence the global multilateral financial architecture. For instance, in July 2014, Brazil, Russia, India, China and South Africa – known as the BRICS countries – announced plans to create both a new multilateral development bank and a shared currency reserve pool. This body, dubbed the New Development Bank (NDB), will have a capital of $50 billion, with 20% contributed by China. Headquartered in Shanghai, the NDB has a similar mandate to the AIIB, namely to support infrastructure and sustainable development projects in BRICS countries and other emerging markets (EMs). The so-called Contingent Reserve Arrangement (CRA) will have a capital base of $100 billion – 41% of which is contributed by China – and tasked with cushioning short-term liquidity needs, a function similar to the IMF and the European Stability Mechanism in the euro area context.

* Concerning how this capital is to be allocated between prospective members, the discussion indicates that regional Asian members would have between 70-75% and non-regional members 30-25% of the total.

Timeline of Events in the Creation and Membership of AIIB

Source: AIIB Website; FT 26.03.2015

The Geopolitics of China's Economic Rise

Chinese actions are not restricted to the economic and financial spheres; they seem to have a clear geopolitical and geostrategic component. The plethora of initiatives that are ostensibly economic – AIIB, NDB, the 'Silk Road' – are clearly aimed, and overtly used, to increase global influence and political reach.

Part of this strategy can be seen as a reaction to repeated attempts to constrain China. The country's growing economic heft would seem to legitimately warrant a greater say in global affairs. But from the refusal to reform IMF voting rights to US efforts to discourage countries from joining the AIIB, attempts by individual countries to limit China's influence in global or regional bodies may end up being responsible for the creation of these 'parallel institutions' in the first place. In addition, China does not seem to aim for a complete overhaul or even derailment of the global financial governance system. The initiatives to date seem more designed to complement the existing financial architecture, possibly reflecting the realisation that China itself is one of the largest beneficiaries of the current global governance framework.

While on the surface this may seem reassuring, there is clearly a sense of nervousness which is shared by some of the EU's key allies. The United States and Japan, along with many EU Member States, see the AIIB as a potential rival to the World Bank or the Asian Development Bank. They also share concerns that the new institution will not uphold common standards of governance, as well as environmental and social protection. Early warning signs are that the AIIB has rejected Taiwan's application to join under its own name, making membership contingent on using a name that signals that the island belongs to China. According to Reuters, China is also proposing to give Asian nations a larger stake in the institution than to European ones – splitting a 70-75% quota between Asian countries based on their economic size a decision that would give China the largest vote.

The Role of the EU: A Look Back – and Forward

The AIIB case highlights the lack of a common strategy among EU Member States, as well as between the EU and its closest allies. The founding of the AIIB was announced as far back as autumn 2013, providing a comfortable time frame in which a more coordinated EU response could have been organised. In its absence, Member States decided largely on their own. The deadline for application to become a founding member was 31 March and has now passed.

Should European institutions decide to pursue membership nonetheless, there are examples of joint European Commission (EC) – European Investment Bank (EIB) participation in multilateral facilities. In the EBRD, for instance, the European Commission (on behalf of the EU) and the EIB each hold 3% of the subscribed capital. The two EU institutions jointly entered the EBRD in 1991, together with all the other (then) EU Member States.

The EIB typically finances its participation in other institutions with 'own resources' after the approval of the EIB Board. The process for the EC tends to be lengthier and more complex. Furthermore, the above mentioned EC's entry in the EBRD occurred before the ratification of the Lisbon Treaty. Given the post-Lisbon decision procedures, the May 2014 European Investment Fund (EIF) capital increase is probably more instructive as an example of how this could be done; there, the EC followed an accelerated co-decision procedure with the European Parliament and the Council, which took around five months.

In the case of a more limited participation by the EC, an equity investment via an existing external 'blending' facility would be an alternative (for example the Asian Investment Facility, managed by DG DEVCO). This avenue could be pursued in a matter of weeks, if there was agreement on substance on the side of the EC. Ahead of that, the EC might wish to convene a meeting with the current EU Member States that have applied for AIIB membership to discuss and align strategies.

An accession of EU institutions into the AIIB could be linked and leveraged with other EU initiatives – from the negotiation of China's participation in European Fund for Strategic Investment to an EU-China bilateral investment. An EU AIIB accession could also add clout to a discussion with traditional EU allies, like the US and Japan, about their own possible participation in that institution, which both partners are still contemplating.

Finally, in order to prevent the repetition of similar situations in the future, an 'early warning' mechanism could be formed to forewarn the EC of upcoming developments of strategic significance. In the particular case of the AIIB, many EU actors were informed but this seems not to have translated into political action: early decisions could have been taken and a more coordinated Europe-wide response organised.
A recommendation for the precise set-up of such an early warning mechanism is beyond the scope of this note.

The AIIB: Prelude for a New World Order?

Short of an unforeseen event, the emergence of China on the global stage is real and here to stay. The AIIB is only another manifestation of the country's quest to offer unparalleled financing capabilities (and increasingly also technical expertise) to help itself and other Asian countries develop infrastructure and wider economic capabilities. While on balance this should be welcome, the EU needs to be vigilant that good governance standards are respected. Europe should not inadvertently help to lay the grounds for a world in which Chinese or AIIB finance will be preferred in emerging markets because it comes without the economic prescriptions and economic and social standards upheld by other multilateral development banks, such as the World Bank.

In addition, Europe needs to keep a close eye on wider geopolitical and geostrategic trends, which suggest that instead of revising borders, China may use its economic and financial prowess to pursue its unilateral political and security interests. The seven 'Strategic Emerging Industries' initiative, which is part of the Chinese government's latest five-year plan, is worth mentioning in this regard. These industries – energy saving and environmental protection, new-generation information technology, biotechnology, high-end equipment manufacturing, new energy, new materials, and new-energy vehicles – lie squarely in the high valued-added segment of the global economy that has hitherto been dominated by Western powers. The fact that these industries were subsidised to the tune of several hundred billion US dollars between 2010 and 2015 (without being subject to state aid rules) can easily give them an unfair advantage, eroding Europe's competitive edge in these key sectors.

Notes

1. Planned quota reforms are set to double the IMF's resources to approximately $734.8 billion and hand more voting power to EMs. Building on the 2008 reforms, these so-called 14th IMF General Review of Quotas, when implemented, will also make China the third largest IMF quota holder. However, this reform has not yet come into effect because the US Congress has refused to ratify it.
2. This is an arbitrary estimation using the average of various leverage ratios of peer MDBs. Given the non-existing information available for the leverage strategies of the AIIB and the potential scale of its lending operations, this assessment is just a supposition.