26th Asian Shadow Financial Regulatory Committee Statement

June 24, 2015

The Asian Infrastructure Investment Bank: Its Role and Likely Impact

The Asian Infrastructure Investment Bank (AIIB) is a multilateral development bank proposed by the government of China. Its purpose is to provide finance to infrastructure projects in the Asia region. In doing so, it will compete with existing multilateral lenders in the region such as the Asian Development Bank (ADB) and to some extent the World Bank Group through its agencies such as the International Bank for Reconstruction and Development (IBRD). The Bank was proposed by China in 2013 and launched in Beijing in October 2014.

The AIIB is expected to be fully established by the end of 2015. As of June 15, 2015 there were 57 prospective founding members. With the support of these members and a policy of maintaining high financial strength (Loan-Capital ratio at par with the ADB), the AIIB will maintain an AAA-credit rating and so compete effectively for funding in international markets.

China's motivation for initiating the AIIB is linked to its current international position and its frustrations with delays by the US Congress to increase its IMF quota and voting rights. China is the world's second largest economy and has accumulated more than USD 4 trillion in foreign reserves, with an estimated two thirds held in USD denominated assets. China needs to diversify its international investment position away from predominantly US dollar reserve assets towards outward FDI. But the share of Chinese investment in the world remains small when compared to other major economies. In part the Asia Infrastructure Investment Bank (AIIB) initiative has the potential to help address these existing imbalances.

To see what role the AIIB could play, it is useful to note how its premises differ from those of the IMF and World Bank. The IMF and World Bank were set up after World War II, at the height of US military/political/economic power. This entrenched Western leadership and control of these organizations continues today. The AIIB is being set up by China while it is still a rising power. Some forecast that it will soon become dominant, but today, it still falls short along significant dimensions: GDP per capita, innovation, and "soft power". The governance structure proposed for the AIIB would ensure Asian dominance, but this is hardly contentious, given its objectives.

The World Bank and IMF began operations as the Cold War became the ideological lens through which international issues were generally viewed. Consequently, they promoted a distinctly Western viewpoint on macroeconomic and microeconomic policy, which they presented to developing economies. After the Cold War, the IMF and World Bank intensified their move toward neoliberalism; their promotion of free markets and minimal government to developing economies became known as the "Washington Consensus", after the location of their headquarters. The AIIB is being set up after China has achieved world recognition for its economic success. However, this success came from a mix of state leadership and market liberalization cooked up from many experiments in a distinctively Chinese kitchen. Consequently, the AIIB is unlikely to conform to or try to promote any particular ideology.

The IMF and World Bank promoted globalization and open markets. These policies were couched as benefitting all countries; they did not directly advance US national interests, although the US initially benefitted the most as the largest, most dynamic economy. By contrast, the AIIB will enhance globalization and world trade only insofar as it lowers transportation costs and enhances connectivity in and around Asia. However, economic reality ensures China the most benefits from the AIIB, whatever its governance structure.

The return on infrastructure investment depends on the value added by the trade that it enables; the highest returns to such investment in Asia will involve its dominant economy, China. One example is fast freight links between western China, where wages remain low, and its major export markets in Europe. Another is pipelines that link Chinese manufacturers to energy sources in Russia and the Middle East. Both in construction and operation, Asian infrastructure opens avenues for China's expansion through thinly-populated areas where its workers, manufactures and industrial skills have few competitors. Building Asian infrastructure will expand opportunities in heavy industries like cement, steel, earthmoving equipment and high-speed railways, where China has strong capabilities, but suffers from overcapacity.

Since China can thus garner most of the economic benefits of the AIIB simply by ensuring that the AIIB adopts economically-rational policies, it can afford to be relaxed about AIIB governance and strategy. For example, nominating a non-Chinese as AIIB president would be a low-cost gesture that would earn China significant goodwill and put US dominance of the IMF and World Bank in a poor light. China can also afford to anticipate US criticism by ensuring that the AIIB uphold "world standards" of governance, transparency, open bidding, labour standards and sustainability. Its deep foreign exchange reserves can always fund infrastructure investments that do not meet these standards via other vehicles, such as the China Development Bank, the Exim Bank and state-linked enterprises.

The AIIB may well be able to facilitate infrastructure funding more effectively than the ADB. The ADB appears to have trouble lending in amounts that would significantly reduce the infrastructure gap in the region, as evidenced by some countries' reluctance to borrow from the ADB, due in large part to its bureaucratic processes. Indeed, what may be preventing greater infrastructure financing in Asia currently is not the lack of finance per se. It may well be more to do with institutional weaknesses in recipient countries, e.g., a weak bureaucracy that is incapable of carrying out project studies and project design as easily as these are done in developed countries. PWC estimates $US8trillion in infrastructure investment will be required in Asia through to 2020 to maintain economic growth thereby delivering on the infrastructure promise. By far the bulk of this funding will have to come from the private sector with market forces driving the decision making process.

China could thus use the AIIB to showcase its arrival as a "responsible stakeholder" in the international system, while undercutting the US-backed institutions by addressing Third World critiques of these institutions. For example, it could avoid the World Bank tendency to bog projects down in conditionality and bureaucracy and to promote a narrow view of economic development. It could also move away from perceived current ADB practice by allocating money in ways that will help recipient countries strengthen the bureaucracy by providing assistance in areas such as feasibility studies, project development, bidding and awards processes, and design. If China makes these intelligent calculations of self-interest, as seems likely from its development of the AIIB to date, then the AIIB could open up significant opportunities for Western business.

Within Asia itself, Japan would potentially have the most to lose from the development of a successful AIIB and the AIIB is unquestionably a serious competitor to the Asian Development Bank (ADB). The AIIB has the potential to be more successful than the ADB. To begin with, the capital base of ADB is not thatlarge relative to the size of the infrastructure gap in the region as well as relative to that of the AIIB. It has a paid up capital of $US5.9billion compared with $US10billion for the AIIB. By comparison the World Bank's International Bank for Reconstruction and Development (IBRD) has a paid up capital of $US14billion. When comparing loan portfolios, the loan portfolio of the ADB currently stands at $US75billion compared to $US152billion for the IBRD and an estimated $US127billion for the AIIB. When looking at the breakdown of lending from the ADB, lending in 2014 totaled approximately $US23billion, of which approximately $US16billion was sovereign lending and $US7billion was non-sovereign lending. Of this amount less than $US0.5billion was allotted to lending for technical assistance. World Bank lending to East Asia and the Pacific in 2014 was $US6.3billion.

To enhance AIIB's potential to effectively carry out its mandate and deliver benefits to both China and countries in the region, the Committee makes the following recommendations:

1. Funding Gap:

Despite the increased commitment to lending from the supranational players since the announcement of the AIIB, there still remains a significant funding gap that can only be provided via intense collaboration with private sector institutions.

We recommend that the AIIB place a strong focus on engaging in Public Private Partnerships (PPP), in addition to traditional multilateral lending and proposed syndication with IBRD and ADB.

2. Governance and Financial Management:

There are existing priorities on the basis of sovereign membership.

It would be better if the governance and management structures of the AIIB could also reflect the ethnographic and religious diversity present in the region, while also conforming to international best practice.

3. Regional Financial Market Development:

Supranational lenders typically match asset and liability positions in terms of foreign exchange and interest rate risks, and hedge residual exposures using derivatives. The AIIB should encourage domestic financial market development by lending and borrowing in local currency and then managing any residual foreign exchange and interest rate risks centrally.

This activity could be linked in the medium to long term to the development of local and regional bond markets including Sukuk bonds and the privatization of government assets.

4. Technical Assistance and Knowledge Transfer:

Infrastructure projects are difficult to evaluate and operate due to their long horizons, large size and high risk. Some countries in the region lack the required capabilities to undertake these evaluations.

It is, therefore, essential for the AIIB to ensure a sufficient level of "soft skill" development through technical assistance and knowledge transfer.

5. Project Insurance:

Because infrastructure projects are difficult to evaluate and operate due to their long horizons, large size and high risk, it is not easy to establish the underlying market for insurance. Nonetheless, the lack of insurance is a key impediment to infrastructure investment.

We recommend that the AIIB investigate the feasibility of establishing a multilateral insurance agency to support infrastructure lending that is also linked to local insurance and Islamic markets.