Beijing’s Challenge to the Global Financial Architecture

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This year marks China’s emergence as a key player in the global financial architecture. It also marks a turning point for the architecture itself.

On 12 March 2015, the United Kingdom (UK) jolted governments and international financial institutions (IFIs) around the world by announcing that it intended to join the China-led Asian Infrastructure Investment Bank (AIIB). Prior to the announcement, the Western donors and Japan, following the lead of the United States, had withheld their support from the initiative. The general assumption was that the AIIB would start out as a modest venture involving mainly Asian and Middle Eastern countries.

The UK’s announcement triggered a spate of similar announcements by other major Western governments and virtually overnight turned the AIIB into a significant financial venture involving China, other emerging economies, and the developed economies. It was seen as a diplomatic triumph for Beijing, and a major setback for Washington, which opposed the bank.

The chain of events leading up to the Western countries’ announcements started last year. In July 2014, at a summit held in the Brazilian city of Fortaleza, the BRICS countries (Brazil, Russia, India, China and South Africa) announced the establishment of the New Development Bank (NDB) and the related Contingent Reserve Arrangement (CRA), which will both be based in Shanghai. Three months later, Chinese President Xi Jinping announced the establishment in Beijing of the AIIB. And in November, China announced the establishment of the bilateral Silk Road Fund.

These new institutions will be established this year. The AIIB will finance Asia’s rapidly expanding infrastructure, as will the Silk Road Fund. The need is enormous and cannot be met by the World Bank and the Asian Development Bank (ADB). The NDB is

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also intended to provide development finance, and the CRA will provide balance of payments support similar to that provided by the International Monetary Fund (IMF).

The establishment of new IFIs reflects China’s and other emerging economies’ frustration with the slow pace of reform of the Bretton Woods institutions, particularly the World Bank and the IMF. “China feels it can’t get anything done in the World Bank or the IMF, so it wants to set up its own World Bank that it can control itself,” one participant in the AIIB negotiations explained.²

The fact that the new IFIs will be based in China marks a significant shift from the current Washington-centric architecture. China has a major stake in their success. The capital base of the AIIB is expected to be about $100 billion, with China contributing half.³ The initial capital of the NDB has been set at $50 billion, with China contributing $10 billion, and its share in the $100 billion CRA currency pool is $41 billion. Together with the $40 billion Silk Road Fund, in the past year alone China has committed $141 billion to international financial initiatives.

How significant is China’s challenge? Many view the new banks as competing with the existing IFIs. The AIIB now also stands to divide the United States, Japan, and other Western countries. Will the new IFIs further fragment the financial architecture? Will they, as the United States has suggested, lead to a “race to the bottom” in lending standards? Or will China, the emerging economies, and the West find new ways to work together constructively?

A Mixed Response

The international response to China’s initiatives has been mixed. In public, China’s Asian neighbors have been positive, but in private several are wary of China’s motives. However, given the huge need for infrastructure in Asia, there is significant convergence between China’s interests and those of its neighbors.

China sounded out the Western donors’ interest to join the AIIB at the ADB’s annual meeting in May 2014. Following an initial lack of enthusiasm from the West, China focused its efforts on Asia and potential creditors in the Middle East. However, it also continued to lobby with Western governments.

The United States has been the most outspoken opponent of the AIIB. The U.S. Treasury Department has criticized the bank as both a deliberate effort by China to undercut the World Bank and the ADB and a tool to pull countries in Southeast Asia into its orbit. The United States lobbied hard with the countries being approached by China, including Australia, South Korea, the UK, and other European countries, not

³ To put this in perspective, the World Bank’s capital base is $223 billion, and the Asian Development Bank’s $163 billion.
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to become founding members. On the eve of the Fortaleza summit, U.S. Treasury representatives reportedly asked their BRICS counterparts how the United States could avert the establishment of the new banks. The question came too late.

Japan has also declined China’s invitation to join the AIIB. It questions the need to create a new bank, noting that its role would duplicate that of the ADB.

The response of the existing IFIs has also been mixed. Consistent with Tokyo’s position, ADB President Takehiko Nakao was initially lukewarm, describing the establishment of the AIIB as “understandable.” A terse official statement in October 2014 noted that once the AIIB is formally set up, the ADB would “consider appropriate collaboration in areas of common priorities.” More recently, Nakao has indicated that the ADB is sharing its experience with the new bank.

In contrast, World Bank President Jim Yong Kim has distanced himself from Washington’s stance. Kim recently indicated that the World Bank supports the AIIB, does not feel threatened by it, and has in fact “been working quite closely” to assist its Chinese colleagues in setting up the bank.

The AIIB is Moving Fast

By February 2015, twenty-seven countries had signed up to become founding members of the AIIB. In addition to China, these included ten countries from Southeast Asia (Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Vietnam), six from South Asia (Bangladesh, India, the Maldives, Nepal, Pakistan, and Sri Lanka), five from the Middle East (Jordan, Kuwait, Oman, Qatar, and Saudi Arabia), and Kazakhstan, Mongolia, Tajikistan and Uzbekistan. The only Organization of Economic Cooperation and Development (OECD) country to sign up was New Zealand.

The situation changed dramatically in March 2015, when the UK broke ranks with the United States and, citing mainly commercial reasons, announced that it wished to become a founding member. In response, in a rare public breach of their “special relationship,” the United States rebuked the UK for its lack of consultation with the Group of Seven, and “a trend of constant accommodation of China.”

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5 The author’s personal communication with government officials, September 2014.
Within days, France, Germany, and Italy followed the UK’s lead. By the end of March 2015, which marked the deadline for founding members to sign up, a total of forty-seven countries had applied for membership. These included twelve European countries (Austria, Denmark, Finland, Luxembourg, the Netherlands, Norway, Sweden and Switzerland, in addition to the four mentioned earlier) as well as Australia, Brazil, Egypt, Georgia, Kyrgyzstan, Russia, South Korea, and Turkey. More countries are expected to follow in due course. Japan, however, did not change its stance, reiterating its concerns about the bank’s management and indicating that for strategic reasons it wished to support the United States.\(^\text{11}\)

The AIIB is advancing faster than the BRICS-led initiatives and is expected to open its doors before the end of 2015. It differs from the NDB and CRA in two respects. First, China, as the lead shareholder, has led decision-making. China’s Ministry of Finance has set up a working group for the AIIB headed by Jin Liqun, a former vice president of the ADB and former chair of the supervisory board of China’s sovereign wealth fund. The group is working with the founding members to map out the bank’s structure and procedures. Second, China has been clear from the outset that the purpose of the AIIB is to finance infrastructure. This has kept the initiative focused.

In contrast, the purpose of the NDB is less clearly articulated, and decision-making among the BRICS countries has been slow. So far, they have reached agreement on the toughest issues: the capital base, voting rights, location, and presidency. China wanted a large capital base, while the smaller countries wanted to ensure an equal split of shares. Eventually, they agreed on a modest capital of $50 billion, with equal contributions and votes. China and India reportedly haggled over the location and presidency up to the eve of the Fortaleza summit. China prevailed, and they agreed to locate the NDB in Shanghai, with the first president coming from India.\(^\text{12}\)

**A Long List of Issues**

The establishment of new IFIs has raised a raft of concerns. First, many have questioned whether the world even needs new IFIs. Since the Bretton Woods institutions were conceived in 1944, the number of IFIs has proliferated.\(^\text{13}\) As Indian economist Ravi Kanbur points out, from a global perspective, it is inefficient “for new institutions to be created when the old ones could in principle be reformed to reflect new realities and economic weights.”\(^\text{14}\) Comprehensive reform of the current institutions might indeed have been the best option, but given the Western governments’ failure to reform the architecture, the question is moot.

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Second, the AIIB’s governance structures are still being worked out. Key issues include the management structure and distribution of seats on the board of directors. The major European countries have indicated that they want to be strongly represented in the bank, and South Korea is reported to have insisted on a senior management position as a condition for joining. The board of directors is a particular bone of contention. Contrary to the practice in most major IFIs, China is planning for the AIIB to have a non-resident board that would meet at regular intervals. Others, including Australia, are pushing for a full-time resident board that would provide “head-office scrutiny of investment decisions.”

Third, concerns have been raised about China’s dominance in the AIIB. It is likely that China will hold 50 percent of the shares and votes. This far exceeds the major voting shares in other IFIs. In the ADB, Japan and the United States each have 12.8 percent of the votes. In the Inter-American Development Bank (IDB), the United States holds 30 percent of the votes, and in the IMF and the World Bank, it holds 16.75 percent and 16.5 percent, respectively.

China’s large shareholding raises questions about the AIIB’s operational priorities. China’s largest policy bank, the China Development Bank, provides international loans as a quid pro quo for investments to secure raw materials and energy for China’s economy. The bilateral Silk Road Fund is intended to finance investment in transportation infrastructure throughout a “Silk Road Economic Belt” stretching across Central Asia to Europe, and a “21st Century Maritime Silk Road” across the South China Sea and the Indian Ocean to Africa and the Middle East. It will also finance China’s access to Central Asia’s energy sources. Some countries are concerned that the AIIB would play a similar role, rather than being genuinely multilateral.

Fourth, China is not a member of the OECD Development Assistance Committee, which tracks the flows of official development assistance. China stresses that it is itself a developing country and so defines its support for developing countries as south-south cooperation rather than development assistance, and does not coordinate with other donors. The Western members, on the other hand, are likely to push for the AIIB to participate in international mechanisms to coordinate development assistance, and to operate within international principles established by the IMF and the World Bank to

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ensure the sustainability of debt in borrowing countries.\textsuperscript{19}

**A Race to the Bottom?**

Most importantly, how will the new banks relate to existing IFIs and the policies and standards that guide their lending? There are notable instances of China using bilateral financing to undercut the World Bank and the IMF, such as when borrowers were unwilling to address policy or governance concerns raised by the IFIs.\textsuperscript{20} Some worry that the new banks might do the same.

The U.S. Treasury has expressed particular concern that the AIIB will fail to meet environmental standards, procurement requirements, and other safeguards applied by the World Bank and ADB, including those to prevent the forced removal of vulnerable populations from their lands. One senior U.S. official wondered, “How would the institution add value? How could the [AIIB] be structured so that it doesn’t undercut the standards with a race to the bottom?\textsuperscript{21} However, the fact that Western countries will now join the AIIB makes it more likely that the bank will adhere to standards similar to those applied by other IFIs.

Jin Liqun also dispels these concerns, stressing that “[w]e have confidence that we can build a bank to high international standards, and we will do our best in project evaluation, environment protection, local culture conservation, promoting continuous economic growth and improving people’s livelihood.”\textsuperscript{22} When Germany, France, and Italy decided to join the bank, they stressed that they wanted to establish “an institution that follows the best standards and policies in terms of governance, safeguards, debt and procurement policies.”\textsuperscript{23}

Market realities will also help to define the AIIB’s operations. In the early 2000s, China’s policy banks rapidly increased their exposure to high-risk borrowers such as Ukraine, Venezuela, and Zimbabwe. Several are now in arrears, with possible defaults on the horizon.\textsuperscript{24} Practical experience is teaching China’s banks the value of conducting due diligence and monitoring the financial housekeeping of their borrowers. As a result, China’s international lending has slowed markedly since 2012.\textsuperscript{25} These lessons are unlikely to be lost on the AIIB.


\textsuperscript{20} Stefan Halper, *The Beijing Consensus* (New York: Basic Books, 2010), 75-100.

\textsuperscript{21} Jane Perlez, “U.S. Opposing China’s Answer to World Bank.”


Finally, as a new bank, the AIIB will need to establish its credit rating. Like other IFIs, the AIIB will raise funds for its lending on the international capital markets. The rating agencies look not only at the IFIs’ financial profiles but also at their business profiles, including risk management policies, governance, and management expertise. To ensure that it can provide financing on competitive terms, the AIIB will need to manage its risk profile carefully. This further diminishes the likelihood of a race to the bottom.

Lessons from History

The challenges faced by the new IFIs are not new. The establishment of the regional development banks over half a century ago offers lessons on the underlying politics, the importance of multilateralism, and the benefits of networking widely when setting up a new bank.

Latin American countries proposed an inter-American bank as far back as 1889, but had to wait seventy years to overcome U.S. objections. Initially the U.S. administration rejected the idea because the bank would compete with private banks. In 1940, the Roosevelt administration endorsed a proposal for a regional bank, but Congress was opposed. In the 1950s, there were several proposals for a regional bank. Again, the United States opposed them, on the grounds that the region’s financing needs could be met through bilateral funding and the newly established World Bank. It was only when the United States shifted to supporting the establishment institutions led by Latin American countries that it was possible for them to set up the IDB in 1959.

When the African Development Bank was established in 1964, the two principal former colonial powers in the region, France and Great Britain, did not initially support the bank. Without their endorsement, the United States was unwilling to participate. As a result, the African bank was established with no participation from developed countries and a small capital base. It got off to a slow start and encountered difficulty in defining its role. In 1972, the bank set up a concessional fund with the participation of major Western donors and, in 1982, membership in the bank was opened to developed economies. This expanded its capital base and helped to align it more closely with the other IFIs.

The establishment of the ADB in 1966 was more inclusive. At the time, the region’s developing countries badly needed capital to meet their investment needs and were dissatisfied with the World Bank, which lent mainly to India and Pakistan and paid scant attention to the rest of the region. To address this financing gap, the Asian countries wanted a bank of their own. Japan, wanting to strengthen its engagement in the region, took the lead, while the United States, in an effort to counterbalance its

27 John White, *Regional Development Banks: A Study of Institutional Style* (St. Albans: Overseas Development Institute, 1970), 141-144.
28 Ibid., 91-110.
escalating role in Vietnam, willingly supported it. The other OECD countries were busy expanding their aid programs and were also pleased to join.

Other IFIs have also played an important role. In the late 1950s, the World Bank's president, Eugene Black, was openly hostile to the establishment of the IDB. He subsequently moderated his views on regional banks, and in 1965, President Lyndon Johnson appointed him as his special advisor on Southeast Asia. Black immediately contacted the consultative committee on the ADB. The ADB is to a significant extent modeled on the World Bank, which is attributed not only to Black's influence but also to the fact that key staff, including the ADB's first president Takeshi Watanabe, had previously served on the board of directors of the World Bank. 29

The regional development banks are well regarded and successful. They coordinate closely with other IFIs and adhere to established standards of governance, due diligence, and safeguards, at times taking the lead in setting standards. Their genuine multilateralism, with wide global membership, is a key ingredient in this success.

What Next?

Bretton Woods was based on an ambitious vision to raise the industrialized nations from the ruins of World War II. Under the guidance of the British economist John Maynard Keynes and the U.S. Treasury's Harry Dexter White, the Western allied powers agreed to open the global economy and established its key financial institutions. Seventy years later, the leading market economies lack a grand vision for the future of the financial architecture.

China and the other emerging economies are driven mainly by a desire to increase their global influence, and have for years been pushing for reform of the governance structures of Bretton Woods. They have now lost patience and are establishing their own IFIs, a situation which some feel could have been avoided. 30

The West should now move quickly to put the emerging economies on a more equal footing in the Bretton Woods institutions. This would help to ensure that they remain central to the architecture. A moderate reform of the IMF quotas was approved by other members in 2010, but has consistently been blocked by the U.S. Congress. As Scott Morris, a former U.S. Treasury official, observes, the United States now finds itself isolated and is paying the price for delaying reform in the IMF. 31

The most effective way to influence new international institutions is to participate in their establishment from the ground up. Drawing from the lessons of the other IFIs, the AIIB would benefit from the widest possible membership. The Western countries that have not yet joined should consider doing so without delay.

The situation is particularly challenging for the United States. Initially, the AIIB risked driving a wedge between China and the emerging economies, as a bloc, and the West. Now that major Western economies are joining the bank, the lingering risk is that divisions will emerge between these countries and those that remain outside, most notably the United States. Fred Bergsten of the Petersen Institute for International Economics describes U.S. opposition to the AIIB as a huge mistake and, reflecting a view shared by many, has called for the administration to reverse course and persuade Congress to provide the funds for a minority share.³²

China is challenging the global financial architecture, but the outcome depends on how the rest of the world responds to the challenge. Several developed market economies have now decided to join the AIIB and influence its development from the inside. In due course, they may also have an opportunity to join the BRICS institutions. The rapidly changing financial architecture reflects a major shift in global economic realities. Western countries should acknowledge the new realities and grasp the opportunity to find new ways to work with China and other emerging economies.

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