The Quest for Global Leadership

U.S.-China Competition in Multilateral Financial Institutions

Devesh Kapur

Abstract: As China emerges as a global power, it has showed great willingness to remake global development finance by setting up new multilateral financial institutions. The creation of those new institutions represents a marked departure from the existing multilateral development bank (MDB) system. For the first time, the new institutions do not depend on the financial largess of the West. To understand the circumstances that have led China to create these new institutions and the likely consequences, the article first examines the Bretton Woods institutional architecture that was created by the United States when it emerged as the principal global economic superpower in the aftermath of World War II. In the second part, it analyzes the competition between China and the United States in global financial governance given Beijing's expanding interests and Washington's declining influence. The article further explores in the third section new opportunities and challenges that the new financial institutions could bring to China, and finally proposes how China could better leverage those new institutions to play a transformative role in promoting its global leadership.

Devesh Kapur is Director, Center for the Advanced Study of India (CASI) and Professor of Political Science, University of Pennsylvania. His mailing address is 3600 Market Street Suite 560, Philadelphia PA 19104, U.S.A. He can also be reached at dkapur@upenn.edu.

Keywords: U.S.-China relations; leadership competition; multilateral financial institutions; global governance.

The emergence of China as a global economic power has been one of the single most transformative events of the early 21st century. While there is broad agreement that the sheer weight of China's economy will have global repercussions — whether in trade, finance, diplomacy, or security — there is little agreement on the precise nature of these changes as well as the pace of change. These debates are shaped by implicit or explicit assumptions about the type of power (or superpower) that China is or wants to be: is it a revisionist or revolutionary power? A precocious or premature power? A sure-footed or a tentative power? The answer to these questions depends in considerable part on the type of activity one looks at.

This article examines one facet of China's emergence as a global power: its willingness to remake global development finance by setting up new multilateral development banks (MDBs), namely the Asian Infrastructure Investment Bank (AIIB) and the New Development Bank (NDB or the "BRICS Bank"). The creation of new MDBs represents a marked departure from the prevailing MDB system, which featured a regional governments-centered governance structure and heavy dependence on the financial support of industrialized countries. Such financial dependence has provided industrialized countries, especially the United States, with an instrument to influence these institutions, although the degree has varied over time and across MDBs.

However, the new China-created institutions, for the first time, do not depend on the financial largess of the West. Their creation raises several questions. First, under what circumstance and considerations did China take the lead in establishing these two banks when there are many existing institutions purportedly doing the same thing? Second, why do the two banks focus on infrastructure building? Third, while clubs provide membership benefits they also have membership obligations. What is the cost-benefit calculus for countries to join these new institutions? Fourth, what are the key challenges that the new institutions will face? And finally, what are the implications for China's development and international status and the changing world order? To understand the circumstances that have led China to create these new MDBs and the likely consequences, the article first examines the Bretton Woods institutional architecture that was created

by the United States when it emerged as the principal global economic superpower in the aftermath of World War II.

Global Financial Governance in Transition

Embedded in the creation of the Bretton Woods institutions was an implicit bargain. Although as international organizations these institutions were meant to pool sovereignty, in practice, members acquiesced to a hegemonic system that accorded the United States special privileges to promote its interests while the United States in turn picked up a major part of the financial costs. Thus Bretton Woods linked unequal power to unequal burden sharing, with the United States providing the bulk of capital — both in the equity of the International Bank for Reconstruction and Development (IBRD), as well as access to the U.S. financial markets, and in that subsequently it became the largest provider of concessional finance in the form of the International Development Association (IDA). In return, the United States maintained firm control of the institution, not only through super-majority rules, managerial personnel (especially the President), and its location (in close proximity to the institutions of the United States government), but also with close links to three other sources of U.S. influence and “soft power”: Wall Street, American academia and civil society.

Since then, much has changed and the rise of “the rest” has led many to comment on the decline of U.S. influence. Indeed, pundits have been commenting on the decline of U.S. influence since the Smithsonian Agreement of 1971, when both the par value system and the gold exchange standard — the two central pillars of the Bretton Woods system — were terminated. But it is also the case that the underlying norms and decision-making procedures that were embedded in the International Monetary Fund (IMF) have persisted.¹ Since then, there have been multiple financial crises in the global system, such as the 1973 oil shocks, the 1980s Latin American debt crisis, the 1990s Mexican “tequila” crisis and the Asian Financial Crisis, and the 2008 Global Financial Crisis, each of which led to calls for global financial reforms and structural changes in the Bretton

¹Benjamin Cohen, “Bretton Woods System,” in R. J. Barry Jones (ed.), *Routledge Encyclopedia of International Political Economy, Volume 1* (London and New York: Routledge, 2001), pp. 95–102.

Woods institutions. During this entire period, while U.S. hegemony has ebbed and flowed, global financial governance has broadened — first to the Group of Seven (G7) and more recently to the Group of Twenty (G20) — but has not fundamentally transformed. However, the appearance of modest change at the surface have masked deeper currents that are upending traditional sources of development finance.

The 2008 global financial crisis marked a potential rupture. For the first time since Bretton Woods, the roots of the financial crisis were in the Western world and the near-meltdown of the financial sector in the United States had a deeply negative impact on the economies of the United States and Europe. More importantly, it raised major questions about the reputation and standing of the American model of capitalism at a time when troubling increases in inequality had already tarnished its reputation. As the United States struggled to cope with the crisis and Europe appeared to be flailing, the massive stimulus package put into place by the Chinese government not only boosted its own economy but the economies of its trading partners as well.

In the aftermath of the 2008 financial crisis, expectations were high that a crisis with causes (and much of the impacts) stemming from the West would transform global financial governance. There were indeed some changes: a more broad-based G20 leaders' forum was created; the dollar's global role came under considerable scrutiny; and there were a host of attempts to regulate international finance, institutionalized in the establishment of the Financial Stability Board (FSB). Yet it would be hard to say that the changes have been transformative. As one analysis put it,

...the G20 leaders forum contributed much less to the management of the crisis than advertised. The U.S. dollar remains unchallenged as the world's dominant international currency. The market-friendly nature of pre-crisis international financial regulation has been not overturned in a significant manner. And the FSB has strengthened the governance of international financial standards in only very modest ways.²

²Eric Helleiner, *The Status Quo Crisis: Global Financial Governance After the 2008 Meltdown* (Oxford: Oxford University Press, 2014), p. 2.

Table 1. Pre- and Post-2008 Financial Crisis GDP (Constant 2010 US\$).

	2000	2008	2015
United States	12.7	15	16.6
EU	14.8	17.4	17.9
China	2.2	5	8.9
India	0.8	1.4	2.3
Brazil	1.5	2.0	2.3
Russia	0.95	1.6	1.6

Source: World Bank.

The reasons for this limited change vary from the resilience of the U.S. economy, the malaise in key industrialized would-be challengers (especially Europe and Japan), and caution among large emerging market countries which — public protests of these countries notwithstanding — have not been able to even unite on a leader for either of the Bretton Woods institutions. The United States, which at one stage appeared at the brink of a financial meltdown, has seen its economy expand, albeit modestly. The economy of the European Union (EU) has barely grown despite Germany's robust performance, reflecting in part the Euro's decline against the dollar. Among Brazil, Russia, India, China and South Africa (the BRICS), Brazil's promising takeoff in the first decade of the 21st century has sputtered. And while Russia may flex its muscles, the collapse of oil prices and the ruble has meant that at least on global economic issues, Moscow will remain a middling player. Among the larger economies, India has seen the most promising growth (tripling in constant dollars since 2000), but on a base too small to be a serious challenger (see Table 1). Within the BRICS, China in 2015 accounted for two-thirds of the gross domestic product (GDP) of the group, 55 percent in Purchasing Power Parity (PPP) terms, a dominance which is likely to continue in the foreseeable future.

The 2008 global financial crisis has made China the sole prominent challenger to U.S. economic dominance.

The only conceivable challenger to U.S. dominance is China whose economy has grown by nearly 80 percent since 2008 (in constant 2010 dollars) and which emerged as the largest economy in PPP terms in 2015. While the burgeoning size of China's economy and exceptional growth rate certainly

matter, its structural features may be even more important. Annual gross savings of the Chinese economy — at over \$5 billion and 48 percent of GDP in 2015 — are about three-fourths of U.S. and EU savings combined. China's banking system is the world's largest by assets, more than the United States and Japan combined, and the world's three largest banks are also Chinese. As commentator Martin Wolf has argued, with a growth rate of 6 percent and incremental capital-output ratio (ICOR) of 6, there are still excess savings of 12 to 15 percent of GDP and the only place for it is to go abroad.³

Much like the United States seven decades ago, China is now attempting to transform its material power and massive current account surpluses into international influence and ideational power. Ideas need to be imbedded in institutions if they are to have lasting influence. The United States achieved that with the Bretton Woods institutions and later the World Trade Organization (WTO), while China is now attempting to leverage its growing economic prowess by creating new international financial institutions that can further its international and domestic goals.

China's Expanding Interests and the Declining U.S. Influence

In 2013, Chinese President Xi Jinping proposed the "Silk Road Economic Belt and the 21st Century Maritime Silk Road" — now known as the "One Belt, One Road (OBOR)" initiative — with the goal to physically connect China to 65 countries and 4.4 billion people across Eurasia and Southeast Asia through "hard" infrastructure projects. With funding requirements for the initiative projected at several trillion dollars over a decade, the Chinese government made major financial commitments, including a \$40 billion Silk Road Fund (SRF) whose investors include the China Investment Corporation⁴ and China's two leading policy banks (the Export-Import Bank of China and the China Development Bank); the AIIB with \$100 billion in authorized capital, with 20 percent paid-in and 80 percent callable; and the NDB with \$50 billion in authorized capital and \$10 billion

³Martin Wolf, "Chinese finance is storing up trouble for the rest of the world," *Financial Times*, April 4, 2017.

⁴The China Investment Corporation is the Country's Sovereign Wealth Fund. In 2014, it had around \$650 billion of assets, of which about \$200 billion was invested overseas.

paid-in and the remaining amount callable. In 2015, China announced a \$62 billion capital injection into the China Development Bank, the Export-Import Bank and debt-ridden Agricultural Bank of China, to prepare for increased lending in line with the OBOR initiative. And in May 2017, at the launch of the OBOR Forum for International Cooperation, President Xi announced a further commitment of \$100 billion including an RMB100 billion (US\$14.5 billion) contribution to China's SRF, RMB250 billion to the China Development Bank and RMB130 billion to the Export-Import Bank of China to support lending for infrastructure and industrial capacity.

More than three decades have passed since China rejoined the global order and multiple international regimes. Its expanding membership of international organizations emerged as sites of social learning as Chinese officials increasingly interacted with policymakers and representatives of other states. The multiple experiences shaped Beijing's socialization into international organizations. At one level, it highlighted how rising powers mimic, seek status and are persuaded by dominant powers to internalize the rules of the game.⁵ But "persuasion" can be a two-way road and the role could well be reversed when a rising power itself becomes a dominant power. Over time, China has become adept at pursuing its interests through the multilateral route. Following its accession to the WTO, China has already taken diplomatic steps to boost its presence in regional fora including the Asia-Pacific Economic Cooperation (APEC) forum, Association of Southeast Asian Nations (ASEAN) Regional Forum (ARF), ASEAN plus Three (APT) and the East Asia Summit (EAS). And to its west, it midwived the creation of the Shanghai Cooperation Organization (SCO) in 2001.

China's interests in creating these new institutions are multiple. It is facing massive industrial overcapacity that had grown to meet the seemingly insatiable domestic demand for infrastructure, which is now ebbing. This capacity can now be directed to meet overseas demand from large infrastructure projects. With growth slowing, expanding overseas has become increasingly important. The OBOR is projected to increase trade with the countries along the proposed routes — both overland from China to Central Asia and then into Europe, and through sea routes encompassing Southeast and South Asia, East Africa, and the Gulf — by \$2.5 trillion over

⁵Alastair Iain Johnston, *Social States: China in International Institutions, 1980–2000* (Princeton, New Jersey: Princeton University Press, 2007).

the next decade. With appetite for trade diminishing in the West, these markets offer better prospects for trade growth. The links to Eurasia should help reduce the economic disparity between the prosperous coastal provinces in South and East China and the less prosperous ones in central and western China, while at same time drawing Central Asia and Europe eastwards. With its massive foreign exchange reserves yielding meager returns (with about half in low-yielding U.S. Treasury bonds), the use of some of these funds in infrastructure projects promises higher yield, portfolio diversification and less reliance on the United States, albeit at the cost of being tied up in illiquid assets. Furthermore, since loans to borrowing countries will include RMB in the basket of currencies used to denominate and settle loans, it will facilitate the internationalization of China's currency and a changing role for Beijing from capital recipient to capital exporter.

Like the United States, China also sees trade as a way to advance its interests. However, while the United States has been attempting to do so through fiscally costless Free Trade Agreements (FTAs), at least until the advent of the Trump Presidency, China is seeking to do so through massive physical investments creating physical connectivity in corridors that link it with partners that have large trade imbalances with China, especially in manufactured goods. China is carrying the lion's share of the investment and, in return, would expect enhanced demand for its exporters and improved relations with countries along the belt and road.

The end of the Cold War marked the beginning of a new era in which U.S. investors did not need direct protection from their government any more. Rather, they relied on arbitration mechanisms, multilateral institutions (some of them strongly dominated by the United States), insurance mechanisms, and bilateral investment treaties (BITs).⁶ As official resources declined, the United States

By setting up new multilateral financial institutions, China aims to achieve multiple international and domestic goals.

⁶Noel Maurer, *The Empire Trap: The Rise and Fall of U.S. Intervention to Protect American Property Overseas, 1893–2013* (Princeton, New Jersey: Princeton University Press, 2013).

took two distinct paths. One was the private sector: Washington put pressure on countries to open up their capital accounts to foreign direct investment (FDI) and legal arrangements like BITs to protect U.S. investments abroad.⁷ The other route was trade, first with the WTO and then, as the institution became unwieldy and less susceptible to U.S. interests, through multilateral agreements such as the Transatlantic Trade and Investment Partnership (TTIP) and the Trans-Pacific Partnership (TPP), a trade agreement with Japan and ten other countries. The latter sought to move the global trade architecture toward new norms, with harmonized regulations at its center. Just as former U.S. President Barack Obama declared, “the world has changed. The rules are changing with it. The United States, not countries like China, should write them.”⁸ For its part, China has been attempting to do so through the creation of new multilateral institutions. In trade, it countered the TPP with the Regional Comprehensive Economic Partnership (RCEP), which would further reduce remaining tariffs across large parts of Asia, largely a continuation of existing models of trade agreements. The TPP is now history, a victim of the vicissitudes of U.S. politics, giving new impetus to the RCEP and China’s leadership in trade in the region.

In the postwar era, U.S. power in international institutions was firmly anchored in its ability and willingness to pay for it, both of which are much less the case today. Even the many bilateral agencies that facilitate investments by U.S. firms and advance an international economic agenda congruent with U.S. interests (such as the Foreign Commercial Service, United States Agency for International Development and the Overseas Private Investment Corporation) have modest heft compared to the past. The intensely partisan battles over the Export-Import Bank, the government-backed trade finance agency that has been under siege by conservative Republicans, is indicative of the U.S.’ inability to underwrite major investments — at a time when there are 85 export credit agencies of other countries vying with U.S. agencies, at least some of which have serious financial capabilities.

⁷The U.S. has signed 47 BITs with developing countries, of which 6 were not in force as of 2016.

⁸Barack Obama, “The TPP would let America, not China, lead the way on global trade,” *The Washington Post*, May 2, 2016.

Perhaps the most important reason for the declining U.S. influence has been a deep ideological distrust of the role of the state in many parts of American society, reflected in the country's politics. In international affairs, states are still the pre-eminent actors, and if they are enfeebled from within, they are unlikely to be externally robust. The domestic strength of the state in China and the United States have had fundamentally different trajectories in recent years, and hence it should not be surprising that their external positions have also followed different trajectories.

Implications of New Financial Institutions for China

Like all grand international initiatives, the OBOR and the new banks have substance and hype, self-interest and shared interests, and a development vision that is distinctively Chinese but is also a redux of older ideas. At the heart of this development vision is a conviction that physical connectivity is the pathway to prosperity, which is similar to the IBRD's initial vision of its role. The financing of infrastructure was the *raison d'être* of the World Bank in its early years. Between 1948 and 1961, nearly four-fifths of all World Bank lending to developing countries was to just two sectors: large-scale power and transport projects, reflecting a belief that infrastructure investments would act as catalysts for private investment in the productive sectors and hence constituted a sound development strategy. But there were three other inter-linked reasons behind this lending strategy of the World Bank in its early decades.

First, the World Bank perceived its own comparative advantage to lie in a combination of technical and financial assistance. Second, infrastructure projects via an operational tool, the specific investment project, were important in the bank's struggle to establish its own creditworthiness by providing "visibility, verifiability and apparent productivity" and projecting an "image of supervised, controlled, safe 'quality' lending," and hence soundness of its loan portfolio.⁹ Finally, the bank's predominant

⁹Devesh Kapur, John Lewis and Richard Webb, *The World Bank: Its First Half Century, Volume 1: History* (Washington D.C.: The Brookings Institution, 1997), p. 122.

shareholder, which also supplied much of the institution's senior management, had demonstrable strengths in infrastructure. In the 1950s, the United States boasted one of the world's best transportation, power and telecommunications infrastructures, was developing the world's largest highway system, and possessed unparalleled engineering and project execution capabilities.

Much has changed in the half-century since, including how we think about development, the aspirations of middle-income countries (or emerging markets) to have high quality infrastructure, and the erosion of the World Bank's technical expertise in "hard" infrastructure sectors — especially since the 1980s, epitomized in the cost overruns of its own headquarters. But most notably there has been a sea change in perceived global leadership in building high quality infrastructure in a cost-effective and timely fashion, from the United States a half-century ago to China today. In part, this has been the result of a sharp decline in U.S. infrastructure spending, as the inability to tax has put a brake on infrastructure expenditures.¹⁰

In 2009, the American Society of Civil Engineers (ASCE) gave the country's infrastructure a D-grade rating. In a speech to business leaders in 2014, then President Obama discussed the contrast between China and the United States in infrastructure

...If they need to build some things, they will build it. Over time, that wears away our advantage competitively. It's embarrassing...[they have] an authoritarian government that's not necessarily accountable. I understand we're not going to do that. They're able to build their ports, their airports, smart grid, and their air traffic control systems with that rapidity, and they are highly superior to ours. Over time, that is going to be a problem for us.¹¹

¹⁰For instance, U.S. spending on transportation infrastructure declined from a trillion dollars annually in the 1960s to a couple of hundred billion dollars in this decade (in constant 2014 dollars), even though the size of its economy grew more than three-fold during this period.

¹¹<http://thehill.com/homenews/administration/225875-obama-state-of-us-infrastructure-embarrassing>.

This is true in other Western countries as well, as public opposition to new infrastructure has resulted in ballooning costs and extensive delays.¹² Fiscal constraints and a broader societal fear of big projects have had spillover effects on the MDBs controlled by the shareholders from these countries. On the one hand, the costs and delays are seen as respecting the rights of project-affected people, which authoritarian countries presumably have to worry less about. On the other hand, questions about whether the protections given to affected populations should be appropriate to context (e.g., density of population, levels of income) and whether the sovereign or the MDB has the right to set standards are given short shrift. In many of these debates, the costs of building are visible and obvious, but the costs of not building are much less so.

For China, one prominent advantage in setting up these new institutions is that there is substantial accumulated knowledge regarding the functioning of the older generation of MDBs. Another advantage of the new institutions is that they do not have the legacy burdens of the older MDBs. In trying to adapt to a changing world, the World Bank has reorganized itself multiple times, and the result has been mainly a demoralized staff. Having succumbed to multiple pressure groups, the World Bank has an Inspection Panel, a Chief Ethics Officer and units (with Vice Presidents) for Internal Audit, Institutional Integrity and a substantial Independent

¹²To give some examples, in the UK, construction of the HS2 railway — regarded as vital to rebalance England's economy away from the southeast — has been held up by environmentalists, residents and taxpayers, and will take more than three times as long to construct as the Shanghai-Beijing high-speed railway. In the UK, the Welsh Assembly building cost over three times and the Scottish parliament almost ten times more than the original estimates. The first high-speed rail link, from London to the Kent coast, cost one-third more than its initially projected cost, the channel tunnel almost twice as much as expected. In the U.S., the Big Dig in Boston (home of many distinguished economists) took a quarter century to be finished (from the onset of its initial official planning in 1982). Originally scheduled to be completed in 1998 at an estimated cost of \$2.8 billion (in 1982 dollars) it cost \$14.6 billion (\$8.1 billion in 1982 dollars, or a near tripling of costs) and will ultimately cost \$22 billion, including interest. New York's subway is one of the most extensive systems in the world but is a testimony to what the U.S. could have done many decades past. After decades of little public investment in new lines, when the first phase of the new Second Avenue line (first conceived in 1919) was completed in end-2016, the cost of the 3.2 km line was \$1.26 billion per km. These figures are 5 to 10 times the costs of subway construction costs around the world.

Evaluation Office, all meant to protect the World Bank from its legions of detractors with costs, both time and money, passed onto borrowers. It has substantial recurring pension liabilities. In 2016, it allocated \$231 million for pension and other post-retirement benefits,¹³ an amount greater than the total administrative costs of the new institutions for many years to come. Perhaps its most crippling legacy has been the U.S. monopoly in selecting the institution's leadership, despite the poor performance of several of past U.S. nominees, which in turn has hobbled the institution's performance.¹⁴

The China-led new financial institutions can be leaner, cleaner and more efficient based on the experience of older generation of MDBs.

While these advantages opened up new opportunities in the design of the institutions, there are also new challenges. In the aftermath of World War II, the multilateral institutional architecture was a *tabula rasa*, whereas today the landscape is more crowded and there is much greater media scrutiny. In the earlier period, the world was politically a simpler place in many ways as global competition was largely between two ideological blocks. Today, the lines are more

blurred as relations between major powers are an admixture of cooperation and competition, which also creates more uncertainties.

Above all, how will these new institutions distinguish themselves from existing ones? At the heart of functioning international organizations is the pooling of sovereignty. Given how much China, Russia and India, in particular, are "sovereignty hawks," the new MDBs are more likely to evolve like the European Investment Bank (EIB) rather than the IBRD, i.e., more commercial and less prescriptive. Like the EIB, they both have non-resident boards. And like the EIB, their staffing will be smaller per unit lending. The absence of soft-loan windows in these institutions is also likely to insulate them from the demands created periodically by the replenishment exercises that have over time undermined the governance of the IBRD.

¹³"Management's Discussion & Analysis and Financial Statements," *World Bank Annual Report 2016*, June 30, 2016, Table 3.

¹⁴Devesh Kapur, "The World Bank's Recipe for Irrelevance," *Project Syndicate*, September 12, 2016.

The extent to which these new institutions will adhere to the same sorts of standards prevailing in the lending operations of the World Bank and other MDBs is an open question. Simply copying those standards raises questions on why create these institutions in the first place if they were simply clones? Nonetheless there do appear to be clear differences in these two new institutions (from the existing MDBs) in four specific ways. First, they will stay away from areas which require a policy dialogue with a borrowing country. As President of the NDB put it, “we don’t want to say: if this is what we want you to do, this is the policy you need to adopt and then we will lend. We don’t want to get into lending with strings attached.”¹⁵ Second, lending will emphasize sustainability. In the case of the NDB, about 60 percent of its lending will go to renewable energy projects. Third, when possible these institutions will raise funds in local currency and on-lend in local currency too, both of which would reduce the effective cost of finance as well as currency risk. And fourth, borrowers are treated as adults and the onus of oversight and standards is on the borrower rather than on the banks.

Next, how much additional resources will these institutions provide? An important question relates to the magnitude of the additional financial resources these new institutions will provide, relative to the costs of financing the institutions themselves. For China itself the costs are modest.¹⁶ For low-income countries with weak credit-worthiness, whether in Central Asia or Pakistan, the additional resources could be substantial. However, for larger countries like Brazil or India, the immediate financial benefits are not obvious.

Take India’s membership in the NDB and AIIB, for example. In their first decade, the equity of each of the two institutions will come from their paid-in capital, for the other source of equity — transfers from net income — will take a while as the loan portfolio gradually builds up. The paid-in capital of both institutions is identical: \$10 billion each. An

¹⁵“Ndb President: 60 Percent of Funding will be for Renewables,” November 21, 2016, http://www.ndb.int/president_desk/ndb-president-60-funding-will-renewables/.

¹⁶For China, the amounts involved are not particularly significant. For example, the AIIB is meant to have a capital of \$100 billion, of which China’s share is roughly 30 percent. Moreover, only 20 percent of this is paid-in (while the rest is callable). In China’s case, this amounts to around \$6 billion of paid-in capital, and even this would only be paid in over several years.

equity-to-loan ratio of 20 percent (the current World Bank floor) would yield lending of \$100 billion for AIIB and \$50 billion for NDB over the next decade. If India gets a third of all lending by the NDB and a sixth of all lending from the AIIB, unlikely as this might be, that amounts to approximately \$16 billion from the NDB and \$9 billion from the AIIB, for a total of \$25 billion additional funding. India's total cash subscriptions to the capital of the two institutions will be \$2 billion (NDB) + \$1.673 billion (AIIB) over the next five years for a total of \$3.673 billion. If this amount of capital was injected into India's stressed banking system, keeping a 10 percent Basle-like capital adequacy ratio could yield additional domestic bank lending of \$36 billion, without any currency risk. Hence, purely from a domestic investment perspective, over a ten-year horizon, the opportunity cost for India participating in the new MDBs is high and the benefits plausible but not too persuasive.

Of course, horizons should be longer. But given the relatively modest investment impact on India compared to the high opportunity costs of India's capital subscriptions, the political logic must be assumed to be compelling. The financial logic could be more credible if one assumes that lending by these institutions could lead to "crowding-in" of cofinancing by other investors, either other MDBs (such as the Asian Development Bank or World Bank) or by the principal Chinese policy banks. From early-2016 when the AIIB opened for business to April 2017, the AIIB has cofinanced five projects with the World Bank and is also working with the Asian Development Bank (ADB), apart from knowledge sharing, staff exchanges and analytical work. According to Jin Lique, President of the AIIB, closer links with existing MDBs fit with the AIIB's "vision of a new kind of internationalism."¹⁷ Besides, while Japan has not joined these institutions, the rivalry with China has led it to commit \$110 billion to a fund dedicated to Asian infrastructure projects.

Furthermore, the new institutions will be operating in a competitive landscape. Both the IBRD and the ADB have some of the lowest borrowing costs, the result of decades of market familiarity and brand reputation, strong balance sheets and a significant shareholding with AA rating (40 percent in the case of the IBRD). Nevertheless, achieving an AAA rating is

¹⁷James Kynge, "Finance will create new alliances across Asia," *The Financial Times*, May 3, 2017.

unlikely to occur overnight. Who will buy their bonds and at what price? Would their bonds be bought by their central banks with the People's Bank of China (PBOC), the purchaser of last resort given the larger stakes for China to ensure that these institutions succeed? In one respect, however, these institutions are differentiating their borrowings from their predecessors: developing local currency borrowing programs, which will reduce the effective cost of borrowings because of lower currency mismatch risk between the currency of borrowing, the currency of lending and the currency of project-related expenditures.

Finally, inter-relationships among and between the domestic Chinese development banks and the Chinese-led MDBs need to be well managed. China has put together a range of official instrumentalities for overseas investments. Two are multilateral: the AIIB and the NDB. And there are a range of sovereign instruments like the SRF, the China Investment Corporation, China Development Bank and the China Export-Import Bank, with the last two together lending more to governments and firms in developing countries than the World Bank. China's two global policy banks, the China Development Bank and the Export-Import Bank of China, are already the largest sources of energy finance for governments across the world. Since 2000, China's development banks have provided roughly \$160 billion across the globe and in 2016, these banks provided as much as \$43.2 billion in energy financing — close to triple the average annual energy lending of the World Bank and all the Western-backed multilateral development banks combined.¹⁸

Why China has so many instruments to achieve broadly similar goals is unclear. But the mix of sovereign and multilateral development finance institutions arguably gives China considerable flexibility, with the latter demonstrating that China respects international rules and wants to cooperate with other countries. On the other hand, while outsiders often presume that China acts in unison, in

China-led financial institutions are facing challenges from the changing political and economic landscape of the world.

¹⁸Kevin Gallagher, "China Global Energy Finance: A New Interactive Database," GEGI POLICY BRIEF 002, 03/2017. <https://www.bu.edu/pardeeschool/files/2017/03/China-Global-Energy.-Gallagher.Finaldraft-1.pdf>.

reality there are bureaucratic conflicts among the finance and foreign ministries and powerful state-owned enterprises (SOEs). How competition among them and with the new MDBs is managed and coordinated remains uncertain.

While the new institutions represent China's growing power, might they paradoxically constrain that power to some degree as well? International organizations (IOs) develop norms, rules and standards that increase the efficiency of collective activities and enhance the organizations' ability to build shared understandings and interests of states. But they can do so only if the IOs have a degree of independence, the ability to act with a degree of autonomy within defined spheres, and neutrality to ensure the legitimacy of specific actions.¹⁹ The international scrutiny on these organizations will be intense and consequently to ensure the success of these new institutions, China may well become more accepting of international norms, at least in the economic sphere. As an example, it is noteworthy that from the time that China decided to create these new institutions, it has been more willing to live up to the G20 communiqués than in the past (see Figure 1).

Fig. 1. G20 Final Compliance by Member, 2008–2015.

Source: G20 Information Center, University of Toronto.

¹⁹Kenneth W. Abbott and Duncan Snidal, "Why States Act Through Formal International Organizations," *The Journal of Conflict Resolution*, Vol. 42, No. 1 (1998), pp. 3–32.

Economic statecraft inevitably links domestic development and external policies. China's infrastructure diplomacy is similar to what the United States has sought to achieve through its trade and foreign investment agenda and Japan has sought to achieve through official development assistance (ODA). China's external policies are embedded in dominant interest groups and prevailing economic institutions that have long placed top priority on infrastructure development within the country. The same core agencies and domestic groups that have forged China's domestic development will also influence the country's infrastructure diplomacy in countries that are part of OBOR. With overseas Chinese investments accelerating, China will also seek to deploy the new MDBs to assist them, in ways analogous to what the United States and Japan have done.

Of course, China itself faces economic challenges as the very high investment and export-led growth rates begin to ebb. However, the momentum of three-and-half decades of the world's most extraordinary economic expansion will continue to have a massive overhang. China's dominance will both provide opportunities (in the large resources that it can potentially deploy) as well as challenges that are inevitable whenever there is a dominant power with the financial and institutional heft to influence other countries' policies.

The example of the United States and the World Bank is instructive. While designed to underpin the post-war order, the IBRD soon became one of America's instruments of the Cold War in its competition with the Soviet Union. The nature of global competition between China and the United States is similarly likely to influence the evolution of these new MDBs. A report from *China Review News* reporting China's think tank expert Wang Wen's²⁰ discussion of the first "Hundred People Forum on the One Belt One Road Initiative" is illustrative:

Sino-U.S. relations are gradually entering the first-ever global scale, three-dimensional competition of big countries. China's diplomacy is entering a new normal state of "bracing up and pressing ahead (奋发有为)." The major projects and planning for the "One Belt and One Road" initiatives are gradually entering the

²⁰Wang Wen is Executive President of the Chongyang Institute of Finance at the People's University of China (Renmin University).

implementation and promotion phase. China and the U.S. are in an unprecedented policy contact and interests collision world-wide at a number of different points, lines and surfaces. However, no matter how much the two countries do not want to see the China-U.S. competition intensify, that China and the U.S. are competing at the global level has become a basic fact. . .²¹

It should be emphasized that the legitimacy of these institutions will depend not just on how they perform but also on what happens in China itself. Critical commentary on the role of the World Bank and U.S. influence has focused on the latter's power to influence the organization, and in turn shape policies in developing countries. However, this gives the institution significantly more importance than is warranted. It is not the power to force but the legitimacy of success that has shaped the receptivity of countries' elites to particular paradigms and policies. The U.S. leadership was underpinned by a legitimacy that came with its achievements in a global war and an economic and political model that worked, but now both are strained. On the economic side, stagnant median incomes amidst spiraling inequality have tarnished the American dream. A host of visible political infirmities — from incarcerations rates to gun violence, to the predicament of African Americans and other marginalized social groups, and most recently the election of President Donald Trump — indicate that the American political model is less of the lodestar that it was in the 20th century.

Conclusion

The formations of the new multilateral banks, within the context of the massively ambitious OBOR, will undoubtedly have a major impact on infrastructure and economic development in many developing countries. But these institutions are more than just about development. They are the collateral put down by China in its bid for global leadership as the Western dominated global order led by the United States falters. Will the new China-dominated multilateral financial institutions provide cover for China's bilateral interests or will they constrain and reshape them? That remains to be seen.

²¹*China Review News*, August 11, 2015.

It is important to note what is distinctive and what is similar about the new Chinese-led MDBs. The sectoral focus of the new institutions is ironically very similar to the initial focus of the World Bank (after the initial reconstruction loans), namely infrastructure, especially energy and transport. The key difference, especially in the case of energy with an emphasis on renewables, is sustainability. In both cases, the underlying philosophy is hard-nosed pragmatism about core public investments-driving growth, where poverty reduction is not the principal goal but rather a desirable outcome of its infrastructure focus. As AIIB President Jin Liqun stated, "...look at China: a rising tide raises all the boats. If you read the articles of the AIIB, there is nothing about the overarching objectives of poverty reduction."²² Many of the problems plaguing the Western-controlled multilateral development banks began when they were viewed as "charitable" institutions. The latter view emerged strongly from the 1980s onwards, with Western non-governmental organizations (NGOs) and legislatures especially pushing this view through the soft loan windows, epitomized in the change in the World Bank's "overarching objective" to "sustainable poverty reduction" in the early-1990s.²³

While these new institutions are not chained to an artificial agenda — poverty reduction was never the overarching goal for China nor the United States when they were lower-income countries — it must also be remembered that the World Bank shifted its infrastructure focus when its limitations became glaring, either because poverty reduction was not happening or because poor policies and infructuous domestic politics within borrowing countries were undermining the infrastructure that had been created. There is an implicit assumption that infrastructure investments would drive growth which, in turn, would raise aggregate incomes and thereby reduce poverty. But what if growth does not take place or is too tepid to repay the debt? A case in point would be the growing risks facing the massive investments by China in Venezuela (estimated at \$50 billion), as that country's economy implodes and appears unable to meet its debt obligations.

²²James Kyngé, "AIIB chief unveils aim to rival lenders such as ADB and World Bank," *Financial Times*, March 3, 2017.

²³Devesh Kapur, John P. Lewis and Richard Webb, *The World Bank: Its First Half Century, Volume 1: History* (Washington D.C.: The Brookings Institution, 1997), p. 51.

Perhaps the single biggest difference between the U.S. goals and instruments in Bretton Woods (and over the next couple of decades) and the new institutional architecture being constructed by China is the absence of a monetary counterpart and relatedly — but critically — the weakness of China's national currency as a global reserve currency. The creation of the IMF and the use of the dollar as the principal reserve currency under the par value system, underpinned U.S. leadership. The various swap arrangements that China has initiated are a step in this direction, but a modest one nonetheless.²⁴ Crucially, despite the RMB's inclusion in the SDR basket, with a weight of 11 percent, one-third the share of the Euro and a quarter of the dollar, suggesting a belief that China's currency would become a significant force in the global economy, the RMB (Yuan) accounted for just over 1 percent of global foreign-exchange reserves as of the end of 2016, barely half of what countries keep even in Canadian dollars, and a tiny fraction of the \$1.6 trillion in foreign-exchange reserves held in Euros and \$5.1 trillion in U.S. dollars.²⁵ Furthermore, the use of the RMB in global trade dropped by nearly 30 percent in 2016 compared to 2015 (from 2.3 percent in 2015 to 1.7 percent) due to tighter capital controls and the dollar's strength.²⁶ While the RMB will undoubtedly become a more important international currency, it is likely to be a longer and rockier road than anticipated.

There are two additional factors that will shape outcomes. First, amidst all the talk of the massive demand for investments in Asia — estimated at \$26 trillion from 2016 to 2030, or \$1.7 trillion per year²⁷ — there is an implicit assumption that there are commensurate “bankable” projects. This assumption is likely to prove very optimistic. Most developing countries do not have the capacity to prepare too many projects rapidly, and face a range of implementation hurdles from land acquisition to environmental approvals to weak execution capabilities and poor governance.

²⁴China is a member of the Chiang Mai Initiative Multilateralization (CMIM) and since 2009 has initiated swap arrangements with 32 countries totaling nearly half trillion dollars. The goal of these swap arrangements is to support trade and investment and to promote the international use of RMB.

²⁵“IMF Releases Data on the Currency Composition of Foreign Exchange Reserves Including Holdings in Renminbi,” IMF Press Release No. 17/108, March 31, 2017.

²⁶<https://www.swift.com/our-solutions/compliance-and-shared-services/business-intelligence/renminbi/rmb-tracker>.

²⁷ADB, *Meeting Asia's Infrastructure Needs*, 2017, <http://dx.doi.org/10.22617/FLS168388-2>.

Second, China's principal competitors in Asia, the United States as well as Japan and India, are apprehensive about the perceived strategic implications, especially of OBOR with which the AIIB and NDB are embedded. Commentators in these countries view the new institutional architecture and investments planned through OBOR as exemplifying geoeconomics, or the "admixture of the logic of conflict and the methods of commerce."²⁸ These investments will undoubtedly do much to help developing countries, but also inevitably shift the global center of gravity towards China. How China allays concerns about the strategic implications is yet to be seen.

In international relations, hegemonic regime theorists have claimed that the hegemon, who enjoys a "preponderance of power," provides global stability by creating and enforcing "rule of the game." The Bretton Woods era was an example of a hegemon providing international public goods. However, the goods are more in the nature of club goods — open to those who join the club and agree to its rules — rather than pure public goods. And, of course, the creators of the clubs shape the rules that are congruent with their national interests. In case of Bretton Woods, the United States provided the liquidity that helped restart the engines of the global economy, and shouldered the burden of providing a stable foreign exchange regime, much needed capital via the Marshall plan as well as the IMF and World Bank, and absorbing large imports from around the world. In the process, it not only boosted its own economy and ushered the world economy to its most prosperous era for the following quarter century, but lifted its allies as well, sealing its status as the global hegemon and thereby meeting its principal foreign policy goal — containing the Soviet Union.

Another global crisis, the 2008 global financial crisis, provided an opportunity for emerging powers, China in particular, to create a new institutional architecture and provision its own set of public goods, focusing on connectivity and infrastructure. However, as explained above, its currency is unlikely to play as dominant a role as the U.S. dollar has played.

Climate change is the most promising area where China can play a transformative role through the new financial institutions.

²⁸Edward Luuwack, *Strategy: The Logic of War and Peace* (Cambridge, Massachusetts: Belknap Press, 1990), p. 17.

In trade its role will be more promising, but its emergence as a manufacturing colossus might well offer limited opportunities for lower-income countries to export manufactured goods to China. The very ambition of what Chinese President Xi Jinping has called “the project of the century” will require massive amounts of investments, which in turn would mean very large amounts of lending, borrowing and debt. Debtor-creditor relationships can unravel if the debt cannot be repaid, and the very friendships the money was meant to buttress can become fraught.

Furthermore, when there is complete agreement on principles, the practice can be more bumpy. Connectivity, for instance, may not always be viewed as a positive-sum game. As President Xi emphasized in his remarks at the launch of the OBOR forum in May 2017, “all countries should respect each other’s sovereignty, dignity and territorial integrity, each other’s development paths and social systems, and each other’s core interests and major concerns.”²⁹ However, Asia’s second largest and rapidly growing country, India, stayed away from the forum on the grounds that, “...No country can accept a project that ignores its core concerns on sovereignty and territorial integrity. . . .”³⁰ How does one respect everyone’s sovereignty, when there are disputes that contest a territory’s sovereignty itself?

There is, however, one area where China can indubitably play a transformative role: climate change, perhaps the single biggest threat facing humanity in this century. If the focus of the AIIB and NDB on sustainable development and renewable energy can be scaled up, it can help attenuate a global threat, further boost Chinese manufacturing leadership in green energy, and elevate China’s global leadership, especially given U.S. prevarications on this vital global issue under the Trump Presidency. If China can do so, it will have as transformative an impact as the U.S. leadership in Bretton Woods achieved more than seven decades ago.

²⁹“China-Pakistan Economic Corridor plan is OBOR flagship: Chinese President Xi Jinping,” *World News*, May 14, 2017, <https://article.wn.com/view/2017/05/14/ChinaPakistan.Economic.Corridor.plan.is.OBOR.flagship.Chines/>.

³⁰The differences arose in the context of the China-Pakistan Economic Corridor (CPEC), which aims to connect Pakistan’s southern Gwadar port city on the Arabian Sea and Kashgar in China’s far-western West Xinjiang province, but will pass through an area in Kashmir that is contested with India claiming that it has been illegally occupied by Pakistan and which Pakistan disputes.