The True Aim of China in Setting up the AIIB

Challenging the International Financial System or Securing Multilateral Credibility?

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The Chinese-initiative Asian Infrastructure Investment Bank (AIIB) has been generating many headlines on the economic front of late — not without justification given its impact, sizeable enough to blow a big hole in the international development financing order. There is a wide range of opinion regarding the true aim of China in taking the lead to establish the AIIB, such as challenging the international financial order, securing geopolitical influence, securing benefits for the national economy, and establishing a new facility to mediate between capital surplus countries and capital deficit countries.

My conclusion after examining the economic relationship between China and the rest of the world and various information coming out of China is that the true aim of China is both economic and diplomatic/political: the former to secure the multilateral creditworthiness that is unavailable to China on its own, the latter to "exercise cooperative influence" (neutralize the idea of "China as a threat" by providing other countries with economic benefits through economic channels).

New Silk Road Vision: "Stepped-up" Version of the Open-Door Policy

The Chinese initiative to establish the AIIB is founded on a regional development strategy: the "New Silk Road" strategy, or the "One Belt and One Road" initiative, consisting of the "Silk Road Economic Belt" and the "New Maritime Silk Road", both proposed by China.

In China it was the coastal region that mainly benefited from 30 years of opening up the domestic economy to the outside world, an open-door policy aimed at the developed economies. In the interior regions, infrastructure was slow to develop, and the open-door policy was limited in scope. Moreover, the neighboring countries there were largely developing countries, so expectations for attracting capital and technology appeared slim.

CHART 1

"One Belt and One Road" initiative & geographical coverage

Source: By author, with information from Vision and Actions on Jointly Building Silk Road Economic Belt and 21st-Century Maritime Silk Road by National Development and Reform Commission, Ministry of Foreign Affairs, and Ministry of Commerce of the People's Republic of China (2015)

But 30 years later, things have changed. With the accumulation of capital, technology and knowhow, and human resources, China has become an exporter of capital, technology, and production capacity, creating an environment where regions in the interior, even where they edge up against frontier states, can also become major players in the open-door movement. The One Belt and One Road initiative is a plan for regional cooperation in the development of infrastructure such as railroads, roads, air transport, telecommunications, and energy, as well as in such areas as cultural affairs, tourism, distribution and logistics, and finance.

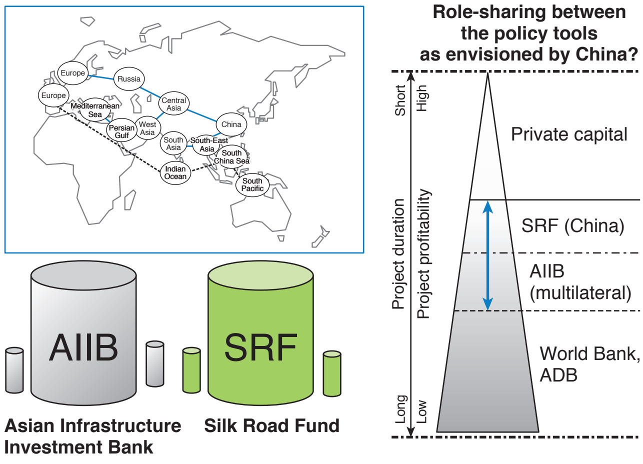
China's open-door policy going forward will place equal emphasis on attracting foreign investment and investing abroad, promoting economic integration with developed countries and emerging and developing economies simultaneously. This is a stepped-up version of its open-door policy, implemented through the One Belt and One Road initiative and other means.

AIIB as Tool for New Silk Road Strategy

China is promoting the establishment of two major institutions as the financial pillars of the New Silk Road strategy, as *Chart 2* shows (Xinhua: "Accelerate the Promotion of the Construction of the Silk Road Economic Belt and the 21st Century Maritime Silk Road"). One is the $40 billion Silk Road Fund (SRF), which was established solely by China. Zhou Xiaochuan, the governor of the People's Bank of China, which oversees the SRF, has stated that "the SRF is like a private equity fund, but its investments are more long-term. It does not solicit funds publicly, but both Chinese investors and foreign investors may

CHART 2

Respective roles of AIIB & SRF (prospective)



Source: Author

invest in it on a commercial basis. Unlike a multilateral institution, there are no concerns about balancing national coverages or political considerations, so it is relatively simple in terms of structure and decision-making. Once it is established, it will be managed on a commercial basis, and the establishment of subsidiary funds is expected." In short, the SRF should be understood as an investment fund aimed at generating profits as well as a convenient policy tool for China.

AIIB Viewed as "Semi-commercial"

The other is the AIIB, a regional development institution that will be established through intergovernmental cooperation. The Ministry of Finance is the government agency responsible for the AIIB in China. Finance Minister Lou Jiwei announced at the APEC Finance Ministers' Meeting in October 2014 that "the AIIB has a 'semi-commercial' nature. In its initial stage, it will provide sovereign loans for building infrastructure in sovereign states. In the future, it will establish trust funds through which it will invest in infrastructure in developing countries in Asia for projects that are unable to secure sovereign guarantees. The trust funds will work with sovereign wealth funds (SWF) and through public-private partnerships (PPP) with pension funds and private-sector investors." In other words, China sees the scope of investment by the AIIB as falling between investments of a purely commercial nature on the one hand and development finance with strongly nonprofit tendencies (World Bank, Asian Development Bank (ADB), etc.) on the other, and aimed at achieving a certain profitability.

In order to secure its "semi-commercial" nature, China emphasizes that the AIIB will focus on providing funds to transport and telecommunications infrastructure and industrial infrastructure, unlike the World Bank and ADB, whose main focus is on reducing poverty. This is a new perspective on development finance that seems to have taken a cue from "inclusive business", an approach that is receiving much attention in business circles. In fact, the AIIB is like an infrastructure version of inclusive business.

Securing Multilateral Credibility

Why does China feel compelled to go to all the trouble of promoting the AIIB, complete with the controversy that it has generated, when it has already set up the SRF as a convenient policy tool? In my view the true aim of China in taking the lead to establish the AIIB is to secure the multilateral credibility that cannot be obtained on its own. In other words, China must have decided that the benefits to be gained by a multilateral approach are potentially larger than the costs.

The reasons for this are the following.

1) Multilateral Influence Necessary to Make Host Countries Honor Contracts and Maintain Integrity of Loans

The geographical scope of AIIB investments is expected to be the emerging and developing economies in South-East Asia, South Asia, Central Asia, and North Africa and elsewhere that is covered by the One Belt and One Road initiative. Many of these countries have issues regarding their political stability, financial credibility (low credit ratings), and the structure and operation of their legal systems. Indeed, there are many cases where China has encountered regime change, labor strife, tax issues, social and environmental movements and the like and wound up having projects suspended (e.g. a dam in country M, a port and harbor development project in country S) and/or suffering heavy losses.

But China continues to stick to its principle of non-intervention (rejection of unilateralism), and is struggling under the lack of the means to compel these countries to honor contracts (the limits of bilateralism). It appears that one of the aims here is to meet the challenge of enforcing contracts and managing claims that it cannot resolve on its own by using the multilateral powers (the concentration of power through the larger number of stakeholders) of the AIIB (orientation towards multilateralism). In this sense, China shares the same concerns that Japan has expressed regarding the management of the claims of the AIIB. The two governments appear to be sharing a common direction.

2) Reinforcement by Multilateral Credibility Necessary to Upgrade Rating and Reduce Financing Costs

Chinese companies have made more than 20,000 foreign direct investments so far, but more than 90% of them are losing money according to one estimate ("Pitfalls in Overseas M&A" by Wang Wenli, *caixin.com*, Aug. 12, 2014). In the past, it had been difficult to calculate the costs and benefits of China's overseas investments because many of them were strategic investments, with the purpose of securing natural resources. But as investment shifted to securing overseas markets, interest in the profitability of the projects has grown. Particularly when the investment funds are being raised in the capital market, the financing costs become an issue. China's government funds alone cannot be depended on to make the One Belt and One Road initiative a reality; reaching out to the private financial market cannot be avoided. The investments envisioned in the One Belt and One Road initiative are infrastructure projects in the emerging and developing economies, but they cannot be expected to have high rates of return. Thus, minimizing financing costs is essential to the sustainability of the projects for the financing institutions. Surely, reducing the financing costs by improving the credit rating must be one of the aims of China in establishing the AIIB.

The long-term bonds issued by China and its state-owned financial institutions, the China Development Bank and the Export-Import Bank of the Republic of China, are all rated AA- by Standard & Poor's, while those issued by the World Bank and ADB are rated AAA. China's state-owned financing institutions are paying interest that is 0.45-0.65 (in dollars over five years) or 1.35 percentage points higher than the World Bank or ADB is paying when they raise funds from the financial market, according to rough comparisons in some reports ("How Can the Asian Infrastructure Investment Bank Secure a Triple-A Rating?" by Gao Bei et al., *Institute of World Economics and Politics, CASS*, Working Paper No. 2015W03). Broadly supported international financing institutions, such as the ADB, have a good chance of securing higher ratings than their main sponsors (Japanese sovereigns at AA-). That is why China is working so hard to secure a triple-A rating for the AIIB. Behind China's strong call to a wide range of countries including Japan and the United States to sign up is the economic motive of securing a triple-A rating.

Bringing a large number of countries to participate, including the United Kingdom, Germany, and Australia, will provide a major boost in securing a high rating for the AIIB, but the capital-to-assets ratio, liquidity, operational capabilities, profitability, risk management capabilities and the like are even more important determinants of ratings. Thus, the governance structure, credit management, sustainability and other issues that Japan and the US have raised are also the concerns of China. Here again, China is oriented in the same direction as Japan and the US.

Need to Influence without Arousing Fears of "China as a Threat"

The AIIB can be understood from the perspective of its economic rationale, as we have seen so far. But much of the analysis outside of China examines it from political and international relations angles, such as challenging the existing international financial system or enhancing geopolitical influence ("Making Bank: Why China's new infrastructure bank represents a challenge to the global order" by Ely Ratner, *Foreign Policy*, November 2014). But if the intent is to challenge the international financial order or to wield geopolitical influence, much of the objective can be achieved through a unilateral facility like the SRF, which China established by itself, making it hard to understand the reason why it must establish the multilateral AIIB. The Marshal Plan, which was aimed at the economic reconstruction of Europe and the attainment of geopolitical influence, was a unilateral program of the US.

The view of Erica Downs, a fellow at the Brookings Institution in Washington, DC, that "the multilateral AIIB could serve as a 'less threatening' alternative to bilateral mechanisms such as the China Development Bank and the Export-Import Bank of China [and that] China could use the AIIB to legitimize its economic expansion" ("U.S. Allies Split with Washington, Bank with China", *U.S.-China Economic and Security Review Commission*, March 2015) comes across as a more reasonable explanation to me. In other words, I see here the intention to globalize the Chinese economy through "collaborative influence" that spreads Chinese influence through the exercise of soft power, economic benefits through a multilateral channel, rather than an aggressive approach that poses an explicit challenge to the international financial order or an overt manifestation of political and diplomatic influence.

The rapid increase of Chinese investments and goods has given rise in Asia and Africa to charges of "threat" and "neocolonialism". Till now, China had adopted a strategy that swaps economic benefits with strategic benefits (neutralize charges of "China as a threat" by providing economic benefits) through FTAs and other bilateral means ("China's FTA Strategy and TPP" by Jianmin Jin, *Fujitsu Research Institute Topics No. 150*, September 2011).

Response to Japanese & American Concerns

Japan and the US have concerns regarding the AIIB as a Chinese initiative due to the behavior of Chinese investors, as they have gone in by themselves to developing countries and Africa and elsewhere ("U.S. Opposing China's Answer to World Bank" by Jane Perlez, *New York Times*, Oct. 10, 2014). Their concerns are focused on the institutional aspects of governance, such as the high proportion of Chinese capital and the lack of a standing board of governors, as well as the lending policies and conditions, such as easy credit standards and the lack of environmental and social considerations and counter-corruption measures.

Jin Liqun, secretary general of the Multilateral Interim Secretariat of the AIIB and seen as a candidate to head the institution, stated at an international conference after this year's National People's Congress that "China does not seek a majority stake, and China's share will inevitably decrease if the number of participating countries grows. The core principles of the AIIB are intelligent, clean, and green, and zero tolerance for corruption. We will build it up into an open, transparent, and inclusive international institution that has the highest levels of environmental and social standards based on international norms." China also emphasizes that it will undertake to reduce costs and enhance the efficiency of AIIB operations in order to avoid repeating the failures and mistakes of existing international financing institutions.

It remains to be seen whether the AIIB will be designed and operated as Jin Liqun claims, but we must admit that the effort is being made to meet the concerns of Japan and the US. In my opinion, this dovetails with the construction of healthy governance and equitable management that Japan and the US advocate.

Couldn't it be that the UK, Australia, and many other developed countries decided to join the AIIB because they have accepted China's attitude in this respect? These member countries will work to ensure the soundness of the institution from the inside, while, for now, Japan and the US will monitor it from the outside. The role that these countries play, resembling that of independent board members in corporations, will be useful in securing the soundness of the AIIB. My hope is that China's actions going forward will prove the fears of Japan, the US, and others to be unfounded. JS

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