

**THE EUROPEAN UNION AND THE CHINA-LED TRANSFORMATION OF  
GLOBAL ECONOMIC GOVERNANCE**



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## INTRODUCTION: CHINA'S MULTIPRONGED APPROACH

Since the inception of the Bretton Woods system in 1945, major fields of global economic governance have been essentially associated with a single international organisation or arrangement. Trade was governed by the General Agreement on Tariffs and Trade (GATT) and later the World Trade Organisation (WTO), whereas the International Monetary Fund has been a key point of reference in finance and monetary issues and the World Bank<sup>1</sup> played a similar role in development policy. A common characteristic of these institutions is that they were set up in the wake of World War II, and the distribution of influence among their members was, for the most part, reflective of mid-twentieth-century balance-of-power considerations. While these long-term institutional arrangements remain cemented, world affairs constantly change, raising the risk of a glaring mismatch between the way in which power is shared in these international institutions and the realities of global politics.

Especially in the last two decades, the structure of the global economy has been rapidly changing. The Group of Seven's (G7) share of global gross domestic product (GDP), for example, dropped from 45% in 2000 (in terms of purchasing power parity) to just 32% by 2014. By the same year, the share of the BRICS (Brazil, Russia, India, China and South Africa) had risen from 18% in 2003 to 30%.<sup>2</sup> Global governance structures have, however, largely failed to mirror such developments. Despite a handful of institutional reforms implemented in favour of emerging powers in the aftermath of the 2008/2009 financial crisis,<sup>3</sup> international financial institutions (IFIs) remain overall dominated by the United States, Europe and Japan. The resulting disillusionment of key emerging powers and notably China has translated into several concrete actions in recent years, and an unfolding transformation in global economic governance after decades of inaction.

In its quest for increased influence in the international – economic – system, China has pursued a multipronged approach of late, often in conjunction with its BRICS partners. Its strategy rests on four key pillars: integration, creation, reinvigoration and innovation.

First, China and its BRICS partners seek to better integrate into established structures and subsequently challenge orthodox policy choices from the inside. All BRICS countries, for example, are now part of the Financial Stability Board and the Basel Committee on Banking Supervision and have obtained increased governance influ-

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<sup>1</sup> Under the term World Bank, this paper refers to the International Development Association (IDA) (concessional window) and the International Bank for Reconstruction and Development (IBRD) (non-concessional window).

<sup>2</sup> The figures are based on the author's own calculation drawing on IMF data.

<sup>3</sup> Examples include the inclusion of all G20 members in the Financial Stability Board and the Basel Committee on Banking Supervision or the shifting of around 5% of voting power from developed to emerging and developing countries in the World Bank.

ence – however limited that may be – in the IMF and the World Bank. Following the entry into force, on 26 January 2016, of the reform package resulting from the IMF’s 14<sup>th</sup> General Review of Quotas,<sup>4</sup> emerging countries led by China now concentrate their efforts on obtaining further influence through the 15<sup>th</sup> Review.<sup>5</sup> Beijing’s increased activism in the Bretton Woods institutions has also been reflected by the senior management positions granted to the country.<sup>6</sup>

Second, in areas where the overhaul of existing bodies proves difficult, China has begun to back the creation of parallel institutions tailored to the needs of emerging powers. 2015 saw the birth of three such multilateral structures. The New Development Bank (NDB) and the Asian Infrastructure and Investment Bank (AIIB) will operate in parallel to the existing multilateral development banks (MDBs), whereas the Contingent Reserve Arrangement (CRA) is hoped to provide an alternative to the IMF by allowing the BRICS to – partially – escape the Fund’s conditionality model when facing liquidity issues. The five-member bloc is also considering setting up a joint credit-rating agency and an India-based NDB institute to identify projects for the Shanghai-based multilateral.<sup>7</sup>

Third, while not directly related to economic issues, the revitalisation of neglected organisations is also part of China’s strategy. Beijing’s intention of reviving the Conference on Interaction and Confidence Building Measures in Asia (CICA) – a marginal security network covering the bulk of Asia but not Japan – during its presidency (2014-2016) is, for example, an explicit attempt to reduce Asia’s reliance on external forces in the security realm, but also to respond to the increasing terrorist threat in Western China.

Finally, China is also seeking to carve out a greater role for itself in the international system through the creation of multilateral networks that do not build on any existing fora. Two of the key schemes falling in this category include the One Belt, One Road (OBOR) initiative<sup>8</sup> and the somewhat less-known China-Central and Eastern Europe framework (CCEE, or 16+1). Launched in Warsaw in 2012, the latter was also equipped with an investment fund worth \$3 billion to help channel funding for projects in Central and Eastern Europe.

This Egmont Paper is part of a double volume focusing on the rise of parallel structures in global economic governance. The set of papers aims to compare the newly

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<sup>4</sup> The Fund’s quota resources were doubled and 6% of the overall quota shares were shifted from developed to developing and emerging countries.

<sup>5</sup> Interview with a Brussels-based Chinese diplomat.

<sup>6</sup> In July 2011, Zhu Min was appointed as one of the four IMF Deputy Managing Directors and became the first Chinese citizen to take over such a senior management position. Justin Lifu Yin was appointed in February 2008 as the World Bank’s Chief Economist and Senior Vice President and became the first Chinese national to hold this position.

<sup>7</sup> *Economic Times*, ‘BRICS may set up ratings agency for emerging markets in October meeting’, 16 May 2016.

<sup>8</sup> A development framework promoting improved infrastructure connectivity between China, Central Asia and Europe.



created China and BRICS-backed bodies to the established institutions they seek to mirror while also discovering various paths the EU may follow in its policy towards them. This first volume will concentrate on the transformation of the international development policy landscape and examine the innovations, challenges and opportunities characterising the two multilateral development institutions created last year: the NDB and the AIIB. The second volume, to be published in the second part of this year, will turn to the field of international finance and monetary policy, carrying out a similar analysis with regard to the CRA and the prospective BRICS-owned credit rating agency.

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# NEW DEVELOPMENT BANK: BREAKING THE ICE

The 6<sup>th</sup> BRICS summit in the Brazilian city of Fortaleza in July 2014 marked a watershed in the co-operation between the five countries. After an initial meeting of the BRICS foreign ministers on the margins of the United Nations General Assembly (UNGA) in September 2006, their collaboration was for nearly a decade constrained to the release of joint declarations and the formulation of common positions on various international affairs, which were prepared through an increasingly dense set of co-ordination mechanisms. With the BRICS leaders signing the Agreement on the New Development Bank on 15 July 2014, the BRICS format finally acquired institutional qualities. Having been ratified by all BRICS parliaments, the agreement entered into force in July 2015, coinciding with the inaugural meeting of its board of governors on 7 July in Moscow and the 7<sup>th</sup> BRICS summit in Ufa, Russia on 8-9 July. After its election by the board of governors in July 2015, the bank's board of directors was convened for the first time in January 2016 and went on to approve a significant number of policies and procedures for all functional areas of the institution. The next important step in the bank's establishment consisted of the finalisation of its headquarters agreement with the Chinese government and the city of Shanghai on 27 February 2016. The NDB, whose first regional office will be in South Africa,<sup>10</sup> is led by former ICICI Bank<sup>11</sup> managing director K. V. Kamath (India).

The BRICS-led institution is the first MDB since the creation of the European Bank for Reconstruction and Development (EBRD) in 1991. It aims to 'mobilise resources for infrastructure and sustainable development projects in BRICS and other emerging market economies and developing countries' through the provision of loans, guarantees, technical assistance and equity investment.<sup>12</sup> The NDB responds to the widely shared recognition that the existing set of financial schemes are inadequate to meet investment needs in infrastructure projects – a central pillar of development from the perspective of most developing countries. The institution has been heralded as complementary to the traditional multilateral and bilateral donors that have largely neglected this aspect of development finance despite repeated calls from beneficiary countries. In spite of G20 leaders' pledges to address infrastructure needs at the Seoul G20 summit in November 2010, neither the Cannes summit in 2011 nor the Los Cabos summit in 2012 led to further commitments in this regard. As a result, when developing country leaders turn to the World Bank for support with economic infrastructure (energy, transportation, telecommunication etc.) development in the spirit of the Seoul G20 summit instructions, they continue to face difficulties in obtaining

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<sup>10</sup> The second regional NDB office is expected to be in Brazil.

<sup>11</sup> The ICICI Bank is one of the largest in India.

<sup>12</sup> Agreement on the New Development Bank, Article 1.

finances for such purposes, despite some recent increase in financing.<sup>13</sup> The NDB is expected to help reduce this gap by specialising in the provision of hard infrastructure finance, and thus help improve physical connections in and between developing countries.<sup>14</sup>

## The NDB and the World Bank

The NDB has most frequently been compared to the World Bank given its geographical scope and the types of functions that it is expected to perform. The Washington-based institution is hitherto the only MDB operating globally and engages in similar operations (loans, technical assistance, guarantees) as the NDB. As far as their mandates are concerned, however, the two institutions differ significantly. While the World Bank is led by the primary objective of eliminating poverty in general by working with sovereign or sovereign-guaranteed borrowers, the NDB focuses on more specific objectives – promotion of economic infrastructure investment and sustainable development – and may concentrate on non-sovereign borrowers (private sector entities) in particular.<sup>15</sup> The NDB is built on the logic that improved physical infrastructure can be a catalyst for a more sustainable and wide-ranging economic development that may, in turn, result in poverty reduction.

The NDB has a subscribed capital stock of \$50 billion that can be raised to \$100 billion, which is the institution's authorised capital set by its founders. Founding members made their first contributions – worth a total of \$750 million – to the NDB on 16 January 2016, representing the first step in the capitalization process. These initial transfers count towards the bank's paid-in capital, which is expected to total \$10 billion (\$2 billion per founding member) and to be paid through seven tranches between 2016 and 2020. The other key part of the NDB's capital base is the subscribed capital of \$40 billion (\$8 billion per founding member) that shareholders must provide when requested by the bank.

From a comparative angle, the NDB's prospective paid-in capital of \$10 billion will bring the new institution close to the World Bank's financial strength, which reached \$15.2 billion in paid-in capital in June 2015. As far as callable capital is concerned, however, the NDB's \$40 billion is dwarfed by that of the World Bank's \$236.6 billion.<sup>16</sup> Although capital base is an important indicator of an MDB's operational capacity, its capacity to leverage its capital through the use of various financial instruments is similarly crucial. Based on a paid-in capital of \$13.4 billion, the World Bank's

<sup>13</sup> In the fiscal year 2014, the World Bank spent \$24.2 billion on economic infrastructure, a 45% increase compared to 2013. The bank also created the Global Infrastructure Facility in 2015 with an initial capitalisation of \$100 million.

<sup>14</sup> Speech by Gregory T. Chin at SPERI Conference 2014: 'China and the Proposed BRICS Development Bank'.

<sup>15</sup> C. Humphrey, *Development revolution or Bretton Woods revisited?*, Working Paper 418, Overseas Development Institute, April 2015.

<sup>16</sup> The World Bank Treasury, [http://treasury.worldbank.org/cmd/htm/financial\\_shareholder.html](http://treasury.worldbank.org/cmd/htm/financial_shareholder.html).

non-concessional International Bank for Reconstruction and Development (IBRD) lending window, for example, had managed to lend cumulatively \$586 billion between 1945 and 2013.<sup>17</sup> This was largely due to the preferred creditor status granted to the World Bank by major rating agencies and the resulting favourable conditions for the bank's operations in private financial markets.<sup>18</sup> As a first step, the NDB management is seeking to leverage two to two and half times the current capital of \$750 million and lend up to \$2 billion this year.<sup>19</sup>

At its fifth meeting on 15 April 2016 at the margins of the IMF and World Bank Group Spring meeting, the NDB's board of directors approved the first set of loans worth a total of \$811 million. These initial loans, which are to be disbursed in tranches, are intended to support 2,370 megawatts of renewable energy capacity in four of the BRICS countries – with Russia being the only one not receiving funds in the first round – and reduce harmful emissions by four million tonnes annually. The biggest beneficiary is Brazil's Banco Nacional de Desenvolvimento Economico e Social, which secured about \$300 million to help build 600 megawatts of renewable energy capacity. The NDB will also provide a \$250-million loan to India's Canara Bank so that it can lend to renewable energy projects hoped to generate 500 megawatts of renewable energy and savings of about 800,000 tonnes of carbon emissions. South Africa's Eskom Holdings SOC Ltd. will receive \$180 million for power lines that will transmit 670 megawatts and transform 500 megawatts of renewable energy generation. China's Shanghai Lingang Hongbo New Energy Development Co. obtained the smallest sum, \$81 million, to fund 100 megawatts of rooftop solar power. Overall, it can be contended that the above NDB loans share four important characteristics: they all support clean energy projects; they will be disbursed in national currencies; their repayment times range from 12 to 20 years; and they will be guaranteed by the respective BRICS governments.<sup>20</sup>

The fact that the bank has already assigned its first loans is unprecedented in existing MDB history. While it takes on average two years for such an institution to complete a project from design to loan approval, the Shanghai-based multilateral has managed cut this to six months.<sup>21</sup> Yet, such an accelerated operation has not been without consequences. The fact that all lending projects are sovereign-guaranteed is at odds with the NDB's objective of working primarily with non-sovereign borrowers. The fact that building up a loan portfolio appears to trump the strict observance of one of the bank's key principles (focus on non-sovereign borrowers) – at least in the initial phases of operation – further underlines the BRICS' oft-repeated commitment to speedy delivery of development aid.

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<sup>17</sup> The World Bank, <http://www.worldbank.org/en/about/annual-report/roles-resources>.

<sup>18</sup> C. Humphrey, *ibid.*, p. 3.

<sup>19</sup> B. Ujvari, 'The BRICS' New Development Bank and the EU's options', Nr. 7, *CEPOB*, April 2016.

<sup>20</sup> *The BRICS Post*, 'BRICS Bank announces first set of loans', 16 April 2016.

<sup>21</sup> *China Daily USA*, 'Shanghai solar energy project wins nation's first NDB loan', 18 April 2016

## Continuity and innovation

An analysis of the NDB's establishing treaty suggests that the institution represents both innovations and continuity vis-à-vis the traditional MDBs. This comparative section focuses on five outstanding issues: the composition of voting power; distribution of influence; governance mechanism; target clientele; and the currencies used for lending.

To begin with, the way voting power is assigned in the NDB essentially differs from all the other MDBs' practices. In the World Bank, for example, the voting power of a member is determined by two factors. First, each member is assigned basic votes, which collectively represent 5.55% of the total voting power. Second, the bulk of a member's voting power is constituted by share votes; one additional vote is given to a member for each share of stock it holds. Given that share ownership in the World Bank has been closely linked to financial contributions, and that larger economies were allowed to make greater contributions to the capital base, economically more powerful countries have traditionally held significant governance influence thanks to their voting power.<sup>22</sup> At first glance, the BRICS' decision to base voting power solely on an equally distributed capital share among the founding members (20% each) may seem to deviate radically from the pattern followed by the World Bank. Yet, this is only partially true. While the equal capital share assigned to the five members clearly differentiates the NDB from the Bretton Woods institution, the way voting power relates to the capital share in fact represents no innovation in relation to the World Bank: each capital share constitutes one vote.

While ensuring an equal number of shares for all founding members is in tune with the BRICS' repeated calls for more equal distribution of influence in established international financial institutions, it also has its downside. The fact that the NDB's initial capital base is only \$50 billion is largely attributable to the fiscal limitations of the smallest founding member, South Africa, whose international reserves (including gold, foreign exchange, IMF special drawing rights) constitute only 1% of China's. Interestingly, alternative arrangements that could have enabled founding members to make varying contributions while still acquiring considerable influence in the bank's governance were not retained in the negotiations between the BRICS. One way to grant increased influence to members with fewer shares is to distribute a significant number of 'basic votes' as has been done by several MDBs to a varying degree.<sup>23</sup> While the World Bank now distributes equally 5.55% of total voting power among members,<sup>24</sup> this ratio is 20% in the Asian Development Bank (ADB).<sup>25</sup> This system greatly reduces the impact of capital contributions on voting power and

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<sup>22</sup> C. Humphrey, *ibid.*, p. 7.

<sup>23</sup> *Ibid.*, p. 8.

<sup>24</sup> World Bank Group Voice Reform

<sup>25</sup> Agreement Establishing the Asian Development Bank, Article 33.

accords more influence to countries with smaller capital share. Yet another solution could have been to gradually reduce the value of a member's capital share once the amount of shares it holds surpass a certain level (translating, for example, three capital shares into just one vote). In brief, prioritising a strictly equal distribution of shares – at least initially – over a more robust capital base indicates that political solidarity was an overriding consideration in the intra-BRICS negotiations about the NDB.

Secondly, as far as the balance of power between borrowing and non-borrowing countries is concerned, one finds significant differences between the World Bank and the NDB. In the former, the collective voting share of developing countries (42.1%) is far outdone by that of the developed ones.<sup>26</sup> Furthermore, borrowing countries have a minority of the chairs in the governance structures and have never provided a president for the Washington-based institution. By sharp contrast, the agreement on the NDB suggests that borrowing members will remain clearly at the helm of the multilateral body even if membership expands in the future. The document stipulates that the collective voting share of the BRICS must reach at least 55% of the total voting power at all times and that of non-borrower countries must not exceed 20%. This is a crucial limitation as substantive issues (e.g., increasing the authorised and subscribed capital stock or changing the proportion of paid-in and callable shares, etc.) will be decided by special majority. This requires an affirmative vote of two-thirds of the total voting power of the members, including an affirmative vote of at least four of the five founding members. But the voice of prospective non-borrowing members will also be strongly limited in the day-to-day operation of the bank, where decisions will be made by simple majority or qualified majority (e.g., creating special funds or calling additional board).<sup>27</sup>

In addition, to consolidate the governance influence of borrowing members, the agreement also states that the 'President of the Bank shall be elected from one of the founding members on a rotational basis, and there shall be at least one Vice President from each of the other founding members' except the country represented by the President.'<sup>28</sup> Taken together, these arrangements appear to build on the approach of several regional development banks, where borrower developing countries have a voting share of at least (50%) and either more chairs than developed non-borrowing countries (as with the African Development Bank) or the same number of chairs (ADB). In sum, even if several developed countries do join the NDB in the future, the dynamic therein is expected to be significantly different from the World Bank and more similar to regional development banks.

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<sup>26</sup> D. Bob et al., 'AIIB: China as responsible stakeholder?', Sasakawa Peace Foundation USA, 2015, p. 9.

<sup>27</sup> Agreement on the New Development Bank, Articles 6 and 8.

<sup>28</sup> *Ibid.*, Article 13.

The third key aspect of the NDB's comparative analysis concerns its governance mechanisms. The institution follows the dual board system of the World Bank that consists of a board of governors and a resident board of directors. Yet, the notable difference is that the NDB's board of directors does not reside permanently in Shanghai. This arrangement also implies a lesser involvement of this body in the daily operation of the bank that goes in hand with an increased role for the resident management. This is a clear diversion from the standard MDB practice where the resident board of directors remains the ultimate point of reference in decision-making. From a BRICS perspective, the non-resident board represents an avenue to improve on existing practices in development finance and accelerate lending by saving governance costs and frictions between the different layers of management. However, this set-up can also be interpreted as an explicit attempt on the part of the founders to limit future members' influence on a supposedly BRICS-dominated senior management. This argument, however, has been increasingly sidelined by the fact that most of the bank's recruitment processes so far have not been limited to nationals from member countries only. Another important characteristic of the NDB's boards is that their members operate on an unpaid basis. This stands in a sharp contrast, for example, to the World Bank's resident board of directors, which entails an annual cost of \$70 million. It is hoped in BRICS capitals that reducing governance expenses will liberate substantial financial resources which could then be redirected for loans, investment, technical assistance, policy advisory or training purposes. While it may seem innovative in relation to the World Bank, it must be noted that the absence of a standing board is not unprecedented in MDB history. Established in 1968, the Development Bank of Latin America (CAF), for example, opted for similar arrangements. As a result, the CAF has been said to process loans in half the time required by the resident board-based Inter-American Development Bank (IADB), the other MDB operating in the region.

Fourthly, another crucial difference between the NDB and traditional MDBs lies in their target clientele. The IBRD charter, for example, prohibits lending without sovereign guarantee. In order to engage exclusively in private sector lending, a separate entity, the International Finance Corporation (IFC) was created in 1956 within the World Bank Group.<sup>29</sup> Yet, its capital base consists of just \$2.3 billion, which, though entirely paid-in, is negligible vis-à-vis the World Bank's \$236.6 billion (including both paid-in and callable capital). In contrast to the World Bank's focus on sovereign borrowers, the NDB builds on the recognition that private investors are increasingly willing to accept commercial risks in emerging markets – provided that some political risks are tempered. In addition to catalysing private lending, the increased focus on the private sector and other non-sovereign entities could also allow the NDB to

<sup>29</sup> In addition to the IBRD and the IDA, the World Bank Group also includes the International Finance Corporation (IFC), the Multilateral Investment Guarantee Agency (MIGA) and the International Centre for Settlement of Investment Disputes (ICSID).

secure higher returns on its equity. This is because the private sector in developing countries calculates with higher interest rates than the public.<sup>30</sup> Despite this emphasis on non-sovereign borrowers, the first batch of loans endorsed by the NDB's board of directors are all guaranteed by governments. Arguably, this is due to the fact that just a few months after becoming operational, the institution seeks to refrain from private sector lending and equity investment, which are much riskier and more exposed to market volatilities.<sup>31</sup>

Lastly, the NDB differs from established structures by virtue of its focus on offering debt instruments in non-hard currencies. While major existing MDBs carry out the bulk of their borrowing in hard currencies such as the US dollar, euro, Japanese yen and pound sterling, the NDB intends to lend mainly in the local currencies of its members – the Brazilian real, the Indian rupee, the Russian rouble, the Chinese renminbi and the South African rand (the five Rs). Reportedly, the NDB's long-term plans also include the possibility of allowing members to return in their own currency loans disbursed to them in the currency of another member state. It is hoped that such operations would be facilitated by the Contingency Reserve Arrangement (CRA) that the BRICS established in 2014 to encourage currency swaps within the bloc.<sup>32</sup> While the first batch of NDB loans are all to be disbursed in local currencies, President Kamath has recently alluded to the possibility of raising resources in dollars on the international capital markets – although this is not due to happen until the NDB obtains ratings from the three main international credit rating agencies (Moody's, Standard&Poor's, Fitch).

## Challenges going forward

As far as their non-concessional lending windows are concerned, MDBs are essentially self-sustaining.<sup>33</sup> This means that, once they have made their required contributions to the paid-in capital, shareholders do not need to make periodical capital contributions to an MDB's capital base. In order to boost their operational capacity, MDBs leverage their capital mainly through the issuance of bonds on the international capital markets. An MDB's ability to raise capital cheaply and fix a low interest rate when lending to borrowers will largely hinge on its credit rating. Most MDBs boast high credit ratings, which renders them a very attractive source of equity even with the interest rate they charge. In fact, developing countries tend to obtain financial resources from MDBs under more favourable conditions than if they turn directly to the international capital markets. This holds true even in cases where an institution draws its entire capital base from developing countries, as with the CAF.<sup>34</sup> In

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<sup>30</sup> C. Humphrey, *ibid.*, p. 19.

<sup>31</sup> Interview with a Brussels-based Russian diplomat.

<sup>32</sup> Institute for Security Studies, 'The five Rs take on the dollar', 3 December 2015.

<sup>33</sup> Concessional lending is mainly funded through donor contributions and non-concessional lending income.

<sup>34</sup> S. Griffith-Jones, 'Governance of the World Bank'.



addition to covering operational costs, an MDB's return on equity is also used to provide technical assistance and knowledge value-added.

In seeking to boost its operational capacity, the NDB will face a number of challenges. Bearing in mind that it has currently \$750 million as paid-in capital, which is due to reach \$10 billion with the current five members, Humphrey estimates that the NDB will have a loan portfolio – that is the aggregate value of the loans it is owed – of \$25-30 billion after five years of its operation – a figure that could rise to \$45-65 billion after ten years of operation. Such a loan portfolio of \$45-65 billion by 2025 would allow the bank to replicate the ADB's performance in 2013 (\$53.1 billion) but would still fall short of the IBRD's loan portfolio of \$141.7 billion in the same year.<sup>35</sup> While this sum would still represent a notable addition in international development finance, it would only be sufficient to cover a small part of the unaddressed needs.

The most direct way to expand an MDB's capital base is to co-opt new members with significant shareholding potential. In the initial phases of its operations, the NDB is set to focus on BRICS countries. The evaluation of membership requests is planned to commence in July 2017 (two years after the bank's launch).<sup>36</sup> While the establishing agreement hints at the possibility of operating quasi globally, the bank is not intended to be a truly global institution in terms of membership. The first prospective round of expansion is expected to concern some key middle-income countries such as Indonesia, Iran, Nigeria and Turkey.<sup>37</sup> The Iranian government in fact already floated the idea of NDB accession in October 2015, although so far this has not been dealt with by the BRICS.<sup>38</sup> Yet, and arguably, the co-option of non-borrowing countries could also benefit the NDB by boosting its creditworthiness and therefore its ability to create a portfolio of well-performing debts. Hitherto, however, few if any developed countries have expressed an interest in joining the institution, showing also a limited awareness of the bank's expected opening to new members in little over a year. It is also not clear at this stage how the NDB would react to the membership requests from traditional donor countries, as the presence of such actors would certainly come with strings attached with regard to the bank's core policies. This holds true even if the BRICS have clearly constrained the influence of prospective non-borrowing members by limiting their collective voting power to 20% of the total.

With its current five members, the NDB's loan portfolio expansion will primarily depend on its ability to leverage its equity on the international capital markets. At the outset, this is a rather challenging endeavour as the bank is composed of borrowing countries only. The absence of developed countries with high credit ratings will certainly render it difficult for the NDB to earn the trust of bond investors and benefit from low interest rates and long maturities. In order to live up to the expectations of

<sup>35</sup> C. Humphrey, *ibid.*, p. 15.

<sup>36</sup> Interview with a Brussels-based Brazilian diplomat.

<sup>37</sup> Interview with a Brussels-based Russian diplomat.

<sup>38</sup> Russia Today, 'Iran to join BRICS New Development Bank', 26 October 2016.

bond rating agencies and thus be able to provide development financing in favourable terms, the bank will most likely not be able to employ its equity capital aggressively at the outset. This means that it will need to keep its equity-to-loans ratio in the 23-27% range during its first years of operation, which would leave 73-77% of its equity generated based on paid-in capital in its outstanding portfolio.<sup>39</sup>

In order to become a well-established multilateral donor, the NDB must ensure that its administrative expenses and its cost of funding are covered by its return on equity. Given that the institution is specialising in just two development issues (infrastructure and sustainable development) and is owned by borrowers with a preference for a lean staff, it is expected to have a fairly limited administrative budget. A key component of an MDB's income is the interest it secures on the loans it grants to borrowers: lending revenue. As for its cost of funding, the investment grade the NDB receives from rating agencies will be decisive. A high grade allows MDBs to raise capital cheaply on the international markets and set an attractive mark-up when lending for development projects. A low investment grade, by contrast, may increase the cost of lending from an MDB, resulting in lesser demand for its services. This, in turn, can deprive a bank of its primary source of income: the lending revenue.

At the inception, the most influential factor on the NDB's rating is the sovereign rating of its founding members. At Standard and Poor's, China is rated AA-, Brazil BB, South Africa and India BBB- and Russia BB+. With two founding members (Brazil and Russia) having a junk bond status, two others having the lowest investment grade (India and South Africa) and China being the only one with a high grade, the overall prospects for the NDB look rather gloomy. Yet, as the CAF's example demonstrates, it is not impossible for an MDB composed exclusively of borrowers to obtain a higher credit rating than its individual members. Still, achieving favourable access to capital markets in such a way takes time. In the meantime, a low rating may complicate the NDB's access to capital markets, resulting in higher cost of funding. This may force the bank to set a relatively high mark-up on its loans that can, in turn, discourage some of the BRICS and middle-income countries from turning to the NDB in so far as they can access capital markets directly at more favourable terms.

Yet, at the end of February 2016, the NDB obtained the highest possible rating (AAA) from two Chinese raters – China Lianhe Credit Rating Co and China Chengxin International. This explains why China, in particular, is relied upon to raise capital for the bank through the issue of bonds. At the end of last April, the NDB issued \$350 million worth of debut green bonds on China's onshore interbank bond market to finance the initial batch of lending for green-energy projects.<sup>40</sup> At the same time, the ongoing negotiations with the 'big three' rating agencies are expected to conclude by the third quarter of 2016, which could pave the way for the NDB's entry into interna-

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<sup>39</sup> C. Humphrey, *ibid.*, p. 16.

<sup>40</sup> [Emergingmarkets.org](http://Emergingmarkets.org), 'Brics bank to open account with green bonds', 8 April 2016.

tional capital markets. However, it is not even clear whether the highest investment rating is crucially sought at this stage by the senior management. As indicated by the Director of the Department of International Financial Relations at the Russian Finance Ministry, Andrey Bokarev, an 'AAA rating implies certain restrictions for a new institution without experience and reputation from the viewpoint of creation of reserves and the need to keep funds in accounts.'<sup>41</sup>

In addition to seeking lending revenue, the Shanghai-based institution may also generate income through equity investment, as has recently been increasingly done by several MDBs. Purchasing shares in the ownership of businesses seeking to carry out large-scale projects and then selling them off to private investors upon completion would be in line with the NDB's focus on non-sovereign actors and could become a potential source of considerable income. Yet, given the scale of involvement (75-100% of project value as opposed to 20-40% for non-sovereign loans) and the high degree of volatility characterising equity investment, the bank is likely to refrain from such operations at the outset.

Alternative sources of income generation would consist of treasury investments, loan syndications, public-private partnerships, co-financing arrangements with bilateral aid agencies and national development banks and even the acceptance of deposits. MDBs prone to assembling such financial instruments include the EBRD, IFC and the European Investment Bank (EIB), which were essentially designed to work with the private sector. As the NDB is still in embryo form, it stands a good chance of adopting the necessary administrative and financial arrangements that would enable it to engage in the above financial instruments.<sup>42</sup>

## **What is in it for the EU?**

In the midst of an unfolding shift away from a Western-dominated multilateral system in which EU member states play a central role, the Union's fundamental interest lies in ensuring that the new structures will complement rather than rival the old ones. While the NDB has officially been heralded as complementary to the existing MDBs, it is reasonable to argue that the institution will also serve to advance the strategic interests of its founders. First, with its focus on infrastructure projects, the NDB creates business opportunities for Chinese – and Russian – engineering companies, potentially also absorbing some of China's excesses in the aluminium, cement and steel industries. Second, by lending primarily in BRICS currencies, the bank may also act to undermine the prevalence of hard currencies such as the US dollar and the euro in international finance. Finally, the BRICS may also aim to impact

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<sup>41</sup> New Development Bank, 'New Development Bank to receive international investment rating by Q3, 2016', 22 March 2016.

<sup>42</sup> C. Humphrey, *ibid.*, pp. 20-22.

on the *modus operandi* of international development finance by offering a less stringent alternative to established structures, notably the World Bank.

Arguably, the NDB's potential deviation from the World Bank's standards is where the EU member states' interests may be concerned most directly. The EU and its 28 member states are staunch supporters of the Washington-based institution and they collectively account for nearly one-third of shares in the IBRD (as opposed to the BRICS' 13%) and half of contributions to the IDA. The EU and the World Bank cooperate closely in promoting goals such as reducing global poverty and shifting economies onto environmentally sustainable growth paths while also adhering to robust governance, social and environmental standards. The European Commission – which has its own development co-operation budget – is in a constant dialogue with the World Bank with the aim of ensuring joined-up and effective action at HQ and field level. Frequent consultations and workshops also take place between the two entities on development-related aspects of trade, agriculture and energy policies. The relationship between the two is governed by the Framework Agreement signed in March 2009, applying to all trust fund agreements concluded between the Commission and the World Bank Group.<sup>43</sup>

Since the NDB is run by emerging powers (notably Russia and China) with questionable adherence to *de facto* standards in international development finance, many have argued that the bank may be loose with environmental, social, labour and procurement standards. The NDB's emergence on the scene has therefore nourished fears that the rigorous standards of the World Bank may come under downward pressure. These concerns have been, however, partially mitigated of late, given the repeated emphasis of NDB officials on sustainable development considerations and the first batch of green projects approved by the bank's board of directors in early April.

In formulating their response to the NDB, EU member states may not only need to take into account the strategic goals behind the institution but also the economic opportunities it represents for European companies. The fact that the Agreement on the NDB restricts participation in project tenders to members only will certainly increase the appetite of non-borrowing countries for membership.<sup>44</sup> If the bank remains focused on green projects in the medium to long term, EU member states with competitive green industries may be particularly tempted to exploit the business opportunities stemming from membership.

Although the EU has not yet formally reacted to the NDB, the European Commission welcomed the creation of additional development financing options, provided they are complementary to existing institutions. It remains to be seen whether individual

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<sup>43</sup> 'The EU and the World Bank Group'.

<sup>44</sup> Agreement on the New Development Bank, Article 21.

member states will follow suit and lay the emphasis on strategic considerations or privilege economic deliberations in their response to the bank. In line with Article 32 of the Treaty on European Union (TEU), any prospective EU reaction to the NDB should in principle start with a consultation among Member States. Art. 32 TEU states that ‘before entering into any commitment which could affect the Union’s interests, each Member State shall consult the others within the European Council or the Council.’<sup>45</sup> If EU member states do manage to form a united front vis-à-vis the NDB once it opens its doors to new members, I argue that four fundamental scenarios can be envisaged.<sup>46</sup>

First, in order to pre-empt the potential fragmentation of the established international development finance landscape, EU member states could collectively engage in an isolationist approach, refusing to consider membership and encouraging others to do the same. Reacting this way, however, would be difficult to reconcile with the recognised need for additional infrastructure investment in the Global South and the EU’s former calls on the BRICS to undertake increased responsibilities on the international stage. Moreover, this approach would also prevent the EU green industry from participating in the NDB-run procurement processes.

Second, EU member states could try to induce some changes in the bank’s policies by rendering their accession contingent upon the NDB’s strict observance of certain social, environmental and labour standards. This strategy could also build on the argument that the NDB’s creditworthiness could significantly benefit from the presence of some EU member states with high credit ratings (although several member states have in fact worse credit ratings than the BRICS themselves). It is nonetheless unlikely that the NDB would be willing to make significant sacrifices on its lenient stance on various standards in exchange for an improved position on the capital markets, because its *raison d’être* is precisely this diversion from the World Bank’s slow and bureaucratic practices. In addition, the NDB’s increasingly obvious focus on green projects and environmental standards would also limit the EU member states’ room for manoeuvre in using their potential membership as a carrot to provoke policy change.

The third option, by contrast, is to influence the evolution of policies from the inside. This scenario could involve the accession of just a few EU member states willing to bear the financial cost of NDB membership. Acceded EU countries could then further the interests of the entire bloc based on regular consultations in a particular preparatory body of the Council of the EU such as the Economic and Financial Committee.<sup>47</sup>

<sup>45</sup> Treaty on European Union, Article 32.

<sup>46</sup> B. Ujvari, *ibid.*

<sup>47</sup> The Economic and Financial Committee is an EU committee set up to promote policy coordination among the member states. Its preparatory work for the Council includes assessments of the economic and financial situation, the coordination of economic and fiscal policies, contributions on financial market matters, exchange rate policies and relations with third countries and international institutions.

Acting in such a way would be in accordance with Article 34 TEU, which stipulates that 'in international organisations and at international conferences where not all the Member States participate, those which do take part shall uphold the Union's positions.'<sup>48</sup> However, experience shows that the legal obligation and the political practice of co-ordination has been rather weak in international organisations (such as the Organisation for Economic Co-operation and Development, the United Nations Security Council and the G8/G20) where certain EU member states hold a privileged position.<sup>49</sup>

Lastly, the EU itself may seek membership in the Shanghai-based institution, whether it be along with or on behalf of its member states. Given that development policy is a shared competence of the Union and the member states, the latter are unlikely to favour the option of being represented exclusively by EU officials. By contrast, the example of the EBRD shows that EU membership in an MDB along with its member states is not unfeasible. However, the agreement on the NDB restricts membership to members of the United Nations, with the possibility of granting observer status in its board of governors to international financial institutions. As the EU fulfils none of these criteria, its accession is dependent on the incorporation of a Regional Economic Integration Organisation (REIO) clause<sup>50</sup> into the institution's mandate. In light of the realist stance of the BRICS on state sovereignty, such a treaty change would require a concerted joint campaign from EU member states present in the NDB.

Overall, while the NDB will certainly not transform, in the foreseeable future, the way international development finance is carried out, it may well enable the BRICS to gradually shape the global development policy discourse. As the world's leading donors of development aid, the EU and its member states cannot turn a blind eye to a new MDB that may challenge some of the principles Europeans have long abided by in implementing their own development policy. The risks of not doing so may include the gradual alteration of international development finance where the receipt of funds is increasingly decoupled from EU-style governance standards and economic prescriptions. Subjugating democracy, transparency and rule of law considerations to economic growth would not only run on counter purposes with the EU's own approach to development policy but would also render the world less like the Union itself. In other words, in a world where a growing part of development aid comes with no or few strings attached, the EU will find it more difficult to promote its values and secure its economic interests through its own development policy.

However, the extent to which the NDB would be able to place established donors' development standards under downward pressure is questionable. First and

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<sup>48</sup> Treaty on European Union, Article 34.

<sup>49</sup> S. Kukeleire and T. Delreux, *The Foreign Policy of the European Union*, Palgrave Macmillan, p. 304.

<sup>50</sup> A prerequisite to the membership of regional integration processes in international organisations.

foremost, this is because even the bank's founders are divided in their attitude towards development policy standards. While Brazil has long been known for robust legislation with regard to environmental and social standards, reflected also in the lending policies of the Brazilian Development Bank (BNDES), China and Russia have shown less interest in championing such issues both domestically and internationally. The first set of green projects embraced by the bank and the repeated emphasis of President Kamath on sustainable development considerations indicate that Brazil has got its way in designing a policy framework for NDB operations.

Second, given its exclusive dedication to economic infrastructure projects, the NDB will only represent an alternative source of finance for developing and emerging countries as far telecommunication, energy and transportation projects are concerned. Most MDBs, by contrast, allocate their operations in a much more balanced fashion. The IBRD and the IDA, for instance, dedicated between 40% and 50% of their operations to social infrastructure (health, education, water supply and civil society etc.) in 2012-2013. Furthermore, the European Commissions' Directorate-General for International Cooperation and Development (EuropeAid) devoted only 10% of its aid to economic infrastructure in 2013.<sup>51</sup> As the NDB has been designed to finance economic infrastructure only, the strategic implications of its existence for the EU's own development policy are also more limited. Yet, this does not mean that the EU member states should not start engaging in a joint discussion on the NDB and try to avoid division that marked the EU's initial response to the AIIB's open door policy. With the bank's overture being just a year ahead, the first formal BRICS institution is presently featuring agonisingly low on the agenda of EU decision makers.

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<sup>51</sup> ec.europa.eu, '2014 Annual Report', 31 October 2014.

## ASIAN INFRASTRUCTURE AND INVESTMENT BANK: CHINA GOES MULTILATERAL

Just one and half years after the idea of setting up a BRICS-owned development bank was mooted at the 4<sup>th</sup> BRICS summit in March 2012, Chinese President Xi Jinping unilaterally proposed another multilateral institution while addressing Indonesia's parliament: the Asian Infrastructure and Investment Bank (AIIB). The AIIB was declared to be open to any members of the IBRD or the ADB from the outset and quickly generated an interest that far exceeded even the most ambitious expectations. Up to the 31 March 2015 deadline set by China for founding members to apply, the bank counted 57 membership requests. Each prospective founding member then still had the chance to have a say about the AIIB charter, which was agreed upon at the 5<sup>th</sup> Chief Negotiators' Meetings on 20-22 May in Singapore.<sup>52</sup> In the next step, Chinese leaders and the representatives of the 56 prospective founding members gathered in Beijing on 29 June 2015 to sign the Memorandum of Understanding (MoU) for the establishment of the AIIB.<sup>53</sup> The bank's Articles of Agreement (AoA) entered into force on 25 December 2015, following the ratification of the document by 17 states that together held 50.1% of the initial subscriptions of the authorised capital stock. At the time of writing, 37 of the 57 prospective founding members have ratified the AoA and have consequently become founding members.<sup>54</sup> The AIIB was declared operational during the inaugural meeting of its board of governors in Beijing on 16 January 2016. The institution's first president is the former ADB Vice-President, Jin Liqun (China).

Importantly, the creation of the AIIB differs from the standard practice of designing international organisations. While the preparatory processes of most international bodies are preceded by a series of discussions and consultations among major stakeholders, China has made many of its initial AIIB-related decisions unilaterally – from the establishment and headquarters of the institution to the time table for its preparatory process and the declaration of the 31 March deadline.

The AIIB is the second MDB to go operational in the past year and shares three fundamental characteristics of the NDB. First, it emanates from an emerging power, China, and is meant to be run primarily by borrowing countries. Second, its primary goal also lies in improving infrastructure connectivity while also fostering sustainable economic development, with the notable difference that the AIIB carries out its

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<sup>52</sup> The first Chief Negotiators' Meeting took place with 22 prospective founding members in Kunming, China in November 2014.

<sup>53</sup> Only 50 countries signed the AoA on 29 June while the remaining seven countries were awaiting domestic approval.

<sup>54</sup> The remaining 27 countries have until the end of 2016 to perform the same legislative process.



mandate only in Asia and Oceania.<sup>55</sup> Third, while the AIIB is heralded as a unit complementary to the established multilateral and development institutions, it also explicitly purports to improve on existing practices in development finance.

## The AIIB and the ADB

By virtue of its exclusive focus on the Asian continent, the AIIB has been depicted by many as a potential alternative to the ADB – the other major MDB concentrating solely on this region.<sup>56</sup> While the two institutions engage in similar functions – including grants, loans, guarantees, technical assistance and equity investment – their mandates differ significantly. At the inception, the ADB was primarily intended to contribute to the economic development of the developing countries of Asia. By the beginning of the twenty-first century, the ADB's focus had gradually shifted from fostering economic growth to promoting poverty reduction, entailing targeted interventions meant to benefit the poor directly.<sup>57</sup> The mid-term review of the Strategy 2020 – the institution's most recent long-term strategic framework – suggests, however, a gradual return to the broader 'economic approach' where the emphasis is on assisting client countries in pursuing their own development path. Leading up to 2020, the ADB will focus its activities on ten strategic priorities as diverse as poverty reduction, inclusive economic growth, climate change adaptation, infrastructure investment and private sector development.<sup>58</sup> In contrast to the ADB's involvement in several aspects of development policy, the AIIB is geared towards just two specific goals: hard infrastructure investment<sup>59</sup> and sustainable development.

The AIIB has an initial capital base of \$100 billion, including a paid-in capital of \$20 billion and a callable capital of \$80 billion. Members' contributions to the paid-in capital are to be disbursed in five instalments, each accounting for 20% of their total contribution. Founding members were to disburse the first instalment within 30 days after the entry into force of the AoA on 25 December 2015. The second instalment is due by 25 December 2016 and the remaining three are to be paid on each successive year from the date on which the preceding instalment becomes due. Expected to be attained by the beginning of 2020, the AIIB's capital base \$100 billion would still fall short of the ADB's financial strength, which currently amounts to about \$175 billion (of which only \$12.6 billion is paid-in, however). This is important as MDBs' scale of

<sup>55</sup> Articles of Agreement of the AIIB, Article 1.

<sup>56</sup> The ADB's membership is composed of countries of East, South-East and Central Asia as well as the Pacific together with a number of non-regional countries. In practice, however, the ADB has tended to concentrate its activities on East and South-East Asia.

<sup>57</sup> M. Okano-Heijmans and D. Waardenburg, *The Asian Development Bank: What is in it for Europe?*, Clingendael report, February 2014, p. 26.

<sup>58</sup> ADB, Strategy 2020 Midterm review.

<sup>59</sup> According to an ADB report dating back to 2009, Asia needs \$8 trillion in economic infrastructure investment between 2010 and 2020. 51% of this sum would be needed for electricity, 29% for roads and 13% for telecommunications.

operations is increasingly becoming dependent on paid-in capital and a sound equity-to-loans ratio, with the callable capital remaining relevant primarily in helping MDBs obtain a higher bond rating. After becoming operational on 16 January 2016, the AIIB aims to perform its first loans in the second quarter of this year and is said to have several co-financing projects (including a motorway project in Pakistan to be funded together with the ADB) and stand-alone projects in the pipeline.

## Continuity and innovation

When compared to more established MDBs, the Beijing-based institution – similarly to the NDB – features both innovations and continuity. As for the composition of voting power, the AIIB follows a similar approach to the ADB. Voting power in the latter is determined by the sum of its basic votes and proportional votes. Basic votes distributed equally among members jointly represent 20% of the total voting power. The greater part of voting power stems therefore from the proportional votes (share votes), which are equal to the number of shares a member holds in the capital stock. Basic votes and share votes also weigh on members' voting power in the AIIB. The basic votes result from the equal distribution among all the members of 12% of the aggregate voting power and share votes are assigned similarly as in the ADB. In addition, the 57 current members of the AIIB also benefit from 600 founding member votes each. Yet, the current number of basic and founding member votes limit only very mildly the governance influence of the main AIIB shareholders. China, for example, holds 30.34% of the shares and it accounts for 26.06% of the votes.

As for the distribution of influence between regional and non-regional members, both the ADB and the AIIB privilege the regional group. In the former, a minimum of 60% of the total subscribed capital stock is reserved for regional countries (including non-borrowing ones such as New Zealand, Australia and Japan), whereas the latter reserves 75% of the total shares for such members. At the moment, the AIIB comes closer to being a borrower-led bank than the ADB. While non-borrowers in the latter have traditionally accounted for more than 50% of voting power,<sup>60</sup> in the AIIB's case this figure is just 35%. The number of shares to be subscribed to the AIIB is determined by the board of governors based on factors such as economic size (GDP) and fiscal capacity. Three countries with the largest voting power based on this formula are China (26.06%), India (7.51%) and Russia (5.93%), which is also considered to be a regional member. Given that substantive decisions (electing the president, increasing the capital stock, increasing individual capital shares, amending the ratio of paid-in and callable capital, etc.) are to be taken by a super majority vote requiring at least 75% of the total voting power, China effectively retains a veto right.

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<sup>60</sup> M. Okano-Heijmans and D. Waardenburg, *ibid.*, p. 8.

The more rigid approach of the NDB – where equal shareholding is privileged over a more robust capital base – is thus not replicated by the AIIB, allowing members with more sound fiscal capacities to make differentiated contributions. While China’s capital share will – in principle – enable the country to play a dominant role initially, Beijing has previously alluded to the possibility of ceding its influence gradually. Reportedly, the Chinese leadership would have already been willing to compromise on this matter had Japan and the United States joined the bank as founding members. This cooperative Chinese attitude towards the AIIB appears to be underpinned by the fact that representatives of non-borrowing countries have, so far, reported no intention from Beijing to wield its governance influence or dominate board meetings.<sup>61</sup>

However, it is worth pointing out that while the majority of the AIIB’s lending is expected to come from its ordinary capital resources, its AoA also opens the door widely to ‘special funds’ to be administered separately from the bank’s balance sheet. In fact, China has already raised plans to contribute \$50 million to a prospective special fund that would facilitate less developed members’ preparation for infrastructure development projects.<sup>62</sup> As the ADB’s case shows, the establishment of such funds may mean that the distribution of voting power does not necessarily reflect accurately the members’ overall engagement with an MDB. Japan and the United States, for example, hold a nearly identical capital stock (15.61% and 15.60% respectively) and voting power (12.84% and 12.75%) in the Manila-based institution. Yet, if contributions to special funds are also taken into account, Tokyo accounts for 45% of all contributions as opposed to Washington’s 12%.<sup>63</sup> Therefore, China’s expected significant contributions to future special funds<sup>64</sup> may be used by Beijing to fend off criticisms directed at its dominant governance influence in the AIIB.

Concerning governance mechanisms, the AIIB appears to follow the NDB’s path and thus represents a departure from the traditional MDBs operating in Asia. Its dual board operates on a non-resident and unpaid basis. This is a sharp divergence from the ADB’s resident board of directors, which convenes on a weekly basis. This arrangement is a clear demonstration of the AIIB’s commitment to a streamlined internal review and assessment procedure and to delivering loans more quickly in general. Members of the board of directors therefore only engage in AIIB-related affairs on a part-time basis and are not immersed in the day-to-day operations of the institution. They correspond electronically and meet physically ‘as often as the business of the bank may require.’<sup>65</sup> Moreover, the endowment of the resident senior management with some decision-making power on loans is also being consid-

<sup>61</sup> Interview with a representative of New Zealand at the AIIB’s board of directors.

<sup>62</sup> China Daily Asia, ‘China-initiated AIIB officially launched,’ 16 January 2016.

<sup>63</sup> M. Okano-Heijmans and D. Waardenburg, *ibid.*, p.12.

<sup>64</sup> Interview with a Brussels-based Chinese diplomat.

<sup>65</sup> Articles of Agreement of the AIIB, Article 27.

ered. While China has justified these arrangements by the need to limit the transaction costs that often characterise the resident boards of established financial bodies, some traditional donor countries have expressed concerns about the potentially dominant role of the resident management staffed by Chinese nationals.<sup>66</sup> This argument, however, appears to be losing its validity in light of the AIIB's global approach in its recruitment procedures and the appointment of two European vice presidents (Germany and United Kingdom). In addition, President Jin has repeatedly emphasised of late that he and his senior management team intended to serve the Bank as international civil servants.<sup>67</sup>

As in the case of the ADB, the AIIB's president is to be drawn from a regional country member and its board of directors is composed of 12 members. The difference lies in the fact that the AIIB reserves nine director positions for the countries of Asia and Oceania in contrast to the ADB's eight seats for that region. Furthermore, fixed seats on the board are assigned to Japan, the United States and China in the ADB, whereas in the AIIB only China and India hold such privileges. Finally, the AIIB's personnel is expected to be much leaner (500-600 staff) than that of the ADB or the World Bank, which employ 3,000 and 10,000 staff respectively.<sup>68</sup>

Some of the most important differences between the AIIB and the ADB are expected to surface with regard to their target clientele. Despite recent efforts by participants to work more with non-sovereign actors at the detriment of sovereign ones, the fact remains that sovereign projects continue to constitute about 75% of the ADB's ordinary resources operations. By contrast, the fact that the AIIB was proposed by China – a quintessential champion of the growth-based poverty reduction strategies – and that the institution is being fine-tuned at a time when most MDBs increasingly engage in financial instruments tailored to the private sector as opposed to standard loans, it is not surprising that the AIIB is designed to work primarily with non-sovereign actors.<sup>69</sup> This emphasis on the private sector is also informed by the fact the demand for sovereign lending is expected to decline as a result of rising public debt levels and higher interest rates. In the context of its One Belt, One Road initiative, China is said to have already experienced growing resistance to sovereign loans from Central Asian countries.<sup>70</sup> As infrastructure projects entail numerous risks and are preceded by a long gestation period, private and institutional investors (pension funds, insurance companies, mutual funds) may be discouraged from being involved in such projects. Provided it accumulates the necessary expertise and earns the trust

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<sup>66</sup> G. T. Chin, 'Asian Infrastructure and Investment Bank, Governance Innovation and Prospects', *Global Governance* 22 (2016), pp. 11-26.

<sup>67</sup> Interview with a representative of New Zealand at the AIIB's board of directors.

<sup>68</sup> Asia Foundation, 'New Asian Infrastructure and Investment Bank Breaks Ground: What You Need to Know', 27 January 2016.

<sup>69</sup> Interview with Brussels-based Korean and Russian diplomats.

<sup>70</sup> L. Greenwood, *AIIB: Now comes the hard part*, Centre for Strategic and International Studies, 18 February 2016.

of bond investors, the AIIB stands a good chance of facilitating the flow of capital from institutional actors to infrastructure projects while also helping private companies create bankable projects through, in particular, equity investment.<sup>71</sup> What also follows from the bank's focus on projects rather than on general budget or sector support is that it will not demand harsh changes to macroeconomic and regulatory settings in exchange for most of its financial aid as has been done by several MDBs, notably the World Bank.<sup>72</sup>

Despite initial predictions that the China-initiated development bank would issue yuan-denominated loans to boost the internationalisation of the renminbi and challenge the US dollar's hegemony, the AIIB will initially not lend in currencies other than the dollar. This is understandable given that most members have made their contributions to the bank's paid-in capital in dollars and that the majority of the resources to be raised in the international capital markets by the AIIB are expected to be in the same currency. In addition, one of the strategic purposes behind the bank's creation is to allow China to use a fraction of its sizeable foreign-exchange reserves, invested mainly in low-yielding US treasuries, for more rewarding purposes. Future borrowers will also find it more practical to receive loans in dollars when dealing with providers of goods and services, given that AIIB's AoA does not restrict procurement to the member countries only. President Jin Liquin did, however, also hint at the possibility of raising capital in other currencies, notably in euro and yuan, in due course. When other major international currencies constitute a greater share of its capital, the bank may also gradually diversify its currency basket to mitigate the adverse impact of exchange rate fluctuations.<sup>73</sup> In the medium term, the AIIB may therefore come to mirror the lending practices of the World Bank and the ADB, which provide debt instruments in several currencies, not least in the US dollar, Japanese yen and euro.<sup>74</sup>

Finally, in a sharp contrast to the traditional MDB model, the AIIB's AoA allows, in principle, for non-sovereign actors to gain membership in the bank. The door is nevertheless only open to private sector entities from countries that are themselves AIIB members. This overture to the non-sovereign sector is in line with China's intention to endow the bank with the best practices of public institutions and private sector companies, and contravenes the non-profit nature of traditional MDBs.<sup>75</sup>

<sup>71</sup> *China Daily*, 'AIIB vows to engage private sector across world in Asia's infrastructure investment', 21 September 2015

<sup>72</sup> Interview with a representative of New Zealand at the AIIB's board of directors.

<sup>73</sup> *Financial Times*, 'China's new Asia development bank will lend in dollars', 17 January 2016.

<sup>74</sup> Asian Development Bank, Financial Products, and the World Bank Treasury, Debt Instruments.

<sup>75</sup> P. Singh, *Reshaping the Global Financial Architecture*, East Asia Research Programme.

## Challenges going forward

In seeking to expand its operational capacity, the AIIB will face similar challenges to the NDB. Yet, the presence of a larger number of shareholders, the consequent greater potential for an AAA credit rating, the somewhat quicker capital payment schedule and the likely accession of additional members suggest that the AIIB may realise a more dynamic portfolio growth than the NDB. Humphrey has prepared several scenarios for how the AIIB's loan portfolio may evolve. Counting with a paid-in capital of \$20 billion, an equity-to-loans ratio of 20% and an average mark-up rate of 5%, the institution's lending portfolio is expected to reach around \$120 billion by 2025. This would allow the bank to boast of a similar loan portfolio to the IADB by the same date (\$120.4 billion) and far bypass that of the ADB (\$73.1 billion).<sup>76</sup>

Similarly to the NDB, one way for the AIIB to expand further its operational capacity is to broaden its membership and thus its capital base. Since the signature by 57 founding members of the MoU for the creation of the AIIB, no further member has been co-opted by the bank's board of governors. Arguably, the largest addition to the AIIB's capital would be represented by the accession of the two largest shareholders of the ADB: Japan and the United States. Being an Asian country, Japan would automatically fall in the group of regional members which, combined with the size of its economy, would result in a significant amount of shares, rendering Tokyo the second most powerful member in the institution.<sup>77</sup> Yet, the Japanese government – along with Mexico – has continued to share the US's opposition to the AIIB, which has officially been justified by the lack of transparency and China's dominant role in the bank's decision-making process. Yet, considering their economic might, both the United States and especially Japan as a regional member would have a significant potential to act as counterbalance to China in the bank and impact strongly on its policies. The genuine reasons of Washington's resistance to membership may rather be traced back to geopolitical considerations and prestige,<sup>78</sup> which Japan has emulated by reason of its commitment to strengthening its alliance with the United States. While concerns about the AIIB's utility as a geopolitical tool – backed up by the OBOR initiative – that benefits China appear to have been allayed in the recent months,<sup>79</sup> membership remains off the table in both Washington and Tokyo.<sup>80</sup>

Currently, there are more than 30 countries seeking to join the AIIB as ordinary members.<sup>81</sup> Apart from the obvious lack of influence over the wording of the bank's AoA, the downside of this status is a somewhat limited governance influence given

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<sup>76</sup> C. Humphrey, *ibid.*, p. 15.

<sup>77</sup> Interview with a Brussels-based Chinese diplomat.

<sup>78</sup> The membership of the United States would also require the approval of the Congress.

<sup>79</sup> Article 31 of the AoA clearly states that financing decisions will be taken solely on the basis of economic considerations, leaving aside 'the political character of the member concerned.'

<sup>80</sup> Interview with a Brussels-based Japanese diplomat.

<sup>81</sup> *The BRICS Post*, 'China to add 30 more nations to AIIB tally', 26 March 2016.

that ordinary members will not be assigned founding member votes. Among the future members are two EU member states, Belgium<sup>82</sup> and Hungary,<sup>83</sup> which have made concrete steps towards accession and are expected to join the institution in the second half of the year. Another crucial prospective member is Hong Kong as a sub-sovereign government, meaning that it has to request China's Ministry of Finance to apply on its behalf. Given its position as an Asian and global financial centre, the special administrative region is expected to help the AIIB raise resources on the international capital markets and act as the bank's international currency exchange centre, specializing in renminbi.<sup>84</sup> By contrast, Taiwan, which has long intended to join the bank under the title 'Chinese-Taipei' but was rejected by China, has recently indicated that it would not accept the 'Hong Kong model'.<sup>85</sup>

Given the presence of several developed countries with AAA rating, it is reasonable to expect that the AIIB will benefit from a stronger position on the international capital markets than the NDB. As per Standard and Poor's, the breakdown of the shareholding suggests that just over 15% of the AIIB's capital stock is in the AAA and 41% is in the AA range. Yet, as argued above, having some AAA-rated members is not the only crucial factor in claiming a high credit rating. The bank will also be under pressure to take a cautious attitude towards capital employment in the early years, maintaining its equity-to-loans ratio in the 23-27% range. At the same time, the strong commitment to the bank expressed by China on several occasions may act to boost bond investors' confidence vis-à-vis the AIIB and thus significantly improve the institution's market position. The bank's room for manoeuvre in making a better use of its equity may also increase if other MDBs also move in this direction. Among a series of measures announced by the World Bank Group President Jim Yong Kim in April 2014 was the intention of making a more aggressive use of the IBRD's shareholder capital. A positive market reaction to such a move may create a wave the AIIB could also ride.<sup>86</sup>

Since becoming operational on 16 January 2016, the bank has not yet been granted any credit ratings. It is expected that, similarly to the NDB, the AIIB will first obtain favourable ratings from the biggest Chinese agencies (China Lianhe Credit Rating Co. and China Chengxin International), which the senior management could subsequently use as a lever of influence over international agencies. As President Jin Liquin warned in September last year, the new international development bank could offset a low credit rating stemming from international agencies by tapping into the Chinese market to raise the necessary resources. Negotiations between the bank and

<sup>82</sup> Vanoverveldt.belgium.be, 'Government gives green light for accession to Asian Infrastructure Investment Bank', 19 June 2015.

<sup>83</sup> Kormany.hu, 'Hungary to join AIIB', 14 April 2015.

<sup>84</sup> Ejinight, 'Hong Kong Should Draft Proposal to join AIIB', 13 April 2016.

<sup>85</sup> SCMP, 'Taiwan says it will not joining the Beijing-led AIIB', 13 April 2016.

<sup>86</sup> World Bank, 'World Bank President Sees \$100 Billion Increase in Lending Ability to Help End Poverty', 1 April 2014.

Standard & Poor's, Moody's and Fitch are currently underway.<sup>87</sup> This means that the first bonds to be issued this year will likely be non-rated by credit agencies.

Owing to its focus on just two facets of development policy (infrastructure investment and sustainable development), the AIIB will operate with a lean staff of around 500-600 employees whose recruitment is not conditional upon the membership of their country of origin. Even though some of the AIIB's planned operations (public-private partnerships, equity operations) will demand the hiring of first-class project staff with significant expertise, the bank's administrative costs will likely be at the lower end of the range in comparison with most other MDBs. This holds true even if some of the non-borrowing members may insist on the formulation of robust review mechanisms that may drive up staffing costs. Furthermore, in contrast to the World Bank and the ADB, the AIIB does not intend to set up an extensive network of local branches and seeks instead to utilise multimedia tools in cooperating with other development actors. Low administrative expenses combined with a high credit rating could result in a low cost of funding for the AIIB. This, in turn, may allow the bank to generate a significant amount of return on equity even on the basis of average interest rates. According to Humphrey's projection, an average mark-up of 3.5% on loans could allow the AIIB to continuously expand its net income and but still remain competitive in relation to other MDBs. Its interest-rate-based revenue may climb up even higher if the AIIB does indeed focus on non-sovereign borrowers in particular, as private sector operations are generally considered more risky and thus entail a higher mark-up. The fact that the EBRD – a development bank designed to work exclusively with the non-sovereign borrowers – was one of the first MDBs with which the AIIB sought to form an institutional partnership last May confirms its expected emphasis on the private sector. The two institutions have already agreed on plans to co-finance a road linking Dushanbe, Tajikistan, with the Uzbek border, pending approval by the AIIB's board of directors in June.<sup>88</sup>

Just like the NDB, the AIIB is also expected to engage in other forms of income generation, notably equity investment. AIIB officials have noted, however, that loans will initially be the major form of operation for the bank, with equity investment, guarantee services and investment funds to be provided at a later date.<sup>89</sup>

## What is in it for the EU?

The AIIB embodies yet another source of development finance for the countries of Asia and Oceania. The two other MDBs active in the area are the World Bank and the ADB, which collectively supply about a third of the official development assistance

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<sup>87</sup> Reuters, 'AIIB says could rely on Chinese investors if ratings unfair', 17 September 2015.

<sup>88</sup> AIIB, 'AIIB to cooperate with EBRD', 11 May 2016

<sup>89</sup> *China Daily*, 'AIIB outlines five core areas for investment', 4 December 2016.



(ODA) flowing into the region.<sup>90</sup> As EU member states have been actively engaged in both of these institutions, the AIIB's emergence on the development landscape of the Asian continent is not without potential consequences for the Union.

In addition to the close link between the EU and the World Bank discussed in the previous chapter, the EU member states also have a strong presence and stake in the ADB: they collectively account for about a third of the total voting power and of the total subscribed capital stock. EuropeAid also makes regular financial contributions to the ADB, totalling €82.19 million in the 2007-2013 period.<sup>91</sup> In addition to their financial support, EU member states have invested a considerable political effort in raising the profile of their own development thinking within the institution. This is because the ADB was at the outset predominantly reflective of the Japanese developmental policy approach that contrasted with the World Bank's market-liberal reformist stance. The bank has tended to function on the basis of consensus and harmony, also featuring a strong bureaucracy and strict hierarchy. In addition, the ADB charter further stipulates that the bank will act in an apolitical fashion and will not interfere in the political affairs of its member states. Put together, the *modus operandi* of the ADB has traditionally been strongly reminiscent of the functioning of most Asian societies.

In their approach to the ADB, EU member states have tended to focus on bolstering the bank's operational capacity while also improving the normative and social aspects of its activities. Over the years, their financial contribution has increasingly become conditional upon a stronger emphasis on human rights, labour and social standards in ADB undertakings. Largely because of this pressure, loans for social issues including education and health have gradually increased in the past two decades at the detriment of economic infrastructure projects, and now make up more than 40% of all ADB loans. Moreover, the goal of being apolitical has also been diluted over the years, allowing the bank to promote more actively governance standards in recipient countries. But rather than following the World Bank's path in launching specific governance projects, the ADB has tended to embed governance and capacity-development considerations within the priority sectors of its country programmes.<sup>92</sup> Overall, while the gradual shift of emphasis away from infrastructure projects to social issues in the ADB has certainly been a welcome development from an EU perspective, the biggest recipient nations, led by China<sup>93</sup> and India, have become increasingly disenchanted given their extensive need for physical infrastructure-oriented loans. In light of what has been said above, it is hardly surprising that the China-led AIIB was conceived with the primary goal of promoting economic infrastructure development.

<sup>90</sup> M. Okano-Heijmans and D. Waardenburg, *ibid.*, p. 13.

<sup>91</sup> ec.europa.eu, 'Financial contributions of EuropeAid to ADB 2007-2013', 31 October 2014.

<sup>92</sup> M. Okano-Heijmans and D. Waardenburg, *ibid.*, p. 15.

<sup>93</sup> Among borrowing ADB members, China has the biggest voting power of 5.47% followed by India's 5.38%.

Arguably, the EU's foremost interest vis-à-vis the AIIB lies in ensuring that the new multilateral will observe labour, social, environmental and procurement standards in the same way as the other two key MDBs (World Bank and ADB) operating in the Asia and Oceania. On the side, member states with competitive engineering companies may also want to exploit the economic benefits that come with the emergence of the new development institution. In the first years of operation, the AIIB is expected to devote 65-70% of its annual lending to transport and energy projects and 25% to urban and water projects.<sup>94</sup> This heavy emphasis on hard infrastructure investment combined with China's dubious adherence to OECD-championed standards has rung alarm bells in several Western capitals. Most concerns among OECD members have arisen with regard to energy projects. While in certain Asian countries like India access to basic electricity remains an outstanding issue, the World Bank, in response to the policy guidelines declared by the United States in 2013, has essentially stopped lending for coal-based electricity projects – the cheapest access to power. These developments spurred India and Indonesia into formulating concrete expectations, in mid-2015, towards the AIIB to finance large-scale coal energy projects. The likelihood of obtaining funds from the bank for such projects is still not clear. The AIIB's current Environmental and Social Framework (ESF)<sup>95</sup> does not technically exclude the possibility of financing projects involving coal and other fossil fuels. The bank's energy-related projects may be guided by a separate Energy Strategy to be developed in the near future.<sup>96</sup> Nonetheless, the large number of outreach efforts undertaken this year by President Jin, including meetings with the leaders of EU countries and MDBs, can be taken to suggest that the AIIB is not likely to position itself against established donors on the issue of standards. President Jin was said to have taken a very open attitude towards the expectations of his negotiating partners, showing willingness to address their concerns to the largest extent possible.<sup>97</sup>

The AIIB has already entered into a form of partnership with several other MDBs, starting with the World Bank on 13 April this year. The Co-financing Framework Agreement sets out the terms on which the two institutions will co-finance investment projects in sectors including transport water and energy in Central Asia, South Asia and East Asia. Of the \$1.2 billion in financing to be approved by the AIIB this year, it is expected that joint projects between the two institutions will account for a substantial share. As all co-financed projects will be prepared and supervised by the World Bank in accordance with its policies and procedures in areas like procurement, environment and social safeguards, the AIIB's room for manoeuvre in ignoring certain standards appears very limited as far as such joint projects are concerned.

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<sup>94</sup> Interview with a Brussels-based Korean diplomat.

<sup>95</sup> Most MDBs have an ESF that sets out the environmental and social standards they adhere to in their operations.

<sup>96</sup> Interview with a representative of New Zealand at the AIIB's board of directors.

<sup>97</sup> Interview with a Brussels-based Russian diplomat.

On 2 May, the AIIB signed a similar agreement with the ADB. The document paves the way for the co-financing of projects in a broad range of areas with a particular emphasis on the road and water sector. The first joint undertaking will concern the construction of Pakistan's M4 highway project, a 64-kilometer stretch of motorway connecting Shorkot to Khanewal in Punjab Province. The two institutions have also vowed to undertake regular high-level consultations and joint data collection to promote the implementation of the sustainable development goals and the climate agreement struck in Paris last year.<sup>98</sup> The Beijing-based multilateral also plans to join the global clean energy initiative launched at the 21<sup>st</sup> Conference of Parties (COP21).<sup>99</sup>

A similar accord was signed between the AIIB and the EBRD on 11 May, setting out a framework for strategic and operational cooperation. The two also agreed to engage in a regular dialogue at the level of senior management, to exchange information on respective policies and strategies and on activities in areas where both institutions are involved. In addition to the planned co-financing of a part of the east-west highway in Central Asia mentioned above, further joint projects are also being considered.

If the AIIB indeed carries out a significant part of its funding through such co-operative frameworks with established MDBs, it will also be less likely to bypass robust standards. Attributable to this openness and President Lin's repeated emphasis on the AIIB's intention to be clean, green and transparent while also achieving the highest standards of good governance, expectations towards the bank appear to have shifted too. This is best exemplified by India's recent demand for \$500 million for solar rather than coal power projects.<sup>100</sup> As to whether concerns of OECD nations about the bank's involvement in coal energy projects are still valid, a Brussels-based Russian diplomat's response may offer a pointer: 'At the AIIB, no one talks about coal.'<sup>101</sup>

In addition to the AIIB's commitment to sound banking policies, the other crucial interest of EU member states relates to their participation in the bank's procurement processes – the foremost incentive for non-borrowing countries to become members of regional development banks. However, in contrast to most other regional MDBs which tie procurement to membership, the AIIB places 'no restriction upon the procurement of goods and services from any country from the proceeds of any financing undertaken in the ordinary or special operations of the Bank.'<sup>102</sup> This is a sharp difference from the ADB's membership-tied procurement practices, which have traditionally left the supply of goods and civil works to borrowing nations and

<sup>98</sup> AIIB, 'AIIB, ADB sign MOU to strengthen cooperation for sustainable growth', 2 May 2016.

<sup>99</sup> Reuters, 'China-led AIIB eyes first loans to India', 31 March 2016.

<sup>100</sup> *The Guardian*, 'India seeks 500m loan for solar projects', 31 March 2016.

<sup>101</sup> Interview with a Brussels-based Russian diplomat.

<sup>102</sup> Articles of Agreement of the AIIB, Article 13.

the provision of consultancy services to non-borrowing ones. This open procurement policy will clearly distinguish the AIIB from the BRICS-led NDB while putting it on a par with the EBRD – the only regional development bank hitherto to have deviated from standard practice of restricted procurement policy. Arguably, the obligation to arrange unrestricted international tenders for AIIB operations may be seen as rendering membership in the bank less important. Yet, it is reasonable to expect that the private sector entities of member countries will stand a much higher chance of successfully bidding for contracts than those of non-members.<sup>103</sup>

Bearing in mind the above considerations, EU member states provided diverse responses to the AIIB. Although a joint EU response was briefly explored in the Economic and Financial Committee, it was eventually dismissed largely due to the UK's unilateral decision to join the bank. Yet, with 14 EU member states having joined the AIIB, and several others edging towards membership (Belgium, Hungary and potentially also the Czech Republic), it appears clear that most EU countries consider that they are more likely to further their interests (ensuring strict observance of standards and/or exploiting economic opportunities) from the inside.

The fragmented EU response to the AIIB has been somewhat remedied by the fact that EU member states have managed to organise themselves into two constituencies in the AIIB. The first one consists exclusively of eurozone members, including Austria, Finland, Germany, Luxembourg, Malta and the Netherlands. France, Italy, Portugal and Spain will join this group once they have ratified the AoA. The constituency where other EU countries are found consists of non-eurozone EU members (Denmark, United Kingdom) as well as non-EU European countries (Iceland, Norway, Switzerland) to be joined by Poland and Sweden. The joint constituency formed by eurozone AIIB members is a unique pattern of unified external representation for the monetary area in an IFI. In established IFIs such as the IMF and the World Bank where EU member states collectively wield over 30% of total voting strength, eurozone members tend to be spread across a range of constituencies. A form of unified representation is only possible in the IMF where the European Central Bank, as an observer at the fund's board, often intervenes on behalf of the eurozone members on monetary and exchange-rate policy.

Constituencies in the AIIB are led by an executive director, up to two alternate directors and three advisors that all form part of the board of directors, allowing for most members of the groups to be directly represented at the board. The eurozone constituency is currently presided over by a German director assisted by an Austrian and a Dutch alternate director, all of whom are elected for two years. The board of directors being non-resident, co-ordination of the eurozone members takes places from the capitals concerned or from Brussels via the Economic and Financial

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<sup>103</sup> Interview with a Brussels-based Korean diplomat.

Committee or the Sub-Committee on IMF under the patronage of country holding the executive director post. The Germany-led constituency forms joint positions on a consensual basis, considering the possibility of split votes in board meetings to be a solution of last resort, while also seeking to co-operate systematically with the other constituency made up of European countries.<sup>104</sup>

If, similarly to the ADB, EU countries manage to form alliances with other European AIIB members such as Iceland, Norway, Switzerland and Turkey, the European bloc will represent 24.6% of the total voting power. In substantive decisions taken by super majority (75% of voting power), this would nearly grant the bloc a *de facto* veto power. This scenario is, however, complicated by the recent deterioration of relations between the EU and Turkey as well as by the fact that the latter is not part of any of the 'European constituencies.' Nonetheless, if acting in harmony, the 20% of combined voting power represented by Europeans could still allow them to weigh heavy in board meetings and draw adequate attention to the normative context of the bank's undertakings. However, in contrast to the ADB, it is less likely that this influence will be sufficient to put separate 'soft' social projects (such as specific governance or education projects) on the bank's agenda given that its *raison d'être* is to make funding available precisely for 'hard' infrastructural projects.

While the accession of the remaining smaller member states would do little to boost the EU's governance influence due to the cap on non-regional members' aggregate voting power, membership for the EU itself in the AIIB could bring about a more streamlined representation. As in the NDB, this would have to be preceded by the incorporation of a REIO clause in the AoA of the AIIB. According to Chinese officials, however, the biggest obstacle to the EU's membership is internal, as it is frowned upon by several member states that fear a loss of influence.<sup>105</sup> Nonetheless, the European Commission's in-house think tank (European Political Strategy Centre) has already presented detailed scenarios for the EU to be represented in the AIIB, whether it be through the Commission or the EIB,<sup>106</sup> which demonstrates that this issue is not entirely off the table.<sup>107</sup>

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<sup>104</sup> Memorandum of the eurozone constituency at the AIIB.

<sup>105</sup> Interview with a Brussels-based Chinese diplomat.

<sup>106</sup> The EIB opened a permanent office in Beijing in June 2015 to foster cooperation between the two development banks.

<sup>107</sup> EPSC, *The Asian Infrastructure and Investment Bank*, 24 April 2015.

## CONCLUSION: OPPORTUNITY RATHER THAN MENACE?

Students of international development policy, left without any new addition to the global development architecture since the end of the Cold War, have been busy analysing the recent wave of MDBs emerging on the horizon. A significant amount of literature on the NDB and the AIIB have emphasised their potential to reshape the development landscape. This report has found that such claims are exaggerated and gloss over some key features of the new multilaterals. More specifically, the conclusion that emerges from this report is threefold.

First, the NDB and the AIIB are often assumed to be driven by the purpose of calling into question the primacy of the World Bank and the ADB, respectively. This argument, however, appears to turn a blind eye to the fact that both new institutions are exclusively dedicated to economic infrastructure projects, which only represent one of the many sectors in which most MDBs are involved. Such projects, for example, constituted only a third of the IBRD's operations in 2012-2013 and even the ADB dedicated just over half of its operations to this sector in the same period.<sup>108</sup> Thus, even if the NDB and the AIIB were to position themselves as a source of funding for transportation and energy projects with a lenient stance on normative considerations, this would have a little if any impact on established MDBs' operations in sectors such as health, education or governance. The IBRD, for instance, has traditionally carried out most of its activities in the area of social development (nearly 50% in 2012-2013) and would therefore be particularly protected from a possible downward pressure emanating from the NDB or the AIIB. But even in terms of new MDBs' involvement with hard infrastructure projects, the oft-repeated emphasis on high banking standards, the prioritisation of green energy projects in initial operations and – particularly in the case of the AIIB – the signature co-financing agreements with several established donors, and the decoupling of procurement from membership suggest that most of these worries are unjustified.

Second, while both the AIIB and the NDB are clearly built around the BRICS as far as governance influence is concerned, it is unlikely that these institutions will primarily serve to further the political agenda and strategic interests of their main shareholders. By recruiting their personnel from all over the world and – in the AIIB – granting positions to European non-regional members in the senior management, the two banks' resident staff will be less apt to engage in politically motivated operations that follow the national interest of their most influential members, including China. Moreover, the presence of nationals from non-borrowing members in key positions in the AIIB can also be taken to diffuse criticisms contending that the non-

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<sup>108</sup> Prizzon, Annalisa et al., *Multilateral Development Banks: a short guide*, Overseas Development Institute, 2015.

resident board structure will be used by the president to push questionable projects past the directors. As the former Chinese World Bank Chief Economist Justin Yifu Lin's relatively successful championing of industrial policies in the institution shows, the assumption of a key position by its national may allow a country to promote its agenda – or block that of the others – despite its limited voting power.<sup>109</sup>

Finally, as far as the EU is concerned, the foregoing analysis suggests that the AIIB and the NDB present an opportunity rather than a threat to EU member states in the field of development policy. Defying critics who suspect their involvement with polluting infrastructure projects, both the AIIB and the NDB have clearly upped the emphasis on green projects in recent months. The first batch of loans approved by the NDB for renewable energy projects is a clear sign that the bank indeed seeks to live up to its mandate and act in a sustainable fashion when financing infrastructure projects. The AIIB, too, appears to have managed to nip in the bud most expectations for financing coal-based energy projects, most recently demonstrated by India's demand for funding for solar investment. Given that EU member states continue to boast of numerous competitive companies in the green industry, the perceived shifting of the AIIB and the NDB towards green projects may generate further interest in EU capitals. While an increasing number of EU countries are edging towards AIIB membership (also driven by the purpose of forging closer ties with China), the NDB, which is due to admit members starting from mid-2017, has received little attention so far. As the Shanghai-based multilateral ties its procurement procedures to membership, it would be particularly timely for the EU to start considering its response to the NDB's future open door policy and avoid the sort of division that characterised its initial reaction to the AIIB.

Notwithstanding these clear signs that the two institutions are operating in a sustainable fashion, the question as to whether they will observe other standards too (social, labour, procurement etc.) remains open.<sup>110</sup> This is certainly more likely in the case of the AIIB given the recent series of co-financing agreements with established MDBs and the bank's declared intention of carrying out a considerable part of its operations through these frameworks. The question of whether the NDB embeds itself in the existing international development architecture through a similar web of partnerships is open-ended.

In brief, on the basis of their first months of operation, neither the AIIB nor the NDB appears to confirm allegations that they seek to rival traditional development actors. Instead, they seem to have grown out of emerging powers' recognition that they may be more effective in championing their economic infrastructure-oriented development policy through the creation of new institutions rather than through the reform

<sup>109</sup> M. Huotari and T. Hanemann, 'Emerging Powers and Change in the Global Financial Order', *Global Policy* Volume 5, Issue 3, September 2014, p. 300.

<sup>110</sup> For more on this, see R. Kamal and K. P. Gallagher, *China goes global with development banks*, Bretton Woods Project, April 2016.

of old ones with an ingrained emphasis on social matters. Provided they retain the best practices of the World Bank, the ADB and the like (including their observance of key standards) and improve on their flaws (such as slow project review), both the AIIB and the NDB stand a unique chance of adding value to the international development architecture. Should the two institutions manage to carve out a role in global governance, Beijing will have nonetheless also given a significant boost to its political influence by demonstrating its ability to launch, host and consolidate new multilateral structures.