ESSAYS

What the AIIB Can Do for the Multilateral System

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The Asian Infrastructure Investment Bank (AIIB) has enjoyed considerable success in its young life, which began with 57 countries, both within Asia and in the West, signing up for membership at its founding nearly two years ago. This mix of leading Asian and European members gave the bank's architect, China, a political win on the global stage, made more striking by the early resistance of the United States to the project.

Just how remarkable was China's early diplomatic success with the AIIB? Consider that the Asian Development Bank (ADB) had 31 sovereign members at its founding in 1966. A decade later it grew to 41 members, and with another growth spurt during the 1990s, the bank stands at 67 member states today. Compare that record with the AIIB. From 57 founding members in early 2016, the AIIB has grown to 80 member countries at the time of its annual meeting in June 2017.

The challenge going forward is to translate this resounding political success into operational effectiveness and sound strategy. Much progress has already been made, reflected in a charter and set of rules and procedures that demonstrate an adherence to key norms that guide other long-standing multilateral development banks (MDBs), as well as a desire to depart from norms where there is a rationale for innovation. Ultimately, sound rules will depend on good implementation, which is too early to gauge for the new institution. Recruitment of a global staff looms large as an objective, and to date, the bank's small staff has largely relied on cofinancing operations with other MDBs as a practical necessity.

But given the political dimensions of this new institution, it is not enough to consider how it will perform on its own. It is also worth considering what it will mean for other MDBs like the World Bank and the ADB. There are large questions of political leadership in the multilateral "system" but also an array of issues on which the AIIB could help shape a new system-wide approach, whether defined by some division of labor among the MDBs or by introducing institutional innovations.

From this perspective, it will be helpful for the MDB system's two largest shareholders, the United States and China, to define elements of a common MDB agenda.

Growth in the MDB system—who will lead?

The United States is the leading shareholder of the MDB system due to a governance structure that was established at the Bretton Woods conference in 1944. Ownership and voting power in these institutions is a function of the amount of capital provided by each member country, which, in turn, is typically based on the country's economic weight. Under this model, the United States is the dominant shareholder in the five MDBs to which it belongs—the World Bank, ADB, the African Development Bank (AfDB), the Inter-American Development Bank (IaDB), and the European Bank for Reconstruction and Development (EBRD). In aggregate, the United States accounts for 17 percent of shareholding across these institutions, or twice as much as Japan, the next largest shareholder. And given the size of these institutions, the United States remains the largest shareholder of the broader system of MDBs, which includes many institutions in which the United States is not a member, such as the AIIB and the 40-year-old Islamic Development Bank. Across the broader system, the United States accounts for 12 percent of shareholding, twice as much as China, the next largest shareholder.

Although this "shareholding" approach to governance has served the MDBs well in some respects (primarily by engendering greater efficiency in decision making compared to a "one country, one vote" model of governance), it also carries some limitations. It largely fails to recognize other sources of financing that countries provide to the MDBs. It also doesn't accommodate countries' desires to increase MDB capital and/or increase a country's shareholding absent agreement by the leading shareholders, and the United States in particular. China has directly encountered both limitations. Neither able to significantly increase its shareholding in the US-led MDBs or to participate in large expansions of their capital bases (due to limited appetite for large-scale capital increases among the Western shareholders), China has established large trust funds (each exceeding USD 1 billion) at the IaDB and AfDB, with smaller trust funds at the World Bank and ADB. These trust funds, which predate the establishment of the AIIB, are likely viewed by Chinese officials as a second-best option since they confer no governing status over the core operations of the institutions. Nonetheless, they likely increase China's informal influence within the institutions since the funds provide additional and substantial support to core operations.

Going forward, the question will be whether and how the system, led by the United States, will accommodate the pressure for growth coming from the developing world and championed by China. The political success of the AIIB reveals an important new outlet for this pressure, alongside trust fund arrangements within the core MDBs. It would seem, then, that there will be MDB growth, even with US resistance. Importantly, the AIIB, as a growth driver, is well positioned to help shape the system going forward.

Innovation at AIIB

By some measures, it may seem implausible that the AIIB could be a source of useful innovation for the MDB system. Its mission—infrastructure development—was defined by the World Bank at its founding over 70 years ago, and at least initially, the AIIB has chosen to go about it in the same way (lending to national governments to finance projects), even relying on the World Bank and other MDBs to take the lead for much of its initial portfolio of projects. Further, the AIIB has an incentive to align itself closely with the rules and practices of the other MDBs, not simply to reassure hesitant shareholders, but also to convince credit ratings agencies that it merits the prized AAA rating held by the other MDBs. In fact, the discipline imposed by borrowing in the marketplace will continue to push the institution toward conformity with the others over time.

Yet, we are already seeing signs of innovation in ways that could usefully inform the other MDBs. Four areas of innovation in governance and operations appear particularly promising.

One innovation is to avoid the trap of dividing up the balance sheet and operations strictly into public and private windows. These institutional "silos" at many of the other MDBs (the ADB being a notable exception) have made it hard for them to work flexibly in an environment that increasingly calls for public *and* private engagement together. Too often at the other MDBs, the work of the private sector arms demonstrates too little alignment with public policy aims and that of the public arms is too far removed from the realities of private finance. Institutional silos have created and reinforced these extremes. A single balance sheet, while introducing its own challenges such as how to allocate capital between public and private activities, avoids these problems. AIIB rules also reflect greater interest in actors that fall between the public and private lines, such as state-owned and sub-sovereign entities.

Second, the AIIB's decision to employ a "nonresident" board of directors was decried by some as a weakening of oversight and embraced by others as the useful rejection of an anachronistic governing model at the other MDBs. There clearly is a dated quality to having full-time representatives of the shareholders within the institutions when information technology largely obviates the need for this circa 1944 creation. At the same time, it could also be true that the AIIB's nonresident board will represent a weakening of oversight. Better evidence in favor of the AIIB's move comes with the recent decision to recruit two external members for the AIIB board's audit committee, chosen for their audit expertise. Through this simple measure, the AIIB's audit committee has likely surpassed all other MDB audit committees in quality. It is a case where more flexible design and rules have enabled a stronger approach—in this case, a stronger oversight function.

Third, the AIIB has also usefully avoided making fundamental distinctions between classes of countries for operational purposes. There are not "borrowing" countries and "non-borrowing" countries, nor are countries organized by per capita income. In practice, the bank will need to be responsive to the creditworthiness of its borrowers and come to terms with whether and how subsidized lending might be employed. It is noteworthy, for example, that the AIIB is financing a project in Tajikistan, a low-income country at high risk of debt distress. The loan is made possible through a cofinancing arrangement with the World Bank, which includes a substantial grant element such that the World Bank is effectively subsidizing the AIIB loan. Over time, the AIIB will likely face pressure to introduce its own concessional arrangements, rather than rely exclusively on other institutions.

But the rigidity that has formed around these issues at the other MDBs has become a barrier to effective development finance. At institutions like the World Bank, a donor-driven set of rules for the allocation of financing to lower-income countries is now struggling to come to terms with a dynamic landscape where many of these countries can more readily access nonconcessional financing, including within the MDBs themselves. The traditional MDBs now grapple with rigid rules for allocation of financing driven by countries' income status as country financing needs call for more flexible approaches.

Fourth, Chinese officials have indicated that there will not be a floor on China's voting power in a manner that protects the country's ability to exercise a veto in the AIIB. This is an important commitment, though it has yet to be tested. At the other MDBs, the interests of the United States and other leading shareholders in protecting their voting power make it difficult to take on new members and to allow for an expansion of the banks' capital.

Each of these measures represents an innovation or departure from longstanding MDB practice that could prove useful elsewhere in the system. But how might these innovations migrate from the AIIB to the other institutions, particularly when they touch on major areas of governance?

Ultimately, the impetus for changes of this sort rests with the MDB shareholders. From this standpoint, it is striking that the AIIB's 80 shareholders collectively hold a majority (50.99 percent) of the voting power in the World Bank. This suggests the possibility for AIIB-inspired innovations to migrate over to the other MDBs if the AIIB's shareholders are convinced of their utility and make a concerted effort to pursue changes in the other institutions.

Finally, there is the prospect that AIIB management and staff will exploit the relative flexibility of its rules, and the virtue of being a new institution, to introduce operational innovations. The World Bank has long been viewed as the leader in areas like procurement and project safeguards, to a degree that neglects the ways in which regional MDBs have introduced innovation. No matter the source, there is a substantial amount of cross-MDB collaboration and engagement (by one measure, there are over 100 cross-MDB working groups), and all MDBs will be well served to have the AIIB engaged in these efforts.

A new division of labor

The advent of the AIIB made clear that the basic MDB model of project finance introduced at the World Bank can be replicated across institutions. It also furthered a trend in which the World Bank is no longer the dominant actor in the MDB system when it comes to project finance. Collectively, the other four core MDBs surpassed the World Bank in capitalization in 2010. Going forward, the regional MDBs, which also tend to be more concentrated in infrastructure project lending than the World Bank, are positioned to lead on the infrastructure agenda, as there no longer appears to be a compelling rationale for World Bank leadership in this area.

Further, there is an emerging case for new leadership for the World Bank that relies on a different division of labor among the MDBs. A recent high-level panel convened by the Center for Global Development called for a clearer reorientation of the World Bank toward a global public goods agenda. There have long been elements of this agenda in play at the bank—notably the institution's strong research and data orientation, and more recently, substantial financing for climate change mitigation and adaptation efforts.

But the panel's case for public goods suggests a more fundamental shift for the bank toward a range of activities that rely primarily on grant support—whether going deeper in support of research across sectors (economics, health, agriculture); providing more subsidies to promote climate-friendly energy investments; or providing financing and technical support to manage cross-border challenges like refugees. Engagement in these areas is problematic from the perspective of the traditional MDB project loan, even as the case for project lending, particularly for infrastructure, continues to be compelling. Hence a new division of labor, with the AIIB and other regional MDBs better prioritizing project lending and the World Bank exploring new approaches in support of global public goods.

The danger of an increasingly crowded system

The opportunity presented by the AIIB's early success is not simply one that can be measured by the additional MDB capital deployed for good development purposes. There is also the prospect that the AIIB could affect change within the system of MDBs, and in turn, the AIIB could continue to adopt the norms that positively define the system.

But there is yet another possibility for a more damaging path, defined by a system that is even more fragmented than what exists today—one that has lost a sense of collective purpose under pressure from the strategic interests of competing shareholders. Imagine, for example, the spring convening of World Bank shareholders occurring at the same time as the annual meeting of the AIIB shareholders, with the conflicting calendars driven by the competitive interests of the United States and China.

The Obama administration effectively pivoted away from a confrontational orientation when it set aside its critical language toward the AIIB in favor of a constructive commitment to work on a shared MDB agenda with Chinese counterparts.

It is highly uncertain in the current political environment whether this commitment will hold. Both US and Chinese officials would do well to recognize that the other shareholders in the multilateral system welcome their leadership so long as it continues to support development progress globally. That means betting on the success of the AIIB and looking for opportunities to migrate those successes across the MDB system. In turn, it also means continuing to expect that the China-led institution will respond to key imperatives around collective norms and actions, typified by standards associated with debt sustainability and responsible lending practices. Both are achievable, even in a constrained political environment.