Discussion Paper

Multilateral development banks in the 21st century

Three perspectives on China and the Asian Infrastructure Investment Bank

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Introduction

Multilateral development banks (MDBs) have played a crucial role in supporting economic development and fighting poverty over the 70 years since the creation of the World Bank, at the Bretton Woods conference. However, the World Bank and major regional multilateral banks are considered by many – particularly in developing countries – to be too inflexible, bureaucratic and dominated by the political interests of wealthy non-borrowing shareholder countries.

Developing countries are creating their own purpose-built bilateral, regional-bilateral and multilateral institutions to provide market-based public lending. Several have long and successful track records, such as the CAF (Corporación Andina de Fomento, now called the Development Bank of Latin America) and the Central American Development Bank. The newest of these are the BRICS' New Development Bank (NDB) and the Asian Infrastructure Investment Bank (AIIB), where Chinese leadership played a large role in setting them up.

Now, more than ever, there is a pressing need to review whether the existing mandates, structures and instruments of MDBs will fulfil adequately their evolving objectives.

The Addis Ababa Agenda for Action on financing the post-2015 Sustainable Development Goals (SDGs) called for MDBs to scale up their financial and technical assistance to meet these ambitious objectives. In the words of the April 2015 Development Committee Discussion Note, the largest MDBs[1] explored what they can do, within their respective institutional mandates, to support, and in particular to finance, the achievement of the proposed post-2015 SDGs, and also to increase the mobilisation of financial resources.

In Kharas's view (2015), the post-2015 agenda reaffirms the development approach pursued by the World Bank and other MDBs. The SDGs are broader and more ambitious in scope than the Millennium Development Goals, covering areas where multilaterals have extensive experience, such as infrastructure and energy, governance and institutions, domestic resource mobilisation, leverage of the private sector and improved business environments, and more.

The MDBs' role in supporting international development and fighting poverty goes beyond the sectors of intervention. MDBs tend to channel a higher share of aid to poorer countries than bilateral donors (Levin and Dollar, 2005) and they are better at providing information and at monitoring recipients' use of funds (Rodrik, 1996); the negotiations between recipient countries and multilateral agencies tend to be less politicised than with bilateral donors (Rodrik, 1996); and multilateral lending was found to have superior enforcement capacity because of its *de jure* seniority (Bulow and Rogoff, 1990). On the side of the aid effectiveness agenda, Greenhill et al. (2015) showed that multilaterals can better absorb and share the risks inherent in working in fragile states, take a longer-term approach to development, tend to make greater use of country systems, score better on assessments of aid quality and provide more predictable finance, giving countries the confidence to make long-term fiscal commitments.

[1] The African Development Bank, the Asian Development Bank, the European Bank for Reconstruction and Development, the European Investment Bank, the Inter-American Development Bank, the International Monetary Fund and the World Bank Group.

The architecture of the MDBs, however, faces specific challenges and opportunities from the evolving landscape of international development finance. Among these, two main trends stand out.

First, countries eligible for the less concessional windows of MDBs, or even for softer loans, are favouring more expensive but less conditional international borrowing options (Greenhill et al., forthcoming). These include borrowing from bilateral export credit agencies and sovereign bond markets. However, responses to a survey of 40 developing countries by Davies and Pickering (2014) strongly indicate that satisfaction levels are higher for multilateral development organisations than for bilateral organisations. The study projects that in 5-10 years' time multilateral loans will be the largest source of finance.

Second, total public resources fall as GDP per capita increases until a country is well into middle-income status, as international assistance declines faster than tax revenues rise. Kharas et al. (2014) describe this phenomenon as the 'missing middle' of development finance. MDB non-concessional resources have been flat for decades, except during global crises, yet MDBs should in principle be well positioned to fill this financing gap. Some MDBs (notably the Asian Development Bank, with its merging of soft and hard windows, and prospectively also the World Bank) have identified specific ways to leverage their concessional window receivables instead of raising new paid-in capital.

Taken together, these trends illustrate and start to explain the scale of the task facing MDBs. What are the main obstacles and challenges facing the World Bank and regional development banks? Will the AIIB and NDB be different in governance and operations (and if so how) and will they achieve the necessary scale to make a meaningful impact? How will all MDBs grapple with the interests and changing power relations of shareholding countries, the increasingly sophisticated requirements of project finance and the evolving demands of capital markets, which supply much of the resources MDBs need to operate?

This paper brings together three different perspectives from leading experts to address some of these questions and shed some light on the challenges ahead for the architecture of MDBs. They are not meant to provide definitive answers but to spark debate, and they have to be considered stand-alone opinions.

- Chris Humphrey (University of Zurich and ODI) elaborates on the impact of the composition of the AIIB and NDB membership on their projected potential loan portfolio, the extent to which AIIB can achieve the goal of a more streamlined and borrower-friendly MDB, and still bring in major western non-borrower countries as shareholders.
- Stephany Griffith-Jones (Columbia University and ODI) reviews the main rationale driving the creation of the AIIB, its main features compared with long-established MDBs and the challenges ahead.
- Jiajun Xu (National School of Development/Center for New Structural Economics at Peking University) and Richard Carey delve into the rationale for China to expand its role in global financing institutions and its main initiatives beyond the AIIB, notably in the context of the Chinese Silk Roads Vision and Action roadmap.

Chris Humphrey: Will the Asian Infrastructure Investment Bank's development effectiveness be a victim of China's diplomatic success?

The world's newest multilateral bank – the Asian Infrastructure Investment Bank (AIIB) – doesn't open its doors until 2016, but the process of building the bank has already been a tremendous success for China. The Interim Secretariat led by Jin Liqun (now AIIB president-designate) has moved with considerable professionalism to get the bank up and running in record time.

In a major diplomatic coup, China convinced 56 other countries to join with it as founding members of the AIIB, most notably a number of major western nations, including the UK, Germany, France and Switzerland, despite pressure from the US not to do so. China retains 26% of AIIB's voting power, enough for a veto on major issues such as capital structure (similar to the US's power at the World Bank), but gave up veto authority on policy and lending decisions in the interests of attracting broad membership.

Bringing in so many important regional and non-regional countries as founding shareholders completely changed the global perception of the AIIB – from a parochial instrument of Chinese influence to a serious new development institution – and also greatly strengthened the AIIB's financial capacity.

At the same time, this diverse membership will pose a number of challenges to the AIIB. Membership and voting power go a long way to determining how a multilateral development bank (MDB) operates. And with governance similar to that of other MDBs – a mix of developing and industrialised non-borrower nations, each with different views on how an MDB should be run – is the AIIB in danger of becoming just a new version of the Asian Development Bank (AsDB) or World Bank, just replacing the US or Japan with China as the major shareholder?

To answer this question, consider the AIIB from the point of view of countries that might want to borrow from it. The factors shaping the usefulness of an MDB from the point of view of borrowers are many, but three broad characteristics stand out: financial terms, non-financial requirements and developmental value added.

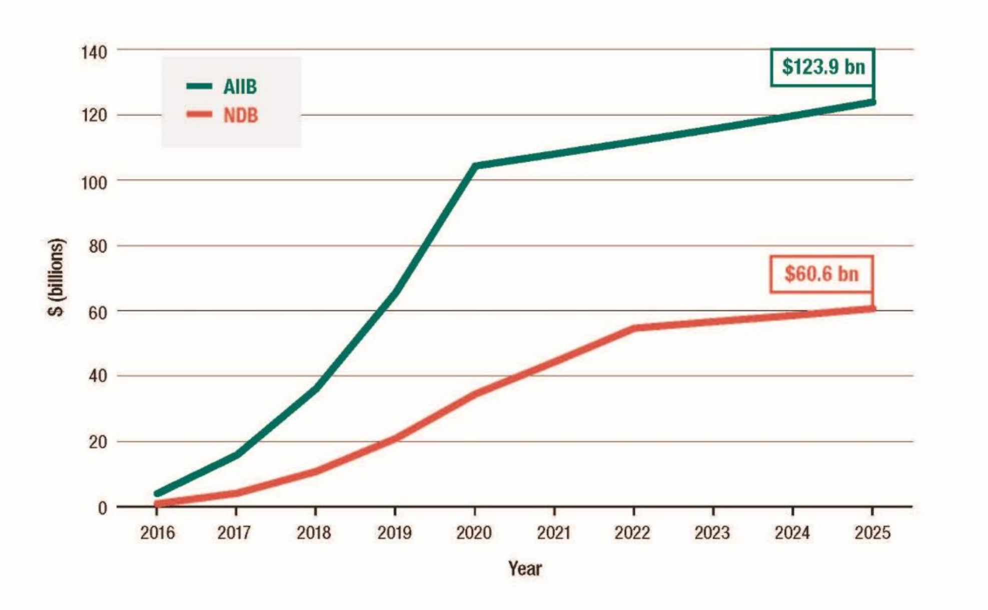
AIIB financial capacity: a clear win for broader membership

Opening up membership to major industrialised countries generates direct benefits for the financial capacity of the AIIB, in terms of overall volume of available resources as well as the financial terms of individual loans.

The most obvious benefit of more shareholders is simply that the AIIB will have more capital when it opens its doors, and hence greater lending capacity. Out of $20 billion in initial authorised paid-in capital, $19.6 billion is already committed. This contrasts with the BRICS' New Development Bank (NDB), which also has initial authorised capital of $20 billion, but commitments of only $10 billion so far. As a result, the AIIB will likely be able to ramp up lending faster and achieve a portfolio more than twice as large as the NDB within 10 years (Figure 1). An AIIB portfolio of $120 billion would be larger than any of the regional MDBs currently, and almost as large as the World Bank's IBRD window ($143.7 billion as of 2014), while the

NDB would be more in the range of the AsDB's current portfolio of just under $60 billion. Depending on how the AIIB manages its finances – capitalisation ratios, administrative costs, reserve and net income – this could grow even higher.

Figure 1: Projected potential loan portfolio of AIIB and NDB ($ billions)



Source: Author's calculations, based on model by J. Tyson, ODI.

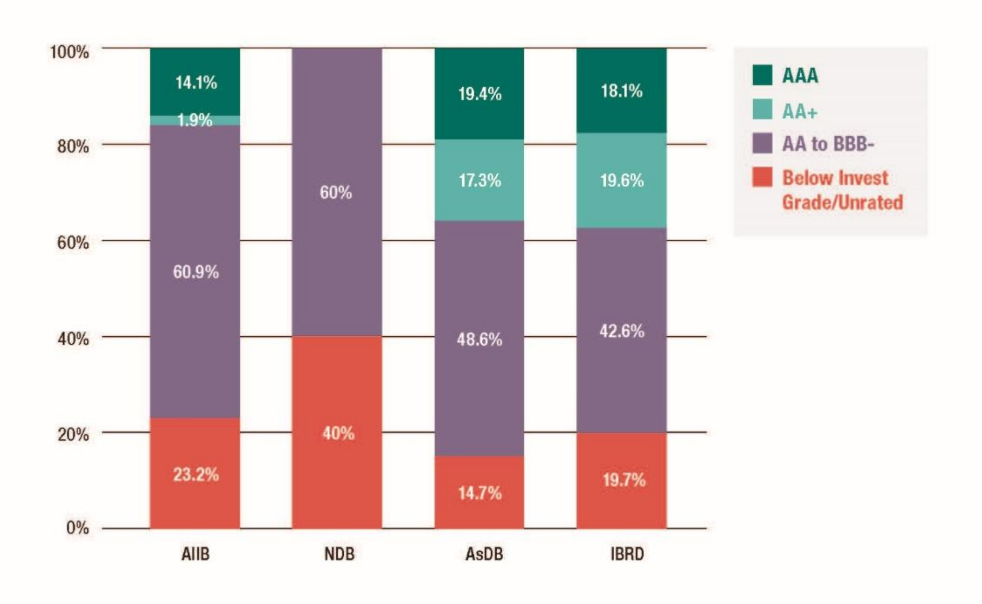
Notes: Assumptions include: return on equity of 3.5% per year, equity/loans ratio of 20%, no returns on lending for first two years, paid-in capital of $19.6 billion (AIIB) and $10 billion (NDB) paid in over five and seven years respectively, as stipulated in articles of agreement. Because the NDB has capital from lower-rated shareholders, assumptions in the model may be too optimistic, meaning it could well have a smaller potential portfolio. Projections do not consider borrower demand, which is not a given for either AIIB or NDB.

Bringing in major non-borrowing country shareholders will also give added confidence to third-party financial agents. MDBs increasingly leverage the developmental impact of their own balance sheets by partnering with other financing sources via co-financing arrangements, syndication or project bonds with private investors, bilateral agencies, export banks, other MDBs or sovereign wealth funds. By all accounts, co-financing, especially with the World Bank and AsDB, will be a major strategy of the AIIB, especially in its early years of operation, as it builds capacity. The participation of countries such as the UK, Germany and Switzerland in the AIIB's governance will greatly improve the willingness of other investors to work together with the AIIB, due to the perception of financial solidity, high standards of governance and low levels of political interference.

Loan pricing is another key characteristic for borrower countries, and which is all too often overlooked in debates on MDB activities. Loan pricing depends mainly on two factors: an MDB's own cost of funding and its targets for generating net income.

The presence of major industrialised country shareholders will improve the AIIB's access to capital markets, compared for example with the BRICS' NDB, which has only the five BRICS shareholders. The guarantee ('callable') capital of the AIIB will be of much higher quality, and comparable with that of other major MDBs (Figure 2). Credit rating agencies take this into account when defining an MDB's rating, and although the AIIB is unlikely to be rated AAA right away, it may be able to achieve the top rating relatively quickly, depending on how it manages its finances. This would allow the bank to fund itself very cheaply, in turn making it able to lend resources at attractive terms for development projects. The BRICS' NDB, on the other hand, is very unlikely to achieve an AAA rating even in the medium term. This will make the NDB's loan costs higher, potentially limiting demand, especially from middle-income developing countries.

Figure 2: Bond ratings of MDB callable capital



Source: Author's calculations, based on 2014 annual reports for AsDB and IBRD, announced capital structure for AIIB and NDB, and Standard and Poor's sovereign ratings as of October 2015.

The AIIB will also have access to other sources of finance, most notably the Chinese capital market, which remains largely closed to outside bond issuers. This is a huge source of finance due to very high amount of Chinese savings seeking safe returns. The Chinese Development Bank – with a loan portfolio of $1.27 trillion at the end of 2014, dwarfing all MDBs – has been extremely successful at funding itself in the Chinese market at very low cost. With the backing and implicit guarantee of the Chinese government, the AIIB will have access to the Chinese capital market, thus giving it an important funding advantage over other MDBs and helping keep its overall funding costs down.

Once funding costs are taken into account, an MDB sets loan pricing based on being able to cover administrative costs and generate a certain level of net income. Administrative costs are likely to be very low at the AIIB, due to low levels of staffing (100-120 initially), in keeping with its aim of being a 'lean' MDB. Incentives to increase net income via higher loan charges are also likely to be less than at other MDBs, where non-borrowing shareholders have grown accustomed to using net income to defray the costs of supporting concessional lending (for example at the World Bank's IDA) and increasing MDB capital. Neither of these is likely to be an issue at the AIIB, at least initially, since there is little appetite to start a concessional lending window and there is no shortage of capital for the new bank.

Non-financial requirements: mixed signals

What about non-financial requirements for lending? The World Bank and major regional MDBs are (despite some recent improvements) highly bureaucratic, with complex policies and processes that are difficult for borrowers to navigate – many put in place at the behest of non-borrowing countries responding to domestic lobbying. In some cases the extra time and hassle these entail lead borrowing countries to shy away from working with these MDBs.

The AIIB was clearly intended to be a different kind of MDB, faster and much less bureaucratic. As Chinese Foreign Minister Lou Jiwei commented in an interview, ‘In many international organizations, it often takes more than three to five years for a project to launch, which we should avoid’ (China Daily, 2015). The article went on to note that the ‘AIIB would simplify the complicated governance structure that many international organizations are using’.

Is it possible for the AIIB to build a more streamlined and borrower-friendly MDB, and still bring in major western non-borrower countries as shareholders? These governments will not be able to commit public resources to the new bank unless they can reassure their citizens (and, more to the point, legislatures) that the AIIB will not build coal-fired power plants by the dozen, pave highways through the rainforest or approve poorly-designed projects that end up being expensive failures. And in their eyes, this could mean more bureaucratic oversight.

Striking a balance between these two seemingly competing goals will not be easy. But a number of early signs suggest that the AIIB may be headed in the right direction. It has helped that both China and the non-regional countries clearly want to reach a deal. China is eager to keep the industrial countries on board, but at the same time these countries know they are not calling the shots and are wary of pushing too hard.[2] Furthermore, several of the non-regional countries, including the UK, Germany and France, recognise the deficiencies of existing MDBs and are open to new approaches, unlike, for example, the US, which is more restricted by domestic politics. Thus, while China and the non-regionals might be coming from different sides, they appear to be working hard to find a pragmatic middle ground acceptable to both.

On environmental and social safeguards – which US government officials flagged as a major concern about the AIIB – the bank has gone out of its way to allay concerns, hiring World Bank safeguards guru Steven Lintner and holding extensive discussions with non-borrower governments and NGOs. The draft safeguard policy in itself seems to say all the right things, but much will depend on how the policy is operationalised: detailed bank/borrower obligations, the exact role and authority of safeguarding staff in project development and oversight/transparency mechanisms have not yet been finalised. One positive sign, however, is the rhetorical emphasis on using country systems whenever possible. This has been a major failure of existing MDBs, which often seem more concerned with protecting their own projects against criticism from NGOs and domestic politicians than in achieving development goals. Greater use of country systems has the dual virtues of promoting greater borrower capacity (and, hence, developmental impact) and streamlining loan approval bureaucracy.

The overall bureaucratic structure and approval process looks to be considerably lighter than for existing MDBs, according to the articles of agreement and draft versions of the financial policy and business plan. The board of executive directors will be non-resident, which will save time in the loan approval process as well as substantial administrative overhead costs. Some member countries may be concerned about the lack of day-to-day shareholder oversight of AIIB operations, but the experience of other MDBs shows that resident boards tend to be overly politicized and add little to an MDB’s development impact. In addition, the AIIB’s draft finance policy envisions that all public sector loans under $300 million and private sector

[2] According to interviews with negotiators from two European shareholding countries.

loans under $200 million will be approved by the president directly, without requiring board consultation. These provisions – which must still be approved by AIIB governors in early 2016 – are a significant break from most major existing MDBs, giving AIIB management greater authority and likely streamlining the approval process considerably.

Developmental value-added: uncertain

The ability of the AIIB to provide expertise to governments and private sector borrowers in designing high-quality projects will be fundamental to its success. Dozens of interviews with borrower government officials for a previous research project, as well as ODI's Age of Choice project and surveys by the MDBs themselves, highlight the importance of MDB knowledge value-added. For example, the World Bank may be highly bureaucratic and prone to imposing its view of development, but governments recognise that it has unparalleled ability to bring global experts and experience to bear in designing projects of very high quality. That helps explain why China – with nearly $4 trillion in reserves – itself continues to borrow from the World Bank.

Building this expertise is not as directly linked to membership and voting power as the financial and non-financial factors discussed above, and it is far from certain how the AIIB will evolve in this regard. The AIIB could carve a very relevant niche for itself by specialising in accumulating and sharing experience on complex infrastructure projects – a set of skills sorely needed in developing countries. The lack of thoroughly designed projects is as much of a bottleneck in infrastructure expansion as the lack of financing, if not more so. The AIIB could take the lead in this area by having a team of experts to advise on engineering, sustainability, social and environmental impacts, fiscal, regulatory and pricing issues, project financial structuring, and attracting external public and private investors. Such a niche could be extraordinarily valuable from a developmental viewpoint, but means that the AIIB would have to dedicate sufficient resources to hire the quantity and calibre of staff essential for such a strategy to succeed.

Conclusion: AIIB has the opportunity to be the best of both worlds

Most aspects of how the AIIB will operate are uncertain, and will remain so until the bank opens for business in 2016 and its governors vote on policies now under negotiation. But on existing evidence, the AIIB is – unlike the BRICS' NDB – extremely well positioned to help push development banking into the 21st century. China is clearly seeking to engage in development with a new, multilateral approach, and a number of major industrialised country shareholders are willing to give support in hope of contributing to a new approach to infrastructure in Asia, and perhaps globally. The combination of China, middle- and low-income countries from Asia and elsewhere, and a group of major industrialised countries could offer the AIIB an opportunity to be the best of both worlds: financially strong, with a focus on high developmental quality, and relatively streamlined and efficient.

Stephany Griffith-Jones: The Asian Infrastructure Investment Bank: changing development finance architecture

The creation of the Asian Infrastructure Investment Bank (AIIB), as well as other development finance institutions (such as the BRICS' New Development Bank and the Silk Road Fund), seems not only to herald a new era, but also to provide a valuable continuity with both the post-World War II era and the more recent past.

The AIIB and the other new institutions signal a break with the past in that they are mainly South-South multilateral institutions. They use a relatively small part of the abundant foreign exchange resources and savings, as well as the expertise, of some emerging economies, especially China, and channel them towards much needed infrastructure in other emerging and developing economies.

The desire to create these new institutions was partly born from the refusal by developed country governments, and the US in particular, to increase the capital of existing multilateral development finance institutions or to give significantly greater voice to the emerging and developing countries (EADC) within them. They had also been fairly unwilling, until recently, to use a sufficiently large part of the resources of the existing multilateral development banks (MDBs) to fund infrastructure, especially for interconnectivity between countries.

This was contrary to the view of most EADC governments, as well as many western scholars, who believed that existing multilateral development finance institutions should be larger, should allow the EADC countries a greater voice, reflecting their increased weight in the world economy, and should devote a larger share of their resources to infrastructure. Indeed, there are numerous studies that show the major deficits in infrastructure, including green infrastructure, that exist in EADC countries. These deficits impede growth and inclusive development in EADC countries, and are an important barrier to the growth of trade between them and with the developed world.

Thus institutions such as the AIIB were born from the need to significantly expand the capacity to fund projects to fill the major gaps in infrastructure (which include, for example, contributing to providing electricity to 1.4 billion people and clean water to 0.9 billion people who do not have access to these utilities), as well as to facilitate connectivity within and between countries. They were also born from the perception that existing public and private institutions could not, on their own, fully fill this major gap.

While it is very new that emerging economies (and particularly China) are taking the key role in these institutions, and are thus starting to change the global governance of development finance, there is continuity in that they are doing it by creating new MDBs. Indeed, this is exactly what the developed economies, particularly the US, started doing when World War II was ending. The World Bank was created initially to help rebuild the infrastructure of a heavily damaged Europe, and then to fund new infrastructure, and later investment for growth more broadly, in developing economies. Most other development banks, such as the European Investment Bank, were also set up to help finance infrastructure, especially in poorer regions in Europe, to support the expansion of trade that European integration was designed to achieve.

It is not just that China and other countries are creating new banks, but that they are (as in the post-World War II period) creating public development banks. Indeed, in some ways this reflects a reversal in the paradigm of development finance, from almost total emphasis on private finance to a far more nuanced, mixed-economy approach. This reflects both the priorities of the emerging economies, such as China, and disillusionment with private finance, linked to the North Atlantic financial crisis, as well as the limited ability of private finance to deliver long-term funding for investment in sectors such as infrastructure. However, it is important to stress that although owned and capitalised by governments, MDBs fund themselves in the private capital markets, and often co-finance their loans and equity with private lenders and investors, and also with national borrowing governments.

Another linked and positive feature is that the creation of these new MDBs, for example the AIIB, reflects a shift by China towards engaging in the funding of EADCs via multilateral institutions. This is very positive. Indeed, China had been urged by developed country governments, the US in particular, to participate more with EADCs through multilateral institutions, and not just via bilateral relations. This would, for example, help them to apply similar environmental and social standards to those applied by existing multilaterals.

Furthermore, it is very positive that, in the case of the AIIB, China – although having the largest share of the votes, at 26% – has offered an invitation to participate to all Asian economies, as well as to all developed economies and other developing economies. As a result of this invitation, 16 of the 20 largest economies in the world have decided to participate. Indeed, at the time of writing, the total membership of the AIIB stands at 57 countries. This includes the largest European economies, whose participation was spearheaded by the UK, the first European country to apply for membership. The UK was followed by Germany, France, Italy and all the other major European economies. Similar enthusiasm has been evident in the Asian Pacific countries (with Asia representing around 75% of the AIIB's capital). Two notable exceptions are Japan and the US, which, at the time of writing, have not expressed a wish to join the AIIB. It would seem positive that a later stage, the US and Japan would join, bringing in all their valuable expertise and accumulated experience.

The new AIIB president-designate, Mr Jin Liqun, has expressed clearly his wish for both continuity and change, emphasising more the former. First, he and other key actors in the AIIB have stressed that the AIIB will model itself in many respects on existing MDBs, such as the World Bank. Indeed, senior current and former officials of existing MDBs have been advising the AIIB in its initial phase, either in an ad-hoc or a more structured way. As a result, the AIIB will benefit from latecomer advantage, in that it can learn lessons from both the positive and negative experiences of other MDBs.

A second signal of the desire for continuity is that the AIIB is already planning, among its first loans, projects co-financed with the World Bank and the Asian Development Bank. More broadly, there are strong signals that there will be close collaboration between the AIIB and existing development banks once the AIIB is fully established, such as the memorandum of understanding being signed between the AIIB and the World Bank. Indeed, the AIIB is expected to come into formal existence by the end of the year, when members finish ratifying its articles of agreement.

Furthermore, Mr Liqun and Chinese officials involved in the creation of the AIIB have signalled that the AIIB will require high environmental and social standards to be complied with in the projects it funds. However, they imply that such standards should be applied in a balanced way and, to some extent, be proportional to recipient countries’ features. This implies the possibility of somewhat greater flexibility when applying those standards in poorer countries.

There is also the important trade-off between speed of approval of funding for projects and requirements of standards, as well as other conditions, which all multilateral banks face. The more and more detailed the conditions (which may or may not improve the quality of the project), the longer the delays for designing a project and securing its approval. This is indeed a frequent and legitimate complaint by borrowers against the World Bank and most other existing multilateral banks; that approval of individual projects or sectorial loans takes too long and can be very expensive in transactions costs. Therefore, the intention signalled by Mr Liqun of having a speedy loan approval process should be music to the ears of developing and emerging market borrowers.

In fact, some regional development banks, such as the Development Bank of Latin America (known more widely as the CAF), pride themselves on having a speedy evaluation and approval process, while maintaining a high quality of loans. This combination of speed and quality of loans by the CAF is reflected in the large increase in its portfolio, the non-existence of defaults on its loans and the fact that several new countries have joined the bank in recent years.

It is interesting that the AIIB (similarly to the CAF, but unlike such institutions as the World Bank) is planning to have a non-resident board, as defined in its articles of agreement. This means that eventually loans would be made at the discretion of the management, but naturally within guidelines and broad lending policies designed by the non-resident board, which would meet at regular periods. This procedure would ensure greater speed of approval. However, it is planned that in the AIIB’s first year (2016) all loans will be approved by the non-resident board, which would ensure that the considerable combined expertise of the board members would be reflected in the loans approved.

The AIIB signals a positive and major step for the existing development finance architecture. It will basically be a complement, more than a competitor, to the existing multilateral institutions. Of course, as with private banks, some healthy competition might be beneficial for public banks (both new and existing development banks) if it results in improvements in aspects such as quality of loans, design of projects, speed of approval and application of standards.

The new development banks, and especially the AIIB, will face important challenges. For example, what are the best channels for encouraging the development of infrastructure that will facilitate not just more rapid economic growth (which is important for poorer countries), but a more inclusive and sustainable model of development? Will the new banks basically respond to individual country requests for project funding, or will they, in a more ambitious way, also support countries in the design of sectorial strategies, to achieve broader aims of inclusive and green development? How can they do this in ways that respect the legitimate desire of borrower countries to maintain their policy space, while ensuring that they contribute to the design of a more strategic approach to the development of key infrastructure in their borrowing countries?

Another important, more technical challenge for the AIIB will be to ensure that projects are of high quality, both to maximise their development impact and to ensure that loans can be paid back on time. Here the positive experiences of China and other member countries will be very valuable. But if the AIIB is to lend an important part of its resources to technically less experienced and poorer countries, how best can their expertise be developed so as to help prepare good projects? A special facility that supports project preparation in such cases could be an important element of achieving this ambition.

These and other challenges are faced not only by the AIIB and the new development banks, but also by the existing multilateral banks. It is to be hoped that the presence of new actors will inspire a positive change throughout the development finance architecture, so that it can meet the important challenges ahead.

Jiajun Xu and Richard Carey: The economic and political geography behind China's emergence as an architect of the international development system

The launch by China of the Asian Infrastructure Investment Bank (AIIB) has profoundly shaken up the world of development finance. The decision by the UK to become a founding member drew in other G7 and OECD applicants, while the US remained vocally opposed. A measure of its seismic effects is the package agreement reached by Presidents Xi and Obama at their September 2015 summit meeting. As recorded in China's outcome list of Xi's state visit to the US, China sought to ensure that any new development finance institutions it sponsors will be structured and managed professionally and will have continuously improving governance, environmental and transparency standards in line with the traditional development banks. The US undertook to pursue ratification of the 2010 G20 agreement to increase China's voting rights in the Bretton Woods Institutions, with an interim solution in the meantime, as currently under discussion in the Bretton Woods Institutions. The recent G20 Leaders Summit in Antalya requested that work on this interim solution be completed. Thus the stand-off that motivated China in effect to exercise an 'exit' option by creating a set of new institutions that might compete with the traditional multilateral banks has finally provoked a new settlement on these systemic issues. China has expressed its readiness in the context of the Xi-Obama Summit to participate 'meaningfully' in concessional funding rounds and capital increases for the traditional development banks.

China has also stated, jointly with the UK, a shared aspiration for the AIIB, with its 'lean, mean and green' approach to infrastructure development, to become an integral part of the global development finance system. The UK for its part has fully bought into China's Silk Road initiative (One Belt, One Road – OBOR) and is looking to work actively with China and others in that context (the European Bank for Reconstruction and Development is already doing so, as announced by its president Sir Suma Chakrabarti in Beijing in Summer 2015).

In fact China is currently promoting four new global financing institutions and three new policy fora. Alongside the AIIB, it is hosting the BRICS' New Development Bank (NDB) in Shanghai, pushing forward the creation of a development bank for the Shanghai Cooperation Organisation (SCO) and has launched the Silk Road Fund as an equity finance fund open to all (not confined to sovereign states, as in the case of traditional MDBs). A new international development knowledge centre in Beijing was announced by President Xi Jinping at the UN Summit meeting on the SDGs in September 2015 and a Silk Road Think Tank Network was launched at the second Silk Road Forum in Madrid in October 2015, under the auspices of the State

Council's Development Research Centre. At an even higher level of international architecture, the summit meeting of the SCO in Ufa in July 2015, held alongside the 2015 BRICS summit, saw the admission of India and Pakistan to the SCO and agreement to foster convergence in the development strategies of the OBOR initiative, the SCO and the Eurasian Economic Union. China proposes to set up an international summit forum on the One Belt and One Road (OBOR) Initiative.

Putting these initiatives together, we are witnessing moves to create a new economic and political geography in Eurasia and beyond. China's own roadmap for its OBOR initiative lays out the detailed geography, in terms of specific corridors of connectivity, both east-west and north-south, linking up the Asian, European and African continents, with a branch also towards the South Pacific. As set out in the 'Vision and Actions' statement on the OBOR initiative issued under the authorisation of China's State Council, the instruments of this new economic and political geography are to be 'policy coordination, facilities connectivity, unimpeded trade, financial integration and people to people bonds'. The cooperation principles are 'policy communication and objectives coordination in a pluralistic and open process with timetables and roadmaps to align national development programmes and regional cooperation plans'. And development pathways are to be market based, 'abiding by market rules and within international norms'. Special economic zones, composite connectivity networks, upgraded agriculture and smart cities will work to generate fast but sustainable development within strengthened international efforts for climate change, and for peace and security. (Prime Minister Li Keqiang laid out such a vision for combining the modernisation of China and Africa at the African Union in May 2014 – with follow-up initiatives on inclusive and sustainable industrialisation likely in the context of the sixth Forum for China Africa Cooperation (FOCAC) in South Africa on 4-5 December 2015.)

China is thus the architect of a very significant enlargement of the international development system, with varying degrees of buy-in from traditional players. Evolutionary change in the post-World War II international system rather than any revolutionary shift to a post-western world order is the essence of this accord, but the pace of evolution has suddenly accelerated in an unforeseen manner.

Thus the scope and instruments of the OBOR initiative go beyond anything that the current international development system could have conceived, let alone made into an actionable programme. China is in effect operating as a global public entrepreneur – supplying the vision, action, innovation and coordination needed to create and maintain a dynamic market economy across a vast geographical space, perceived through China's own historical and contemporary lens. The new financial institutions China is promoting are instruments of this vision. But perhaps more fundamental are the political forums and intellectual networks that China is establishing in Eurasia and across the world. These are intended to generate the political space and cooperation that will provide the backdrop for investment ideas for the hard and soft infrastructure and the human and social capital essential to those projects. The geopolitics of this vision are highly complex, and risks of conflict and terrorism driven by religious extremism are evident, but the roadmap itself is a potentially game-changing contribution to managing these risks by adding a socio-economic element into the Eurasian cooperation agenda.

What China is bringing to the international development system is in fact its own development experience, in which public entrepreneurship has crowded in private entrepreneurship. In the course of its phenomenal economic development process, China has created an economy with huge emerging capacities. Public entrepreneurship may be defined as the public action needed to create and sustain a dynamic market economy, a central element in development thinking since Alexander Hamilton and earlier.

That China's economy as it is today is most aptly represented by this public entrepreneurship-private entrepreneurship paradigm has now been recognised by the UK government. The extensive set of outcomes from the recent visit to China by Chancellor George Osborne, which culminated during President Xi Jinping's subsequent state visit to the UK, looks to apply China's public entrepreneurship model to the UK economy, bringing in Chinese nuclear and rail investors and operators, setting up a branch office of the China Development Bank in London, and developing the Chinese foreign exchange and bond markets as major activities in the London financial markets. This represents a strong vote of confidence in the long-term future of China and its role in a stable multipolar international system.

It is a recognition also that the development paradigm of the 21st century in all countries requires intensive public-private interaction. And it is a recognition of the strength of the organisational and human capacities that China has built up over the past 30 years, reflecting its ability to absorb knowhow from its bilateral and multilateral partners and investors and to generate its own technological capacities and innovation-driven development pathway.

China's 'going global' policy will indeed continue to be the most important global development vector as it becomes the largest economy in the world in the coming decades, even as it negotiates its own complex economic and political reform agenda and seeks to strengthen financial structures in its local government and private sectors. It has the entrepreneurial capacities in both its public and private enterprise sectors and the financial strength to become the largest exporter of capital in the world, investing its foreign exchange reserves in real capital and developing and opening up its financial markets. As Chinese wage rates rise, and in the context of the OBOR strategy, Chinese industries will export jobs and management skills and its technology to developing countries, in effect exporting its own 'Lewis process' of economic transformation. Chinese foreign direct investment (FDI) is set to grow dynamically over the coming decade, expanding the role of FDI even further as the most important global development finance channel.

From the perspective of public entrepreneurship, long-term national and regional planning is of paramount importance in the operation of the China Development Bank (CDB) – a major player in China's industrialisation and urbanisation process, with eight times the outstanding loans of the World Bank. CDB's financial engineering and planning experience (and lessons learned) can serve to inform other development financing institutions. The CDB's Planning Unit develops comprehensive long-term plans crucial to achieving leapfrog development. They start with a vision that aims to achieve long-term strategic development goals across China's regions, unleashing the potential of latecomer advantage to catch up with advanced economies. While China's context has been unique, the capacity of the CDB to help generate and accompany comprehensive transformative change with innovative financing is an addition to the competencies of the international development system. And its experience is likely to influence the approach of the AIIB, and also that of the NDB initiated by the BRICS countries (an initiative inspired by the then president of the CDB, Chen Yuan, who has been closely associated with the setting up of the NDB).

Again in line with the spirit of public entrepreneurship, long-term strategic equity investment is prominent in China's new initiatives, especially the Silk Road Fund. The Silk Road Fund was established in December 2014, jointly backed by China's foreign exchange reserves, the China Investment Corporation, the Export-Import

Bank of China and the CDB. In the first phase, the company raised $10 billion, with foreign exchange reserves taking up 65%, CDB 5% and the other two companies each investing 15%. It welcomes private and institutional investors with a long-term investment horizon. In terms of financial engineering, where traditional lending may further exacerbate debt distress, partner countries with poor sovereign creditworthiness can use land or resources to obtain shares of newly established infrastructure development corporations (responsible for both fund-raising and construction). The positive impact of successful, bottleneck-releasing infrastructure then improves the sovereign creditworthiness of the indebted partner countries.

Together the new financial institutions promoted by China have the potential to break new ground in the effort to develop infrastructure finance. For example, it has been suggested that in their early stages they could deploy a proportion of their capital to buy into existing projects through structured financing vehicles. This would help to create deeper bond markets, not least in China itself, for infrastructure ventures at the point where they are operating, generating long-term income streams for pension funds and other long-term investors.

In conclusion, China's initiative to establish the AIIB is triggering agreement on moving the governance and the shape of the whole multilateral financing system forward. It has helped to cement China's role as a major power, rising within the ongoing evolution of the established international system, with the G20 (to be chaired by China in 2016) as a key element in global economic governance, and now with the likely inclusion of the renminbi in the SDR basket. At the same time, China's broader OBOR vision brings the potential for new economic and political dynamics between Asia, Europe and Africa, opening up a new frontier of global growth at a time when the Sustainable Development Goals have been launched as a roadmap for 'Transforming our world'.

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