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THE ASIAN INFRASTRUCTURE INVESTMENT BANK

A NEW BRETTON WOODS MOMENT? A TOTAL CHINESE TRIUMPH?

Hongying Wang

Key Points

- The enthusiastic response by many countries to the Asian Infrastructure Investment Bank (AIIB), despite the opposition of the United States, has caught the world by surprise. Many see the new China-led bank as the beginning of a new international financial order and a triumph for China.
- The AIIB is not a new "Bretton Woods moment." While the new bank and other new minilateral financial institutions involving China are, in part, designed to stimulate reform of the Bretton Woods system, they remain closely linked to it. In any case, the creation of a new financial order is always a long historical process, rather than a sudden transformation.
- The AIIB is a major diplomatic victory for China and a foreign policy fiasco for the United States. But it is not necessarily conducive to China's long-term economic well-being. In seeking better access to resources overseas, exporting overcapacity and improving the performance of China's external assets, China's new economic activism — including the AIIB — may further delay the economic restructuring and rebalancing the country urgently needs.

In October 2014, the Chinese government and 20 other Asian countries signed a memorandum of understanding to set up a development bank with initial capital of US$100 billion to finance infrastructure in the region. At the time, this seemed to be an innocuous attempt to solve a pressing problem. According to the Asian Development Bank (ADB), between 2010 and 2020 Asia needs US$8 trillion for infrastructure development (ADB and ADBI 2009). A more recent study by HSBC estimates infrastructure development in the region will require US$11 trillion between 2015 and 2030 (French 2014). To the surprise of many, including the Chinese, the AIIB has quickly gained great momentum. By the end of March, which the Chinese government set as the deadline for countries to apply to be founding members of the bank, 46 countries from Asia and beyond had submitted their applications. Some countries that did not meet the deadline have nonetheless expressed an interest in participation in the future.

The unfolding of the membership application process has attracted attention far beyond the development and financial circles in recent weeks. In early March, the United Kingdom surprised the world by announcing its decision to join the AIIB, despite the explicit warning of the United States to the contrary. In response, the US government openly criticized the British government for doing so without consultation with the United States, and for its "constant accommodation of China" (Dyer and Parker 2015). What followed was an avalanche of new applications from major economies in different parts of the world, including most of the United States' strong allies, such as Germany, France, Italy, Korea, Australia, Taiwan and Israel. Left in a state of diplomatic isolation, the United States has softened its opposition to the new bank, but the embarrassment has been profound. Former US Treasury Secretary Larry Summers (2015) commented: "This past month may be remembered as the moment the United States lost its role as the underwriter of the global economic system." Former US Secretary of State Madeleine Albright put it just as bluntly: "'We screwed it up'" (quoted in Sands 2015). Pundits and reporters across the globe have portrayed the establishment of the AIIB as a symbol of the emergence of a new international financial/economic order (see, for example, Chhibber 2015; Zhang Zhongkai 2015) and of a power shift from a declining United States to a rising China (see, for example, Merry 2015; Shen 2015).

Does the establishment of the AIIB represent a new Bretton Woods moment? Has it been a total triumph for China? This policy brief offers a skeptical view.

A New Bretton Woods Moment?

Calls for reforming the post-World War II international financial system can be traced back a long way. In the early 1980s, faced with a destabilized exchange rate system, French and US finance officials called for a new Bretton Woods conference, although it was never acted on (Boughton 2009). Although the old system showed more and more problems, a new system did not come into being because reform lost impetus. Scholarly discussions of a new Bretton Woods system go back to at least the same time (see, for example, Camps 1980; Helleiner 1983).

Following the outbreak of the global financial crisis in 2008, the talk about a new Bretton Woods system has intensified among policy makers as well as scholars. For instance, in October 2008, the British prime minister and the French president called for a new Bretton Woods agreement. Many others expressed hope for a new global financial architecture with better financial oversight and regulations, and greater representation of the emerging economies in major international institutions. However, despite the reformist rhetoric, there has not been any fundamental change to the main features of the existing financial order. The Group of 20 (G20), touted to be the premier forum of economic cooperation among developed and emerging economies after the crisis, has not played as big a role as advertised in the management of the crisis. The US dollar continues to be the dominant international currency. The pro-market nature of financial standards remains largely intact. The Financial Stability Board, established after the crisis to strengthen financial regulation, has limited capacity (Helleiner 2014a).

Now, with the establishment of the AIIB and with countries from around the world stampeding toward the China-led new development bank, are we finally witnessing the rise of a new international financial order? When scholars of the future look back, will they see March 2015 as a truly new Bretton Woods moment? The answer is likely to be no.

First of all, as Eric Helleiner showed in his recent book, *Forgotten Foundations of Bretton Woods: International Development and the Making of the Postwar Order*, the Bretton Woods conference in July 1944 may appear to have been a decisive moment, when nations came together to redesign the international financial system, but it was actually the culmination of an extended historical process that had been underway for a number of years. The final blueprint of the new system drew heavily from the intellectual and policy experiments that had been going on since the 1930s, including the New Deal in the United States, state-led economic growth in Latin American countries and various international currency-stabilization programs (Helleiner 2014b).

Similarly, the emergence of a new international financial architecture today is not likely to be accomplished by a single event. The establishment of the AIIB as a China-led international development bank may seem to be a momentous turning point from a US-dominated financial governance system. But it is only the latest event in more than a decade of increasing Chinese involvement in minilateral financial cooperation (Wang 2014a).[1]

After the Asian financial crisis in the late 1990s, China joined the Chiang Mai Initiative (CMI), a regional arrangement of bilateral currency swaps. It also pushed for the Asia Bond Market Initiative (ABMI) in the early 2000s, seeking to increase Asian countries' self-sufficiency in financing. Later, China played an important role in multilateralizing the swap arrangements of the CMI, turning it into the Chiang Mai Initiative Multilateralized (CMIM), a regional pool of foreign reserves of US$240 billion.

In the last two years, China has become more active in initiating and leading minilateral financial institutions. In July 2014, it cooperated with the other BRICS countries — Brazil, Russia, India and South Africa — and established a New Development Bank (NDB). With an initial subscribed capital of US$50 billion and authorized capital of US$100 billion, the BRICS bank plans to invest in infrastructure and sustainable development projects in member countries and other developing countries. At the same time, China and fellow BRICS countries also created a Contingent Reserve Arrangement (CRA) of US$100 billion. The stated goal of the CRA is to help members deal with short-term balance-of-payment pressures and reduce financial instability caused by liquidity problems. That was followed by the announcement of the planned AIIB in October 2014.

Compared with the earlier regional financial arrangements — the CMI, ABMI and CMIM, the more recent initiatives of financial minilateralism — the NDB, CRA and AIIB, are far more China-centred. However, several common ideas underlie all these minilateral institutions — dissatisfaction with, and distrust in, the Bretton Woods institutions dominated by Western powers, a strong desire for self-assurance and mutual assistance, and a belief in the importance of infrastructure for economic development and the role of governments therein. These ideas have come from years of development experience of China and other countries in the region, and from their

1 Minilateralism refers to the gathering of a subgroup of countries within or outside a multilateral institution to solve a problem when the multilateral institution is unable to reach agreements among its members (Naim 2009; Brummer 2014).

disappointment in how Bretton Woods institutions responded to the Asian financial crisis and the global financial crisis. If the establishment of the AIIB were to be followed by major reforms of the Bretton Woods system, the sources of reforms would have to be traced to the incremental process of change of the previous decade or more.

It is also not clear just how much of a break the AIIB and other minilateral financial arrangements that China is involved in are making from the Bretton Woods system. The governance structure and rules of operation of the AIIB have yet to be formulated. Those of the NDB and CRA have not had a chance to be fully implemented. We have had more time to observe the regional institutions China has participated in. From what we can see so far, the new institutions seem to be quite closely tied to the Bretton Woods system.

For instance, under the CMIM and the CRA, 70 percent of the lending to countries facing liquidity problems is linked to International Monetary Fund (IMF) programs for those countries — i.e., they must have an on-track arrangement with the IMF that involves a commitment of the IMF to provide financing to them based on conditionality, and the compliance of the borrowing countries with the terms and conditions of the arrangement. It is questionable how useful the non-IMF-linked portions (30 percent) of those funds can be. A telling case was that during the global financial crisis, Asian countries faced with a liquidity crisis did not resort to the CMI/CMIM, but rather sought assistance through bilateral swaps with the United States and other countries.

In the case of the AIIB, Chinese officials in charge of its creation have gone out of their way to emphasize that the new bank will "play by the rules." China's Foreign Ministry spokesman stated: "the AIIB will follow the principles of openness, inclusiveness, transparency, responsibility and fairness in its governance structure and operational policies" (Ministry of Foreign Affairs 2015). Perhaps speaking in particular with reference to some of the familiar criticisms of China in the past, Chinese officials stress that the AIIB will be a "green and clean" bank, upholding high environmental standards with zero tolerance for corruption (Xinhua 2015). Recently, news about staff recruitment for the AIIB indicates China aims to bring on board individuals with strong experience in multilateral financial organizations, prompting some observers to conclude that China really wants to build the new bank after the prevailing international model (Zhang Han 2015).

Some commentators see China's minilateral financial arrangements as instruments to promote the internationalization of the renminbi (RMB), which will ultimately undermine the dominance of the US dollar, a central feature of the Bretton Woods system. If the AIIB (as the NDB) makes loans and extends credit in RMB in significant ways, it will expand the use of the Chinese currency overseas. That may well be a long-term prospect and is certainly a fond hope of Chinese policy makers and analysts (Wang 2014a). However, in the near term, these minilateral financial institutions, including the AIIB, are most likely to be conducting their business mainly in US dollars. After all, as will be discussed in the next section, a major reason for the creation of these institutions is to cope with China's large foreign reserve holdings.

Aside from these minilateral financial initiatives, there are other signs that China is not ready to break away from the Bretton Woods system. This should not be surprising given the benefits China has derived from the existing economic order and the gradual convergence of its interest toward that of the dominant Western powers. For instance, in recent years, China has become a major international creditor, making loans to other countries in the world. Contrary to widely shared criticism of the IMF, China's central bank governor has spoken favourably about the Fund's conditionality as a way to discipline countries borrowing internationally (Zhou 2012). On various financial regulatory issues, China has also been eager to meet the standards set by international agencies dominated by Western countries (Kempthorne 2015).

This is not to say that the AIIB and other new minilateral financial institutions established by China and other emerging powers do not have an impact on the existing financial order. They do. The desire to reform the Bretton Woods system is an important force behind China's growing activism in minilateral financial diplomacy (Wang 2014a). While the so-called "voice" reform at the World Bank and the IMF — which aims to increase the representation of China and other emerging economies — has been going very slowly, there are signs of change in other areas. For instance, partly response to these new initiatives focusing on infrastructure development, the World Bank launched a new Global Infrastructure Facility in October 2014, which would provide billions of dollars for infrastructure projects in developing countries. In November 2014, the G20 summit in Brisbane made infrastructure a major issue on its agenda. But overall, the AIIB, and the other new initiatives in China's foreign financial policy, are not designed to overturn the Bretton Woods system. Whatever change comes about with the new institutions is likely to be reformist rather than revolutionary.

A Total Triumph for China?

On the surface, the establishment of the AIIB looks like a total victory for China against the United States in that, despite American opposition, a large number of countries have rushed to join the new bank. As mentioned above, this has clearly been a diplomatic fiasco for the United States, which many in US policy circles have been critical of and feel embarrassed by. It demonstrates a decline in American influence over other countries, including traditional allies of the United States. It also highlights a foreign policy failure that involves the entire US government (Drezner 2015). However, it is less clear if the AIIB represents a total triumph for China beyond the diplomatic sphere.

China's increasingly activist foreign economic policy since the early 2000s has been driven by a variety of economic and political considerations. Chief among the economic motives are the desire to ensure access to energy and raw materials, to export China's overcapacity and to improve the financial performance of China's external assets. All of these economic necessities are closely related to China's investment- and export-dependent economic growth model. A large portion of China's energy consumption is attributable to investment in construction and manufacturing (Fu et al. 2014). The buildup of overcapacity has resulted from the gap between high investment in production, especially in sectors favoured by the developmental state, and the relatively low level of consumption in China (Cai 2015). The accumulation of huge foreign reserves, most of which have been held in low-yielding US government debt, comes from the persistent current account surplus in recent years, which is ultimately attributable to the high saving rate and low consumption in China (Pettis 2014; Wang 2014b). All of these problems challenge China's sustainable economic development. The last of them — the accumulation of dollar assets — has also led to huge financial losses for China, whose positive net internati investment position has, ironically, resulted in negative net international income in recent years (Brown and Wang 2015).

For over a decade, China's leaders have called for a change of development model — a transition to domestic consumption-based economic growth. This would involve reform of the financial sector, liberalizing exchange rates and interest rates, and reform of the public finance system, giving greater weight to social welfare. Despite steps taken in the right direction from time to time, the overall pace of reform has been painfully slow because of the strong political resistance by vested interests (Wang 2014c).

Short of fundamental structural change in the Chinese economy, the Chinese government has chosen to deal with the problems of the current model, including overcapacity and the burden of managing large foreign reserves, by encouraging the diversification of its overseas assets. New policies have eased the procedures for Chinese companies to invest abroad. By 2014, China had become the third-largest source country of foreign direct investment. The Chinese government has also set up a number of national wealth funds to look for overseas investment opportunities. The establishment of minilateral financial institutions, such as the AIIB and the NDB, is part of this overall strategy. Alongside these, China has also recently launched a US$40 billion Silk Road Infrastructure Fund that serves similar purposes.

Seen in this light, the AIIB potentially offers a short-term and partial solution to a much broader problem. To the extent it succeeds in helping to export China's overcapacity and to improve the income performance of China's foreign assets, it may well further delay the structural reform necessary for China's transition to a new and more sustainable development model. This may be beneficial for the Chinese government and some Chinese corporations, but is hardly in the interest of the long-term health of the Chinese economy or the well-being of the general public in China.

Furthermore, there are reasons to be skeptical as to how successful the AIIB will be in accomplishing its mission of helping to develop the infrastructure in Asia and — later on — elsewhere. It is well-known that investment under China's statist capitalism has long been inefficient (Chen et al. 2011). Recently, the *Financial Times* reported that Chinese researchers from the government's National Development and Reform Commission reported US$6.8 trillion in wasted investment since 2009. The Chinese government carried out a massive stimulus package after the global financial crisis in 2008. However, much of the funds went into projects that turned out to be abandoned highways, mothballed steel mills and entire ghost cities (Anderlini 2014). Will a China-led AIIB be able to move beyond this pattern? Some commentators in China have already expressed doubts (see, for example, *Dongfang Ribao* 2015).

Conclusion

The establishment of the AIIB is symptomatic of many things. It certainly highlights the widely shared dissatisfaction with the Bretton Woods institutions and their existing power structure, and the growing financial and economic clout of China. The arrogant and ultimately self-defeating response of the US government reflects the difficulty of the United States in adjusting to the reality of a less US-dominated world. However, for the reasons elaborated above, the AIIB does not constitute a new Bretton Woods moment or a total triumph for China in the broad sense.

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About the Author

Hongying Wang is a CIGI senior fellow. She is also associate professor of political science at the University of Waterloo, specializing in international political economy, Chinese politics and Chinese foreign policy. Her current research explores the domestic and international politics shaping China's role in global economic governance. At CIGI, Hongying is focusing on several projects related to China in the international financial system.

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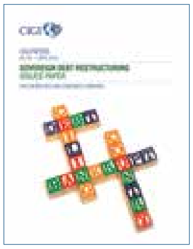

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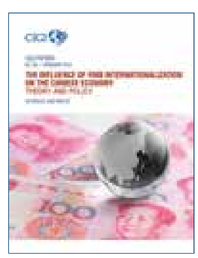

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