

CENTER ON JAPANESE ECONOMY AND BUSINESS

日本経済経営研究所

Occasional Paper Series

June 2015, No. 72

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This paper is available online at www.gsb.columbia.edu/cjeb/research

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The Future of the Asian Infrastructure Investment Bank: Concerns for Transparency and Governance¹

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Abstract

China has proposed the Asian Infrastructure Investment Bank (AIIB), initiating a key turning point in the international finance system. Unfortunately, its design at present is quite problematic, for several reasons: it limits participation by Western countries, effectively locking in China as the undisputed leader; the lack of a Board of Directors in residence; the potential for a conflict of interest if the AIIB will fund projects within China; the potential of China to use AIIB for political purposes; the relationship the AIIB will have with already-existing international financial institutions; and the potential for a weakening of “best practices” in order to compete against the other international finance institutions. For these reasons, it was the right decision for Japan not to join as a charter member in order to negotiate the MOU; nevertheless, Japan should maintain the option of joining the AIIB in order to have leverage over the architecture of the AIIB.

¹ The original article written in Japanese was published in Nihon Keizai Shinbun, column of Keizai Kyoshitsu, on April 30, 2015.

At the time of the IMF and World Bank Spring meeting in Washington in April, there was much media attention over the Asian Infrastructure Investment Bank (AIIB) proposed by China. Both the IMF and the World Bank have publicly welcomed the AIIB as a sign of increase in funding for infrastructure needs in Asia, but hope that the AIIB will cooperate well with these existing international institutions.

Thus far, there is no apparent opposition to the AIIB, which is in stark contrast with 18 years ago, when Japan's proposal for an "Asia Monetary Fund" at the IMF and World Bank Fall meeting fell through due to criticism from both the United States and China.

China's push for the AIIB originated from China's frustration toward the existing international financial institutions, such as the IMF or the World Bank, that favor the West through voting rights distribution and head post appointments, as well as the ADB, which holds Japan as the largest shareholder and has traditionally maintained Japanese presidents. It could be a part of China's national strategic plan to raise its stature in the international financial system to match its status as the number two country in the world by GDP.

Regarding the necessity of the AIIB, China has reasoned that the ADB and the World Bank alone cannot provide for the growing infrastructure needs in Asia; it has also pointed to the IMF's new quota reform, which has not been ratified due to opposition from Congress in the United States. This second point, especially, plays on the United States' weakness.

When the AIIB was first proposed in October 2013, China was prepared to do the following: establish its headquarters in Beijing; appoint a Chinese president; secure capital up to 100 billion dollars; and establish China as 50% holder of AIIB shares. The initial consensus, mostly expressed by the developed countries, was that the AIIB would be "a bank of China, by China and for China," and would not be accepted as an international financial institution.

Since then, China has continuously modified the core architecture of the AIIB, such as lowering its own shareholder percentage, and has attempted in various ways to call for nations to join the AIIB. Even then, the participating members were limited to developing and emerging countries – until this February.

Nearly half a month before the deadline at the end of March to become charter members of the AIIB, the United Kingdom suddenly announced it would join the AIIB and entered into negotiations. Germany, France, Italy, Australia, and Korea quickly followed suit, announcing their participation in the new investment bank. The charter members thus took shape with Japan, the United States, and Canada as the only major players to be excluded.

Ultimately, over 50 countries are participating in the negotiation process to become founding members of the AIIB, providing an impetus toward the charter signing in June and the subsequent initiation of the bank by year-end. As shown in the chart below, membership of the AIIB shows little difference from the ADB.

Comparison of ADB and AIIB members

Members of ADB, but not in AIIB	Not members of ADB, but in AIIB
Japan, United States, Belgium, Canada, Ireland, Afghanistan, Armenia, Bhutan, Cook Islands, Fiji, Kiribati, Marshall Islands, Federated States of Micronesia, Nauru, Palau, Papua New Guinea, Samoa, Solomon Islands, Taiwan*, Timor, Tonga, Tuvalu, Vanuatu	Iran, Israel, Jordan, Kuwait, Oman, Qatar, Russia, Saudi Arabia, UAE, Brazil, Egypt, Iceland, Malta, Poland, South Africa

*Taiwan is showing a desire to join AIIB, but China is denying their status

The announcements of the United Kingdom, Germany, France, and Italy that they would join the AIIB came as a surprise to both the Japanese and United States governments. The fact that the United States was unable to stop the formation of the AIIB, not to mention prevent the British from joining the bank, points to a diminishing level of economic and diplomatic influence on the part of the United States. It could be said that the international finance system has reached a major turning point.

There is some opinion that Japan has been left behind in this scheme, or that Japan not joining the AIIB is a defeat on the grounds of diplomacy. However, Japan should not join the AIIB when there are crucial concerns about the governance and transparency in its management. The choices Japan had in March were to urge governance reform as a condition for Japan’s joining the AIIB either from the inside or from the outside. The latter option was chosen, but the strategy has remained the same.

Some believe that if Japan does not join the AIIB, Japanese corporations may face disadvantages when bidding for AIIB-funded projects. On this issue, the ideal would be for corporations of non-AIIB members to have an equal opportunity for funding. The reality is that even with the ADB’s bidding process, the chances of Japanese corporations being selected are quite low.

There are three major problems with China’s plan for the AIIB governance structure. The first problem is that China will be by far the leading shareholder in the bank. It has already been determined that the ratio of quota (voting shares) held by regional members to non-regional members will be constant at 3 to 1, thus limiting the

influence of western nations from the outset. Meanwhile, the ratio of shares held by the regional members will be determined according to each nation's GDP. Naturally, China has the largest GDP in the region and will hold the top quota and share of votes. Japan's GDP is half that of China, and even the combined sum of the GDPs of Japan, Australia, Korea, and India does not reach China's level.

Purely from a GDP perspective, it would not be surprising for China to ultimately reach a 25% quota share. By predetermining the ratio of shareholders by region, China plans to keep Western influence at a minimum, and to lock in its place as the number one shareholder.

Furthermore, China does not plan to set up a resident 'Board of Directors' that holds the power to make the final decisions on any financing operations. Without the presence of the Board, there is a danger that the financing operations will strongly reflect the opinions of the AIIB president and executives, dominated by China. Having a board that constantly checks this management is indispensable to good governance. Issues such as these cannot be ignored when seriously considering the influence the AIIB could have in the future.

The second issue is the concern over conditions for approving financial operations. The first question is whether the AIIB will fund projects within China as well. There is a large conflict of interest that arises when the largest shareholder member uses its influence within the AIIB to eventually fund infrastructure needs for its own nation. Another major question is whether China may use the AIIB politically, easing application conditions to nations it deems important, or to which it has strong ties.

From these various concerns, emphasis is placed on finalizing a concrete set of 'investment rules' as well as on the performance of the AIIB in the first two to three years of its initiation. The first problem of governance becomes crucial here as well.

The third problem is the relationship the AIIB will have with already-existing international financial institutions. China, as a borrower from ADB and the World Bank, will also become the top shareholder of the AIIB. There is an odd feeling about China borrowing at low rates from ADB and the World Bank for its national infrastructure needs, while simultaneously using the AIIB to take leadership in financing infrastructure needs in Asia.

Also, there will be a temptation for the AIIB to offer better conditions advantageous to the borrower in an attempt to win over financing projects in an area where two other international financial institutions—the ADB and World Bank—are already active. In addition, there is the possibility that the AIIB will finance high-risk cases, and result in non-performing loans.

One outcome that must be avoided is a competitive easing of financing conditions. When making development-financing loans, the World Bank and ADB are held to best practice standards that take into consideration its potential influence on the

environment, on minority groups, as well as on low-income households. To this, China has replied, “We do not know what ‘best practice’ is. There is only ‘good.’” After a few years for the AIIB to gather knowhow in the field, it could potentially deviate from the accepted practices of the ADB and the World Bank.

Now that Japan has chosen not to be a charter member of the AIIB, what should its future actions be? One step is to keep close ties to and exchange valuable information with the European nations as well as Australia, and to work toward eliminating the aforementioned concerns as a player from the outside. It is important that Japan keep the possibility of joining the AIIB in the event that key reform plans are proposed before the charter agreements are signed in June.

The Japanese government thus far has stated that they are cautious of the AIIB due to its issues with transparency as well as governance, and in principle they are right to be wary. However, it should also make proposals of several specific conditions that Japan cannot do without, and push for reform. For instance:

1. Set the maximum quota percentage of the top contributor, i.e., China, at 20%, and mandate a 75% majority vote necessary for deciding on matters of high importance;
2. Install a resident Board of Directors at the headquarters and make this Board responsible for giving final approval on financing projects;
3. Clarify the ‘investment rules’ before initiation of the AIIB;
4. Maintain a complementary relationship with the existing international financial institutions, and pledge to use best practices (such as refraining from entering into a condition-easing competition with the other institutions).

How Japan interacts with the AIIB until this June is important, both in view of the Japan-China diplomatic relationship as well as Japan’s role in the international finance system.

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