

## AIIB: much ado about very little

**Author :** Robert Bestani

**Date :** August 10, 2015



It has been quite surprising to see how much press attention has been focused on China's creation of the new Asian Infrastructure Investment Bank (AIIB). Usually, these institutions do their work rather quietly and without fanfare. And, because they play such a small role in the market, they hardly cause a ripple. The Asian Development Bank, for instance, finances less than two per cent of Asia's funding needs. Moreover, this number has been steadily declining as loan volumes and commitments are being canceled and as prepayments are continuing, even as the Asian financial markets continue to grow. If the ADB or the AIIB were private sector banks, they would get very little press attention.

No doubt all the media focus is a function of the implicit conflict the press perceives between China, the U.S. and Japan in the establishment of this new institution. This attention has certainly grown in the last few weeks as the U.S. chided Britain over its membership, [issuing a statement saying](#): "We are wary about a trend toward constant accommodation of China, which is not the best way to engage a rising power."

There is a clear sense that the Chinese would like to play a bigger role on the Asian and world stage, and that they feel rebuffed from doing so at the IMF and the World Bank by the U.S. Congress. Equally as important, the Japanese and American domination of the ADB can be seen a lingering source of frustration to the senior political leadership in Beijing, as China's economy and political standing have grown. As always, conflict draws media attention.

It is hard to see this as the true story. The Chinese have a reasonably big role in the ADB, with one of the three dedicated single country seats on the Board of Directors making them the third largest owner. Moreover, they have very rarely objected to proposed policies and/or transactions. Indeed, the Chinese representatives at the ADB have often been teased for not being "revolutionary" enough in pressing for needed reforms. And as for the IMF, they are again the third largest shareholder and currently hold one of the three Deputy Managing Director positions within that institution, along with Japan and Brazil. Within the World Bank, Chinese nationals man the CEO and CFO positions of the IFC, arguably the most successful and, therefore, important unit of the institution.

Others say that the creation of the AIIB will help them in the building of the new "[Economic Belt Silk Road](#)", which will cut across their northern territories. Surely China can do so on their own, in cooperation with their Central Asian neighbors, without external financing. All things considered, it is hard to escape the conclusion that the Chinese are merely putting down a "marker" with the AIIB that they intend to play a major role in Asia's affairs, and are unwilling to take a back seat to the Japanese as a matter of principle.

But it is most interesting that the Chinese have chosen the vehicle of a development bank as their

instrument. While such an institution looks good politically and seems to make sense given Asia's deep infrastructure needs, it is certainly not clear that they will make much progress on related investments through this vehicle. For the AIIB to be an effective political instrument, it needs to be a successful financial and development institution. That will be very hard to fully pull off.

For one thing, if one looks at the existing development banks, one sees very little to cheer about. Over the last decade or more, they have been told by the emerging countries that they are adding very little expertise, are overly reliant on external consultants, take far too long to make decisions, and are bringing very little to the table that the international capital markets cannot do faster and cheaper. Indeed, the middle income countries have now all backed away from actively borrowing, leaving the multinationals with only the very smallest, most impoverished and therefore riskiest of countries to work in. The banks, which are designed to be financially self-sustaining, can barely maintain themselves on just these countries as clients. Certainly they can no longer afford to be making the grants they once did, or absorbing the loan losses they have been forced to endure.

The reason they are struggling and losing money is because their "business model" is very much out of date. They were conceived of and created in an era when investment capital was scarce and the banking community was minimally attending to international needs. But the world is now awash with money. The capital markets have also developed in sophistication, to the point that the private sector is far more capable of mobilizing and deploying funds that can be properly employed than the public sector is. In fact, the developing countries have long been exporting funds, as their capacity to employ their indigenous savings is quite low.

Indeed, the multinational development banks (MDBs) are all facing a real crisis. They were designed to be self-funding. But as their lending has dried up, the MDBs have been offering funds at below market rates in order to bolster their lending volumes. This has lasted only as long as their balance sheets could bear the losses and the specter of ratings downgrades. With their ratings now under threat, the below market rates they have been offering their client countries have disappeared, with the parallel drop in demand.

As the emerging countries make clear that they have little interest in further borrowing from them, the MDBs are facing severe fiscal constraints and thus cost cutting. All of them are now lending less and less money and therefore facing severe financial constraints. Staff cutbacks are widespread and budgets are being slashed. The World Bank, for example, remains in considerable disarray and struggling with its own serious financial and managerial issues as it struggles to redefine itself.

In a [recent article](#) [pay-wall] David Dollar, a World Bank veteran who has acted as an unpaid consultant to the AIIB, was quoted as saying "the World Bank had become so slow and risk-averse that most governments had stopped coming to it for infrastructure financing." He quotes an Indian official, exasperated at the pace of World Bank-sponsored projects, as saying "Mr Dollar, the combination of our bureaucracy and your bureaucracy is deadly."

In truth, it is very hard to make the case that they can still deliver on the promise of development that was to be their ostensible reason for being in the first place. The only part of these organizations that are doing well are their private sector arms. These operating units are needed because only they can provide the political risk mitigation that is urgently needed to attract private sector investors. And yet, because of the statist nature of the MDBs, they resent, distrust and generally thwart those operations, even though they are the only things keeping the broader institution financially afloat.

The point has been made many times that the principal reason the emerging countries have not developed is because their internal governance is exceptionally poor. There is generally little rule of law, weak judiciaries, few independent regulators and little assurance that the governments will live up to the promises they make to attract foreign investment. The required risk premium they would need to justify such projects typically makes very little business sense. The private sector is thus highly reluctant to work in these countries and provide the much needed goods, services and jobs that are needed for a prosperous economy.

But because of the public lending ethos of the MDBs they have been so consumed with pushing public sector loans out the door (over the last decade at below market rates) that they have missed their true value proposition. Their political clout in support of the private sector is their true value addition for development.

Quite simply, these institutions are and have been financial and developmental anachronisms for a very long time. Most of the development banks (such as the World Bank, Inter-American Development Bank, the ADB and African Development Bank) were founded in the 1950s and 1960s, at the time when the prevailing theories of development preached that the reason countries did not grow was because of the lack of investment funds – the so called “funding gap” theory of development. Hence, all of these institutions were created to fill that specific need. But by the early to mid-1970s, the funding gap theory was widely discredited. No self-respecting development economist believes in this theory anymore. And yet, there they are, institutions actively pushing unwanted loans, fighting the last war as it were.

Over the last 25 to 30 years, as their lending dropped, the focus shifted to a wide variety of other subjects, such as gender equality, environmental protection, policy advice, and income distribution. The World Bank’s former Managing Director Jessica Einhorn politely dubbed it as [“Mission Creep.”](#) These are all important issues and politically popular issues, no doubt. But they are not the principal mission of development.

In point of fact, the true nature of development banks is as political entities, far more than they are development institutions. This was evident in their founding. Truth be known, the U.S. organized and created the Asian Development Bank in 1964-1965 principally to ease the political pain of the Vietnam War, which Lyndon Johnson was ramping up. In the process, the Japanese were subsequently given the leadership role in an effort to help them reintegrate into Asia. The institution was seated in Manila to assuage Ferdinand Marcos, who threatened to actively scuttle the Bank because Japan was a member and the ADB was to be located in Tokyo. Of course, all this runs counter to the official line that the ADB was a Japanese creation, borne of frustration with the World Bank’s inattention to Asia. Ironically, Lyndon Johnson pressed the retired Eugene Black, the former President of the World Bank, to establish the ADB.

Years later, the European Bank for Reconstruction and Development (EBRD) was explicitly created to help East Europe make the transition away from communism and to foster democracy. But 25 years or so on, they too have drifted away from their original mission. Having run out of relevance to East Europe, they first drifted to Central Asia and then to the Middle East where they overlap with the ADB, the World Bank, the IFC, etc. Like most of their sister institutions, they too are struggling to find their own reason for being and are clearly feeling the financial pinch. So much for the rhetoric that the job of the MDBs is to work themselves out of business.

In 1967, Ross Coggins of the World Bank wrote the now famous and highly circulated satirical poem [“The Development Set”](#) about these institutions that is just as true and funny today as the day he wrote it. Another World Bank officer, Bill Easterly, has gone over to academia and [written scathingly](#) about these institutions. One has to ask if the world really needs another such institution.

This is not to say that the MDBs have not and are not capable of making a contribution. Clearly that would be a gross overstatement. But few would argue with the assertion that these institutions need to be rethought in light of the current circumstances of the world’s financial management. Given the track record of the MDBs, they can only be successful if they stress private sector investments. Jin Liqun, who has been [tapped to run the AIIB](#), is very familiar with such operations from his days at the ADB. Perhaps the AIIB will do so, but it is far too early to say.

A central issue to understanding the AIIB will be what they choose as their working currency. From a practical point of view for promoting infrastructure, they should chose the U.S. dollar. They will undoubtedly want to choose the RMB instead – for political reasons. Moreover, if China were really principally interested in creating a financial institution to promote infrastructure investment, the AIIB would be located in Singapore or Hong Kong. By placing it in Beijing, it is patently clear that they view the AIIB as principally a political institution.

Finally, the ultimate irony in this whole saga is that the Chinese have managed to undercut, over decades, every western company that undertook infrastructure projects in the PRC. The list of sponsors of failed projects reads like the “Who’s Who” of global power and water companies. For China to have toyed with these highly respected and powerful companies says a lot about the governance deficiencies of doing business in China. For China to now hold itself out as the paragon of governance and infrastructure finance is curious at best. Will those companies really jump into deals that are now sponsored by the Chinese AIIB?

With this as the backdrop, one wonders why Beijing chose this route and how successful it can be as a development institution and ultimately as a political institution. The Chinese would be well advised to remember their own classic admonition: “Be careful what you wish for.” But one thing is clear: Beijing has cleverly capitalized on the political value of their new AIIB – but only in the short run.

*Robert Bestani teaches at the National Defense University in Washington, DC. He formerly worked as the Director General for Private Sector Finance at the Asian Development Bank as well as at Citibank and the Bank of America where he specialized in energy and infrastructure finance. He also served as Deputy Assistant Secretary for International Monetary Affairs at the U.S. Treasury and is a long standing member of the Council on Foreign Relations.*