Center for American Progress

# China's New International Financing Institutions

## Challenges and Opportunities for Sustainable Investment Standards

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In recent years, China has moved into development finance in a very big way. In July 2014, China took the lead in bringing together the major emerging national economies of Brazil, Russia, India, China, and South Africa—known as the BRICS—to form the New Development Bank, or NDB, an international lending institution that will provide at least $50 billion in development funding to emerging markets.[1] Then, in June 2015, China led a group of more than 50 nations to launch the Asia Infrastructure Investment Bank, or AIIB, another China-led development bank that plans to invest at least $100 billion to build new infrastructure projects across Asia.[2] The AIIB launch was a major coup for Beijing because it was not just a developing country initiative. Multiple G7 nations, including France, Germany, Italy, and the United Kingdom, rushed to join the AIIB as founding members. Importantly, the United Kingdom joined despite reported objections from the United States, which chose to stay out of the AIIB and openly criticized the United Kingdom's decision to join.[3] With the AIIB, China is now playing a leading role not only among emerging nations, but among major developed economies as well.

In addition to these two multilateral initiatives, China is also rolling out two new unilateral lending programs: China's South-South Cooperation Fund, which will provide $20 million annually to support climate work in developing nations, and the $40 billion China Silk Road Fund that will fund projects associated with China's Belt and Road Initiative, which is China's new marquis outbound investment initiative.[4]

Based on dollar amounts alone the NDB, AIIB, and Silk Road Fund stand to operate on par with existing financial institutions, such as the World Bank Group and the Asian Development Bank, which operate on capital bases—money both paid in and pledged by member nations—of $223 billion and just more than $160 billion, respectively.[5]

Once the new organizations get rolling, borrowing nations will have a much larger menu of lending options to choose from. The U.S.-dominated World Bank and the Asian Development Bank—in which the United States is the first and second largest shareholder, respectively—will no longer be the biggest lending game in town, particularly in the broader Asia-Pacific region.

From a Chinese perspective, challenging U.S. dominance is exactly the point. Chinese leaders are throwing capital into these new lending institutions because they are frustrated with Washington's refusal to support reforms in the World Bank and the International Monetary Fund, or IMF, that would give China and other emerging nations more voting power—and more lending responsibility—on par with their growing economic clout.[6] The U.S. Congress has been the biggest roadblock to reform in the IMF. The Obama administration has made multiple attempts to move forward on IMF governance reform. But those changes require congressional approval, and Congress has refused to support reform even though the proposed changes would not substantially reduce the U.S. votes in the IMF relative to other member nations.[7]

U.S. congressional representatives may have been resisting these reforms in an attempt to deny China's aspiration for a stronger voice in the current international financial architecture. But instead of containing China, U.S. inaction emboldened China to go out and form its own institutions. Even more importantly from Beijing's perspective: when China stepped up to the plate, other nations were willing to follow, even major developed nations such as the United Kingdom. Now the major U.S.-led institutions face stiff competition from new Chinese-led institutions where the United States is not a member.

It would be easy to assume that this shift in the balance of lending power poses strategic threats to the United States and the U.S.-led global financial architecture. However, the United States does want China to take on more responsibilities in development finance, and Beijing is not going to put more Chinese money on the table without having a say about where that money is spent. That is certainly an understandable position.

If Washington can help Beijing implement responsible lending practices within these new banks, then China's challenge may be just what America's existing infrastructure needs to get out of a stagnant rut. Current U.S.-led organizations such as the World Bank, IMF, and Asia Development Bank, or ADB, are not keeping pace with changing global investment needs; these pre-existing institutions are not attracting enough capital from lender nations to fill escalating investment needs, and their outdated governance structures have failed to effectively leverage lending capital from China and other rising economies. The alacrity with which the AIIB was formed points to the potential of the AIIB and other new international institutions—such as the BRICS' New Development Bank—to stimulate much needed reform and innovation in the existing international economic order. Development lending, just like other markets, benefits from competition. At present, however, China and its new lending partners are going to need more engagement and support from the United States and existing financial institutions to kick off this positive cycle.

This issue brief will provide an overview of the existing international financial order, how China's new financial institutions fit in to the status quo system, and what the United States should do to make sure these new banks drive a race to the top in finance for sustainable investment.

## The existing order

In many ways, the formation of the AIIB is a symptom of a larger problem: the current development financing system is outdated and badly in need of reform. The World Bank, IMF, and ADB simply are not putting forward enough capital to meet current development needs, borrowers complain of unreasonable demands and delays, and the structure of these institutions has not evolved over time to fit a changing global economy. Within these institutions, China and other fast-rising economies can shift from borrowers to lenders as their economies grow. But regardless of how much capital they are willing to put forward, they are not granted decision-making power on par with the original founding nations.

The World Bank is badly in need of a new strategy. Lending has declined in recent years, driven by low capital infusions from World Bank members and increased competition from regional development banks and private institutions. Commitments from the International Bank for Reconstruction and Development—the branch of the World Bank that loans to middle-income countries[8]—averaged more than $25 billion per year during the 1980s and 1990s. But support has since declined to around $15 billion per year, although 2014 saw an increase to $18.6 billion.[9]

Lack of adequate, stable resources—the result of low capital infusions and inconsistent capital increases—has been a continual problem. The proliferation of ad-hoc trust funds—which began as a way to co-finance specific projects but are now mostly focused on global public goods that cross borders, such as climate change or public health initiatives—point to the inadequacy of the World Bank's traditional lending instruments to tackle complex global problems.[10]

The Asian Development Bank is facing similar challenges. The United States is the second largest shareholder in the Asian Development Bank, behind Japan; China is number three. The combined capital base of the World Bank and ADB is less than $400 billion, not enough to meet growing infrastructure investment needs in developing Asia-Pacific nations.

## China's new kids on the block

The New Development Bank was the first new Chinese-led institution to come online. It was established in July 2014 by Brazil, Russia, India, China, and South Africa at the annual BRICS Summit with $100 billion in authorized capital and $50 billion in subscribed capital.[11]

The NDB is structured to heavily favor the founding BRICS members, and any contributions from new members may not reduce the BRICS' voting shares below 55 percent or increase the new members' shares beyond 7 percent of the total voting shares.[12] The ADB has similar minimum regional representations. The protected dominance in voting shares, along with a requirement that the president and vice president hail from BRICS countries, are likely to discourage other large economies from joining. While the BRICS claim that they are aiming for a more inclusive governance structure compared to existing institutions,[13] their terms belie these claims.

In contrast, the Asian Infrastructure Investment Bank is more open, with 57 founding members, compared to five for the BRICS bank.[14] AIIB's Articles of Agreement specify an open procurement policy, which means non-AIIB members can provide goods and services for AIIB-funded projects.[15] However, China will be the largest shareholder and host the headquarters of the AIIB.[16]

While the call for members opened the floodgates that led to a diplomatic coup for China, the result of AIIB's broader membership roster is that it is much more likely to adopt more stringent governance and higher environmental and social standards, with strong support from countries such as South Korea and Australia. Non-Asian members will be limited to 25 percent of the AIIB's voting share and therefore will have less influence on its decisions.[17]

As far as these big new multilateral institutions are concerned, while the United States won't be writing the lending rules in the Asia-Pacific, neither will the Chinese. There is a great deal of potential, then, for these new institutions to create the impetus for revitalizing the global lending system as a whole in both old and new multilateral development banks, and in the process, create a race to the top.

## The standards question

There is a clear need for new investment capital in the developing world. The estimated need of infrastructure investments in Asia alone over the coming years is more than $1 trillion annually.[18] The AIIB's $100 billion capitalization would make the AIIB two-thirds the size of the ADB. Given that the needs for Asian infrastructure have been estimated in the trillions, there is more than enough space for multiple lenders in the region.

In terms of investment demand, the AIIB and NDB are clearly filling a gap. The unanswered question is which type of projects these new development banks will support, and that is determined by the standards they employ for project approval. If these institutions adopt strong standards that safeguard people and the environment, they will support new development projects with a positive impact on borrowing nations and regions. High environmental and social standards at the AIIB and NDB could even push existing international lending institutions to tighten their own project standards and streamline their processes to become more efficient. On the other hand, if the AIIB and NDB adopt standards that are too lax, they could wind up funding a wave of problematic projects such as hydroelectric dams that devastate the local environment or coal plants that accelerate global warming.[19]

Although most of its neighbors in the region welcome Chinese lending—including via the AIIB—Beijing is already encountering push back from nations that initially welcomed Chinese investment but later turned sour on China after it became clear that the projects brought unacceptable environmental damage or were poorly constructed.

Striking the right balance on lending standards for development aid is a difficult task. The AIIB has said it will require projects to be legally transparent and protect social and environmental interests; the AIIB secretariat is currently circulating a draft environmental and social framework for public comment.[20] The NDB, however, has been silent on the specifics of its standards. On the environmental front in particular, the question remains: should a development bank support energy developments that provide cheap fossil energy but also increase local air pollution, possibly damaging local public health and speeding global climate change?

The World Bank is a pioneer in the area of establishing safeguards but can hardly claim unambiguous success. There is tension between alignment with borrower priorities and the often slow and arduous process of safeguards and accountability. This trade-off will only become sharper as recipient countries grow in economic size and are presented with more lending options, as will be the case when the AIIB and NDB come online.

The World Bank's introduction of mandatory environmental and social safeguards followed the 1991 Pelosi Amendment. The U.S. Congress passed the provision, sponsored by Rep. Nancy Pelosi (D-CA), to force the World Bank to conduct environmental assessments for proposed projects and reject those with significant negative environmental effects. This led to the rapid expansion of safeguard expertise at the bank. Additional governance safeguards were developed during former World Bank President Paul Wolfowitz's 2005 reforms. Yet even with safeguards in place, the system is far from perfect.

In 2010, the World Bank green-lighted a $3.75 billion development loan for the Medupi coal-fired power plant project in South Africa.[21] At that time, South Africa was suffering severe power shortages, and the World Bank believed that coal-fired power was the best option for bringing energy online in large quantities and at low rates despite the projects expected environmental costs. The bank required the plant to incorporate emission-control equipment, but the United States, United Kingdom, Netherlands, Norway, and Italy all viewed the proposed power station project as a potential environmental disaster. Those nations supported sustainability over fast fixes and were frustrated by their inability to block World Bank funding for the Medupi project.[22]

In October 2013, as part of President Barack Obama's climate action plan, the U.S. Treasury Department announced that the United States would no longer support multilateral development bank funding for new coal-fired power plants "except in narrowly defined circumstances."[23] The Obama administration took that unilateral step because it wanted to ensure that American taxpayer dollars would not be used to support development projects that undermine public health and climate security. The World Bank adopted a similar policy and now limits funding for new coal-fired power projects to so-called rare circumstances.[24] The United Kingdom, France, and several other industrialized lending nations have followed suit.[25]

On this issue, the World Bank and the major industrialized lending nations are now presenting a relatively united front. The question now becomes, will the AIIB and NDB support or undermine these efforts to strengthen development-lending standards? On coal-fired power, will AIIB and NDB adopt a similar stance, or will they step in to build all of the dirty-coal plants that the World Bank refused to fund? If the AIIB and NDB go with the latter approach, that could severely undermine the global battle to combat climate change.

If instead the new banks adopt a reasonably high-standards approach, then the projects that they fund will complement what the World Bank is already doing. The new lending institutions could even wind up challenging the World Bank to further tighten its own standards, thus driving a global race to the top.

Of course, setting high lending standards is not an easy thing to do. A Center for American Progress research team recently visited potential AIIB borrowing nations across Southeast Asia to find out what emerging markets in the broader Asia-Pacific region expect from the AIIB and how they are communicating those expectations to China and other AIIB member nations. Many Southeast Asian nations are lobbying against high AIIB project standards. They argue that if standards are set too high, then some nations will not qualify for a single AIIB loan. Indonesia, for example, has been unable to move forward on projects with the World Bank because Indonesia cannot meet the bank's high project standards.[26] Indonesia and many other emerging markets expect China to provide a helping hand to its developing neighbors. These nations expect that it will be easier to secure loans through the AIIB than it would be for them to obtain funding from the World Bank.[27]

On the other hand, Beijing understands the political damage China will face if the AIIB, NDB, and Silk Road Fund become synonymous with dirty-coal plants and crumbling infrastructure. China is already facing some of these problems with its outbound foreign direct investment. In Myanmar, for example, officials in that nation forced Chinese investors to halt construction of the planned Myitsone dam after local citizens complained that the dam would flood critical historical areas and damage biodiversity.[28] As a consequence of that project's controversy, China's image has been severely undermined among the Myanmar people. In Malaysia, citizens are complaining about bauxite-mining operations that supply aluminum production in China but flood surrounding areas with poisonous byproducts, including cadmium, lead, and thorium.[29]

Can China thread the needle between providing funding where it is most needed, while at the same time setting standards high enough to ensure that AIIB will not trigger Asia's next environmental disaster? Chinese leaders have indicated that they do indeed want to aim high. AIIB Interim Secretary Jin Liqun has stated that the bank will aim to operate in a "lean, clean, and green" fashion and absolutely will not replicate China's "pollution first mistakes"—which required expensive clean up—in AIIB borrowing nations.[30] However, in private conversations, it is clear that Chinese leaders have not yet figured out how they are going to keep that promise.

Unfortunately, the AIIB's draft environmental and social framework, released last week, does not look promising.[31] The framework is the set of loan application and loan assessment guidelines that will determine the types of projects the AIIB will support and the environmental and social measures project borrowers will need to employ to remain compliant with AIIB lending standards.[32] While the current draft suggests that the AIIB secretariat is making environmental and climate protection a high priority in principle, the language in the draft framework contains plenty of loopholes. It appears extremely likely that the AIIB will support new coal projects, creating massive climate risk.

There is no explicit ban on coal-fired power plants. Coal-fired power is not even mentioned in the "environmental and social exclusion list," which is the list of banned projects, nor does the draft specify limitations or conditions on funding coal projects, such as certain levels of efficiency, or how they will promote cleaner alternatives.

The AIIB guidelines include the following statements:[33]

- Loan applicants should assess a project's potential climate impacts and "develop mitigation or adaptation measures, as appropriate." Based on the current draft, there is no specificity regarding the mitigation or adaptation measures that would be "appropriate" or required in a specific circumstance. Project developers could potentially decide that it would be "appropriate" to do nothing.

- “Consider alternatives and implement technically and financially feasible and cost-effective options to reduce Operation-related greenhouse gas emissions during design and operation.” Based on the current draft, project developers could apparently “consider” various alternatives and then reject them on the grounds that they are too expensive to employ.

- “For Operations that are expected to or currently produce more than 25,000 tons of CO2-equivalent annually, where technically and financially feasible, quantify direct emissions from the facilities owned or controlled within the physical boundary of the Operation.” Based on the current draft, project developers can apparently get out of this requirement by claiming that it is not “technically and financially feasible” to report the project’s greenhouse gas emissions.

Most of the draft environmental and social guidelines depend on the host country’s own regulatory framework; if a project does not violate host country standards, then it will be eligible for funding. Based on this draft, the AIIB could wind up funding projects that benefit powerful local interest groups but violate international environmental standards and would therefore not be eligible for World Bank funding. Such projects often anger local communities and can lead to massive environmental and social disasters that turn host governments against these project as well. If the AIIB begins lending based on these current draft environmental and social guidelines, not only is there a massive risk of climate and environmental damage, but many AIIB projects could create political headaches for Beijing and undermine China’s image as a good economic partner in the Asia-Pacific region.

The current draft is just that—a draft—and the AIIB secretariat released the draft because it wanted to consult with a large array of experts and hear their ideas for modifying this draft. Now that the draft is out, this is an ideal time for the United States to engage. That doesn’t mean the United States needs to join the AIIB; but the United States could work with institutions of which it is a member, such as the World Bank, IMF, and ADB, and the new Chinese-led institutions to improve and unify standards across the board by building on the hard-won lessons learned by the World Bank and other international financial institutions and multilateral development banks.

Given the risks if proper safeguards are not in place, it behooves new and old institutions to cooperate. The AIIB and NDB, especially, will be preoccupied with obtaining a high credit rating, which will allow them to loan on favorable terms, and they will therefore need to carefully assess lending risks.[34] World Bank President Jim Kim’s remarks ahead of the 2015 annual spring World Bank/IMF meetings reflected the realization of this when he said, “If the world’s multilateral banks, including the new ones, can form alliances, work together, and support development that addresses these challenges, we all benefit.”[35]

## Recommendations

The IMF and the World Bank are already engaging the AIIB and NDB to help these new banks learn from best practices in the west, but there is also a need for the United States to engage directly. Currently, if one were to ask Chinese officials and international financial experts what the U.S. position is on the new China-led financial institutions, they would say the United States opposes the new banks and would point to the fact that Washington reportedly tried to block its allies from joining the AIIB and failed. In addition, the Chinese would note that the United States in essence turned AIIB membership into a choice between it and China—and China won.

Moving forward, the United States needs to take a more balanced approach to China-led development financing and make it very clear that America welcomes China and other nations to step up to the plate and provide much needed development financing, as long as those projects meet reasonable environmental and social investment standards. The Obama administration is certainly moving in that direction with official statements, but the United States still does not have actual direct engagement on this issue. This week's U.S.-China presidential summit is a great opportunity to begin rectifying that situation.

Specifically, when it comes to the new development banks, the United States should support a review of current and expected future global financing needs and engage in discussions about how the institutions—new and old—can complement each other in their investment focus. Even with the new institutions online, a funding gap will remain. Thus it is important to develop a shared understanding of the needs and where the highest priorities lie, as well as the comparative advantage of each institution in undertaking specific projects.

As part of this exercise, all development banks—the World Bank, the regional development banks, and the new institutions such as the AIIB—should come together around a shared vision and objectives based on achievement of the United Nation's Sustainable Development Goals summit in late September in Washington.

The United States should work with China to formulate sustainable investment standards that are acceptable to both developed and developing countries. The United States and China have already tackled the developed versus developing country divide under the United Nations Convention on Climate Change.[36] The two nations can apply the same model to international development finance. If the United States and China can identify a set of common standards that both nations can accept, it is highly likely those standards will be acceptable to other nations as well. As they did in the climate negotiation realm, Washington and Beijing will need to think outside the box to find a model that indicates complementarity without requiring complete agreement across all parameters. For example, China—or the AIIB secretariat—could issue a lending policy on coal-fired power that parallels the U.S. policy, even if it does not perfectly match it.

## Conclusion

It is clear that the world of development finance is becoming more diverse and fragmented and that can be a great thing for the United States: Washington can finally let China and other rising economies carry more water around the world. Investment needs are too great to leave potential lending nations on the sidelines. As more lending options emerge, however, standards are going to become even more critical for shaping the types of projects development banks fund around the world. The United States faces a stark choice between leading a cross-bank standardization effort or stepping back and ceding that role to others. America has much to gain from helping China find its way forward on this issue. From a U.S. perspective, leaning in should be the only option on the table.

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