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The AIIB: Political influence and infrastructure policy

Summary

The decision by the UK to participate in the founding of the Asian Infrastructure Investment Bank (AIIB) provoked an intemperate response from Washington, which it as a challenge to the primacy of the Bretton Woods institutions and an instrument of Chinese regional influence. But the AIIB is also a concrete policy response to a very concrete policy problem. Whatever the uncomfortable realities for Washington suggested by Beijing's desire to assert its own influence over regional institutions there is a wider need to recognise the shared aims in improving and derisking public and private capital formation for Asian infrastructure, especially for cross border trade. Viewed this way, an effective AIIB could reinforce US policy in the region, even if it remains out of US control.

The decision by the UK and a number of European capitals to participate in the founding of the Asian Infrastructure Investment Bank (AIIB) last week provoked an intemperate response from Washington. The US inevitably sees the bank as a challenge to the primacy of the Bretton Woods institutions and an instrument of Chinese regional influence, but this is to see the prospective bank purely as an instrument of power projection. The AIIB is also a concrete policy response to a very concrete policy problem, and is worth assessing in those terms, especially for those with an interest in the incentives for capital formation for infrastructure in Asia. Whatever the uncomfortable realities for Washington and Tokyo in particular suggested by Beijing's desire to assert its own influence over regional institutions there is a wider need to recognise the shared aims in improving and derisking capital formation in Asia for infrastructure.

The momentum behind the AIIB lies in a series of debates about Asian infrastructure needs that cristalised in 2010 around an analysis by the Asian Development Bank (ADB). This analysis was generated from national infrastructure plans that had advanced to feasibility study stage and thus has some price tag attached, meaning that it is likely to be a lower bound of recognised needs. It suggested a rough figure of around $800bn in annual infrastructure investment needs for Central, South, East and South East developing Asia for the period 2010-2020. This covered both new build and infrastructure maintenance.

Half of this huge total is in China, but the ADB identified substantial needs in Indonesia, Malaysia, the Philippines, Thailand, Vietnam and India, with needs in these markets heavily skewed towards new build rather than upkeep. Importantly, the ADB flagged around $320bn of needs for regional or sub-regional projects designed to build cross-border interconnectivity and especially vulnerable as projects to coordination failures and investor risk-aversion. The scale of this total requirement is equivalent to around 6.5% of the region's projected GDP for the period to 2020. This is about double the current average rate of infrastructure investment in OECD states.

The money problem

Two especially pressing deficits jumped out of this analysis and are still at the heart of the basic problem. The first was energy infrastructure at the national level – almost half of the ADB's projected infrastructure deficit is electricity generation and transmission infrastructure. The second was transport infrastructure at the regional or sub-regional level, especially port infrastructure and cross border road and especially rail connections. Of the estimated $320bn in regional or sub-regional investment requirements, more than two thirds is transport infrastructure. This includes more than $50bn for large container port upgrades of the sort needed to realise Beijing's notion of a 'string of pearls' shipping infrastructure though the Indian ocean or Jakarta's 'maritime axis' concept of Indonesia's ports as new transhipment hubs. It also includes $130bn for pan-Asian rail links, especially east-west connections between the Pacific seaboard and the markets of South and Central Asia.

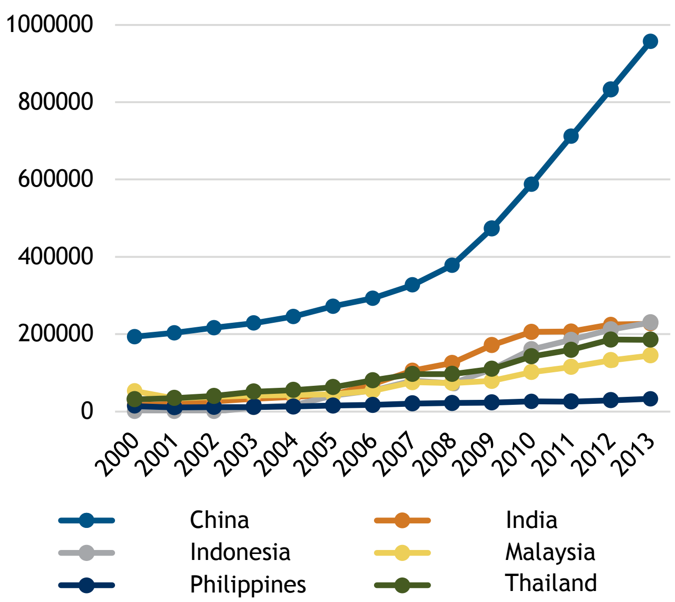

Fig 1: Fixed inward investment stock ($mn)
Source: UNCTAD

Against this backdrop the question of fixed capital formation for Asian infrastructure becomes a growth question of the first order. China has spent huge amounts on infrastructure since 2010 as part of its general fixed investment strategy and the large 2010 stimulus package, as have other South East Asian countries. But scope for this form of expansion is and was limited (and in China's case, probably counterproductive at the margin given the difficulty of channelling large scale infrastructure spending through opaque state-owned banks to poorly-costed and planned regional projects). Moreover, further fixed capital formation across most of South and South East Asia remains constrained by low tax bases and limited state balance sheet space. Both India and Indonesia have used falling oil prices to direct significant revenues previously channelled into fuel subsidies into infrastructure investment in 2015 budgets, but the sums are low when set against needs and fiscal space is limited in both cases.

This is compounded by the limited appetite (or focus) of private capital, and the competition to attract it, which is problematic if it is assumed that private sector participation will be required to meet a considerable part of these spending needs. The World Bank estimated in 2011 that total private sector investment in infrastructure in Asia since 1990 was less than $500bn – which is just over half of the annual estimated requirement for the region for this decade. Asian bond markets are relatively undeveloped and Asian pools of capital (like Asian foreign exchange reserves) are as likely to be invested outside the region as in it.

Moreover, foreign fixed capital allocation of all kinds to developing Asia since the middle of the last decade has been massively skewed towards China (Fig 1), and has largely plateaued in net terms in all large ASEAN markets and developing Asia except China since 2010. This represents something of a resource allocation problem in terms of spreading inward fixed capital for infrastructure around the region and governments outside of China have struggled to encourage investors to look beyond the massive apparent opportunities in the Chinese mainland. For regional or sub-regional projects, with their greater complexity and political sensitivity this ability to attract foreign capital is even weaker.

These joint problems of fiscal constraint and private sector appetite add up to a serious public policy problem. Estimates of the size of the subsequent investment gap vary, but when the ASEAN Investment Fund was set up in as a joint fund administered in partnership with the Asia Development Bank in 2011 the two parties jointly estimated that the ASEAN regional investment deficit at just under half of estimated annual needs of around $100bn. This is probably a good rough guide to the scale of the problem the ADB framed four years on.

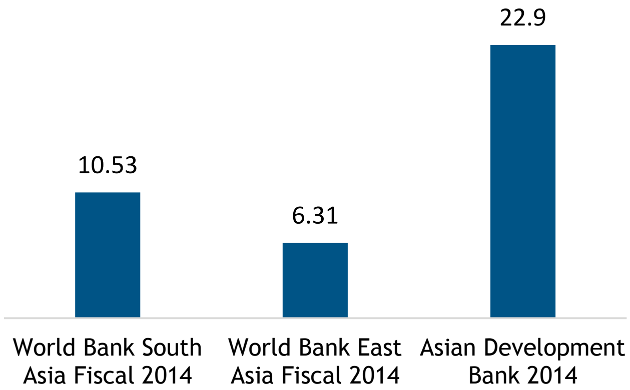

Fig 2: MFI new loans approved 2014, most recent planning year ($bn)
Source: World Bank, ADB

The institutions problem

To what extent is the AIIB a credible response to this? Much obviously depends on how it is capitalised and then run. But in principle, the problem is larger than the current institutional solutions. The World Bank currently has some $70bn committed in total the South and East Asian regions and lent around $17bn in 2014 (Fig 2). The Asian Development Bank deployed a further $13bn in 2014, drawing in further $10bn in official sector co-financing. $500mn of this was deployed on regional projects. Set against the $800bn annually implied by the ADB analysis this is notably small. Moreover, while elements of infrastructure spending are spread across this lending, much covers governance and social development also. Specialised funds like the ASEAN Infrastructure Fund have an dedicated remit for infrastructure, but trade and connectivity projects make up only a small minority of development bank projects.

So why not simply expand the current institutional capacities and tweak its lending focus - as the ADB's analysts no doubt anticipated in posing the infrastructure in the first place? The capital of the ADB was increased by 200% in 2009 in response to a call from the G20. However China remains suspicious of Japanese influence over the ADB and US influence over both the ADB and Bretton Woods institutions. This has been exacerbated by a major lending package to India in 2010 – when tensions between the two were at a high - on which Beijing's objections were over-ruled and which reinforced China's resentment at its relative influence in the bank. US Congressional reluctance to authorise an expanded role and powers for China in the Bretton Woods institutions – despite such an expansion being an implicit commitment alongside the establishment of the G20 in 2009 – has also contributed to Beijing's interest in a new regional institution.

If Chinese unwillingness to work solely in existing structures cannot be tempered with internal reform – and neither the US or Japan show much instinct for this, then alternatives are inevitable. If Chinese disengagement reduces the scope for effective capital formation for infrastructure, then alternatives are desirable. This is especially the case given that there is no reason why the AIIB cannot exist and work alongside the Bretton Woods institutions and given the wide investment scope of the current development banks above and beyond infrastructure and the potential value in a dedicated investor. The unspoken anxiety in some parts of Washington at the prospect of Asian regional political self-sufficiency is hard to justify. Washington may not be inclined to see it this way, but effective regional capital formation in South East Asia, especially for cross border connectivity is actually a key support for US regional policy. The 'mega-regional' Trans Pacific Partnership trade liberalisation initiative (like the various ASEAN and APEC trade integration initiatives that precede and run alongside it) is highly dependent on improved regional interconnectivity to deliver its true benefits, both in terms of greater trade intensity and lower trade costs (Fig 3). An AIIB that succeeds in convening public and private investors in infrastructure in Asia can align well with US foreign policy, even if the US finds it has little control over it.

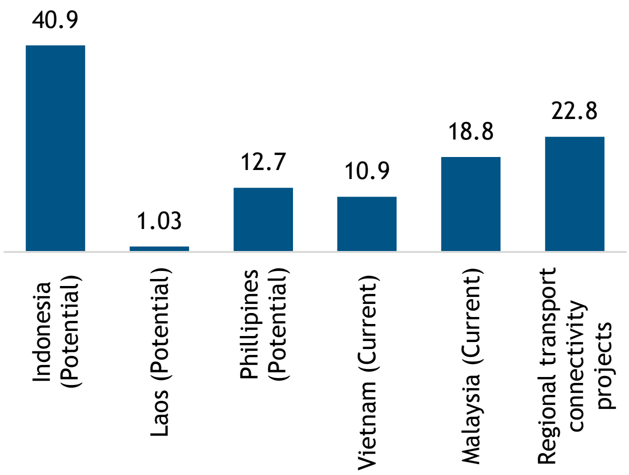

Fig 3: US current and potential developing Asia TPP partners annual infrastructure investment needs 2010-2020 ($bn)
Source: ADB 2010

As momentum behind the AIIB gathers, other sceptics in the region are likely to move. Jakarta's reluctant tone was perked up this week when President Widodo signalled that he would like the headquarters in Indonesia. Japan and Korea are both likely to join. US concerns about governance and lending standards are best addressed by joining the institution rather than standing apart from it – as London no doubt calculates. China will no doubt make its own views felt, but this is inevitable given the weight of China in almost every aspect of regional policy simply as a function of its scale. If China wants to exercise influence with money, the AIIB will prove an unwieldy and indirect way of doing it in comparison to the much more opaque and unbalanced conduct of Beijing in parts of Africa, for example. The China Development Bank provides a good example in some ways of the kind of opacity that would justify a genuine critique of the AIIB if they were replicated. However, the lesson of an exercise like the Shanghai Free Trade Zone since 2013 suggests that Beijing is as likely to have an appetite for sucking in and learning from others' experience on institutional governance and effectiveness. The interim head of the AIIB Jin Liqun has moved through the China Investment Corporation (CIC) and China International Capital Corporation (CICC) and in both cases shown some appetite for raising the standards of Chinese institutions of this kind to international standards. The impact of the UK and European founders in this respect could be disproportionate. If Beijing's instincts are less creditable it will quickly become apparent.

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