

PERSPECTIVE

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AIIB Portents Significant Impact on Global Financial Governance

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EXECUTIVE SUMMARY

- The Asian Infrastructure Investment Bank (AIIB) is a Multilateral Development Bank (MDB) specially designed to provide financial support for infrastructure development and regional connectivity in Asia. Conflicts and competition between AIIB and other existing MDBs in terms of aid conditions and criteria are therefore inevitable; and it will take time for them to develop common norms and reach a painless consensus.
- AIIB officials are presently studying the feasibility of co-financing projects submitted by the ADB. The first batch of co-financed projects include a 64-kilometer long highway project located in Pakistan. But how such joint efforts are carried out depends largely on how the different entities reconcile their priorities, interests, and operational procedures, since they now diverge on rules and regulations regarding lending, procurement and labour.
- A salient contribution that AIIB can make to global financial governance is its injection of new funds which will narrow the huge financing gap found especially in the infrastructure sector and which puts less developed areas in Asia at a disadvantage. Countries in Southeast Asia should be the main beneficiaries since they have numerous projects already conceptualized and that are waiting for funding.
- China, the initiator of the AIIB, aims to strengthen both policy integration and economic collaboration with ASEAN, and is understandably identifying industries most suited to pioneer the bank's activities. It is also developing a mechanism for international cooperation and strengthening regional financial arrangements.

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INTRODUCTION

The creation of the Asian Infrastructure Development Bank (AIIB) understandably grabbed attention throughout the world. The initial response in the US, Japan and some other countries was to view it as a challenge to the post-World War II Bretton Woods order. Many saw it as an attempt by the Chinese to create an alternative institution after having failed to gain greater traction for reform of the existing system of international financial institutions. At the same time, many others see the AIIB as a major event in the history of international financial development with many positive implications for promoting global financial governance. As a Multilateral Development Bank (MDB), AIIB focuses on infrastructure investment in Asia and attempts to construct new mechanisms for international cooperation. It will undoubtedly push for reforms in global financial governance in terms of financial rule-making and loan allocations, and enhance regional financial integration in East Asia.

AIIB – A NEW MDB MODEL

The AIIB's Articles of Agreement signed in Beijing by 57 countries on 29 June 2015 clarify the nature of AIIB as a MDB (Multilateral Development Bank), confirming that it will focus exclusively on infrastructure and other physical investments in developing countries in Asia and work towards regional connectivity. The bank can be perceived as a "quasi-commercial bank", meaning that its investment must generate returns. Moreover, it will follow high economic standards that are very similar to those of existing MDBs such as the World Bank and the Asian Development Bank (ADB).

As its president, former ADB vice president Jin Liqun has said, the AIIB will be "lean, clean, and green".¹ It will put emphasis on transparency, accountability, openness, and independence and combine the merits of existing MDBs and of competitive private banks. At the same time, the AIIB is developing its own way of doing things. For example, unlike the ADB or the World Bank, its Board of Directors will function on a non-resident basis, meaning they will not permanently sit at the headquarters in Beijing. The AIIB secretariat plans to have only 700 personnel, which is substantially less than the 2,000 employees stationed at ADB headquarters.

The AIIB's Articles of Agreement allow for procurement for its projects to be global, instead of being limited to its members. This should enable all funding recipients to purchase the most suitable products for their projects at the lowest possible prices. This is in sharp contrast to how other multilateral financial institutions function.

According to some Chinese scholars, existing MDBs exhibit a "North-South" (the rich helping the poor) orientation. This to some extent is a reflection of the "Washington Consensus" concerning international development (using measures that are in line with the

¹ Zheng Yangpen, "AIIB chief vows to run clean, lean, green institution", *China Daily*, 1 January 2016.

International Monetary Fund's loan conditions), that furthermore adopts an operating policy based on principles set by the 2005 "Paris Declaration".²

For traditional MDBs and for the IMF, donors are mainly developed countries, and when they provide loans to developing countries, these institutions often attach guidelines and loan conditions that are often not adapted to the realities and needs of these countries.³

For example, following the Asian Financial Crisis in 1997, the South Korean government had to seek emergency assistance from the IMF. The effects of IMF interference were however not beneficial to the country. As Taiwanese scholar Zhu Yunhan noted, "The essence of IMF's rescue prescription was to guarantee the short-term interests of Western lending institutions at the expense of the long-term development of East Asian countries."⁴ This seemed to be the main reason why many developing countries are reluctant to apply for loans from the IMF – they deemed the cost in the form of weakened autonomy to be much higher than the potential benefits that an IMF loan could provide.⁵

The AIIB on the other hand, and despite the fact that some of its members are extra-regional developed countries, is on the whole based on a "South-South" (the poor helping the poor). Its policy idea, to a certain degree, deviates from the Washington Consensus, as "it opposes political conditions attached to loan assistance, and will give more consideration to the actual situation and needs of the recipient countries, stressing the simplicity, efficiency, and transparency of the lending procedures."⁶

The AIIB is also adopting a set of risk assessment standards that promise to be more suited for developing countries. This is aimed at detecting projects that may have real investment value but that have been rejected by existing financing institutions for various reasons. In this sense, the AIIB is a new MDB model that could alter the landscape of international development assistance.

² In March 2005, more than 100 donors and developing countries signed the "Paris Declaration" that sets up rules for development aids and loans. It advocates, on the basis of respecting the sovereignty of borrowing countries, that donors should follow uniform rules and procedures. However, the Declaration soon developed league and coordination principles that in fact favour the donors (see 王达、项卫星, "亚投行的全球金融治理意义、挑战与中国的应对" (Wang Da and Xiang Weixin, "The significance of AIIB and the challenge posed to global financial governance, and China's response), 《国际观察》 (International Survey), No.1, 2015).

³ 舒建中, "亚洲基础设施投资银行与国际金融秩序" (Su Jianzhong, AIIB and the international financial order), 《国际关系研究》 (International Studies), No.4, 2015.

⁴ 朱云汉, "中国与 21 世纪世界秩序" (Zhu Yunhan, China and the World order in 21st century), 《世界经济与政治》 (World Economy and Politics), No.10, 2001.

⁵ 孙伊然, "亚投行、'一带一路'与中国的国际秩序观"(Sun Yiran, "AIIB, One Belt One Road, and the Chinese vision for an international order"), 《外交评论》 (Foreign Affairs Review), No.1, 2016.

⁶ 徐奇渊, "亚投行如何融入现有的国际体系?" (Xu Qiyuan, "How can AIIB be integrated into the current global system?"), *CASS Policy Brief* No.15.008, 31 March 2015.

COMPETITION AND COOPERATION WITH THE EXISTING MDBs

As analysed above, the China-led AIIB, although jointly formed with some developed countries, is essentially based on South-South cooperation. In Chan's view, "this kind of South-South cooperation, in contrast to the traditional model, is more based on mutual benefits among the parties involved, with infrastructure development as a main driver of economic growth"... "It does not set the kind of 'good governance' conditions, as do the World Bank and the IMF, which require aid-receiving countries to make major political and economic changes to their governance system."⁷

While Felix K. Chang believes that since this South-South cooperation can be seen to be competing with OECD countries for the hearts and minds of the people in developing countries, "it is inevitable that it may experience conflicts and competition with the existing MDBs where its guiding concept of South-South cooperation, aid conditions and criteria are concerned".⁸ It may take some time for the two sides to reconcile policies and priorities, and to develop common norms and reach consensus.

The AIIB and the ADB have indeed announced that they will work together to identify opportunities for co-financing, but with the ADB claiming the leading role. "The ADB is the lead financing partner for the project and administers it on behalf of the other co-financiers," and it insists that "bidding shall be carried out in accordance with ADB's procurement guidelines and procedure."⁹ The question now is how their differences are to be ironed out. The ADB may want the AIIB to adopt its practices, but the latter may have in mind a more flexible approach.

In any case, the AIIB is expected to face intense competition from the ADB in Southeast Asia. Geopolitically, Southeast Asia is important to US and Japan, who together are the largest source of FDI for the region. For many years now, Southeast Asia has been the lending target of the ADB. In 2013, the ADB's investment priorities were Southeast Asia, Central Asia and South Asia, and its loan amount for that year was US\$21 billion.¹⁰

In 2009, ADB published a report entitled "Infrastructure for Seamless Asia", estimating that from 2010 to 2020, Asia would need US\$8.3 trillion in infrastructure investments. The report outlined a blueprint for Asian infrastructure, covering highways, railways, airports, seaports, power plants, networks of communication and others. The ADB's basic idea is to further cooperate with the private sector and expand its already well-established capacity

⁷ Gerald Chan, "China's High-speed Rail Diplomacy: Global Impacts and East Asian Responses", EAI Working Paper, February 2016, available at <
http://www.eai.or.kr/type/panelView.asp?bytag=p&catcode=+&code=eng_report&idx=14512&page=1> [accessed on 4 April 2016]

⁸ Felix K. Chang, "China's 'win-win development bargain: China, the AIIB, and the international order – analysis'", Foreign Policy Research Institute, *E-Notes*, 29 June 2015.

⁹ Tome Mitchell, "China's AIIB seeks to pave new Silk Road with first projects", *Financial Times*, 19 April 2016.

¹⁰ ADB 2014 Annual Report.

and deepen its imprint on Asia's infrastructure. Given the ADB's present dominance, the AIIB cannot but undercut Japan's leadership in the region.¹¹

Japan has proclaimed a new development programme, "The Partnership for Quality Infrastructure", which it announced in May 2015 and which it has been promoting to Southeast Asian states.¹² This programme emphasizes collaboration between Japan and the ADB to promote "quality infrastructure investment" as an international standard. Under this scheme, Japan increases its infrastructure investment to \$110 billion for the next five years. It is believed that this programme is meant to counteract the AIIB's influence, as "both Japan and the US were significantly concerned about China's AIIB initiative because of its lack of transparency, low lending standards, and China's increasing influence in development."¹³

Meanwhile, the AIIB had before its founding consulted with the ADB and the World Bank and had sought to play a supplementary role to the existing MDBs. On 13 April 2016, AIIB President Jin Liqun signed its first co-financing framework agreement with World Bank President Jim Yong Kim in Washington. The two are now discussing the possibility of co-financing 12 projects, mainly related to transportation, water and energy projects in Central Asia, South Asia and East Asia. On 2 May 2016, the AIIB President and ADB President Nakao Takehiko signed a cooperation memorandum in Frankfurt in which the two sides agreed to strengthen cooperation in energy, transport, telecommunication and other aspects of development.¹⁴

On 24 June 2016, the board of AIIB approved \$509 million in investments for its first four projects, three of which are co-financed with the World Bank, the ADB, the United Kingdom Department for International Development, and the European Bank for Reconstruction and Development.¹⁵ These projects concern power grid upgrades in Bangladesh, slum renovation in Indonesia and highway construction in Pakistan and Tajikistan.

However, how such joint efforts will be carried out further in the future depends largely on how the different entities can reconcile their priorities, interests, and operational procedures, as they diverge on rules and regulations such as lending conditions, procurement policy, and labor stands. ADB has made it clear that there will be no co-financing with the AIIB until ADB safeguard policies are accepted.

¹¹ Xing Yuqing, "The Asian Infrastructure Investment Bank and China's role in regional economic governance", *EAI Background Brief No. 1073*, 28 October 2015.

¹² MOFA, MOF, METI, MLIT, "Summary: 'Partnership for Quality Infrastructure: Investment for Asia's Future'", 21 May 2015.

¹³ "ADB says will maintain standards when cooperating with AIIB", *Business New*, 2 May 2015.

¹⁴ 羌建新, "同行合作: 亚投行的新步伐"(Qiang Jianguo, "Peer cooperation: AIIB's new step"), 《世界知识》(World Knowledge), No.11, 2016.

¹⁵ "China-backed AIIB approves \$509 million for first four projects", *Asia Times*, 24 June 2016, <<http://atimes.com/2016/06/china-backed-aiib-approves-509-million-for-first-four-projects/>>

IMPACT ON GLOBAL FINANCIAL GOVERNANCE

According to Daniel Bradlow, international financial governance should have two objectives. The first is to support an international monetary system that is predictable and stable and that facilitates payments for international economic transactions. The second is to oversee an international financial system that both protects the interests of investors and allocates credit resources efficiently and fairly amongst all potential borrowers. The ultimate goal is to facilitate productive and sustainable economic activity that serves the interests of all stakeholders in the international economic order.¹⁶

The current global financial governance system is large and complex. Although having experienced dynamic changes and reforms, the Bretton Woods system established after the Second World War still shapes the global financial and economic order. The International Monetary Fund (IMF) and the World Bank, the multinational institutions of the Bretton Woods system, lead the development lending and international financial regulations. The IMF, the World Bank and four small regional MDBs—ADB, Africa Development Bank, Inter-American Bank, and the European Reconstruction and Development Bank—comprise the architecture of current global financial governance.

But for a long time now, this global financial system has been facing many problems. The initial signs of the system having reached a crossroads came during the 1997 Asian Financial Crisis when many Asian countries objected to IMF interventions and played with the idea of setting up an Asian Monetary Fund. The problems persisted however, and after the global crisis in 2008, the need for reform became ever more obvious to many. China and other emerging economies wanted to re-evaluate the existing international financial governance structures, especially the issues of the undervalued quota shares of China and other emerging countries in the IMF and the World Bank. But these suggestions encountered strong resistance. The 2010 reform package to reform the Bretton Woods institutions by offering emerging economics a larger voting share, for example, were stymied for years by the US congress.¹⁷ The challenges facing the current global financial governance system also form the background for the establishment of the AIIB.

However, as matters now stand, the impact of the AIIB on the global financial governance may nevertheless be limited. This is because China has explicitly positioned AIIB as a multilateral development financing bank, and its main task is “to foster sustainable economic development, create wealth and improve infrastructure connectivity in Asia by investing in infrastructure and other productive sectors.”¹⁸ Wang and Xiang stressed that its role is to supplement existing multilateral financial institutions and invest in those areas and

¹⁶ Daniel Bradlow, “Materials for a 4-Part On-Line Course on Global Financial Governance”, American University, WCL Research Paper No. 2009-28, 2009 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1488020> [accessed 12 April 2016]

¹⁷ Ren Xiao, “China as an institution-builder: the case of the AIIB”, *The Pacific Review*, Vol.29, No. 3, 2016.

¹⁸ “Articles of Agreement of Asian Infrastructure Investment Bank”, dated 29 June 2015 <http://www.aiib.org/html/topic/Entry_into_Force/> [accessed 12 April 2016]

sectors that had been neglected, so as to meet new dynamic changes in global financial markets.¹⁹

This position makes it difficult for the AIIB to contribute strongly to global monetary system reform, not to mention to “shake or challenge America’s core interests in global financial field”.²⁰ It can make some incremental changes with the global financial system, though, in terms of new perceptions, loan allocations and new rules-making. One salient contribution is the AIIB’s ability, through new injections of funds, to reduce the huge financing gap found especially in the infrastructure sector throughout Asia and in less developed regions.

Investment in infrastructure has a strong economic spill-over effect. According to Makmun, every \$1 investment in infrastructure can result in \$3 to \$4 being invested in other economic sectors. In Asia, every \$1 billion investment in the infrastructure sector can create 18,000 employment opportunities.²¹ The ADB study mentioned earlier also predicts that a 10% increase in paved roads increases economic growth by more than 5%; and the subsequent reduction of electric power transmission and distribution losses by 1% increases growth by 1.1%.²²

However, developing countries often lack funds. Investments in such countries by private banks and investment firms from developed countries mainly focus on areas such as energy and manufacturing. This trend contributes to the infrastructure gap that acts as a major bottleneck for improving the competitiveness of developing countries.²³

Moreover, recovery from the 2008-09 crisis has increased the need for building and construction at the same time as the lending capability of global financial institutions remains seriously affected. This has resulted in massive unmet loan needs. The World Bank estimates that in the 2010-2020 period, the unmet demand for infrastructure investment in emerging markets and developing economies will be \$1.8-2.3 trillion, and ODA from developed countries and financing loans from international financial institutes can only meet about 7% of this need.²⁴

While the AIIB, which is likely to disburse around \$2 billion in loans in its first year of operation, will initially not be able to reduce this gap greatly, it promises to move more

¹⁹舒建中, “亚洲基础设施投资银行与国际金融秩序” (Su Jianzhong, AIIB and international financial order), 《国际关系研究》(International Studies), No.4, 2015.

²⁰王达、项卫星, “亚投行的全球金融治理意义、挑战与中国的应对” (Wang Da and Xiang Weixin, “The significance of AIIB and the challenge posed to global financial governance, and China’s response), 《国际观察》(International Survey), No.1, 2015).

²¹ Makmun Syadullah, “Prospects of Asian Infrastructure Investment Bank”, *Journal of Social and Development Sciences*, Vol.5, No. 3, pp.155-167, September 2014.

²² Georg Inderst, “Infrastructure investment, private finance, and institutional investors: Asia from a global perspective”, *ADB Working Paper Series*, No. 555, January 2016.

²³ OECD, *Perspectives on Global Development 2013: Industrial Policies in a Changing World*, OECD Publishing, 2013, p.18.

²⁴ Adopted from Marianne Fay, Michael Toman, Daniel Benitez, and Stefan Csordas, “Meeting the infrastructure Challenges: the case for a new development bank”, presentation in the Global Economic Governance Seminar, Madrid, 11 March 2013.

swiftly in approving and financing finance projects that other MDBs and bilateral donors are not funding for environmental, social, or governance reasons.²⁵

IMPLICATIONS FOR SOUTHEAST ASIA

The need for infrastructure investments is great in many Southeast Asian countries. According to the often-cited ADB estimate, during 2010-2020, Asian countries will need to invest \$8.3 trillion in national infrastructure and an additional \$290 billion in regional infrastructure projects in transport and energy.²⁶ ADB studies also show that Southeast Asian countries will need to invest at least \$1.2 trillion in national infrastructure construction in that same period,²⁷ while the International Energy Agency predicts that the region requires \$2.5 trillion in investment in energy and infrastructure over the next 20 years.²⁸

Sanchita Basu Das joins this estimate by noting that Thailand has identified 20 infrastructure projects costing nearly \$50 billion to be undertaken before 2018. At the same time, the Indonesian government in its 2016 State Budget has earmarked \$23 billion for infrastructure development. Similarly, the Ministry of Planning and Investment of Vietnam estimated in 2014 that the country needs \$500 billion for its infrastructure development over the next ten years.²⁹ So far, the support mainly comes from government sources, and these are limited in all cases.

The existing development banks cannot meet such a huge demand. ADB operations are largely focused on addressing growing income and social disparities, enhancing resource management, investing in innovation, and responding to requests for emergency support. For example, in 2013 the primary sectors in Southeast Asia receiving ADB lending support were public sector management (50%), transport (15%) and energy (10%).³⁰ The ADB cannot adequately meet the infrastructure needs in Southeast Asia. As ADB President Nakao Takehiko has said, the ADB has only about \$13 billion for new lending each year.³¹

The World Bank also acknowledges that its funds for global infrastructure are limited. Its President Kim Yong Kim announced that the infrastructure needs in developing countries started at \$1 trillion a year, and that this figure greatly exceeded private-sector investment

²⁵ Daniel F. Runde and Conor M. Savoy, "Global infrastructure development: a strategic approach to U.S. leadership", *CSIS Research Report*, March 2016.

²⁶ "Infrastructure for a Seamless Asia", *ADB Report*, 31 August 2009.

²⁷ Biswa Nath Bhattacharyay, "Estimating demand for infrastructure in energy, transport, telecommunications, water and sanitation in Asia and the Pacific: 2010-2020", ADBI Working Paper No. 248, 2010.

²⁸ Cited in "China, ASEAN to deepen cooperation on industrial capacity", *China Day*, 2 June 2016.

²⁹ Sanchita Basu Das, "ASEAN regional integration will be determined by better connectivity in the future", *ISEAS Perspective*, No. 28, 31 May 2016.

³⁰ ADB Annual Report 2013, p.33.

³¹ "ADB will be 'very happy' to work with China's Asian Infrastructure Bank", *Reuters*, 2 May 2014.

of about \$150 billion a year.³² Thus, China with its total foreign reserves of around \$3.4 trillion and total outward FDI of \$120 billion in 2015 has a potentially significant role to play in satisfying Southeast Asia's infrastructure sectors.

Indeed, China is seeking to invest overseas for bigger returns. Chinese capital "going out" is an inevitable trend. As predicted by the World Bank, by 2030, China's share in the global total investment will reach 30%, ranking it first in the World.³³ In addition, infrastructure building is one of the most competitive areas for Chinese firms. Their costs for constructing high-speed rails, for example, are much lower than for other competitors, with the unit cost being equivalent to or even below two-thirds of those of European competitors.³⁴

Southeast Asian countries look to be the main beneficiaries of this development because they have numerous projects waiting for funding, especially those that have been identified under the Master Plan of ASEAN connectivity such as the ASEAN Highway Network and the Singapore-Kunming Railway. Happily, these projects would also help China develop its relatively backward southwestern region, and in linking it effectively to the outside world, improve its export capacity.

The ASEAN Connectivity Coordinating Committee (the body tasked to coordinate and oversee the effective implementation of the Master Plan on ASEAN Connectivity) has held several meetings with its Chinese counterpart, the Chinese Working Committee of the China-ASEAN Connectivity Cooperation Committee.³⁵ Both agree to continue the consultation process to expand project-financing channels and enhance cooperation in infrastructure technology transfer and personnel training. They are banking on the AIIB and Maritime Silk Road Fund founded within the Belt and Road Initiative framework generating innovative modes of financing and playing a major role in developing ASEAN connectivity.

China is also hoping to strengthen policy integration and collaboration with ASEAN by identifying industries suited for immediate investments, improving cooperation mechanisms, and strengthening regional financial arrangements. Successful policy coordination between China and ASEAN would serve the global financial reform agenda.

CONCLUSION

The AIIB aims to provide an additional mechanism for global financing and to play a complementary role in less prioritized economic areas. To be sure, healthy competition improves the efficiency of resource allocation and can act as a catalyst for important reforms in global financial governance. Regardless of China's motives, Asia stands to benefit greatly

³² "World Bank welcomes China-led infrastructure bank", *Reuters*, 8 July 2014.

³³ World Bank, "Capital for the Future: Saving and Investment in an Interdependent World", Global Development Horizons, 2013, p.5.

³⁴ Gerald Ollivier, Jitendra Sondhi and Nanyan Zhou, "High-Speed railways in China: a look at construction costs", China Transport Topics, No.9, World Bank Office, 2014, p.8.

³⁵ ASEAN Secretariat, "Overview of China-ASEAN dialogue relations", 18 January 2016 <http://www.asean.org/?static_post=overview-asean-china-dialogue-relations> [accessed on 20 March 2016].

from the establishment of the AIIB. Billions of dollars in investment either dispersed directly or leveraged by AIIB cannot but greatly improve energy supply and expand the networks of highways and railways in the region. The expected infrastructure boom led by AIIB will unleash the pent-up demand and stimulate the sluggish world economy.

In strategic response to Asian countries needing financial integration and cooperation, China established in 2014 the \$40 billion Silk Road Fund to boost Asian interconnectivity. The revised version of the Chiang Mai Initiative Multilateralism (CMIM) took effect the same year, and the funds targeted to enhance the multilateral currency swap mechanism were raised from \$120 billion to \$240 billion, largely strengthening Asian countries' ability to manage currency crises.³⁶ In early 2013, China participated in the creation of the BRICS contingency reserve arrangement, aiming to enhance BRICS countries' ability and confidence to resist financial crisis.³⁷ All these arrangements have the intention of providing regional public goods. The fact that many countries now increasingly consider the AIIB necessary in reforming the global financial architecture means that this new MDB could alter the landscape of the global financial order and strengthen regional financial cooperation in the future.

Without a doubt, a rising China will definitely attempt to revise some of the rules of global economic and financial governance, but this does not mean that its efforts should be obstructed. As Chinese scholar Ren Xiao has said, "when a nation has reached a certain level and starts to pursue a legitimate international status, it is not just an issue of helping to enhance others' development, or seeking discursive power internationally... real world status comes from the capability to influence the thinking and the future direction of the world."³⁸ The China-led AIIB should be seen as a step in that direction.

³⁶ “清迈倡议多边化协议修订稿生效”，2014年7月18日

<http://finance.ce.cn/rolling/201407/18/t20140718_3188689.shtml> [accessed on 7 June 2016]

³⁷ “中国人民银行副行长易纲谈建立金砖国家应急储备安排”，2013年8月27日 <<http://dm.chineseembassy.org/chn/zgxw/t1069954.htm>> [accessed on 8 June 2016]

³⁸ Ren Xiao, “China as an institution-builder: the case of the AIIB”, *The Pacific Review*, Vol.29, No. 3, 2016.

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