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THE ROLE OF NEW MULTILATERAL DEVELOPMENT BANKS IN THE GEOPOLITICS OF DECARBONISATION

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Summary

This paper provides a synthesis of research and analysis on how the changing landscape of development finance could impact the geopolitics of decarbonisation. Specifically, it considers whether the emergence of new multilateral institutions that are led by developing countries is more likely to lead to stronger international cooperation on climate change and decarbonisation, or to greater rivalry and competition.

The scope has been limited to focus primarily on the Asian Infrastructure Investment Bank (AIIB) and the New Development Bank (NDB) as two of the most recently established and largest developing country-led multilateral institutions. The sources reviewed were chosen based on their relevance to the following three issues: 1) the relative strength of the climate and environmental standards of the AIIB and NDB in comparison with other development institutions; 2) the extent to which the AIIB and NDB are being used to achieve geopolitical objectives for example in securing preferential trade agreements, infrastructure contracts or access to natural resources; and 3) China's role in the development finance landscape as a major shareholder of both institutions.

Overall, the evidence suggests that the multilateral nature of the AIIB and NDB compared with other bilateral development banks or institutions offers an opportunity to use them as models both for international cooperation on decarbonisation and for how to successfully deliver sustainable infrastructure investment in developing countries. On truly global challenges like climate change, cooperative institutions are more likely to encourage higher standards and have less geopolitical linkages than bilateral lending. The real focus of attention should

therefore be on the overall balance of financial flows between bilateral or multilateral institutions. In addition to the questions posed above, the paper also highlights several emerging geopolitical issues that are not covered as extensively in the literature but that will have implications for development finance and decarbonisation.

The first is debt sustainability. Progress on this issue more than any other will likely determine how much capacity developing countries can put towards decarbonisation efforts in the coming years. Second and third round impacts from COVID-19 are already hitting countries from the global economic slowdown, collapse of tourism sectors and credit downgrades. The role of the International Monetary Fund (IMF) and Multilateral Development Banks (MDBs) will increase under these conditions. There will be geopolitical tensions over who controls bailout and debt relief terms especially for developing countries highly indebted to China, and whether green conditions are attached. If the AIIB and NDB can be employed to help find common ground on the global debt crisis and ensure a sustainable recovery, this would free up fiscal space for developing countries to devote more resources to decarbonising their economies and sharing best practices and lessons learned with partners.

The second issue relates to standard setting of, and access to, digital technologies. Research shows that digital technologies such as Artificial Intelligence and the Internet of Things have a key role to play in meeting decarbonisation objectives. The digital sphere is also increasingly geopolitical. The debate over the use of 5G technology and Huawei is perhaps the most notable example, but China's "Made in 2025" initiative to upgrade Chinese industry identifies advanced information technology as a priority sector. Additionally, the EU's Connectivity Strategy for Europe and Asia features digital connectivity as a priority and specifically seeks to leverage financial resources from international financial institutions and multilateral development banks.

Development Finance Institutions (DFIs) could provide a route for digital technologies into developing countries. Countries building hardware financed by these new institutions will therefore need to make choices about standards. Ultimately, digitalisation can make decarbonisation easier and cooperation more likely. The AIIB and NDB could facilitate the integration of technological systems and multilateral agreement on standards and practices leading to a scenario characterized by beneficial data-sharing, cross-border electricity interconnection of renewable energy and local smart-grids.

Finally, the role of recipient countries as geopolitical actors either individually or collectively has not been covered extensively in the existing literature but would be an important topic for further research. Developing countries have the means to influence donor country behaviour through participation in international venues and institutions and could coordinate to demand a shift in financial flows, for example towards net zero energy sources or building resilience to climate impacts.

The paper has several limitations. First, only sources written in English have been reviewed and therefore important research might have been unintentionally excluded. Secondly, there are many other development finance institutions that are geopolitical actors, for example national development banks or export-import banks. These are mentioned but are not the focus. Widening the scope to include more in-depth analysis of the role of bilateral institutions would be a useful future exercise. Finally, for the purposes of this analysis the AIIB and NDB are often lumped together, but in fact they differ from each other with respect to standards and practices.

Introduction

Efforts to limit the risks from climate change by decarbonising national economies will change the nature of international relations**.** As the value of some natural resources rise and others fall and the strategic importance of certain geographies shift, so will the power dynamics between nation states and in some cases the balance between cooperation and rivalry. The nature of climate change itself as a global public goods challenge might also incentivize greater cooperation; although the geophysical impacts of climate change could also increase regional or global instability.

Financial institutions will play a significant role in determining how quickly countries decarbonise. The decisions made by public and private banks, funds and investors will determine how quickly financial flows are redirected away from more conventional energy projects and towards low carbon or net zero alternatives, or to projects that improve resource or energy efficiency.

In this context, DFIs have a unique role to play as potential first movers and catalysts of change. DFIs leverage multiple times their investments from private capital, provide economic advice to governments on development pathways, can afford to make long-term investments and as publicly funded institutions are duty-bound to work in the public interest[1]. They are key leverage points in accelerating the financial reform process necessary to meet decarbonisation objectives and provide an opportunity for countries to develop and be able to finance clear pathways towards net zero economies.

At the same time, nation-states are increasingly looking to financial institutions as vehicles for achieving geopolitical influence[2]. The hardening of geopolitics in recent years from rising nationalism alongside trade and security tensions has not escaped the world of development finance, where some countries have made a strategic shift towards using development finance for geopolitical ends[3]. Potential geopolitical motives for development finance include securing access to natural resources, infrastructure contracts or preferential trade agreements, as well as endorsement of territorial claims.

The landscape of development finance has changed in recent years. Existing multilateral institutions, particularly the World Bank and International Monetary Fund (IMF), have been criticized for lack of representation[4]. Emerging economies have sought to increase their influence in existing multilateral institutions while also establishing new institutions. The Asian

[1] **https://www.e3g.org/publications/banking-on-reform-aligning-development-banks-with-paris-climate-agreement/**

[2] **https://www.geopoliticalmonitor.com/geopolitics-and-the-asian-infrastructure-investment-bank/**

[3] **https://www.devex.com/news/how-geopolitics-shaped-global-development-in-2019-96253**

[4] **http://www.reuters.com/article/idUSN25300517**

Infrastructure Investment Bank and New Development Bank are the two largest new multilateral institutions, but there have been other recent examples of regional, bilateral or Export-Import banks.

Developed countries have responded by reassessing their own practices in development finance and building new institutions themselves. To give a recent example, in 2018 just a few months after China launched the new China International Development Cooperation Agency (CIDCA) the United States Congress passed the Better Utilization of Investment Leading to Development (BUILD) Act which established the United States International Development Finance Corporation (USIDFC)[5]. The USIDFC is expressly intended to support US foreign policy objectives[6]. It, along with other new banks or initiatives such as the European Climate and Sustainable Development Bank and US-Japan-Australia Blue Dot Network for Infrastructure Financing are all geopolitical responses to rising emerging market power being exercised through their DFIs.

The emerging economy-led institutions have been met with questions from the foreign policy community about whether they represent a strategic shift in the development finance landscape. Considering the importance of decarbonisation as a global challenge, it is worth considering the impact of these new institutions on the geopolitical landscape. Are they more likely to act as drivers of greater international cooperation on climate change through for example the growth of new green markets or in a new stream of support for fossil fuels and carbon intensive infrastructure and potentially a widening geopolitical split between the global North and South.

This paper synthesizes key findings from recent research and analysis on the role of new financial institutions as drivers of international cooperation or competition on climate change and decarbonisation. We have limited the scope to focus on the two largest and most recently established developing country-led Multilateral Developments Banks: the Asian Infrastructure Investment Bank and the New Development Bank, both of which began operating in 2016. Other financial institutions that are relevant for geopolitics include national development banks, regional and bilateral funds, development aid agencies and export-import banks. Doing a deeper dive on bilateral development finance institutions was beyond the scope of this paper but would be a useful future exercise.

Section 2 provides a brief overview of recent trends on climate change in the financial sector, focusing on the role of the traditional MDBs. Section 3 provides background and context on the AIIB and NDB as the latest 'wave' of MDBs. Section 4 summarizes the key findings of recent reports or other literature that address the role of these institutions either as geopolitical actors or with respect to their role in driving the low carbon transition, or both. Section 4 also includes a synthesis of analysis on the role of China as the largest single influence on the changing geopolitics of development finance. Section 5 concludes by posing several questions that emerge from the research and highlights three geopolitical issues relevant for decarbonisation that are likely to grow in importance in the future: the geopolitics of debt

[5] **https://www.ccpwatch.org/single-post/2019/01/29/Too-Much-Risk-or-Not-Enough-New-Development-Finance-Agencies-in-China-and-the-United-States**

[6] **https://www.congress.gov/bill/115th-congress/senate-bill/2463**

sustainability; control over digital technologies; and the role of recipient countries as geopolitical actors.

Climate-related trends in the financial sector and the Multilateral Development Banks

In recent years financial sector actors have grown increasingly concerned about climate-related risks, including to the stability of the global financial system. Climate-related financial risk driven by climate policy success is known as transition risk. In this case, a rapid shift to a zero-carbon economy driven by a combination of climate policy, technological innovation and changes in public preferences leads to devaluation of carbon-intensive assets which become stranded in a stockpile of 'unburnable' carbon. Considering the high degree of entanglement of fossil fuel assets in pension funds and other institutional investors this would impact the financial sector and wider economy.

On the other hand, failure to lower emissions and strengthen resilience of infrastructure, economies and social systems to climate impacts will lead to an increase in physical risk, driven by the increase in extreme weather events like droughts, floods and heatwaves. These impacts are already leading to damage to infrastructure and insurance losses that are rippling through the financial system for example through rising premiums. These two scenarios are not mutually exclusive. In fact, elements of each are already beginning to play out in parallel. A global transition towards a net zero economy is underway, albeit slowly, and has already led to rapid and dramatic revenue losses[7]. There is also evidence that physical impacts from climate change are accelerating which is impacting financial and insurance markets[8].

These concerns are now widely shared by public and private financial actors including central bankers, finance ministries, asset managers and institutional investors. These are typically more conservative actors that are adopting a risk-management stance to avoid material damage to their bottom lines and the global economy. New networks and initiatives led by financial actors have formed in response. These include the Financial Stability Board's Task Force on Climate-Related Financial Risk Disclosure as well as the Network for Greening the Financial System (NGFS) which brings together central banks and supervisors committed to understanding and managing the financial risks and opportunities associated with climate change. The NGFS was launched in December 2017 with eight members; as of July 2020, the network includes 46-member institutions and 9 observers, including the IMF, OECD and World Bank Group.

The growing understanding and concern about climate risk has also led to a change in approach from the main 'traditional' MDBs, including the World Bank Group, Inter-American Development Bank (IDB), the African Development Bank (AfDB), the Asian Development Bank (ADB), European Bank for Reconstruction and Development (EBRD) and the European Investment Bank (EIB). For decades the traditional MDBs focused mainly on

[7] See for example the loss by several major European utilities of half a trillion euros in 2013 due to overinvestment in fossil fuels. **https://www.economist.com/briefing/2013/10/15/how-to-lose-half-a-trillion-euros**.

[8] **https://www.munichre.com/topics-online/en/climate-change-and-natural-disasters.html**

infrastructure spending without much concern for issues related to governance; 70% of the World Bank's lending in the 1950s and 1960s was on infrastructure[9]. Over time, civil society groups began to criticize the MDBs for a lack of transparency and for a failure to prioritize social, environmental and governance issues[10].

In recent years there have been efforts to address these problems through a greater focus on governance issues and environmental protection[11]. There has been a new push to scale up these efforts including with a more specific focus on climate change with the seven largest MDBs collectively committed to align their financial flows with the Paris Agreement[12]. Financing provided by MDBs for climate change action in developing countries has increased in recent years, as have pledges for future action. The World Bank Group for example announced it will invest and mobilize $200 billion over 2021-2025[13]. Others have made similar pledges, for example the European Investment Bank pledge to phase out fossil fuel investment almost entirely, with some exceptions[14]. The EBRD has cut out coal financing since 2018[15]. The share of finance going towards climate adaptation and resilience projects is also increasing, and MDBs are working on improving their climate risk management systems[16].

It should be noted that none of the major development banks are fully aligned with the Paris Agreement[17]. Some continue to fund coal projects, and the overall lending ratio for some MDBs remains too heavily skewed towards fossil fuels[18]. While most MDBs are making significant progress on coal and oil, the role of natural gas is still being debated and this will also likely become more of a geopolitical issue. Transparency is limited for others and some still lack a comprehensive strategy on climate change. Nevertheless, analysis of the overall trend of developments in the financial sector as well as actions of the MDBs suggest that they are moving towards a more sustainable development pathway and are ramping up efforts to assist partner countries in reducing climate risk. This reflects an increase in demand for this type of support from developing countries but also the influence of the MDB shareholders, most of which are also setting decarbonisation targets and integrating climate change considerations into their own national governance and decision-making.

Developing countries and emerging economies have long called for greater voice in and reform of the international financial governance system including concerns regarding international financial institutions and the MDBs. This resulted in a reform package in 2010 that increased the voting share for China and other emerging economies in the World Bank and IMF[19]. Delay

[9] https://onlinelibrary.wiley.com/doi/full/10.1111/1758-5899.12396

[10] https://onlinelibrary.wiley.com/doi/epdf/10.1111/dech.12473

[11] https://www.csis.org/toward-better-multilateral-development-banks-can-united-states-and-china-lead-together

[12] https://www.worldbank.org/en/news/press-release/2018/12/03/multilateral-development-banks-mdbs-announced-a-joint-framework-for-aligning-their-activities-with-the-goals-of-the-paris-agreement

[13] https://www.worldbank.org/en/news/press-release/2019/06/13/mdb-climate-finance-hit-record-high-of-us431-billion-in-2018

[14] https://www.theguardian.com/environment/2019/nov/15/european-investment-bank-to-phase-out-fossil-fuels-financing

[15] https://www.ft.com/content/7d0814f0-fd6f-11e8-ac00-57a2a826423e

[16] https://www.e3g.org/publications/banking-on-reform-aligning-development-banks-with-paris-climate-agreement/

[17] https://www.e3g.org/publications/banking-on-reform-aligning-development-banks-with-paris-climate-agreement/

[18] https://www.e3g.org/publications/executive-summary-banking-on-asia/

[19] https://www.cigionline.org/sites/default/files/cigi_paper_no.106.pdf

to the IMF governance reform package was in part what prompted China and the BRICS to more seriously consider establishing entirely new institutions, including the NDB and AIIB which have been called the 'third wave' of MDBs[20].

Background on the Asian Infrastructure Investment Bank and New Development Bank

Asian Infrastructure Investment Bank

Headquartered in Beijing and conceptualized by China, the Asian Infrastructure Investment Bank's stated mission is to improve economic and social outcomes in Asia. It has 102 approved members and a total of $16.2bn in investments as of June 2020 (by comparison total disbursements from the World Bank Group to partner countries in 2019 was $49.3bn[21]). In its first year, the AIIB co-financed most of its projects with other development banks[22]. Of the regional shareholders China has by far the most voting power at 26.7%. For reference, India has 7.6% and Russia has 6%. Germany is the highest non-regional shareholder, with a 4% stake, followed by France and the UK which each stand at roughly 3%.

AIIB leadership have consistently highlighted the bank's commitment to sustainability. The AIIB's president Jin Liqun promised early on that the bank would be "lean, clean and green", meaning that it would be cost effective, have zero-tolerance on corruption, and promote the low carbon economy[23]. The AIIB has an environmental and social framework that was approved in 2016 and amended in 2019.

The ESG strategy specifically supports the objectives of the Paris Agreement and "plans to prioritize investments promoting greenhouse gas emission neutral and climate resilient infrastructure, including actions for reducing emissions, climate proofing and promotion of renewable energy"[24]. There is explicit support for green economic growth including low-carbon technologies, renewable energy, cleaner production, sustainable transport systems and sustainable urban development. The AIIB says it prioritizes clean energy, but notably includes natural gas in that category and has not completely ruled out investment in coal and oil in special cases, for example if the new investment was replacing less efficient systems.

The New Development Bank

The New Development Bank was first proposed at the BRICS Summit in 2012 as a vehicle for mobilizing resources for infrastructure and sustainable development projects in emerging economies and developing countries. Like the AIIB, the NDB became fully operational in 2016. In 2019, the Bank approved 22 loans for about USD 7.2 billion[25]. Each of the five founding

[20] https://onlinelibrary.wiley.com/doi/full/10.1111/1758-5899.12396

[21] https://www.worldbank.org/en/about/annual-report/fiscal-year-data

[22] https://chinadialogue.net/article/show/single/en/9867-The-AIIB-is-about-to-face-two-major-tests

[23] https://www.reuters.com/article/us-asia-aiib-idUSKBN0N302B20150412

[24] https://www.aiib.org/en/policies-strategies/_download/environment-framework/Final-ESF-Mar-14-2019-Final-P.pdf

[25] https://www.ndb.int/president_desk/speech-mr-k-v-kamath-president-new-development-bank-fifth-annual-meeting-board-governors/

members of the bank – Brazil, Russia, India, China and South Africa - have equal shares of voting power and holding rights (20%). While other countries can become members, the share of the BRICS nations can never be less than 55% of voting power[26].

The NDB has also approved an Environmental and Social Framework. Under its ESG guidelines it "integrates the principles of environmental and social sustainability in its policies and operations to ensure that its financing and investments in infrastructure and sustainable development projects have minimal adverse impact on the environment and people." With respect to climate change the Bank "seeks to promote mitigation and adaptation measures to address climate change. The NDB aims to build upon existing green economic growth initiatives and provide support for new ones at regional, national, sub-national and private sector levels. The Bank also encourages climate proofing of its infrastructure financing and investments to build resilience to climate change."[27]

Overall, the NDB operates more like a traditional development bank and is controlled through equal voting share by the BRICs, while the AIIB is a financial institution with membership open to developed and developing countries, but where China has veto power over some decisions.

Synthesis of existing research and analysis on the role of the AIIB and NDB in the geopolitics of decarbonisation

Even before the AIIB and NDB began operating they attracted the attention of researchers and analysts from across the foreign policy, finance and environmental communities. This section highlights key findings from this body of literature. It focuses on analysis relevant to the following three questions:

> How "green" and sustainable are the AIIB and NDB?
> How geopolitical are the AIIB and NDB?
> What is China's role in the development finance landscape?

How green and sustainable are the AIIB and NDB?

The AIIB and NDB have both emphasized that they will respect developing country circumstances and avoid using development finance as a lever for social or political change in developing countries, and that decision-making will be based on financial analysis and risk management approaches[28]. While they have published environmental and social frameworks, civil society organizations have been critical of the lack of detail, transparency and consultation in the development of these safeguards[29].

Several studies have highlighted the importance of new financial institutions in meeting decarbonisation objectives. Writing in a report published by the NGO Germanwatch, Hirsch et al. (2019) point to the critical role the AIIB could play in ensuring financial flows are consistent

[26] https://www.ndb.int/about-us/organisation/members/
[27] https://www.ndb.int/about-us/strategy/environmental-social-sustainability/
[28] https://onlinelibrary.wiley.com/doi/full/10.1111/1758-5899.12396
[29] https://onlinelibrary.wiley.com/doi/full/10.1111/1758-5899.12396

with the Paris Agreement, given its focus on Asia where much of the world's new infrastructure will be built. They find that compared to best practices of the other MDBs the AIIB is not yet up to the mark and that most of its approved projects are closer to business as usual rather than Paris-aligned given a lack of ESG performance indicators, its support for gas projects and the fact that it has not ruled out coal and oil. The Bank Information Center Europe (2018) draws similar conclusions, claiming that the AIIB is "likely" currently behind the other MDBs, including the NDB. The report points to weak transparency policies and the fact that over half of the AIIB's investments in the energy sector went towards fossil fuels. Unlike some other MDBs the AIIB has made no commitment to end financing for oil and gas extraction or to prohibit financing for coal projects.

Humphrey (2020) of the ETH Zürich Center for Development and Cooperation argues that while the AIIB and NDB both show considerable promise in supporting sustainable infrastructure, there are significant gaps in commitments and definitions[30]. For example, the "AIIB has not yet defined what it means by being a 'green' bank in a way that can be measured and verified, nor has it set any operational targets related to green or sustainable projects." The NDB has not released any new definitions, policies, strategies, sustainability indicators or benchmarks. Looking at the projects that have been approved, 50.4% of AIIB's infrastructure investments to end-2019 classify as sustainable[31], compared to 60.4% for the NDB. In comparison, 77.1% and 61.9% of the IDB and ADB's 2018 projects were sustainable. 73.8% of the NDB's energy loans through 2019 went to renewable energy projects, mostly solar, wind or storage. The AIIB has 35% of energy sector approvals for renewable energy sources through 2019, with about 40% being for hydroelectric installations.

While the AIIB and NDB do not seem to be exceeding the environmental standards and practices of the traditional MDBs, the evidence suggests that fears of a 'race to the bottom' have so far been exaggerated. For example, Beniflah et al. (2017) from the University of Pennsylvania find that there are no indications that the AIIB is diverging significantly from international norms and best practices on sustainable development. They highlight the fact that civil society organisations were invited to comment on the draft of the Environmental and Social Framework and that many senior staff at the AIIB have experience working for other MDBs. They caution however that eventually the AIIB's need to borrow from capital markets and its institutional 'leanness' could result in it taking on riskier projects and lower environmental and other standards[32].

He (2016) from the Centre for International Governance Innovation argues that the support shown to the AIIB from developed countries including the United Kingdom, Germany, Australia and South Korea was what convinced China that it could become not just a tool for projecting China's national interests abroad but more of a world class MDB that maintained high standards in environmental protection, human rights and governance. Maintaining these standards will determine the level of success of the AIIB. In a policy memo for the University of

[30] **https://www.g24.org/wp-content/uploads/2020/04/Humphrey_AIIB.NDB_.April2020.FINAL_.pdf**

[31] The definition of sustainable used here is based on the principles set by the International Development Finance Club in its Green Finance Mapping Reports (IDFC 2018, 2015), and adapted to account for the Paris Agreement by Bhattacharya et al. (2019).

[32] **https://global.upenn.edu/sites/default/files/perry-world-house/AIIBReportForCampusCopy.pdf**

Oxford, Hale et al. (2019) make the case that the massive infrastructure investment gap combined with the need for sustainable development puts the AIIB in position as a new 'orchestrator' of the regional and international system of institutions, including for example testing and scaling innovative approaches to green finance, convening stakeholders and harmonizing standards[33].

The AIIB and NDB, along with the seven traditional MDBs, both signed a declaration supporting a global response to climate change in 2017. This involved several commitments including to support developing countries with their own climate change plans as well as to mainstream climate in their own activities and align financial flows with the Paris Agreement[34]. The first several projects approved by the AIIB were jointly funded with other mainstream MDBs including an agreement between the AIIB and ADB to jointly finance sustainable development projects[35]. The AIIB was one of the first MDBs to reference the importance of climate change in its positioning of COVID-19 response and recovery, announcing that "project development especially those mitigating climate change should receive continued or even enhanced financing support in order to not put long term economic or environmental sustainability at risk, even as policy makers deal with this present crisis"[36].

It should be noted that there are differences between the standards and practices of the two institutions, so there are limitations to evaluating them in tandem. Writing for the International Institute of Social Studies, Wang (2019) for example argues that the NDB is more innovative than the AIIB in terms of its approach to financing green projects. The NDB has committed through its operational strategy for 2017-2021 to devoting two-thirds of its lending to sustainable infrastructure[37]. While the AIIB has pledged to have the highest international standards and works closely with other MDBs, the NDB works more with national governments and development banks. The AIIB is closer in this respect to the mainstream MDBs, while the NDB follows other borrower-led institutions.

How geopolitical are the new MDBs?

As direct military conflicts - although notably not proxy wars - between the great powers have effectively ceased, countries have increasingly sought geopolitical influence through financial means, including the use of development finance institutions. Writing in Geopolitical Monitor, Alonso-Trabanco (2019) argues that the worlds of finance and geopolitical grand strategy are converging, and that the AIIB is an instrument China is using to advance its geopolitical interests of strategic rebalancing. These interests include undermining American attempts to restrict China's ambitions, projecting financial power and influence, funding the Belt and Road Initiative (BRI), fragmenting the US-led global alliance, and challenging the supremacy of the dollar as the global reserve currency. Alonso-Trabanco further argues that "strategic maneuvers that combine geopolitical and financial elements –including of course the

[33] https://www.bsg.ox.ac.uk/sites/default/files/2019-07/2019-07-08%20AIIB-BSG%20Policy%20Memo_3.pdf

[34] https://www.ndb.int/president_desk/truly-global-response-climate-change/

[35] http://www.adb.org/news/adb-aiib-sign-mou-strengthen-cooperation-sustainable-growth

[36] https://www.aiib.org/en/news-events/news/2020/_download/Background-Impact-of-Covid-19-and-Implications-on-Infrastructure-Priorities.pdf

[37] https://www.die-gdi.de/uploads/media/DP__18.2018.pdf

instrumental employment of multilateral banking institutions– are here to stay as tools for power projection…" and that accordingly "the international financial system is doomed to become an increasingly confrontational arena in terms of high strategy."

Writing in the China Quarterly of International Strategic Studies, Daksueva & Yilmaz (2018) argue that the AIIB "offers China a viable platform to have a greater say in regional development, which may be translated into greater ability to influence regional geo-politics and geo-economics." Ongoing disputes over the South China Sea are cited as a one example where China could use its financial muscle to gain support for its territorial claims. They note that China is simply duplicating the model the US followed with the creation of the Bretton Woods institutions, where the US holds the greatest influence in decision-making. Institutions like the AIIB have the potential to either alleviate geopolitical tensions by establishing rules-based structures or increase tensions by giving more power to China. He (2016) argues that the NDB serves several foreign policy goals shared by China and the other BRICs including increasing their influence in global affairs and giving more legitimacy to overseas investments. This is supported by Wang (2017), writing in Global Policy, who argues that the new MDBs are driven in part by the national interests of their shareholders[38].

However, several recent reports or papers point out that while the new MDBs have the potential to be used geopolitically there is little evidence that this is happening in practice. According to Gutner (2018) from American University's School of International Service and writing for the Council on Foreign Relations, the AIIB has followed a similar path to other major MDBs. Most of the bank's projects have been co-financed and several senior figures in its leadership have experience working for the World Bank Group or other more traditional multilateral institutions. It has a similar governance structure and the second largest membership amongst MDBs, behind only the World Bank. While China is not currently using the AIIB to undermine the development finance ecosystem, Gutner does note that the AIIB gives China more stature and cautions that it is not clear yet how closely the AIIB will align with China in the future.

Humphrey (2020) finds that there is little evidence to suggest that the NDB is a significant part of China's geopolitical strategy as only 5% of approved projects would be considered part of the BRI. Further, while almost all AIIB borrower countries have some links to the BRI, lending patterns do not suggest an obvious trend, with about 14% of total financing going to sectors that are BRI priorities and the top two borrowers being India and Turkey. Humphrey notes that "the current financial and technical capacity of AIIB and NDB pale in comparison to China's policy banks like China Ex-Im and China Development Bank (with loan portfolios of US$490 billion and US$1.7 trillion at end-2018, respectively)."[39]

After arguing that the NDB does support foreign policy goals shared by China and the other BRICS, He (2016) also claims that the legitimacy of the AIIB and NDB will depend on whether they maintain high standards of governance including on the issue of environmental and social policy as well as debt sustainability. He further states that while the AIIB does serve China's

[38] **https://onlinelibrary.wiley.com/doi/full/10.1111/1758-5899.12396**

[39] **https://www.g24.org/wp-content/uploads/2020/04/Humphrey_AIIB.NDB_.April2020.FINAL_.pdf**

geopolitical interests, China must find a way to balance this with convincing other country governments that it can also be to their benefit.

Ikenberry and Lim (2017) from the Brookings Institution put forward a framework for understanding the spectrum of strategic choices that countries face in their relationship to international institutions, from "status-quo stakeholder" at one end to "opposition" on the other. The AIIB and NDB would fall under the category of "external innovation" whereby new institutions are built but within that a choice needs to be made about whether the new institutions are offering an alternative mode of cooperation or promoting alternative rules and norms which could ultimately challenge or replace the existing system[40]. It is notable that the membership of developed countries in the AIIB gives them influence in the bank's decision-making, as many of these countries are strongly supportive of existing rules and norms of development finance. The UK for example has explicitly stated that part of its rationale for joining the AIIB was to ensure it follow best practices in accountability, transparency and governance[41]. Ikenberry & Lim (2017) also note that the AIIB will be constrained by the fact that a significant source of its funding comes from international financial markets. Investments that are clearly driven by political or foreign policy objectives could increase the risk of default on loans and therefore result in higher borrowing costs.

The evidence on the geopolitics of the AIIB and NDB paints a mixed picture. Overall, most analysis focuses on the potential for shareholders to use the institutions to secure resources, support territorial claims or other objectives but do not present examples of this happening in practice. There is little evidence of the AIIB and NDB being used as a direct and strategic challenge to the existing international financial governance regime. One shareholder, China, attracts far more attention than the others in this context and is therefore worth a closer look.

What is China's role in the development finance landscape?

China's foreign policy and diplomacy has increasingly focused on engagement with multilateral institutions[42]. This has involved both increasing its influence in existing institutions like the World Bank Group and IMF, as well as creating new multilateral institutions like the AIIB and NDB. It is impossible to separate out a discussion of China from a discussion of the new MDBs in the context of geopolitics. China is the most significant geopolitical actor behind the new MDBs as the largest shareholder in the AIIB and having an equal share to the other BRICS in the NDB. Both institutions are headquartered in China. Perhaps the most often-cited concern about the new MDBs is that China's outsized role gives it the ability to use them as means for achieving its foreign policy objectives[43]. However, the evidence again paints a complex picture.

Wang (2017) argues that "Chinese supremacy in these institutions is inevitable" and that it will likely gain political influence as a result. But Wang (2019) argues that China sits on both sides of the fence in the international finance arena. In different cases China either supports or challenges traditional multilateral financial institutions, and China has been a beneficiary of

[40] **https://www.brookings.edu/wp-content/uploads/2017/04/chinas-emerging-institutional-statecraft.pdf**

[41] https://www.gov.uk/government/news/uk-announces-plans-to-join-asian-infrastructure-investment- bank.

[42] **https://www.cigionline.org/sites/default/files/cigi_paper_no.106.pdf**

[43] **https://onlinelibrary.wiley.com/doi/full/10.1111/1758-5899.12396**

the existing international order in many ways. In terms of international financial governance, China more often finds itself aligned with advanced economies than with developing countries. As a creditor it has incentives to support economic surveillance and orderly debt restructuring and has worked with the IMF towards these ends. On the other hand, its need for energy and resources means it needs to maintain good relationships with developing countries that call for protections of debtor nations and suffer from poor credit ratings[44]. Wang (2019) argues that the differences between the AIIB and NDB shows that China is not promoting a coherent new model or approach to development finance that undermines existing institutions but is "straddling different traditions due to its complex political and economic interests."[45]

Ikenberry & Lim (2017) draw similar conclusions, finding that China's "Institutional statecraft" will both reinforce China's integration into the international system and challenge the existing system of rules and institutions, depending on the circumstances. They also argue that the nature of multilateralism, as requiring the cooperation of other nation-states, and the rules that entails, will limit China's or any other country's ability to wield new institutions as "instruments" of its political and economic goals[46]. There won't be a single choice that China makes to either defend or challenge the existing international rules-based order. They find that the AIIB can advance Chinese interests both as a competitive node of interstate cooperation and as an instrument of influence; but that ultimately China is "working within the system and respecting its rules to enhance its position and authority."[47]

Daksueva & Yilmaz (2018) consider whether the AIIB represents a fundamental change in the political economy of the Asia-Pacific region. They note that while its Board resembles other development finance institutions it is unique in that it was initiated and promoted by China alone. They argue that China's foreign policy shows it has gained enough power to make a shift from the Southern to the Northern bloc of countries, which is exemplified in part by the AIIB which is an effort to use development finance to accrue certain political and economic benefits. "…the Northern countries have the ability not only to support and sustain existing international institutions but also to establish new ones thanks to their accumulated material and ideational power."

It should be noted that MDB financing is a relatively small share of China's development assistance. China's financial ties to the rest of the world have grown – including foreign aid totals which have grown at an average rate of 21.8% annually[48]. China controls other development finance institutions with significant influence, including the China Development Bank (CDB) and the Export-Import Bank of China. China has founded or co-founded at least 13 regional and bilateral funds[49]. While reliable data on China's development aid is hard to come by, much of this assistance has gone to high carbon energy or transport infrastructure projects that would not be compatible with decarbonisation objectives. Some of China's loans to

[44] https://onlinelibrary.wiley.com/doi/epdf/10.1111/dech.12473

[45] https://onlinelibrary.wiley.com/doi/epdf/10.1111/dech.12473

[46] https://www.brookings.edu/wp-content/uploads/2017/04/chinas-emerging-institutional-statecraft.pdf

[47] https://www.brookings.edu/wp-content/uploads/2017/04/chinas-emerging-institutional-statecraft.pdf

[48] https://sites.tufts.edu/cierp/files/2018/03/CPL_ChinaOverseasDev.pdf

[49] https://www.globalpolicyjournal.com/blog/03/02/2017/chinese-development-finance-convergence-passions-and-interests

developing countries come with conditions including repayment in the form of fossil energy resources (mainly oil) or other commodities, or infrastructure contracts[50]. China's overseas lending for clean energy projects has also risen steadily in recent years, however.

Writing for Yale Environment 360 Hilton (2018) has highlighted the discrepancy between China's domestic actions on climate and environmental issues with its spending overseas given the size of the global economy that is represented in BRI countries. Domestically, China has embraced the net zero economy as a strategic economic opportunity and internationally it has been a leader in green finance which has been a core part of its climate diplomacy particularly in the G20. However, it continues to struggle to shift financial flows away from fossil fuels both at home and abroad. There is evidence that China has shown a determination to promote ESG including through its approach to the BRI[51]. However, a majority of BRI projects are energy related and most of China's financing of energy projects goes to fossil fuels[52]. While China has taken action to shut down its own coal power in order to reduce air pollution and lower its climate risk, it is also financing hundreds of coal projects overseas including in at least 25 BRI countries[53].

The expectation is that other MDBs will also join the BRI, for example the World Bank Group and EBRD[54]. As discussed in section 2, these institutions are adopting better climate indicators and taking other steps to better disclose and manage climate-related risks. The question is, what influence, if any, these institutions can have on China's decisions on foreign aid and investment?

Conclusions and future challenges

Concerns about climate change and decarbonisation were not the primary drivers behind the establishment of the AIIB and NDB, or indeed of other recent emerging economy-led development finance institutions. The main driving forces were rather the massive infrastructure investment gap in the Global South and a desire to promote their own interests through financial means in response to the slow pace of change inside the Bretton Woods institutions. Nevertheless, decision-making in the major DFIs could have an important impact on the balance of cooperation and competition on decarbonisation and climate change.
The evidence suggests that while the AIIB and NDB do lag somewhat behind the traditional MDBs on standards and formal targets, in practice they are following a similar path to the traditional institutions in terms of scaling up investment in green projects and adopting green standards and practices. The AIIB has a relatively high share of fossil fuel energy projects, but much like their counterparts in the traditional institutions it along with the NDB are making efforts to improve and can point to important progress.

[50] http://www.lse.ac.uk/GranthamInstitute/news/china-energy-development-aid/

[51] https://www.bakermckenzie.com/-/media/files/insight/publications/2020/03/bribeyond2020_part_2.pdf?la=en

[52] https://e360.yale.edu/features/how-chinas-big-overseas-initiative-threatens-climate-progress

[53] https://e360.yale.edu/features/how-chinas-big-overseas-initiative-threatens-climate-progress

[54] https://reader.chathamhouse.org/role-investors-promoting-sustainable-infrastructure-under-belt-and-road-initiative#context-of-the-belt-and-road-initiative

While many experts have raised concerns about the potential for the AIIB and NDB to be used by shareholders to secure access to natural resources, infrastructure contracts or other geopolitical ends, the literature suggests that this does not seem to be happening in a systematic way. Nor are they being employed systematically to challenge the existing multilateral rules-based system, although it is frequently noted that this remains a possibility in the future. There are limitations however to lumping the two organisations together for the purposes of this analysis, as they differ with respect to standards and actual investment.

China and other major emerging economies are, however, using development finance and foreign direct investment more generally as a means of increasing geopolitical influence. There is evidence for example of a link between Chinese development assistance and its interest in natural resource acquisition[55]. The Belt and Road Initiative is the most high-profile example of this type of effort, and most of this investment is not aligned with sustainable development or climate targets. Between 2000 and 2019, China Development Bank and Export-Import Bank of China provided $183bn in energy finance to BRI countries, which went mostly to fossil fuels and hydropower[56]. There is a divergence between China's domestic ambition on net zero development and green finance and the projects it is supporting overseas. It is important to clarify in this context that many countries consider geopolitical objectives in their development assistance. The USIDFC for example was created in response to the rising influence of China expressly to help achieve the United States' foreign and national security policy objectives[57]. It remains unclear how strongly sustainability criteria will guide its lending.

The multilateral nature of the AIIB and NDB offers an opportunity to use them as models both for international cooperation and for how to deliver the benefits of sustainable infrastructure investment, which could encourage China and other major emerging economy shareholders to more closely align their bilateral development finance with decarbonisation objectives. On truly global challenges like climate change, cooperative institutions are more likely to encourage higher standards and have less geopolitical linkages than bilateral lending. The AIIB and NDB could also bolster existing multilateral efforts to harmonize green standards in the financial sector, such as the International Platform for Sustainable Finance which counts the EU and China as members[58].

Given the deficit in infrastructure investment in developing countries, strategic competition in development finance may be positive in terms of investment scale, especially if it prompts a race to the top in quality. Recent examples of OECD-driven institutions that have been launched in part in response to China and other emerging economies include the USIDFC, European Climate and Sustainable Development Bank and US-Japan-Australia Blue Dot Network for Infrastructure Financing.

[55] https://hal.archives-ouvertes.fr/hal-01777484/document

[56] https://www.ft.com/content/e00426f4-8ead-11ea-af59-5283fc4c0cb0

[57] https://www.csis.org/analysis/build-act-has-passed-whats-next#:~:text=The%20success%20of%20the%20BUILD%20Act%20is%20something,development%20agency%E2%80%94the%20U.S.%20International%20Development%20Finance%20Corporation%20%28USIDFC%29.

[58] https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/200325-international-platform-sustainable-finance-factsheet_en.pdf

Looking to the near future, and beyond the literature review conducted for this paper, three geopolitical issues that will have growing implications for development finance and decarbonisation stand out. The first is debt sustainability. Second and third round impacts from COVID-19 are already hitting countries from the global economic slowdown, collapse of tourism sectors and credit downgrades. Arguably this more than any other factor will determine the extent to which developing countries will have the capacity to devote resources towards decarbonisation and cooperation on climate change. The role of the IMF and the MDBs will increase under these conditions. There will be geopolitical tensions over who controls bailout and debt relief terms especially for developing countries highly indebted to China, and whether green conditions are attached. These risks are compounded by the fact that the financial architecture of debt is fragmented. There is no recognised resolution mechanism or institution which can carry out restructurings.

The rise of China as a major creditor is making this fragmentation more pronounced. In terms of outstanding debt, it is the second largest lender to low income countries after the World Bank Group[59]. China has also been criticized for a lack of transparency, for the fact that its lending typically has higher interest rates and shorter maturities than the concessionary loans offered by OECD countries and MDBs[60], for using commodities as collateral and for investing in extractive industries with few environmental safeguards[61]. The reputational risk on debt is particularly high for China which needs support from developing countries on its foreign policy priorities.

While China has resisted calls for largescale debt forgiveness, there are positive signs in terms of cooperation including China signing up to the G20 pledge to suspend debt service for low-income countries. To the extent that the AIIB and NDB can be employed to help resolve the global debt crisis and ensure financial assistance is targeted towards sustainable recovery. This could help free up fiscal space for many developing countries to devote more resources to decarbonise their economies and share best practices and lessons learned with partners.

The second issue that stands out relates to standard setting of and access to digital technologies. Research shows that digital technologies such as Artificial Intelligence and the Internet of Things have a key role to play in decarbonisation objectives[62]. They will be essential for example in greenhouse gas mitigation that will come from optimising systems across sectors like agriculture, energy, transport and industrial processes.

The digital sphere is also increasingly geopolitical. The debate over the use of 5G technology and Huawei is perhaps the most notable example, but there are others. For example, several major powers including the EU, China and India are challenging the United States' supremacy in its Global Positioning System (GPS)[63]. China's "Made in 2025" initiative to upgrade Chinese industry identifies advanced information technology as a priority sector and the EU's

[59] https://thediplomat.com/2020/06/putting-a-dollar-amount-on-chinas-loans-to-the-developing-world/

[60] https://www.ifw-kiel.de/fileadmin/Dateiverwaltung/IfW-Publications/Christoph_Trebesch/KWP_2132.pdf

[61] https://www.odi.org/sites/odi.org.uk/files/resource-documents/the_aiib_and_investment_in_action_final_20160413.pdf

[62] https://gesi.org/research/gesi-digital-with-purpose-summary

[63] https://techcrunch.com/2018/12/21/the-gps-wars-have-begun/

Connectivity Strategy for Europe and Asia features digital connectivity as a priority and specifically seeks to leverage financial resources from international financial institutions and multilateral development banks. DFIs could provide a route for digital technologies into developing countries. Countries building hardware financed by these new institutions will need to make choices about the standards to which this hardware is used. Digitalisation can make decarbonisation easier and cooperation more likely. The AIIB and NDB could facilitate the integration of technological systems and multilateral agreement on standards and practices leading to a scenario characterized by data sharing, cross-border electricity interconnection of renewable energy and local smart-grids.

Finally, the role of recipient countries as geopolitical actors either individually or collectively has not been covered very extensively in the existing literature but would be an important topic for further research. Developing countries do have means to influence donor country behaviour through international venues and institutions and could mobilise themselves to band together and demand a shift in investment for example towards net zero energy sources or building resilience to climate impacts.

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