

## CHINA'S STRATEGIES TOWARDS INSTITUTIONAL REFORM: CREATION OF THE AIIB AND ITS DEVELOPMENT SUCCESS

Çin'in Kurumsal Reforma Yönelik Stratejileri: AAYB'nin Kuruluşu ve  
Gelişimindeki Başarı

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### Abstract

While existing studies largely focus on the implications of China-led new multilateral institutions to international order, the question of underlying reasons for the establishment of those institutions and their future development success have received less attention. China's strategies towards institutional reform are mainly based on its dissatisfaction with asymmetrical distributional gains within existing multilateral institutions such as World Bank and International Monetary Fund (IMF). By using bargaining theory in international relations, this article contributes to explain the main conditions and mechanisms of the creation of Asian Infrastructure Investment Bank (AIIB). In creating AIIB, China aims to increase its bargaining leverage which provides itself direct and indirect benefits vis-a-vis the costs emanating from intensified strategic competition with the US. Thus, it is argued that China's expectation of success reinforced by direct and indirect benefits for the development of AIIB reflects both the significant motivations underpinning its creation and also the possibility of extended institutional reform into other multilateral regimes. Within the context of power transition, the political bargaining process in reforming existing multilateral regimes is likely to be shaped by the tension between unilateralist strategies of rising powers and truly multilateral operations within newly emerging financial regime.

### Key words:

China, Asian  
Infrastructure  
Investment Bank (AIIB),  
Distributional Conflict,  
Institutional Reform,  
Bargaining

### JEL Codes:

C78, F51, F55,  
G24, O18, O19

### Özet

Mevcut çalışmaların pek çoğu Çin'in liderlik ettiği yeni çok taraflı kurumların uluslararası düzen üzerinde yaratacağı etkilere odaklanırken, bu kurumların kuruluşunun altında yatan nedenler ve gelişimlerinde gösterdikleri başarı konusu yeterince dikkate alınmamaktadır. Çin'in kurumsal reforma yönelik stratejileri en temelde Dünya Bankası ve İMF gibi mevcut çok taraflı kurumlarda var olan asimetrik dağılımsal kazanımlardan duyduğu hoşnutsuzluğa dayanmaktadır. Bu makale uluslararası ilişkilerde pazarlık teorisinden faydalanarak Asya Altyapı ve Yatırım Bankası (AAYB)'nin kurulmasında etkili olan ana koşulların ve mekanizmaların açıklanmasına katkı sunmaktadır. Çin, AAYB'nin kurulmasına öncülük ederek ABD ile yoğunlaşan stratejik rekabetinden kaynaklanan maliyetler karşısında kendisine doğrudan ve dolaylı faydalar sağlayarak pazarlık gücünü artırmayı amaçlamaktadır. Çin'in edindiği doğrudan ve dolaylı faydalarla pekişen başarı beklentisi, AAYB'nin kuruluşunun altında yatan ana motivasyonları yansıttığı gibi diğer çok taraflı rejimleri de içine alan daha kapsamlı bir kurumsal reform ihtimalini de gündeme getirmektedir. Ancak, güç geçişi bağlamında mevcut çok taraflı kurumların reforme edilmesinde yaşanan politik pazarlık sürecinin, yükselen güçlerin mini taraflı stratejileri ile hakiki çok taraflı uygulamalar arasında var olan gerilime dayalı olarak şekillenmesi kuvvetle muhtemeldir.

### Anahtar Kelimeler:

Çin, Asya Altyapı ve  
Yatırım Bankası (AAYB),  
Dağılımsal çatışma,  
Kurumsal Reform,  
Pazarlık

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## 1. Introduction

The institutional configuration of multilateral financial regime has demonstrated an interesting presence after the developments of global financial crisis in 2008. While Beijing is competing with existing multilateral framework by establishing "parallel institutions", it also remains an active member in the Bretton Woods system (Heilmann, 2014). The China-led new institutions do not only imply the possibility of an alternative regime creation, but they also represent the growing participation in global economic governance, which are closely cooperate with their established counterparts. Their interactions between each other can be considered as cooperative and complementary or competitive in nature.

Although the creation of AIIB has caused some debates about Chinese underlying motivations, it is clearly the most important symbol of Beijing's activism in an attempt for establishing new multilateral financial regime. Regarding economic motivations, some analyses focus on Asia's paramount demand for infrastructure investment and China's domestic needs to transform its economic model with respect to the problem of industrial overcapacity. Some others, however, argue that the AIIB is an institutional balancing effort against the US 'pivot to Asia' strategy by stressing the geopolitical motivations (Etzioni, 2016; Ren, 2016; Yu, 2017). Making a linkage between China's main interests and ongoing competition over regional order, the creation of the AIIB's contribution to its institutional influence is emphasized (He, 2015). The AIIB is also considered as an instrument of bargaining for promoting reform in global financial governance. It signals Beijing's dissatisfaction with the existing regime and also warns that China has both capacity and resolve to bypass the system if necessary (Reisen, 2015). By contrast, there is another view that the AIIB is mostly used as an instrument of strategic reassurance by China to ease the commitment problems associated with power transition process (Chen and Liu, 2018).

All of those factors mentioned above have some explanatory force in China's creation of the AIIB. However, there are still some important questions to be raised not just by focusing on China's motivations but also its practices in establishing the AIIB. First, it is important to ask whether China is enough powerful to pose a credible challenge to the existing international order or not. If it is so, China would have been able to achieve its desired outcomes for reform in a different way rather than creating new multilateral institutions. Second, why did China choose to establish a multilateral framework instead of creating bilateral basis of interactions as a means of reforming the existing financial regime? In creating the AIIB, as a new multilateral bank, how does China gain benefits while venturing the costs resulting from it? Third, if the AIIB is created merely to challenge the existing US-led liberal institutions, how is it possible to explain its cooperation with them, such as the World Bank and the Asian Development Bank (ADB)? Finally, if China creates the AIIB not just for posing credible threat but also for demonstrating its increased commitments for future cooperation, then to what extent this dual strategic considerations can help to successfully develop the AIIB?

It is reasonable to assume that China is not enough capable of changing the existing multilateral financial regime defined by US-led liberal order. But rather by creating the AIIB it aims to increase its bargaining leverage which provides direct and indirect benefits vis-a-vis the costs emanating from intensified strategic competition. In this context, it is critical for China to adopt a more balanced approach on the implementation of threat credibility and reassurance simultaneously for resolving emerging commitment problems. Thus, it is argued that China's

expectation of success reinforced by direct and indirect benefits for the development of the AIIB reflects both the significant motivations underlying its creation and also the possibility of extended institutional reform in multilateral regimes, from financial to monetary and ultimately to trade regimes.

By applying the bargaining theory in international relations for explaining the creation and development of the AIIB, some theoretical propositions, which are responsive to the empirical questions above, are formulated for constructing a new analytical framework.

- 1) When a dissatisfied rising power is unable to change the status quo financial regime, it might create a new multilateral institution in order to increase its bargaining leverage in institutional reform.
- 2) In creating a new multilateral institution, a reform-oriented rising power expect to gain direct and indirect benefits, while venturing the costs of being labeled as revisionist state by established power.
- 3) In institutional reform bargaining, posing credible threat capabilities has to be combined with reassurance strategies by a reform-oriented power for resolving commitment problems.
- 4) Even if a reform-oriented rising power's expectation of success for the development of a new multilateral institution rely on rational calculations, it would not be sufficient for changing regime. Multilateral regime change is only possible through the establishment of a dissatisfied coalition against existing regime.

## **2. Theoretical Framework**

### **2.1. Power Transition and Political Influence in Institutional Reform Bargaining**

Focusing on institutional reform within the context of power transition, bargaining process between the rising powers and the established powers can be considered as "extraordinary bargaining" different than "routine bargaining" (Schneider, 2011). In extraordinary bargaining, the rising powers that anticipate distributional conflict from rapid power shift can threaten the established powers to block negotiations and increase their bargaining leverage even if they are not enough powerful politically. From this perspective, the dissatisfied rising powers tend to bargain with the established powers to gain more institutional benefits and privileges, which are appropriate to their increasing political influence. The dissatisfied rising powers face two options of promoting reforms or withdrawing from existing institutions. The established powers, in turn, can either accommodate or contain rising powers' reformist attempts.

Recent studies mostly consider the creation of new multilateral institutions as an 'exit' move, or outside option, in turn, their creation can be prevented by some modifications within the established institutions. Those views are based on the ideas suggested by Albert Hirschman in his classic book, *Exit, Voice and Loyalty* (1970). Although 'voice', which means "to promote reforms within the established institutions, is similarly costly", it enables an opportunity of "sharing surplus from avoiding 'exit' for each side" (Gehlbach, 2006). Having credible outside options, however, provides states to increase their bargaining leverage within the existing institutions. The rising power can gain favourable position in the negotiations for better terms, if it makes a credible threat of 'exit' to undermine the effectiveness of existing institutions. In the case of China's initiative to create the AIIB, however, institutional reform bargaining can be

either partially explained by credible threat of outside option or a trigger for readjustment of temporary phase in starting future renegotiations. The credibility of such a threat, generally, reflects the main condition and mechanism of institutional adaptations (Zangl, Heubner, Kruck and Lanzendörfer, 2016, p. 171).

Bargaining approach explains why states establish new institutions instead of engaging to the old ones that already exist and probably carrying out similar functions. The explanation is based on the idea that the creation of a new institution is resulted from bargaining failure. But, in bargaining logic, a dissatisfied rising power tends to make its threat much more credible by creating a new institution, and subsequently an established power, as expected, corresponds to it by reforming the existing institution so as to prevent rising power from creating a new institution. For Hirschman, the outside or exit options of a rising power are understood as they are not necessarily to be implemented for promoting reform. The possibility of bargaining failure leads two sides to come into compromise in the bargaining range in avoiding utility loss for at least one side. The established power gives more 'voice', as a concession, to the rising power to avert its 'exit'.

Nevertheless, states sometimes can create new institutions even if a compromise is favourable in terms of both sides' interests. The question of "why states engage in costly conflicts when a bargaining range exists" is often explained by two factors: "information asymmetries and commitment problems" (Fearon, 1995; Powell, 2002). Another explanation, which is also based on threat credibility, comes from the contested multilateralism argument (Morse and Keohane, 2014). It suggests that even if a state has no willingness to replace existing institutions, it may initiate its 'exit' option to demonstrate its capabilities and decisiveness when receiving a perception of underestimation about its own strength and resolve from the other states. Contested multilateralism occurs when dissatisfied actors are not capable of changing the status quo. "When a dissatisfied coalition seeks to change a blocked institution, the coalition's ability to pursue outside options is a necessary condition for successful contested multilateralism" (p. 390).

Moreover, this article argues that there are some other significant factors that affect the creation of new multilateral institutions. It is not enough to argue that states create new multilateral institutions merely because of bargaining failure. It is also reasonable to expect that bargaining failure does not always result in establishing new multilateral institutions. So, what is important to make a theoretically and empirically relevant account of when and how bargaining can be expected to produce new multilateral institutions.

## **2.2. Direct and Indirect Benefits From the Creation of New Multilateral Institutions**

The creation of new multilateral institutions is likely when rising power insists on reform but established power's cost of conceding this reform is high. Creating new multilateral institutions are used as a bargaining leverage by the rising power for gaining direct and indirect benefits at the expense of the established power's imposed costs. This outcome can be expected when the estimated benefits exceed the estimated costs for a rising power and its expectation of success is high. There is a potential of increasing rising power's payoff by the creation of new institution.

Historically in American experience, the US leadership owes many decisions favouring ‘exit’ option over ‘voice’ in its new institutionalization efforts with regard to existing ones (Hirschman, 1970, p. 106). When looking at two contrasting historical cases, the 1933 World Monetary and Economic Conference in London which was ended in bargaining failure and the 1944 the Bretton Woods agreement that established successful new multilateral institutions, it can be clearly understood that the most important reason for the different bargaining outcomes was the changed behavior of the US. As Odell argues, the 1933 US behavior exemplifies what could be called an “exploitative” or competitive bargaining strategy which aims to have bigger piece of the common pie in accordance with the change in underlying distribution of power (1988, pp. 290-291). On the other side, Britain’s main concern was war debt payments to the Americans and make the US agreed on European terms with financial issues, especially stabilizing the currencies in terms of gold. The 1944 US behavior, however, illustrates what could be called a partly “expansive” bargaining strategy which does not only benefit itself in particular at the expense of other states but also agree to measures that will benefit both or many parties. In this context, it is very helpful to trace back to the debates between John Maynard Keynes and Harry Dexter White in New Hampshire during 1944 the Bretton Woods agreement in order to understand the ongoing bargaining process between Britain and the US for building new institutions (Steil, 2013).

The London-Bretton Woods contrast illuminates why the US bargaining strategies shift from exploitative to expansive moves. In 1933, while the US had a willingness to gain more additional benefits by reforming the existing system, it mainly refrained to take a responsibility for the repercussions of the Great Depression in Europe. The Roosevelt administration was convinced that focusing on domestic economy would be more beneficial to the American interests than creating a new multilateral institution in the medium run. In 1944, however, with the help of optimistic view on recovery from the depression and the increasing confidence in itself, the US obviously decided to take international leadership and realized that an actor limited to the exploitative strategy is likely to obtain only limited gain, especially considering the estimated future benefits over time. In creating the Bretton Woods institutions, the US was aware of the fact that the more itself becomes a hub of an integrated global economy, the more influence it would gain in global stage. Furthermore, institutionalizing this influence within the Bretton Woods system provided a level of stability and legitimacy to the increasing US global power. As John Ikenberry explains, the US pursued a path of multilateralism after victory in World War II, because institutionalization of power creates durability in submission to a particular political order (Ikenberry, 2001).

Although the US experience after the second World War demonstrates how new multilateral institutions, namely the Bretton Woods system, were created under the leadership of a rising power in the past, it is important to note that the current power transition, characterized by increasing power distribution as well as power diffusion away from the Western actors to non-Western actors, makes the nature of institutional change and the strategies of rising powers slightly different from the past experiences. Because of this significant difference, any multilateral regime change today cannot be accomplished without the consensus of other dissatisfied members of a newly created multilateral institution.

Generally speaking, multilateral institutions are used by states in order to minimize the transaction costs of cooperation. Their functions to facilitate cooperation include enforcing behaviour, collecting resources, supplying information, and accelerating bargaining. Besides,

some scholars have argued that creation of multilateral institutions is costly (Abbott and Snidal, 1998). It is difficult to establish and implement effective rules for governing state behaviour. Moreover, creating an alternative institution is much more costly, because there is no guarantee of success in terms of other states' participation to it. It is important to recognize that new multilateral institutionalization is different from regime shifting, because it includes both transaction and bargaining costs and implies higher risks (Jupille and Snidal, 2006). If this is correct, why do the rising powers willing to pay all those high costs and risks?

The answer is directly related to the nature and degree of dissatisfaction of the rising power. It has been already known that states make strategic choices among existing multilateral institutions and strong states tend to use alternative institutions for advancing their strategic goals (Busch, 2007; Drezner, 2009). The dissatisfaction of rising power arises in a situation that the established power has a dominance on agenda setting within the existing institution and much influence on distributional outcomes to such an extent that the status quo carries a high cost to the rising power. In this situation, established power and rising power with diverging preferences are in distributional conflict (Krasner, 1991). The asymmetry of influence, which refers to the established power's material capabilities are disproportional to its influence in the existing institution, is the main source of distributional conflict between the two powers. Since existing institutions are largely controlled by the interests that hold a distributive bias opposed to the rising power, rising power expect to compensate the costs resulting from the unequal distribution of gains by creating new institutions (Mansfield, 1995). And, the losing legitimacy of the existing institutions may also help to the creation of new institutions by the rising power (Cottrell, 2009).

Without distributional conflict and asymmetry of influence, established power and rising power resolve their policy disagreements easily. However, when existing institution is "captured" by established power, a bargaining analysis has to be made. In the absence of the dissatisfaction associated with distributional conflict, "bargaining within the confines of an existing institution is efficient". Yet, if distributional conflict is occurred, established power's willingness to reform require deeper changes in institutional rules and structures (Urpelainen and Graaf, 2015).

The expectation that the new institution would acquire support among third parties is also relevant for the equilibrium likelihood of a new multilateral institution's creation (Urpelainen, 2011). This support allows new institution to be effective on governance structure in some relevant issue areas. If expectation of political support high, rising power's impute to establish a new institution is also high.

The domestic demands pushing for changes in the existing order also affect the creation of new institutions. Basically, they increase rising power's incentive to pay for changing the status quo. Both in autocratic and democratic systems, governments depend on "internal support for political survival" (Bueno de Mesquita, 2003). It is also relevant in China case that domestic politics matters in shaping policy making process. China's urgent domestic needs create considerable pressure on government for making new linkages with global economy. Besides, in non-democratic governments, like China, the indirect benefits from the learning process and increasing legitimacy through the new multilateral institutions are specifically important for meeting the domestic political needs. Those institutions provide some extra opportunities in multilateral frameworks than bilateral initiatives could possibly offer for the rising powers. Domestic demands induce the government to struggle for the distributive bias in the existing

institution. Domestic political demands to break away from the status quo alters government's calculations towards the creation of a new institution.

If domestic demands are low, the rising power's incentive to create a new institution is mostly shaped by government's foreign policy and ideological choices. With high domestic demands, however, rising power has a strong incentive to create a new institution. In both cases, domestic economic and political needs reflect the indirect material benefits from the creation of a new institution.

Multilateral institutions help governments by offering "an extra mechanism" in their commitments to provide "public goods" and ease "worries about cheating" (Koremenos, 2005; Roserhoff and Milner, 2001). Delegating one's authority to international institutions in a certain degree also helps rising power "to mitigate other states' fear of power abuse", and subsequently "induce them to accommodate its increasing influence" (Abbott and Snidal, 1998, p. 11). Especially when the lack of universal suffrage and free media in non-democratic societies are concerned, international mechanisms at multilateral level play a significant role for setting self-limitations and signalling good intentions to reassure other actors.

### **2.3. Trade-off Between Threat Credibility and Reassurance for Resolving Commitment Problems**

Another factor that specifically affects the bargaining process is commitment problems. It refers to a situation where at least one side expects the other to break the terms of a settlement. An obstacle can be occurred when the credibility of their promises diminishes. Power transition make commitments to maintain much more difficult by creating uncertainty among the parties alongside the long-term contracts (Powell, 2012). Since gaining institutional privileges are regarded as strategic assets, redistributive gains imply the change in relative strength and asymmetrical benefits for the negotiating parties. While considering the 'exit' option as a way of enhancing the power of 'voice', there would be another possibility of making "the 'voice' option relatively less attractive" (Gehlbach, 2006, p. 397). Even if the rising power's 'exit' option credible, the established power may prefer not to make reform in the existing arrangements (Powell, 2004). The suspicions emanated from the possible revisionist demands of rising powers in the future, after receiving important concessions, may lead the established powers to take some precautions.

In the literature of bargaining theory, whereas inside option of a player is considered as the obtained payoff in the bargaining process when the relevant parties temporarily come to a disagreement, the development of new institutions gives rising powers additional leverage by providing "alternative tools such as coordination, monitoring and enforcement" in the ongoing negotiations (Muthoo, 1999). It means that rising powers are able to manage to establish "alternative regimes to escape from the deadlocks in institutional reforms" (Kastner, Pearson and Rector, 2016).

Investing in a new regime, however, brings another risk of negotiation shutdown in the power transition process. The possibility of creating an alternative regime predominated by the rising power may wary other states about its assertiveness. Rising powers, therefore, face a dual task of posing threat and granting reassurance in a more balanced way within the context of institutional reform bargaining. Any successful coercive diplomacy consists of both using clear

threats combined with credible reassurance to force other countries to do something or prevent them from undesirable behaviour (Schelling, 1960).

The outcome of bargaining depends on the structure of the bargaining situation. Rationally calculated equilibrium solution is necessary for exercising both threat credibility and strategic reassurance. Otherwise, it is possible to expect a risk aversion situation on behalf of the other states. The established powers, sincerely believe or not, become suspicious about rising powers' attitudes for undermining their leadership role in the future. Even they charge to label the rising powers as dangerous for the maintenance of existing order. Small states and middle powers also become anxious of being dominated by the new rising power. In order to provide successful and sustainable development of the new institution, the rising powers should strengthen their reassurance strategies towards other states in a way that their future intentions are limited and predictable. It is important to persuade others that the exercise of their influence is restrained by cooperative commitments.

As a consequence, bargaining in institutional reform between rising and established powers come up with some serious commitment problems with regard to rapid and uncertain shifts in distributional power. Actors may come to an agreement on today's redistributions, but it is not easy to make commitments to sustain it in the long term. If the distribution of power shifts rapidly, "few settlements would be time-consistent" (Powell, 2012, p. 52). It is not easy to build mutual trust when each side has an incentive to renege. Thus, even when rising powers signal some credible threats, negotiations for reform still might be suffered by negative perceptions due to the mutual distrust among actors (Chen and Liu, 2018, p. 4). If the attempts for institutional reform becomes more difficult or impossible, the rising powers lean to establish alternative regimes.

#### **2.4. Expectation of Success for the Development of New Multilateral Institutions**

However, rising powers would be mindful of the risks to create alternative regimes when they are not enough powerful for changing existing regimes. Instead, they would prefer to establish competitive regimes due to their expectation of success for further bargaining stage in institutional reform process. According to conventional cooperation theory, the uncertainty of future development of a new institution has to be an enough deterrent against its foundation. But, if the new institution is established, there should be a high expectation of success for this institution's ability to survive in the shadow of uncertainty. So, expectation of success is mainly understood as the probability of garnering support from other states through the creation of a new institution.

Inadequacies of existing institutions to meet increasing needs enhance the expectation of success for the establishment of new institutions. The growing demands for certain issue areas can be a reasonable support for the creation of competing regimes. The domestic political demands of the rising power are also an important factor. If the linkage between the domestic needs and the creation of new multilateral institution has been strong, the expectation of success becomes high. Additionally, increasing self-confidence of the rising powers reinforce their desires to create new multilateral institutions. Moreover, the past experiences of rising powers in the existing international institutions play an important role for the expectation of success. Gained political support from other countries in some existing international institutions create



hope for extending it in other specific issue areas. Especially China's successful diplomatic efforts in the UN in the last decades have to be noticed in considering the significance of learning through experience.

However, there is a risk of bumping against one another and becoming overlapping institutions as the international institutions proliferate (Young, 2002, p. 129). Multilateral institutions may be easier to create than to successfully maintain. The political bargaining process associated with power transition has to be completed peacefully. Successfully developed multilateral institutions does not only imply a large number of membership and well-functioning governance structure. More importantly, it also requires to become operative truly in multilateral character.

### **3. China's Creation of The AIIB and Its Development Success**

#### **3.1. Distributional Conflict, the Reform Gridlock and the AIIB's Creation**

It is clear that the creation of the AIIB was a response to the slowing down of reform process in the existing financial regime. Although it has been participating in the Bretton Woods institutions, Beijing has never concealed its dissatisfaction with their operations. The changing distribution of power has remained to be inadequately represented in those institutions. For example, just before the 2010 reform plan, "China had a low share of only 3.81% of voting right in the IMF quota system". European countries, however, were allocated 27.5% in aggregate and the US had 16.74% (International Monetary Fund, 2017). "As the world's second largest economy, China had a voting share of 4.42% in the World Bank, compared to 16.4% for the US and 7.9% for Japan. Similarly, Japan and the US play a dominant role within the ADB" (Lim and Vreeland, 2013, p. 48). According to December 2017 data, "China's total holding in the ADB was only 6.4%, whereas Japan and the US each held 15.6% respectively" (Asian Development Bank, 2017).

Despite China has strongly advocated the reform in the global financial order, the developed countries have been largely impeded the progress towards the restructuring process of new economic governance. Even when G20 leaders had come to an agreement upon the need for reforming the IMF and the World Bank, the decision made by executive boards of both institutions for modifying voting power distributions in 2010 was failed (International Monetary Fund, 2010). The positive prospect for more balanced representation still seems to be not close.

Even though the main reason behind the dissatisfaction of China much more deeper, it would not be wrong to suggest that China's initiation of the New Development Bank and the AIIB was directly affected by the reform deadlock. The main theme in the political discourse by Chinese officials and correspondants at that time was to use multilateral institutions as an instrument to increase China's "right to speak" at global institutions (Wang, 2014, p. 2). The IMF reform plan, for instance, was hindered primarily by the US, although the European countries not the US would directly face the problem of losing voting share. The reform plan has been blocked by the US Congress for a long time to come (Lesage, 2013; Vestergaard and Wade, 2013). If proposed reform is implemented, the US financial commitments to the IMF would not be increased. Or, the share of US voting power at the IMF would fall inconsequentially so that it would allow to keep the exceptional right to veto over most of the critical decisions. However, the real concern can be seen when looking at the increasing

scepticism raised by American legislators on developing countries' commitment to the existing norms and values of financial institutions. They are suspiciously hesitate to implement the reform, because there is a possibility that "these countries may prefer financial and trade strategies that are less aligned with those of the US" (Frankel, 2014).

Washington has long been insisting on the idea of 'responsible stakeholder', which prescribes China to make more contributions to global governance (Christensen, 2015; Zoellick, 2005). While some American strategists, like Zbigniew Brzezinski offered G2 strategic arrangement of comprehensive cooperation between the two countries, China demanded a new-type of great power relations with the US. However, neither China nor the US was able to show their willingness for coming to a final agreement to reframe their relations. Especially since 2008, the US has tended to suspect Beijing's attitudes that would disrupt established rules after obtaining more institutional influence. There has been widespread perception in the Western world that China has gained a momentum of economic leverage to be much more influential at global level. The increasing sensitivity of China's comparative advantage for transforming crisis situation into its own opportunities has become dominant among US elites (Lieberthal and Jisi, 2012). The growing anxiety of eroding US hegemony has been combined with the fear of "China threat" thesis (Allison, 2015). So, the stagnation of the IMF reform process has been largely affected by Washington's concerns about the redistributive gains and suspicions on China's increasing institutional influence.

China's creation of the AIIB can be partly explained as the "price" paid for the US' unwillingness to accommodation. The pessimistic standpoint in the US Congress for approving the IMF reform package led China to believe that "the US cannot credibly promise to accommodate China's demands" (Xinhua News Net, 2013). So, the creation of the AIIB and other new financial institutions reflect both Beijing's dissatisfaction with its uneven representation in the existing institutions and its disappointment with the moodily slowing prospect of reform process.

### **3.2. China's Direct and Indirect Benefits from the AIIB As an Outside Option**

While the adaptation of existing financial institutions to redistributive change remains stagnant, the AIIB provides a useful instrument for China in pursuing its economic goals effectively. It gives China an opportunity to offset its missings with regard to underrepresentation problem. China has already obtained the net benefits after the creation of the AIIB. Although any attempt to diversify China's foreign investment portfolio previously has been failed, China has recently become a net capital surplus exporter (The Economist, 2015).

China reached a huge capacity in terms of foreign exchange reserve and lending capabilities. By the end of 2013, China had 3.9 trillion dollar of foreign-exchange reserve, "with about 1.4 trillion invested in US treasury bonds" (Wang, 2014). China's purchase of the US Treasury bonds caused some criticisms, manipulation risk in the US and low cost-effectiveness consideration in China, for both sides. Moreover, "China has already become a global lender" (Woods, 2008). China's increasing lending capabilities are competing with existing institutions. Two important policy banks, the China Development Bank and the Export-Import Bank of China (C-EXIM), have demonstrated that they are capable of holding "more assets than the combined sum of the assets of the Western-backed MDBs" (Kamal and Gallagher, 2016).

Chinese funds have been already conceived as an alternative source by the borrowers, who seek to escape from the strictures of the Bretton Woods framework. With this remarkable financial power, it is necessary to recognize that China could pose credible threats to the US interests with its own policy tools, like offering loans with fewer strings attached sources (Koh, 2015).

The creation of the AIIB also contributes to meet some domestic political demands that are essential for China's future project of economic development. Since the sustainable domestic economic development is considered as a first priority for consolidating regime stability, the indirect benefits of the AIIB are also critical. For example, after China reoriented its economic diplomacy with new initiatives, like the AIIB, Beijing used its financial capital in a more effective for solving its industrial excess capacity and the piling-up of foreign exchange reserves. Because of their experiences, competitive advantages and available production capacities, Chinese companies have the edge over other companies in taking great amount of the project contracts from the infrastructure initiatives.

Gaining political support from developing countries for its legitimate actions through the AIIB is also an important strategic asset for China. This usage of the AIIB, which concentrates on political solidarity with developing countries while excluding some other great powers' influence within newly created institutions, is described as financial minilateralism by some scholars (Brummer, 2014; Naim, 2009). Besides, the AIIB is designed to provide financial public goods for its members in enhancing regional financial cooperation. The importance of strengthening common financial security and encouraging common economic development had been recognized by Chinese leaders after the Asian financial crisis in the late 1990s. It was appreciated that regional cooperation was needed both for economic growth and regional security in the long term (Jiang, 2010). The AIIB and other new financial institutions are helpful to ensure the financial stability of developing countries and in turn serve China's economic interests.

The AIIB is also linked to China's overall strategic calculations in a subtle way. The bank was created when China's strategic orientation was shifted in a way of seeking to increase the capacity of Chinese overseas economic activities. Particularly, the creation of AIIB is directly attributed to the Belt and Road Initiative (BRI). The main economic calculations behind the BRI lie on the needs of "exporting China's economic overcapacity, making efficient use of its abundant foreign exchange reserve" and pushing for the internationalization of the RMB (Ren, 2016, p. 441). In strategic realm, however, the BRI serves as a useful instrument within the context of shifting "China's geopolitical priority to Eurasia in response to the US 'pivot' to the Asia-Pacific" (Ross, 2012; Jisi, 2015). The BRI also plays a significant role in increasing Chinese influence at regional level through "the improvement of physical inter-regional connectivity" (Ramasamy, Yeung and Laforet, 2012). While the bank is not created merely for the BRI, it is understood that the AIIB's one of the primary functions is to promote the BRI-related projects (Callaghan and Hubbard, 2016). In this context, the AIIB provides China to expand its options to pursue the BRI objectives. This may probably be the most important indirect benefit that China expects to obtain through the establishment of the AIIB.

Another important aspect of the AIIB's creation is to provide an opportunity for learning from the experience. Beijing is likely to be determined to benefit from the lending experience and expertise of its partners in the AIIB in order to "share risks, reduce moral hazards and increase China's foreign investment efficiency" (Huotari and Heep, 2016). Given the fact that

Beijing's new initiatives are closely linked to its changing capitalist development path, new financial initiatives serve to manage the economic and political risks associated with financial internationalization. Whereas policy experimentation implemented by China is understood as "the layering and nesting of initiatives to allow for risk-minimizing", learning-oriented approach is the primary focus of China's financial internationalization. Most importantly, this learning process not only concerns the technical aspects of international arrangements and financial exchanges, but it also includes "how to turn its new economic weight into legitimate and effective leadership" (Wang, 2014, p. 5).

It is difficult to deny that China aims to translate its economic power into political influence. It obviously can pose a credible threat with its financial power that is getting increasingly influential in infrastructure development where existing financial mechanisms are relatively not satisfactory. Mostly because of the US Congress's suspicion of China's future attitudes, the reform process was interrupted. This situation of uncertainty facilitate China's decision to create the AIIB. In other words, the gridlock in reforming the existing regimes creates suitable conditions for China to justify its efforts in establishing the AIIB.

### **3.3. The AIIB's Inside Option for Resolving Commitment Problems**

After the AIIB was created, Beijing has continued to demonstrate its aspiration for pushing reform in the Bretton Woods institutions. While being the third largest funder of the ADB, the AIIB's closest competitor, China still plays an active role both in the World Bank and the IMF. The Chinese officials insist on advocating for more balanced representation in those institutions and making pressure for fulfilling the promise that has already been made (Zhou, 2014). From this perspective, it can be argued that Beijing is not attempting to replace the existing regimes with new ones, but rather try to stimulate reforms in a competitive manner. China's position in supporting reforms of the existing governance structure is consolidated by creation of the AIIB, which also strengthens inside option of China in the ongoing process of bargaining.

The AIIB and other the MDBs provide some significant advantageous to the governments compared to bilateral modes of investment activities. First of all, the MDBs have capable of enabling their creditors a specialized expertise in economic and regional issues and monitoring of project spending for supporting more effective use of their dividends. They also obtain some sort of autonomy in their activities, which gives them a separation to a certain degree from participating governments, for enjoying profit-oriented transactions in the financial market globally (Rodrik, 1995). In the case of AIIB as a multilateral bank, it is more useful instrument than other tools used by China for its bilateral investment activities for suspending external suspicions about China's geopolitical ambitions resulted from its growing economic influence. Moreover, it also gives a discipline to China's behaviour in a multilateral framework that helps to minimize lost of credibility and reduce moral hazard of lending with its arrangements.

In the US side, however, the main suspicion has been articulated in a way that China will use the new bank as an instrument to project its economic capabilities for pursuing some geopolitical ambitions. The critics also put forward that the AIIB is used strategically by China to disrupt the US global leadership (Liao, 2015; Zakaria, 2014). More specifically, the critics are worried about China's future practices in financial regime that move to undermine the

Bretton Woods system and liberal international order. Even if those suspicions about China has been increased since the Trump administration, it had been also observed in some official statements of the Obama administration previously. When Obama refers to the importance of Trans-Pacific Partnership Agreement for the US and its citizens, he put it: “China wants to write the rules for the world’s fastest-growing region. That would put our workers and our businesses at a disadvantage. Why would we let that happen? We should write those rules” (Obama, 2015). Although Trump administration made an opposite decision on TPP by withdrawing from it, both Obama and Trump used similar public discourse concerning China that was “bring back jobs from China”.

Despite the existence of opposition campaign conducted by the US, the traditional US allies including Australia, the United Kingdom and Germany joined the bank together at the same date of 2015. France, Italy and Israel followed the first group to seek founding membership. Besides, the AIIB also includes some countries from different regions of the world. The diversity of membership is transforming it from a regional institution to a global development bank and brings to mind a possibility of ‘World Infrastructure Investment Bank’. If this possibility comes true in the future, it is more likely to claim that China seriously owns an intention to replace the US as the hegemon. But, for now, it is reasonable to suggest that when China’s capability of steering the AIIB is increased, its credible threat for rebalancing of influence away from the existing regimes will be effective.

However, using the AIIB as an instrument for coming into conflict with the US or colliding with the existing order at the expense of making other countries uneasy would not be neither China’s strategic interests nor it be realistic. The main reason is that China has still urgent need of improving domestic economic development in order to protect regime stability at home. In doing so, the continuing integration into the global economy is a vital precondition. Persuading its neighbours and other states as committed to be a responsible power is also necessary for Beijing to avoid strategic containment. It is clear that China has been enough careful not to challenge the US hegemony directly and prevent to be labeled as revisionist state. However, as the strategic competition between the US and China has been increased in many different fields over time, the struggle for institutional capture has been also affected in a negative way. In this context, China’s pursuit of inclusive and cooperative approach combined with a search for political support on its legitimate actions should be maintained.

As being mindful of the difficulties resulting from increasing strategic competition with the US, China has successfully managed to utilize the bank’s multilateral framework which provides more influential means to induce other powers. Beijing has taken some necessary adjustments in the institutional formation according to needs arisen throughout the negotiation process. Concerns for transparency and governance have always been the top issue for criticism of the AIIB.

#### **3.4. China’s Expectation of Success for the AIIB’s Development**

Within the bargaining approach, China’s threat credibility does not sufficiently explain the creation of the AIIB in an attempt to achieve the desired IMF reform. There are some other significant factors that effect the ongoing bargaining process for institutional reform. China’s expectation of success provides an explanation for the AIIB’s creation and development even

when China's threat is not enough credible for pushing reform in financial regime. China's growing economic strength for capitalizing new benefits in financial field has been already improved in a significant level. Instead of using different means, however, China preferred to focus on infrastructure investment, mainly because the existing multilateral institutions, such as the World Bank and the ADB, cannot fulfill the required demands (Steinbock, 2015). So, it is clear that the insufficiency of existing regimes to support infrastructure development gives Beijing a significant opportunity to bypass them.

China's increasing self-confidence at home and abroad facilitates the creation of the AIIB. As the Western countries lose their competitive advantages in many different fields, China embodies its own strategic choices much more resolutely (Hu, 2008, p. 27). The impact of 2008 financial crisis and the failure of existing financial mechanisms to cope with the negative implications of the crisis obviously have reinforced China's self-confidence in a way that it extended its scope of economic initiatives at global level. Besides, the ongoing discourse on China's national rejuvenation at domestic level demonstrates the internal source of growing China's confidence in itself and its role in the world.

China's increasing engagement with international institutions and the experiences drawn from it for the last decades have reinforced its aspiration for the AIIB's creation. The idea of creating political solidarity among the developing countries at international institutions has been an important part of China's selective engagement strategy (Matsuda, 2014). Especially with regard to the China's diplomatic influence in the UN platform, the political support from the developing countries has been increased over time (Struver, 2014). This diplomatic success of China combined with the increasing tendency of other emerging countries for collaboration outside of the existing financial institutions has been a sign of their existent autonomy and intent to set up their role (Huotari and Hanemann, 2014). Thus, the achieved political support from the developing countries in the past and their continuing willingness to the creation of new institutions encourages China to take a lead on the efforts for reforming financial regime.

Nevertheless, given that the major concerns of the US and some other countries concentrating on the AIIB were about governance standards at the bank, it is important to investigate whether the AIIB will become a genuine multilateral institution, or an instrument that serves mostly for Chinese interests. In this sense, how the formation of the AIIB will take a direction is critically important not just for the bank's legitimacy, but also for the influence of Chinese initiatives in the future. China's attempts to appease other countries in the negotiation process of the AIIB's Articles of Agreement can be given as an example. China successfully satisfied other countries' concerns by addressing that "the AIIB would be modelled on the style and function of existing multilateral development banks" (Callaghan and Hubbard, 2016, p. 128).

From the beginning of the establishment process of the AIIB, Beijing has taken seriously to mobilize its diplomatic resources for the successful development of the institution. It added some new features to the AIIB for promoting its attraction to the partners. For example, the founding member privilege, which promises more power to founding members than to latecomers in bank's voting system, was one of the most important strategic approach against the US campaign that aimed to turn the AIIB into the battlefield for global influence. Moreover, similar to the ADB, the AIIB demonstrated its first priority to the regional development finance by making a distinction between regional members and non-regional members. And, then in an

effort to make a more balanced approach it was recognized an openness for both members and non-members in terms of proposing new projects and hiring staff within the institution. The AIIB Articles, representing a different approach than other MDBs have, also allow non-sovereign members for joining to the institution. This opens a possibility for Taiwan's participation to the bank. Even if its application for joining was not accepted in the first place, the mainland leave the door open to Taiwan with the precondition of acceptable name (Xinhua, 2015).

Even though Beijing has been very attentive for making institutional arrangements in the foundation and development of the AIIB, the bank still lies under some suspicions and faces serious obstructions. For example, Japan's non-participation to the AIIB attracts much attention with regard to the inclusiveness of the AIIB. Beijing attempted to involve Japan to the bank by offering vice president position, but Tokyo never gave a positive response (Hamanaka, 2016, p. 290). Unlike in the case of Chiang Mai Initiative Multilateralization and ASEAN+3 mechanism where the two countries shared joint leadership, it can be understood that Japan's involvement to the AIIB was considered at that time as a junior partner by China. Moreover, simultaneous existence of the AIIB and ADB in the same region with similar objectives and functions raised some questions about the future development of regional cooperation. By showing their reluctance to join the AIIB, Japanese commentators largely consider the bank as camouflaged by multilateral dress, which essentially serves Chinese interests.

China is the largest shareholder in the AIIB with the largest right of voting at around 26%. India (7.5%); Russia (6%) and Germany (4%) follows at a distance from China (Asian Infrastructure Investment Bank, 2019). China's voting power in the AIIB is currently larger than their counterparts in the World Bank and the ADB. China does not formally acquire a veto power over project-level decisions. However, when major decisions are concerned, which require a super majority of 75%, its 26% voting share makes its position effective. This situation is similar to the US veto over World Bank decisions, which require an 85% super majority (Callaghan and Hubbard, 2016, p. 129).

Particularly, "China has more control over the appointment of the President of the AIIB than the US has in the World Bank and Japan in the ADB" (Callaghan and Hubbard, 2016, p. 130). Whereas China insists on the importance of veto mechanism over the designation of the AIIB President, the US in the World Bank and Japan in the ADB have some influence in terms of informal arrangements. It refers to the conventional practice that the President of the World Bank can always be elected from American citizens and the head of the IMF can always be a European. Given the increasing dissatisfaction by developing countries upon this tradition, China pioneered to make a decision that designation of the AIIB President should be elected according to his/her merits. Although the main principle was embraced as regardless of nationality, China also advocated that the President must be a citizen among bank's members, which follows same arrangement in the ADB.

The biggest risk with regard to the governance structure of the bank is related to Beijing's sensitivity to keep control over China-led institutions. In comparison to the ADB and the World Bank, China has a more effective *de facto* veto power in the AIIB than the major shareholders currently have in those other multilateral banks. It can be suggested that relying on persuasion and consensus is more reasonable for future multilateral development of the institution rather than seeking control through vote power privilege. China's exercise of persuasion based on the

idea that major shareholder can have informal influence over decisions, as it has been recognized in the World Bank and the ADB, may be more effective than the implementation of its veto power within the institution. Otherwise, some decisions that are supported by a vast number of members may collide with China's veto power, which may lead to some political disagreements in the future.

Regarding to make the AIIB operative, one of the most important dimensions that the AIIB needs to concentrate is its future interactions with other existing institutions. The ongoing ambiguity of the precise role of the AIIB with its relations to other MDBs as well as some Chinese institutions has to be clarified. During the early stage of the creation of the AIIB, Chinese officials did not hesitate to make some endorsements of financial support for the BRI through the bank's fund. Over time, however, the emphasis on the linkage with the BRI has been decreased due to the growing concerns over Chinese domination in the AIIB. The AIIB President Jin Liqun frequently made a statement that it "would finance infrastructure projects in all emerging market economies even though they don't belong to the Belt and Road initiative" (Zhong and Cai, 2016). With this official recognition of displacement, Beijing facilitate its efforts to make institutional links with other MDBs. For instance, "the AIIB and ADB signed a memorandum of understanding to strengthen cooperation through co-financing, knowledge sharing and joint policy dialogues and consultations" (Asian Development Bank, 2016).

Although the most distinctive feature that feeds the expectation of the AIIB's development success is the prospect that it could contribute to fill the 8 trillion dollar infrastructure gap in Asia (Bhattacharyay, 2010), the direct funding by the AIIB will only match a small amount of needs. But, the real challenge is to catalyze available private investment into infrastructure rather than the belief that there is no enough saving for financing Asia's infrastructure needs. Even though the significance of infrastructure development is recognized by many for the future economic growth, most of the private investors prefers to pay attention to small projects with lower risks and higher returns. This growing need of private financing is much more important for other developing countries, because they do not have enough public accumulations to support infrastructure development as China does have.

In order to overcome this significant challenge, in addition to the intermediary role between the countries and private investment, the AIIB also has to help other countries to learn how to manage their effective project selection processes. Those processes include "cost-benefit procedures in order to select and prioritize projects, maintaining the rule of law along with stable regulatory and taxation environments, developing skills to manage public-private partnership projects and ensuring a sound and stable economic environment" (Callaghan and Hubbard, 2016, p. 135). Actually, many of those concerns are standing for China itself to be resolved, but there is an opportunity to gain another indirect benefit from the AIIB's learning mechanism if it makes bank's this role operative. However, for achieving this goal, China should make a strategic decision first whether it will help to facilitate the capacity of other countries to access private financing through the AIIB or not.

#### **4. Conclusion**

Theoretically, it is not enough to assume that bargaining failure is always the foundational rationale in explaining the establishment of new multilateral institutions. When



and how bargaining process can be expected to generate new multilateral institutions depends on the intensity of direct and indirect benefits that a rising power can gain through the creation of new multilateral institutions and its expectation of success for their development. The creation of new multilateral institutions is likely when rising power insists on reform but established power's cost of granting this reform is high. Creating new multilateral institutions are used as a bargaining leverage by the rising power in expecting to gain direct and indirect benefits at the expense of the established power's imposed costs. In this context, the degree of dissatisfaction based on the unequal distributional gains lead rising power to show its willingness to pay high costs and risks by creating new multilateral institutions.

Empirically, the creation of the AIIB is the outcome of distributional conflict between the US and China and emanates after from the reform gridlock occurred in the IMF. The direct and indirect benefits resulted from the AIIB as an outside option combined with the high expectation of development success led China to champion the establishment of the AIIB despite the uncertainty raised by power transition process. Due to the linkage between the domestic economic and political demands and the creation of the AIIB had been strong, China's expectation for its development success became high. This perspective explains why China appeal for the costly and difficult strategy of new multilateral institutional creation. Moreover, the AIIB as an inside option is also a useful instrument for overcoming the bargaining difficulties by supporting threat credibility with reassurance strategies in persuading other states through making increased commitments for future cooperation. China's ongoing participation with other multilateral institutions and the AIIB's cooperation with other MDBs helps to appease the suspicions related to the intensified US-China strategic competition.

However, the expected outcome as a new institution would be attractive for gaining support successfully from other states is a necessary but not a sufficient condition for reforming the existing multilateral financial regime. Even when a greater autonomy for collaboration among rising powers exists within the competitive multilateral regime, their own limitations and differences are more likely to preclude the formation of a dissatisfied coalition. Thus, the AIIB's future development success does not only depend on the factors that affect the China's expectation of success, but it also depends on the consistent responses of both developed and developing countries. The political bargaining process associated with power transition has to be completed peacefully. The future development prospect of new multilateral institutions is likely to be shaped by the tension between unilateralist strategies of the rising powers and truly multilateral operations within newly emerging financial regime.

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