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Is Asia's development machine stuttering?

With their own development banks, China and Russia want to provide an alternative to the West. But the war in Ukraine has dealt them a big blow

China is a critical component of the global financial architecture in two different ways – not only is it a member of the international institutions, it is also now a builder of institutions. China has played a role in the creation of two multilateral development banks, the Asian Infrastructure Investment Bank (AIIB) – which is led by China – and the New Development Bank (NDB) – which is led equally by all the BRICS states.

Neither bank has a long track record (both began their operations in 2016) but by setting themselves robust governance standards like those of the World Bank, they have shown that they are intended to complement the existing international institutions. Indeed, both banks have worked with the existing institutions on projects such as the Trans Anatolian Natural Gas Pipeline, which was co-financed by the AIIB, the World Bank, the Asian Development Bank (ADB), the European Investment Bank (EIB), and the European Bank for Reconstruction and Development (EBRD).

The smooth set-up and functioning of the AIIB and the NDB have granted China some significant reputational benefits, showing that it can be a trustworthy player in the international order. Unlike China's bilateral initiatives such as the Belt and Road, the AIIB and the NDB show little signs of creating friction between China and the rest of the world going forwards. However, Russia's aggression against Ukraine has complicated this picture.

The outbreak of the Russia-Ukraine war

China is Russia's main trading partner and a close strategic ally. In 2014, when Russia was feeling the pressure of western sanctions imposed after the annexation of Crimea, it was the bilateral swap line with the People's

Bank of China (PBoC) that provided some respite. The two have collaborated on several institutional arrangements, such as the BRICS Contingent Reserve Arrangement (CRA), and Russia is a significant shareholder in both new development banks.

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In the AIIB, Russia is the third largest shareholder with 6.74 per cent of capital and a Russian national occupies one of the five vice-presidencies. Each of the BRICS countries account for 19.42 per cent of the NDB's capital, and the NDB issued its first rouble bond programme on the Moscow Exchange (MOEX) in November 2019 which, with a maximum size of 100bn roubles and unlimited validity, is governed by Russian laws.

In response to Russia's invasion of Ukraine in 2022, many countries, businesses, and institutions imposed sanctions on Russia and worked to sever any ties with the country. In early March, the AIIB announced that all its activities relating to Russia and Belarus would be put on hold citing 'adherence to international law' and the need to 'safeguard the financial integrity' of the bank. The NDB similarly announced that 'sound banking principles' required that all new transactions with Russia be put on hold. The World Bank brought all of its activity in Russia and Belarus to a total halt.

The sanctions imposed against Russia have dealt a big blow to the NDB, as they make it more difficult for the bank to raise funds by issuing bonds on international capital markets. The NDB had 16 approved projects in Russia at the end of 2021 totalling $4.8bn (with the majority of loans made either to the Russian Federation or state-owned companies such as Russian Railways), roughly 16 per cent of the bank's total approved funding at the time. Despite these projects being put on hold, Fitch downgraded its rating for the Outlook on the NDB's Long-Term Issuer Default Rating from Stable to Negative in mid-March, citing the risk inherent in having Russia as a large shareholder and the downside risks to the bank's credit risk profile and solvency posed by the exposure to Russia in the bank's project portfolio.

What's next for the banks?

The cost of the war and the sanctions imposed on Russia make it more difficult for it to continue meeting its NDB loan requirements by, for example, accessing foreign exchange reserves. As such, there is a need for the bank to increase its loan buffers and diversify its project portfolio.

Increasing the bank's membership would help, and indeed this is the route advocated by Chinese officials responsible for the NDB. However, it is unlikely that this will significantly improve the bank's position any time soon.

Obtaining new members can take time – the NDB's strategy is to expand its membership gradually – and the presence of Russia will certainly put some countries off. The NDB approved the principles for admitting new members in 2017, but so far only four countries have applied (Bangladesh and the United Arab Emirates became members in 2021 and Uruguay and Egypt are currently prospective members). The bank's articles of agreement further limits the options for expanding its capital by placing restrictions on the distribution of shares in the bank; no individual new member can account for more than 7 per cent, non-borrowing countries cannot account for more than 20 per cent, and the founding BRICS members must account for at least 55 per cent.

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Even though Russia holds a significant position within the AIIB, the future for the bank looks better than that of the NDB. China is the largest shareholder in the AIIB with 30.72 per cent of capital and holds veto rights over a number of matters. Looking at the AIIB's projects, it had just two approved projects in Russia totalling $800 million at the end of 2021, or 2.58 per cent of its total $31bn funding (the top locations for AIIB projects include India, Turkey, Bangladesh, Indonesia, and China).

By number of members, the AIIB with over 100 countries is the second largest multilateral development bank after the World Bank. However, it is also important to acknowledge that the AIIB was conceived during the height of Robert Zoellick's 'responsible stakeholder' approach which has now dissipated – and it is unlikely that the creation of the bank would be possible today.

China's fork in the road

The renminbi managed to remain stable for almost two months after Russia invaded Ukraine at the end of February, causing some to question whether it could become a safe-haven for investors and one step closer to fulfilling Beijing's ambitions of becoming a fully-fledged international currency. However, by mid-April, the combined impact of continued lockdowns in China and rate hikes in the US caused the renminbi to

have its worst month since the end of its US dollar peg in 2005.

With the pressure on China mounting – and the sanctions against Russia increasingly fragmenting the global order – the critical question is: will China continue to focus efforts on creating credible institutions such as the AIIB, or will it follow Russia's approach in turning to aggression to get its own way?



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