A PATH TO US LEADERSHIP IN THE ASIA-PACIFIC: REVITALIZING THE MULTILATERAL FINANCIAL INSTITUTIONS

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ISBN: 978-1-61977-454-4

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November 2016
Acknowledgements

In the course of preparing this report, the authors consulted with and benefited from many individuals with considerable expertise and experience on international economic policy matters and Asia-Pacific regional affairs, as well as some officials in governments and international organizations. The authors wish to express their sincere appreciation, particularly to those listed below. In respect of the privacy of those in government and/or international organizations, their affiliations shall remain nameless. This listing implies no general or specific endorsement of the report and/or recommendations therein by those mentioned.

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Executive Summary

Economic growth and infrastructure development are today at the top of the agenda of Asian political leaders and will remain priorities for the foreseeable future. The stability and prosperity of the Asia-Pacific region and the further development of a liberal market-oriented economic order will rest on the coordinated economic engagement of the United States and like-minded countries in writing the rules of cross-border movement of goods, services and information—and, no less, on how they engage on infrastructure development.

Over the past several decades, the United States has led globally on expansion of a rules-based trade agenda. However, the United States has not had a development agenda of comparable priority. The Bretton Woods economic institutions and the leading regional multilateral development banks (MDBs), which have formed the core multilateral financial architecture since World War II, today face skepticism as to their long-term relevance, particularly in the face of declining US support. This report focuses on the challenge of revitalizing these institutions on behalf of an economic order aligned with the strategic interests of the United States and its closest Asian allies.

In terms of multilateral financial institutions, there are at least four central challenges facing the United States and like-minded countries in the Asia-Pacific:

- The need to define a politically supportable long-term mission for MDBs as countries graduate from concessional lending and as the current model of primary reliance on sovereign lending gives way to a wider array of market-based financing alternatives. The World Bank goal of eliminating extreme poverty by 2030 appears within reach, yet the infrastructure development requirements of middle-income countries will grow larger.

- The urgency in addressing the operational effectiveness and competence of existing multilateral institutions—burdened by bureaucracy, restrictive financing requirements, and legislative policy constraints, especially social and environmental safeguards.

- China is transforming the global infrastructure financing landscape and has become the largest source of development finance. China's financing through its state-owned policy banks exceeds the total provided by the World Bank and the Asian Development Bank (ADB) combined. The United States was caught flat-footed when China launched its 2014 effort to create the Asian Infrastructure Investment Bank (AIIB). The United States has not yet awakened to the challenge of China's global financing capability—and it is a formidable one.

- There is a shortage of “bankable” infrastructure projects (not a shortage of capital), given underlying weaknesses in local governance, transparency, rule of law, and anti-corruption efforts, as well as shortcomings in the enabling investment environment within countries.

The central recommendation of this report is that the United States needs a new narrative on economic policy in the Asia-Pacific region and a more comprehensive and robust economic strategy in the region—one that encompasses both trade and infrastructure, strengthens multilateral financial institutions (in particular the World Bank Group and the ADB), proactively coordinates with allies, and emphasizes private sector investment through upgrading local governance and enabling investment regimes. The recommendation is not to support the US government directly financing large projects, but rather to revitalize existing institutions through leveraging the collective strength of like-minded shareholders.

Given new dynamics in Asia, the United States—including Congress and the Executive Branch—needs to think afresh on the role of international financial institutions as a part of US geopolitical strategy. The United States has neglected the extent to which infrastructure financing is a political and economic priority for Asian governments. Infrastructure—roads, bridges, ports, dams, airports,
power plants, and communications networks—are the connectors and lubricants of national economies, and the enablers of development. Existing multilateral finance institutions should be important components of US strategy in the Asia-Pacific region, but their future within US strategy is not clearly defined.

The United States should address the central question of whether it should make a serious effort to lead on the Asian infrastructure development agenda or continue to play a defensive strategy that means a diminishing role for existing MDBs and, over time, yielding to the aggressive strategy of other players and new institutions. Should the United States concede that reform of the MDBs is too difficult a task on which to spend political capital, and let the drift continue? Or should the United States shift course and move in a strong way to revitalize the MDBs as priority components of US international economic policy?

The Chinese state-owned policy banks are becoming the world’s dominant development banks and are, to some extent, forcing that choice. The sheer volume of lending, the less stringent conditions of Chinese banks, and their streamlined procedures will likely offer an attractive alternative to traditional MDBs. Though it is premature to judge how the new lending institutions anchored by China and China’s state-owned policy banks will transform the world of development finance, there is little doubt that they will present strong alternatives to the Bretton Woods institutions, to US economic statecraft writ large and to US geopolitical influence in the Asia-Pacific region.

Asian leaders convey the worry that, despite the Obama administration’s “pivot to East Asia” in 2012, US commitment to the region is increasingly uncertain. There is a loud and consistent refrain from many countries in Asia calling for more comprehensive and consistent engagement in the region by the United States.

In the past, the MDBs have shown the ability to adapt to changing circumstances. Their response may be slow, and they have been constrained by major shareholding governments focused on maintaining the status quo. However, they have played an important role in supporting growth and development across the globe. The MDBs—with their access to cheap capital in international markets, technical expertise and experience with complex infrastructure projects, and ability to leverage private investment—remain very important to both global development and US geostrategic interests. At present, the MDBs are an underappreciated asset in US foreign policy, with inadequate backing and a competitive international financial environment. The MDBs, in some instances, have the ability to do what bilateral strategies cannot. The MDBs can also enable the United States to leverage its resources within a larger institution through which it provides leadership. With respect to failed or fragile states, MDBs can provide support not accessible through the US budgetary process.

The challenge for the United States is whether a mix of new initiatives—coordinated with allies and friends and supportive of market mechanisms and private investment, structural reform within domestic economies of the region, and revitalization of established multilateral financial institutions—can offer an effective means to play a central role in the complex world of Asian finance and close the gap between infrastructure needs and available financing. To achieve this result, development and infrastructure finance must become a higher priority in US economic policy in Asia. It must command bipartisan domestic support and place US leadership behind a more comprehensive and dynamic engagement, including through existing multilateral lending institutions. The United States should not seek to imitate China’s infrastructure initiatives, but should develop an alternative narrative and policies that play to the strengths of the United States and its like-minded partners in the region.

This report recommends some specific actions to achieve these objectives. A summary of these recommendations is provided below and discussed in more detail in the body of this report.

**Summary of Recommendations**

**Elements of a New US Economic Engagement in Asia**

- **A New Narrative Conveyed Through Public Diplomacy**
  - Centered on rules-based economic order, open flow of goods capital and ideas, democratic process, strong regional institutions, promotion of private enterprise, infrastructure development, good domestic governance and partnership with like-minded countries

- **New Infrastructure Development Agenda**
  - Led by the United States and Like-Minded Country Partners
  - Revitalize the relevance of the World Bank and Asian Development Bank through giving higher priority to infrastructure financing, more effective leveraging of existing resources, improved project preparation and decision-making efficiencies, and mobilization of private
capital through good enabling investment environment and local governance.

- **Inclusiveness Around High Standards**
  - Seek inclusive rules-based economic order in the region around high standards of openness and collaboration between long-standing institutions and newly established institutions on the basis of generally accepted norms.

- **New Rules in the Economic Sphere Beyond Trade**
  - Seek stronger multilateral arrangements providing for discipline on cross-border financing through official export-credit agencies and state-owned policy banks, open and stable domestic investment environments, untied and transparent infrastructure procurement processes and reform of capital markets.

**Strengthening the Effectiveness of Multilateral Development Banks**

- **Stronger Mandate on Infrastructure for the World Bank Group and the Asian Development Bank**
  - Focus their mandate on the primary mission of financing infrastructure development

- **Accelerated Movement toward a Private Investment Model, While Continuing Core Reliance on Sovereign Lending**
  - Expand the role of the IFC within the World Bank
  - Enlarge the ADB’s allocation of financing to the private sector
  - Make greater use of private investment managers
  - Integrate the Multilateral Investment Guarantee Agency (MIGA) into the IFC
  - Expand subnational and regional financing approaches

- **Innovative Approaches to Greater Leverage of Existing Resources within the Sovereign-Lending Model**
  - Within the boundaries of prudent financial management, find greater leverage within MDBs’ current capital structure so as to enlarge lending capacity
  - More creative use of trust funds contributed by MDB shareholders
  - Utilize more loan guarantees, loan syndications, and co-financings with private-sector partners

- **Addressing the Enabling Investment Environment as Fundamental to Infrastructure Development**
  - Give higher priority to the investment environment on the bilateral agenda with selective countries pursuing infrastructure development
  - Support greater regulatory and data transparency through MDB disclosure requirements on all shareholders—markets, in turn, will utilize this information in assessing project risk
  - Seek higher level political focus on the enabling investment environment on the agenda of regional mechanisms—such as APEC, ASEAN, and the East Asia Summit

- **Producing New Internal Administrative/Process Efficiencies within MDBs**
  - Reduce the time for project design, preparation, and approval

- **Openness to Safeguards Reform**
  - Pursue a balance between satisfying shareholders’ concerns about project outcomes and remaining attractive sources of finance for developing nations

- **Receptivity to Internal Governance Reform**
  - Periodic review of governance structure and process within MDBs to enable better alignment of developing country participation commensurate with their growing economic weight
CHAPTER 1:
The Relevance of Multilateral Financial Institutions to US Strategic Interests in the Asia-Pacific Region

Economic growth and infrastructure development remain at the top of the political agenda for Asian governments and political leaders. They are saying loudly that, notwithstanding the economic dynamism in the region over the past four decades, economic growth and infrastructure development remain at the top of the region’s political agenda and are likely to remain there for the foreseeable future. In this context, whether the United States succeeds in sustaining and deepening a liberal, market-oriented economic order in the Asia-Pacific region will likely depend on the United States and its closest allies playing the major role in writing the rules on cross-border movement of goods, services and information—and, no less, on whether and how they engage on infrastructure development. The stability and prosperity of the Asia-Pacific region as a whole, as well as the strategic positioning of the United States in the region, will rest on the coordinated economic engagement of the United States and like-minded countries.

Over the past several decades, the United States has led globally on the expansion of a rules-based free-trade agenda, though domestic anti-globalization backlash may be putting this in doubt. However, the United States has not had a development agenda of comparable priority. The Bretton Woods economic institutions and the leading regional multilateral development banks (MDBs), which have formed the core multilateral financial architecture since World War II, face skepticism as to their long-term relevance, particularly in the face of declining US support. This report focuses on the challenge of revitalizing these institutions on behalf of an economic order aligned with the strategic interests of the United States and its closest Asian allies.

In terms of international financing institutions, there are at least four central challenges facing the United States and its allies in the Asia-Pacific:

• Defining a politically supportable long-term mission for MDBs as countries graduate from concessionary lending, and as the current model of primary reliance on sovereign lending gives way to a wider array of market-based financing alternatives.

• Addressing the institutional effectiveness and competence of existing multilateral institutions—burdened by bureaucracy, restrictive financing requirements, and legislative policy constraints, especially social and environmental safeguards.

• China is transforming the global financial landscape and becoming the largest source of development finance. The United States was caught flat-footed when China launched its 2014 effort to create the Asian Infrastructure Investment Bank (AIIB). The United States has not yet awakened to this challenge—and it is a formidable one. China’s financing through its policy banks exceeds the combined total provided by the World Bank and the Asian Development Bank (ADB). Moreover, the recent establishment of new multilateral financing institutions supported by China has gained political momentum, in part, because of the perceived ineffectiveness of the World Bank and the ADB, and because of their inadequate lending capacity.

• A shortage of “bankable” infrastructure projects (not a shortage of capital), given underlying weaknesses in local governance, transparency, rule of law, and anti-corruption efforts, as well as shortcomings in the enabling investment environment within countries.

The central recommendation of this report is that the United States needs a new narrative on economic policy in the Asia-Pacific region and a more comprehensive and robust economic strategy in the region—one that encompasses both trade and infrastructure, relies on revitalized multilateral financing institutions, proactively coordinates with allies, and emphasizes private-sector investment through upgrading local governance and enabling investment regimes.
The Atlantic Council’s June 2015 report called for a new infrastructure-development agenda focused on the Asia-Pacific region, led by the United States and like-minded countries. The recommendation was not to pull the US government into directly financing large projects, but to revitalize existing institutions through leveraging the collective strength of like-minded shareholders. (Strategy must confront the reality of constraints on public budgets, and the fact that US bilateral assistance programs can no longer support large infrastructure projects.) More specifically, the proposed initiative should focus on enhancing the effectiveness of the World Bank Group and the ADB, particularly in terms of their potential to encourage private financing of infrastructure development, greater efficiency in project preparation, and higher priority to governance and rule of law in Asia’s emerging economies.

The United States has neglected the extent to which infrastructure financing is a political and economic priority for Asian governments. Infrastructure—roads, bridges, ports, dams, airports, power plants, and communications networks—are the connectors and lubricants of national economies, and the enablers of development. The AIIB should be a wake-up call. Existing multilateral finance institutions should be important components of US strategy in the Asia-Pacific region. However, their future within US strategy is not clearly defined. The challenge is to define new tools, policies, and approaches regarding financing. Given new dynamics in Asia, the United States—including Congress and the executive branch, particularly the Treasury Department—needs to think fresh on the role of international financial institutions as a part of US geopolitical strategy. Ideas developed now, even with some repackaging from the past, should have greater relevance and attractiveness in the context of the challenges posed by rising powers, as well as a more robust and comprehensive US leadership role in the Asia-Pacific generally.

Looking back, it can be fairly concluded that the post-WWII configuration of multilateral economic institutions has underpinned and facilitated economic growth and stability over seven decades, and has enhanced US geostrategic interests. Regional multilateral institutions, such as the ADB, have provided more focused lending, though within the Bretton Woods family. In many ways, the early rationale for the multilateral financing institutions has been met. There has been significant progress in reducing extreme poverty. The World Bank goal of eliminating extreme poverty by 2030 appears within reach, and many low-income countries are graduating from concessional to non-concessional borrowing. There is also growth of other development-finance channels, such as private markets and non-traditional donors, and the rise of competing knowledge providers in the policy sphere.

Nonetheless, the AIIB controversy highlighted how the development agenda has evolved, and how infrastructure remains a large priority for global and regional agendas. However, international financing institutions are less of a priority for the United States, political support for enhanced resources is low, and the United States has played a defensive strategy in the face of initiatives to enhance infrastructure-development priorities. In recent decades, the US focus has been on the trade agenda (rules of open trade and investment), rather than seeking to lead on the development agenda—apart, perhaps, from climate change, global health, disaster relief, and millennial development goals. In general, US bilateral aid responds to narrow country priorities.

In light of the above considerations, the United States should address the central question of whether it should make a serious effort to respond to the Asian infrastructure-development agenda in an enhanced way—with a higher-priority policy agenda and resources—or continue to play a defensive strategy that means a diminishing role for existing MDBs and, over time, yielding to the aggressive strategy of other players and new institutions. As will be discussed later in this report, the Chinese state-owned policy banks are becoming the world’s dominant development banks and are, to some extent, forcing that choice. Will MDBs remain relevant institutions for maintaining and furthering US geostrategic interests and those of like-minded allies? Should the United States concede that reform of the MDBs is too difficult a task on which to spend political capital, and let the drift continue? Or should the United States shift course and move in a strong way to revitalize the MDBs as important components of US international economic policy?

CHAPTER 2:

Global and Asian Regional Demand for Infrastructure Development

There is broad consensus that both global and Asian infrastructure needs are enormous. One oft-cited Asian Development Bank estimate is that Asia requires some $8 trillion in infrastructure investment between 2010-20. A more recent McKinsey report concluded that, “From 2016 through 2030, the world needs to invest about 3.8 percent of gross domestic product (GDP), or an average of $3.3 trillion a year, in economic infrastructure just to support expected rates of growth.”

There is a large measure of guesswork in these estimates, as they include judgments as to the financial viability of projects and the willingness of governments to provide the necessary domestic resources. Total financing commitments by the World Bank spiked in 2010 in the wake of the global financial crisis. Though commitments returned to more traditional levels two years later, its commitments reached record-high levels in each of the past two years. In 2014, the International Development Association (IDA) had a record replenishment in IDA17 and became the largest source of World Bank Group commitments, even as a number of countries graduated from concessional borrowing.

It is widely acknowledged that infrastructure investment has a multiplier effect on growth and jobs. Ongoing urbanization creates new requirements for efficient and livable cities. In developing countries, infrastructure is an essential enabler of broad economic development and raising millions out of poverty. The interconnectedness of economies necessitates transportation and communication links, and growth demands new energy capacity. Multilateral lending institutions feel this pressure, with demands from borrowing countries for additional financing. Last year’s total lending by the World Bank exceeded the levels reached during the 2008-2010 financial crisis.

In the developing world, the reality of one billion people without access to modern energy services, and millions without access to clean water, reflects the gap in infrastructure investment. Projections suggest that the largest needs for infrastructure investment over the coming decade will be in the Asia-Pacific region.

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6 Woetzel et al., Bridging Global Infrastructure Gaps.

7 Ibid.


9 Inderst, Infrastructure Investment, Private Finance, and Institutional Investors: Asia from a Global Perspective
Sources of Capital for Infrastructure Finance: The Landscape

Strong capital flows into Asia in the early/mid-2000s spurred economic growth and infrastructure development. With the 2008-2010 financial crisis, the flows began to reverse. Western banks and financial institutions hit hard by the financial crisis slowed lending and investment in Asia. Nonetheless, the issue is not the overall amount of capital available. Rather, it is the availability of viable projects supported by good governance, and hence ability to attract capital from the market. That means a strong, enabling regulatory environment and sound project planning. Good projects will attract capital.

With the remarkable progress made toward elimination of extreme poverty over the past several decades, low-income developing countries have had growing success in obtaining financing outside official development assistance (ODA) channels. These sources include: sovereign bond issuances, higher levels of foreign direct investment, overseas remittance flows, and domestic public financing as a result of higher tax revenues and accumulated domestic savings. As a result, developing countries are more easily able to access private flows of capital. The trend of the World Bank and MDBs providing a declining share of developing-country financing is likely to continue. The World Bank Group as a whole had aggregate investment commitments of $60 billion in 2015, a record level, indicating overall demand remains strong. However, infrastructure was a declining percentage of the total and in absolute amounts as well, as was the case with the ADB.

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The following charts summarize infrastructure commitments of the World Bank, International Finance Corporation (IFC), and ADB as percentages of total commitments, and also show the declining infrastructure-financing commitments of both the World Bank and the ADB over the past five years.11

CHAPTER 3:
The Role of Chinese Capital and its Geostrategic Significance

i. China has Become the Dominant Global Development Bank for Infrastructure Finance

Financing through Chinese state-owned policy banks makes China the dominant source of global infrastructure finance. Amounts of capital larger than those provided on an annual basis by the World Bank and the ABD combined are now committed through Chinese state-owned policy banks and new China-centric finance mechanisms. This financing by China is, by and large, deployed outside established multilateral arrangements.

Here are the statistics:

During the three years 2013-2015, China committed to finance 192 infrastructure transactions totaling $135 billion, primarily through its state-owned policy banks.\(^\text{12}\) By comparison, the World Bank and the ADB provided $43.95 and $28.26 billion, respectively, for infrastructure.\(^\text{13}\)

In 2016, this pattern of infrastructure financing by China has continued at an even faster pace. During the first three quarters of 2016, China has committed to finance forty-three transactions totaling $52 billion.\(^\text{14}\)

Moreover, there has been a shift in the regional focus of these loans. In 2013, Asia received 21 percent of China’s external lending; in 2015, Asia’s share nearly doubled to 38 percent. The big decline was in lending to Africa—from 40 percent in 2013 to 22 percent in 2015.\(^\text{15}\)

The China Development Bank (CDB) and the China Export-Import Bank (China Exim) are the state-owned policy banks providing most of the external infrastructure financing. The CDB was founded in 1994, as a policy financial institution under the direct leadership of the State Council. The CDB had reported assets of RMB 10.3 trillion at the end of 2014. CDB is the world’s largest development finance institution, and the largest Chinese bank providing foreign investment, long-term lending, and bond issuance. It ranked eighty-seven on the Fortune Global 500 list in 2015.\(^\text{16}\)

China Exim defines its mandate as to “facilitate the export and import of Chinese products, assist Chinese companies with comparative advantage in their offshore project contracting and outbound investment, and promote international economic cooperation and trade.”\(^\text{17}\) By international standards, China Exim offers limited transparency on performance and its balance sheet. However, according to the ADB, as of 2012, China Exim's total assets were RMB 1.558 trillion.\(^\text{18}\) According to estimates, the combined assets of CDB and China Exim, both inside and outside China, are in excess of $2 trillion. CDB has overtaken the World Bank as the world’s single largest provider of international development finance, with estimated overseas assets of $375 billion at the end of 2014, compared to the World Bank’s assets of $350 billion. China Exim’s overseas assets at the end of 2014 stood at approximately $300 billion, the ADB’s at approximately $110 billion, and the Inter-American Development Bank’s at approximately $100 billion.\(^\text{19}\)

From the standpoint of outstanding global loan portfolio, China's two largest policy banks and its thirteen regional

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15 Ibid.
funds have outstanding overseas assets in excess of the loan portfolios of all six of the largest MDBs.20

There is an absence of international discipline in regard to the financial terms and conditions of the lending operations and transparency of China Exim and China Development Bank; their performance is opaque and extremely difficult to evaluate. China is not a member of the Organization for Economic Co-operation and Development (OECD). Thus, it sits outside the OECD Arrangement on Export Credits and is not a member of the OECD's Development Assistance Committee (DAC). The DAC maintains the inventory of OECD members' foreign-assistance data.

However, China has loaned tens of billions to corrupt and poorly governed states—$65 billion to Venezuela, $28 billion to Angola ($86 billion to sub-Saharan Africa from 2000-2014).21 Many loans were also made to oil-exporting nations before prices collapsed. Repayment of such loans may be dubious and could, over time, make Chinese financial managers more cautious.22 The New Silk Road may face similar challenges in finding projects with sound economic rationale—though, in many instances, diplomatic considerations may override financial viability. Moreover, the slowing of China's domestic economic performance, and the need to constrain large outward flows of capital, may reduce the volume of state-bank lending. China's escalating debt-to-GDP ratio may, in time, also inject caution in external lending to projects with questionable financial underpinnings.23

Nonetheless, with infrastructure needs being a high priority for most Asian nations, the challenge from China's policy banks is clear and direct. China has become the largest source of infrastructure financing, one operating essentially outside established institutions, norms, and standards. The large volumes of Chinese infrastructure financing reinforce the perception that infrastructure in the Asia-Pacific region is not a US priority and that long-established MDBs are ineffective. This may also serve to tilt the region's geopolitical balance in China's direction.

ii. China's Transition to a New Model of Growth

China's willingness to provide large amounts of external infrastructure financing dovetails with its need to shift its economic model to new drivers of growth. Because China, over the past several decades, has relied on high domestic levels of fixed asset investment and on exports, it has accumulated enormous hard-currency reserves. As China's economy has slowed, it has permitted recycling of capital into global markets as a way of easing the transition for Chinese heavy industries with overcapacity by providing export markets for their industrial products and services. This is one part of China's underlying rationale for the One Belt One Road (OBOR) initiative.24

iii. Geopolitical Assertiveness and the One Belt One Road Initiative

The availability of capital for offshore deployment has occurred in the context of a more assertive foreign policy posture under President Xi Jinping, beginning in 2013. This more ambitious approach incorporates a willingness to utilize financial resources to extend geopolitical reach on China's periphery. These elements were brought together in 2013 under the slogan of One Belt One Road. China's offshore lending is increasingly conforming to the geography of OBOR. In the first five months of 2016, more than half of China's overseas construction contracts were signed with countries along the Silk Road, from $40 billion in commitments to Pakistan, to roads in Tajikistan and Uzbekistan. Indeed, China Exim is the largest external creditor to Tajikistan and Kyrgyzstan, holding 49 percent and 36 percent of debt, respectively.25 Internally, as many as two-thirds of Chinese provinces see OBOR as a vehicle for generating loans and investment.26 Part of the underlying rationale is to help absorb China's enormous excess industrial capacity.

OBOR is closely associated with President Xi Jinping and is a centerpiece of his foreign policy. The OBOR initiative is part of the "China Dream," and involves taking advantage of a benign environment to strengthen the

21 Ibid.
24 But China's inefficient, state-driven approach to its own infrastructure, according to one recent study, may actually constrain long-term growth. Moreover, since 2015, net capital outflows, propelled by a variety of factors, have reduced China's foreign-currency reserves from $4 trillion to $3.2 trillion.
country’s external influence. China has announced that it will invest more than $4 trillion in OBOR, though it has not specified the time period nor provided a roadmap for how sums of this magnitude will be financed. Under OBOR, support for infrastructure globally has increased, but the allocation also follows the contours of OBOR. China claims that nine hundred deals are already underway, totaling $890 billion.\(^{27}\)

In addition to its state-owned policy banks, China is deploying a number of mechanisms to finance OBOR: the CITIC Bank financing commitment ($113 billion), Silk Road Fund ($40 billion), and the People’s Bank of China (PBOC) injection of $82 billion into three Chinese banks for OBOR. This collection of financial institutions, along with some participation by the AIIB, will fund the OBOR’s ambitious vision of a connected economic belt from China through Central Asia to Europe, and a maritime route to the Indian Ocean and beyond.

OBOR serves multiple goals simultaneously:\(^{28}\)

- it repackages and provides an overarching framework and rationale for energy and transportation investment that has gravitated for some time toward Central and Southeast Asia
- it is a demonstration of China providing public goods to expand its global role
- it may help absorb China’s enormous excess industrial capacity, providing a rationale for more state capital to keep troubled state-owned enterprises (SOEs) in business by expanding steel, cement, and other industries abroad
- it is viewed as a means of modernizing and building connectivity in its less developed provinces (particularly in Western China), all of which are seizing on OBOR as a justification for channeling investment capital to their region
- it offers a comprehensive geostrategic vision of China as a great power, shaping a more Sino-centric international system

China has a strategic conceptual framework for OBOR, though its implementation will be challenging and specifics are still evolving. Moreover, there are differing views on OBOR inside China’s policy community. For example, the big policy banks are concerned about political pressures to finance projects that lack financial viability; loans in default are frequently not recognized, but merely restructured. There is also pushback from within foreign countries on the OBOR (such as Pakistan and Thailand) and suspicions from countries on China’s periphery of China’s effort to extend its geopolitical reach.

Nonetheless, OBOR poses a long-term strategic challenge to the US geopolitical position in Asia, particularly Central Asia. OBOR targets an integrated single zone from Asia to Europe through Central Asia—a zone not held together by common trade or investment rules, but rather by China’s financing strategy and the geopolitical influence that may accompany it, particularly if the Trans-Pacific Partnership (TPP) does not succeed. Efforts to integrate Central Asia and build trans-Eurasian transport routes—to build connectivity, boost Central Asian economies, and enhance prosperity outward from Western China—can be seen as positive for the United States and the global economy. Yet, absent US-led efforts to upgrade trade and financial institutions, the application of Chinese financial clout could undercut a rules-based order for open trade and investment, and instead support a move toward Beijing-shaped norms for the region.

iv. China-Sponsored Multilateral Financial Institutions

When China began its efforts to establish the AIIB in 2014, concern mounted in Washington that Beijing sought to create a Sino-centric alternative to the Bretton Woods institutions. China’s ardent desire for recognition and respect as a major power, in a modified world order in which it shapes rules, is undoubtedly behind its AIIB initiative. Much as the Obama administration views the TPP as not just a trade accord, but also as a key strategic element of its role as a Pacific power, China views the AIIB as more than just a financial institution. For Beijing, the AIIB is an important symbol of China’s rise, and of its global economic influence and stature.

Much of the apprehension in Washington about the AIIB and the New Development Bank (NDB) concerned whether they would respect established operating norms. It remains to be seen to what extent the AIIB and NDB will transform the Asian financial landscape over the long term. However, the curtain has been lifted somewhat, as the AIIB has become an operating institution. An initial assessment can be made of the AIIB’s management structures, lending processes, and governance, and of its compatibility with the World Bank and the ADB.

\(^{27}\) Ibid.
Thus far, based on structure, policy guidelines, personnel, and initial loan activities, the AIIB appears more like another regional development bank, largely compatible with the World Bank and ADB, than it does an alternative institution. The AIIB has fifty-seven member nations, with initial authorized capital of $100 billion. China contributed $29.78 billion and holds 26.06 percent of voting rights. India and Russia are the next-largest contributors—$8.37 billion and $6.54 billion, respectively, with 7.51 and 5.93 percent of voting rights. Beijing has also indicated a willingness to adjust its voting shares in the event of additional members joining.

AIIB’s initial tranche of loans suggests general compatibility with traditional MDBs. There appears to be strong interest in co-investment opportunities on the parts of the ADB, World Bank, and AIIB. Of the four initial AIIB loans, three were co-financed: a $216.5 million slum-upgrading project in Indonesia, co-financed with the World Bank; a $100 million construction of a section of highway in Pakistan, co-financed with the ADB in the lead, along with the United Kingdom’s aid agency Department for International Development (DFID); a $27.5 border-road improvement in Tajikistan, co-financed with the European Bank for Reconstruction and Development (EBRD). This structure will likely help AIIB attain AAA bond ratings, which is critical for MDBs to gain access to private capital at low interest rates. Its only sole-financed project is a $165 million power-distribution system in Bangladesh.29 These loans amount to less than half of the AIIB’s $1.2 billion projected loans for 2016. It is worth noting that all of the countries receiving these initial loans are along China’s Silk Road economic belt.

Many in AIIB leadership positions have had previous experience in the ADB and World Bank. AIIB leadership has characterized the AIIB as “lean, clean, and green.” This slogan is intended to illustrate some contrasts between AIIB and the Bretton Woods institutions. “Lean” means a smaller staff (fewer than one hundred in 2016, as opposed to more than ten thousand World Bank employees) and less bureaucracy. “Clean” refers to more efficient implementation. AIIB will not have a resident board of directors to directly oversee operations, as the World Bank does, but an unpaid, nonresident board. It will meet only periodically, giving AIIB executives more power to make decisions.30 This absence of a resident board is one significant difference between AIIB and the ADB or World Bank, and it has fostered a perception that China will exercise more control. Robert Orr, US ambassador to the ADB from 2010-16, has argued that, “The absence of a resident board inhibits transparency and accountability. A resident board would provide civil society with easier access and a voice with management, giving them a better sense of inclusiveness.”31

As for “green,” AIIB seeks to get less bogged down than traditional MDBs in the details of the social and environmental impacts of loans. Activist NGOs have pressured the World Bank and others to carefully weigh the social and environmental costs of their projects. Such concerns have led to a more cautious approach by the World Bank and were a factor in the decline in its infrastructure loans. To date, the AIIB has only issued a vague framework for social and environmental safeguards. Furthermore, AIIB procurement and contracting procedures will likely be scrutinized to assess the proportion of contracts that are awarded to Chinese state-owned enterprises.

Both the AIIB and the NDB view their respective approaches as learning from the lessons and experiences of the Bretton Woods MDBs. They reject policy-oriented loans designed to alter recipient nations’ domestic policies, with emphasis on poverty reduction, privatization, or deregulation. Instead, their emphasis will be on the viability of the infrastructure projects themselves. As former Chinese Finance Minister Lou Jiwei said of the NDB, “This bank will place greater emphasis on the needs of developing countries and have greater respect for developing countries’ national situations.”32

The NDB is conceived more explicitly as a “South-South” institution. The NDB has an initial subscribed capital of $50 billion, equally divided between each of the five BRICS nations (Brazil, Russia, India, China, and South Africa). The NDB governance structure differs significantly from that of AIIB. Each of the BRICS nations will have an equal percentage of voting rights. This parity will also be reflected in the board of governors,


directors, and senior management. Like AIIB, the NDB will not have a resident governance board. Each NDB member state will provide paid-in capital over a seven-year period. This gradual accumulation of paid-in capital will likely mean circumscribed lending operations in its early years. Moreover, given the sovereign ratings of its shareholders—Brazil and India are at the low end of investment-grade ratings; Russia and South Africa are in the junk-bond category—NDB is likely to have difficulty obtaining investment-grade bond ratings.33 While AIIB loans are thus far in dollar denominations, the NDB is more likely to issue at least some of its loans in local currencies or in yuan. The NDB's value proposition is not as well developed as the AIIB's.

v. Competition or Cooperation? Collectively, a Formidable Challenge to the US Position in Asia

How will these new institutions impact the world of development finance in general, and the Bretton Woods institutions in particular? AIIB and NDB are forcing a shift in the development agenda, with a renewed priority placed on infrastructure. For many developing nations, the hope is for access to more resources, with more options and fewer conditions. For the Bretton Woods institutions, the fear is that AIIB and/or NDB will not play by current rules, norms, and standards.

Obviously, it will be many years before the magnitude of their loan portfolios and impact can be fully assessed. But the initial activities of the AIIB—and, to a lesser extent, the NDB—suggest both constraints and advantages. As evidenced by AIIB's first tranche of loans, co-financing and leveraging private capital are keys to its success. These, along with its bond rating, would be at risk if AIIB were to veer significantly from compatible policies. While its approval processes may be streamlined, there may be risk that social or environmental damage results from AIIB infrastructure projects. Its “lean” structure may mean that AIIB’s ability to monitor projects is limited. What happens when AIIB projects go awry, causing social or environmental damage and protests? How will AIIB and/or NDB respond to member-state activism, from European, Brazilian, or Indian nongovernmental organizations (NGOs)? On the other hand, the streamlined approval procedures might create pressure on the World Bank and ADB to modify their cumbersome lending procedures and streamline safeguards.

Such questions aside, these new Chinese-driven institutions are reshaping the international landscape of development finance in ways only beginning to show themselves. AIIB and NDB suggest a dovetailing of Chinese economic and strategic interests with globalizing connectivity and developing nations’ economic needs. Some aspects of competition with traditional MDBs may be healthy. AIIB may put pressure on the World Bank and ADB to reform their cumbersome, multilayered loan practices. The growing volume of lending may spur the World Bank and ADB to be more creative in leveraging their balance sheets to increase loan capacity. To some extent, this has begun to happen. The ADB combining the Asian Development Fund’s equity and lending operations with the Ordinary Capital Resources (OCR) in 2015 significantly increased its lending capacity. Similarly, the World Bank may have created its Global Infrastructure Facility (GIF) as it was looking over its shoulder at the onset of the AIIB.

The net effect of AIIB and NDB, combined with Chinese policy-bank activity, in terms of sheer volume and streamlined lending procedures, could also cause modification of international standards, because of pressure on the World Bank/IFC and ADB to compete. The AIIB, OBOR, and Chinese development banks are forcing questions about reforming existing institutions, and about their relevance. The volume of loans will give recipient countries choices that can only reduce US leverage. Of course, this presumes that China avoids problems with low growth, high debt, and the challenges of the middle-income trap. Otherwise, resources to pursue this soft-power strategy may be constrained.

33 Ibid.
CHAPTER 4:

The earlier chapters in this report have set forth major challenges to the US economic position in Asia, including the need to reinvigorate the multilateral financing institutions that the United States and its allies have relied on for many decades. The sheer volume of new infrastructure lending in coming years will alter the dynamics of international finance and, in turn, will affect US geopolitical influence in the region. Though it is premature to judge how the new lending institutions anchored by China and China’s state-owned policy banks will transform the world of development finance, there is little doubt that they will present strong alternatives to the Bretton Woods institutions and to US economic statecraft writ large.

Taken together, China Exim, the China Development Bank, the AIIB, and the NDB will have the capacity to fill the largest share of regional infrastructure financing provided by non-local government and MDB sources. The sheer volume of lending, the less stringent conditions of Chinese banks, and their streamlined procedures will likely offer an attractive alternative to traditional MDBs.

Asian leaders convey the worry that, despite the Obama administration’s “pivot to East Asia” in 2012, US commitment to the region is uncertain and highly transactional. It is not viewed as a comprehensive, long-term, sustained engagement. Even TPP, which had been seen as an essential part of the “rebalance,” is now in doubt. There is a loud and consistent refrain from Asia calling for more engagement in the region by the United States.

A variety of reasons motivate Asian desire for more comprehensive and consistent US engagement. The desire to counterbalance China is one obvious reason, but that is not the full explanation. A preference also exists for the American model of prosperity centered around innovation, efficient and skillful management, open markets and information flows, and private enterprise as the long-term foundation for growth and jobs. For most governments in the region, this is preferable to the Chinese model of state subsidies, public ownership, and intrusive government regulation, despite these governments’ desire to benefit from available Chinese financing.

In the past, the MDBs have shown the ability to adapt to changing circumstances. Their response may be slow, and they have been constrained by major shareholding governments focused on maintaining the status quo. However, they have played an important role in supporting growth and development across the globe. Funding infrastructure projects was a central part of their initial raison d’être, and infrastructure remains a key enabler of development and economic growth. The demand for infrastructure finance in the Asia-Pacific region is strong.

The MDBs—with their access to cheap capital in international markets, technical expertise and experience with complex infrastructure projects, and ability to leverage private investment—remain very important to both global development and US geostrategic interests. At present, the MDBs are an underappreciated asset in US foreign policy, with inadequate backing and a competitive international financial environment. The MDBs, in some instances, have the ability to do what bilateral strategies cannot. The MDBs can also enable the United States to leverage its resources within a larger institution through which it provides leadership. With respect to failed or fragile states, MDBs can provide support not accessible through the US budgetary

process. Ukraine, Myanmar, Jordan, and Tunisia are recent examples of this.

Over time, the World Bank and the Asian Development Bank, particularly under the leadership of President Takehiko Nakao, have sought to sharpen and strengthen their mandates, increase lending capacity, and undertake internal reform measures to improve project development and decision-making efficiency. However, much more needs to be done in the face of strong challenges, if they are to retain long-term relevance and exercise their full potential.

Some may contend that revisiting the Bretton Woods and related institutions with a renewed commitment to reform is too complex a process and requires too much political capital. Developing-nation borrowers also see MDBs as inefficient, risk adverse, cumbersome, and slow to act. These borrowers see bloated bureaucracy and interminable reviews to satisfy the social advocacy needs of nongovernmental organizations. Though MDBs have shown an ability to adapt over time, their track record is seen as mixed and bogged down by parochial interests. As the AIIB and the NDB ramp up their international lending over the coming decade, prospective borrowers will undoubtedly have a wider array of choices in seeking financing. Traditional MDBs will face more competition in trying to balance high standards with reducing the complex hurdles that tend to make prospective borrowers wary. They need a new dynamism to stimulate private-sector investments and to generate public-private partnerships to meet infrastructure needs.

There is a window of several years before the magnitude of AIIB and NDB lending reaches a level that is more than a fraction of World Bank Group and ADB lending. However, the pressures from China’s policy banks are immediate.

Japanese Prime Minister Shinzo Abe is keenly aware of the challenge and has upped Japan’s game, committing Tokyo to increase infrastructure finance by $200 billion over the next five years. Prime Minister Abe’s advocacy of support for “high quality infrastructure” begins to shape a theme around which specific initiatives with the United State and others might be built. South Korea’s EXIM bank is also engaging in growing infrastructure finance. These bilateral efforts, combined with allied efforts to reform MDBs, could together comprise a substantial force to address Asia-Pacific infrastructure needs, while reinforcing the standards and governance norms of traditional MDBs.

The challenge for the United States is whether a mix of new initiatives—coordinated with allies and friends, and reliant on support for market mechanisms and private investment, structural reform within domestic economies of the region, and revitalization of established financing institutions—can offer the effective means to play a central role in the complex world of Asian finance and close the gap between infrastructure needs and available financing. To achieve this result, development and infrastructure finance must become a higher priority in US economic policy in Asia. It must command bipartisan domestic support and place US leadership behind a more comprehensive and dynamic engagement, including through existing multilateral lending institutions. The United States should not seek to imitate China’s infrastructure initiatives, but should develop an alternative narrative and policies that play to the strengths of the United States and its like-minded partners in the region.

Addressing the Backlash Against Globalization

There is an anti-globalization backlash in the United States and, more broadly, in Western nations. The focus of this backlash, evident in the 2016 US presidential campaign, has been on trade, with both major candidates opposing the TPP. However, it has been manifest in other areas: Congress’s protracted delay in approving the 2010 International Monetary Fund (IMF) reform package; resistance to World Bank/IMF replenishments; and efforts to shut down the US Export-Import Bank. All these issues reflect a new middle-class angst, a sense that globalization may not be a net good in the slow-growth world economy. The dysfunction in the US political system is taking a toll on the credibility of US global leadership.

35 In recent years, for example, under the leadership of President James Kim, the World Bank has sought to reduce costs by $400 million and to restructure more along functional lines. The Asian Development Bank has undertaken even more significant structural reforms by combining the OCA and the soft window, as well as increasing processing time. Both have sought, to some degree, to gain more leverage from existing resources and mitigate some of the burdensome effects of social and environmental safeguards.


Even if the political will of the United States to strengthen MDBs was not in question, fiscal realities would impose constraints. While some US support for MDBs involves budgetary commitments (which are leveraged multiple times by other nations’ funds), MDB general capital increases include a commitment to “callable capital,” which is backed by national treasuries, and expands MDBs’ ability to borrow and lend. It does not, as a practical matter, involve budgetary outlays. However, non-borrowing shareholders with conservative financial-management policies do not want to risk receiving calls for capital, even though MDBs have never drawn on callable capital since their creation. Both the US Export-Import Bank (EXIM Bank) and Overseas Private Investment Corporation (OPIC) actually add to the US treasury, and require no net budgetary outlay. Reticence in Congress to support such efforts reflects not just a climate of budget austerity, but also a popular backlash against globalization, perceived as serving “corporate” special interests.

International institutions only work to the degree that major powers are invested in them. The Bretton Woods institutions have, in general, been a force multiplier, providing public goods to facilitate global growth and also to support US geostrategic interests. The global economic dynamism that has produced growth in much of the developing world has been key to expanding markets, and to the political stability in Asia that US security capabilities and commitments have underwritten. They reinforce the soft power and appeal of US leadership.

The backlash against globalization, including the perception of resulting job losses and inequalities in income, has become a political force too significant to ignore. Political discourse in both major parties in the United States appears to be moving to the view that reliance on trade liberalization as a model will simultaneously require more effectively addressing the negative consequences of globalization (this is also a sentiment strongly felt in many European countries). A sine qua non for meeting the challenges to US policy in the Asia-Pacific region is shoring up the US political consensus for strengthening engagement in the region. Absent that consensus, the recommendations in this report will face a steep climb.

**Recommendations**

The following initiatives frame the elements of new US economic engagement in Asia:

i. **A New Narrative Conveyed Through Public Diplomacy**

The United States should seek to capture the regional dialogue through effective and robust public diplomacy, centered on the following themes and values: an open-market, rules-based economic order; open flow of goods, capital, and ideas; democratic processes; strong regional institutions; promotion of private enterprise; and good domestic governance. It should stress the importance of partnership with like-minded countries, such as Japan, South Korea, and Australia, and of reinvigorated alliances and tangible collective action, pursued through an enabling investment environment, strengthened regional institutions, and consultative mechanisms.

The two substantive pillars should be the rules-based trade and investment regime and an infrastructure-development agenda that responds to Asia political and economic priorities. This will entail a revitalization of multilateral lending institutions and the robust use of regional economic forums in Asia (e.g., East Asia Summit and the Asia-Pacific Economic Cooperation [APEC] forum). The United States also needs to show strong support for the Association of Southeast Asian Nations’ (ASEAN) economic-integration process.

The United States will need also to address the domestic backlash against globalization and the perceived disruption from technologies and open borders. It must also give greater priority to a level playing field and fairness in trade and investment (this will be addressed in a separate report).

Finally, the narrative must be inclusive—meaning the strategy should embrace China’s continued integration into an updated regional and global order, reflecting the growing weight of China, India, and other emerging powers.

China has an active public diplomacy in Asia—geared to calming fears and showing the benefits to the region from Chinese participation and capital. Its public diplomacy is pursued through a wide range of channels, including media outlets in the region, people-to-people exchanges, and economic ties. The United States should more creatively use its instruments of soft power in the region.

ii. **New Infrastructure Development Agenda Led by the United States and Like-Minded Country Partners**

A multipronged, long-term infrastructure agenda led by the United States can fill a void in US policy in the region. Raising the political priority given to revitalizing
US leadership in MDBs does not necessarily entail significant new budgetary commitments or increases in bilateral aid. Rather, it requires making better use of existing resources, leveraging private-sector capital, creating the conditions for an enabling private-investment environment, and developing concerted policies in collaboration with allies. US leadership is not a resource or capacity issue. However, the United States alone cannot determine policy within the MDBs; it requires the support of like-minded allies working together within the institutions.

To this end, the United States, Japan, Australia, South Korea, and other like-minded countries should announce a new infrastructure-development agenda centered around revitalizing the relevance of the World Bank and Asian Development Bank through giving higher priority to infrastructure and development financing. This would consist of more effective leveraging of existing resources of MDBs, greater internal MDB process efficiencies, and initiatives that seek to mobilize private investment through enabling investment environments and local governance. 38 Prime Minister Abe’s theme of support for “high quality infrastructure” is worthy of attention and elaboration.

Such a robust infrastructure-development agenda will certainly require a more explicit US policy framework that relates to MDB commitments, including policy-level budget targets and priority allocations (or reallocations). The US foreign assistance budget, known as the 150 account, stands at approximately $31 billion in fiscal year 2016.

In addition, such an infrastructure development agenda should include a willingness to use relevant fora, such as the Group of Twenty (G20) and the OECD to bargain for structural reforms within MDBs, in exchange for financial support (e.g., IDA replenishment and possible general capital increases).

iii. Inclusiveness Around High Standards

Integration of China into the existing rules-based economic order should continue to be a central priority of US policy in the Asia-Pacific region. System-threatening conflict with China is not preordained. China has benefited from its participation in the current international order and in existing multilateral institutions. China wishes to maintain these benefits of integration into the international economy, while it pursues its quest to carve out a regional and global role as a major power commensurate with what it sees as its new economic and strategic weight. China will hedge and look to create new channels of economic influence more responsive to its interests. However, as has been seen in the IMF and with AIIB, Beijing is willing to work within existing institutions, if it can secure a position within them that reflects its growing economic weight. The goal for the United States should be to strengthen the economic architecture of the region, so as to demonstrate to China the benefits of playing within that framework. Most nations in the region appear supportive of an open architecture based on high standards and rules, and do not wish for emergence of Sino-centric institutions that draw in discrete blocs of countries. Where new institutions are established, the region should endeavor for them to become collaborative partners with established institutions and to operate on the basis of generally accepted norms.

Moreover, there are wide areas of regional cooperation in new technologies that are nonpolitical, and which benefit humankind beyond national identity. These are in the fields, for example, of genetics and medicine, clean energy, food, and water. These provide opportunities for new, inclusive institutional arrangements that help bind nations to an inclusive order.

iv. New Rules in the Economic Sphere

Beyond Trade

New rules are needed affecting infrastructure development and the cross-border flow of goods, services, and capital related to infrastructure. These are in the fields of export-credit discipline, government procurement, investment regimes, and the development of capital markets. The United States should raise the priority it gives to the negotiating new multilateral arrangements in these issue areas and place them on the agenda of the G20.

Most of the cross-border financing provided by export-credit agencies and state-owned policy banks in Asia is outside the discipline of the OECD Arrangement on Official Export Credits. The OECD Arrangement needs to be replaced by a stronger set of disciplines on all major countries providing export financing, whether through official export-credit agencies or state-owned policy banks. In 2012, presidents Obama and Xi announced a new international working group outside the OECD, to develop a new and more comprehensive arrangement. This effort has yielded little progress toward a more effective set of guidelines regulating export credits. Although the World Trade Organization (WTO) has a
Government Procurement Code, its effectiveness is undermined by the myriad exclusions that ratifying countries place on their obligations to open procurement to foreign suppliers. Government procurement rules should be changed, so that they break the link between the country providing financing and the vendors supplying the major equipment or services. Providers should compete without financing tied to procurement.

Stable and open investment regimes that protect the integrity of investments and contract rights, and provide fair legal processes for the resolution of disputes, are central to the ability of developing markets to attract significant private financing for infrastructure. Bilateral investment treaties move countries toward a rules-based approach. Still, developing countries themselves need to recognize the benefits that flow from their own initiative in putting in place high-quality investment regimes.

Advanced economies, as well as MDBs, need to place higher priority on encouraging developing Asian countries to accelerate reform of their capital markets, including lowering capital controls, deepening debt markets, and enhancing disclosure and transparency. This can be expected to attract more private capital, from both domestic savings and foreign financial institutions, into long-term infrastructure investment. This should extend to insurance markets, as insurance firms are one of the largest sources of long-term capital not yet effectively mobilized for infrastructure investment.

v. Revitalizing Existing Economic Institutions: Strengthening the Effectiveness of Multilateral Development Banks

This report has set forth changes in the global financial architecture that have emerged over the past several decades, and that have important implications for the future of the multilateral development banks. Most significant has been the fragmentation of the global financial architecture, and the reality of private flows of capital far exceeding official flows. Moreover, the progress made in the elimination of poverty on a global scale—and the rise of low-income countries into middle-income status, with financing capabilities of their own—has called into question the long-term relevance of the MDBs. Furthermore, non-borrowing industrial countries face fiscal constraints that politically limit their ability to support large new contributions to the capital base of the MDBs. At the same time, they show reluctance to make governance changes reflective of the shifting weight of economic power globally. Although the MDBs have technical strength, knowledge, and expertise related to development issues, private alternatives are diminishing the importance of this MDB asset in relative terms. Through its state-owned policy banks and newly sponsored financing institutions, China is providing attractive alternatives to the established multilateral institutions. Thus, in broad terms, the advanced industrial world can either permit the MDBs to make incremental reforms while the broader trends continue to cut against their current mandate and mode of operations, or they can reposition the major MDBs, such as the World Bank Group and the Asian Development Bank, with a revitalized mandate focused on infrastructure and critical global public needs, and with new approaches to governance and financing.\(^\text{39}\) This report recommends the latter alternative, based on the finding that the world needs capable and relevant global financing institutions in the twenty-first century, and that US leadership is essential to their success. These recommendations are set forth in the following Chapter.

\(^{39}\) Some have argued that MDBs have served their purposes and should be wound down, but this fails to recognize that there is strong demand across most countries for their continued role. Winding down is not a politically acceptable option.
CHAPTER 5:
Recommendations to Strengthen the Effectiveness of Multilateral Development Banks

i. Stronger Mandate on Infrastructure for the MDBs
The MDBs should focus their mandate on the primary mission of financing infrastructure development where market failures persist and private investment alone is insufficient. Over time, the World Bank and the ADB moved away from their historic mandate, placing greater focus on poverty alleviation. However, poverty reduction in Asia has made substantial progress. By 2024, only two of the ADB’s borrowing member countries are expected to be eligible for concessional lending. Also, as indicated earlier in this report, there will be a significant reduction in IDA-eligible countries, particularly in Africa. The MDBs should give top priority to infrastructure investment, and decrease their emphasis on poverty reduction. A development bank should, first and foremost, be a bank.

Today, approximately half of the World Bank’s financing is for infrastructure; for the ADB, that percentage is approximately 70 percent. Over the next decade, the World Bank should move its allocation to infrastructure to 75 percent, and the ADB to more than 90 percent. Over the past several decades, the ADB—though emphasizing poverty reduction as well—has had a stronger track record on infrastructure. In recent years, under President Nakao, it has taken steps to increase its focus on infrastructure, and to improve efficacy and lending capacity.

Over the years, the World Bank’s knowledge role has grown. Its technical knowledge and experience continue to contribute to poverty alleviation, project development, and, in the policy sphere, promoting good domestic governance and the enabling environment underlying bankable financing. However, measuring the return on knowledge is difficult, and there are private sources with similar expertise. The staffing structure at the World Bank is too heavily weighted on the knowledge side. The World Bank should reduce, but not eliminate, capacity in this area.

Some responsible voices have sought to encourage the World Bank and other MDBs to see their future relevance in terms of support for “global public goods” (GPGs). Though the World Bank and MDBs may have a role to play in financing the provision of certain GPGs, such as in the areas of the environment and climate change, this should not become the primary mandate of the MDBs. Other mechanisms are perhaps more conducive to providing support for GPGs.

ii. Accelerated Movement toward a Private Investment Model, While Continuing Core Reliance on Sovereign Lending
The multilateral development banks have historically provided financing primarily to sovereign governments. The charter of the International Bank for Reconstruction and Development (IBRD) restricts its lending to sovereigns and most, though not all, regional MDBs have, in practice, financed into the public sector. The charter of the Asian Development Bank does not limit its financing to sovereigns, but sovereign lending has been its primary approach in practice. In recent years, the ADB has allocated approximately 11–16 percent of its financing to private investment projects.


(IFC), established in 1956, has been the major private-investment arm.

So, to what extent can there be reliance on private capital to finance development? Should the IFC model overtake the World Bank sovereign role? The answer is that private capital can play a significant role in financing infrastructure development, and should be expanded, but the IFC model cannot, and should not, replace the World Bank sovereign role.

The reasons for the sovereign-lending model are understandable. MDBs are established to provide financing for development purposes where private funding is not available. Infrastructure and development projects are, to a significant extent, public purpose in character. Therefore, they require public financing, as private capital is frequently unwilling to take risks on these projects, or private markets are not functional. Thus, there are limits on the extent to which MDBs can leverage private investment; private investment in infrastructure will not replace public financing in its entirety. However, private capital can play a larger role in infrastructure financing.42 The MDBs should pursue strategies that increasingly shift the emphasis toward private-investment approaches. The World Bank cannot easily move toward a private investment model for the institution as a whole, as there are limitations in the World Bank charter, and amendment of the charter would be politically very difficult to achieve. Still, there are approaches that could be undertaken without requiring World Bank charter amendment:

- **Expand the role of the IFC within the World Bank Group:** The IFC lends only to the private sector; it does no sovereign lending. Its total subscribed capital is small by MDB standards ($2.4 billion, all of which is paid in). However, given its profitability, its capital base has grown to approximately $25 billion without increases in shareholder capital. Unlike most other MDBs, the IFC’s charter imposes no fixed limit on the size of its operating portfolio relative to its capital base. In fact, its financial management has been extremely conservative, among the most conservative of the MDBs, with an equity-to-loan ratio in the 65 percent range. By comparison, the equity-to-loan ratio of the World Bank stands at approximately 28 percent, and the ADB’s at 32 percent. Private banks are typically in the 12-15 percent range. This provides the IFC with considerable headroom for expanding its portfolio as a private investor, but with sensitivity to its infrastructure-development mandate. The IFC has significant room for expanding its lending program, consistent with prudent financial management. Moreover, the IFC is in a position to use a larger share of its net income to support project design and preparation. The IFC will need to face the ever-present question of additionality—that is, whether it is offering value-added support that would not otherwise be available from the private sector. However, pressures will undoubtedly exist for the IFC to move into areas in which private-sector interest is more hesitant, such as in post-conflict or fragile states, and in certain IDA countries. The IFC will continue to be advantaged by the World Bank Group’s preferred-creditor status and linkages to member-country governments. Over time, the IFC may grow to rival the World Bank as private sector demand continues to expand. In that circumstance, the use of IFC profits may become a more contentious issue. On the other hand, IFC profitability offers the possibility of capital accumulation away from general capital increases by World Bank shareholders.

- **Enlarge the ADB’s allocation of financing to the private sector:** The ADB now provides about 10 percent of its financing to the private sector. It has set a target of increasing that amount to 50 percent by 2020.43 The ADB has no requirement in its charter mandating only sovereign lending and no limitation in its charter on the percentage of its lending to the private sector—that allocation is a matter of ADB policy determined by the shareholders of the bank. The ADB’s major shareholders should conduct a fresh review to determine a long-term target for investment in the private sector—perhaps targeting a range of about 50 percent over the next decade. The ADB is financially sound, with its AAA credit rating (permitting funding in the market on favorable terms). At only around 30 percent, it is nowhere near its statutory portfolio limit (100 percent of total capital and reserves). Thus, it has considerable capacity for expanded lending into the private sector.

- **Make greater use of private investment managers:** The asset management company model of IFC can be deployed more widely, including by the Asian Development Bank. Both the IFC and the ADB are in a position, and have ample precedent, to employ the asset management company model, whereby the MDB provides sponsor or anchor capital to private investment managers, enabling the MDB to leverage those funds to raise even larger institutional funds for infrastructure

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43 In 2008 the Asian Development Bank did a rethink called the Long-Term Strategic Framework. Member countries called for private-sector investment to be the lead priority, and to reach 50 percent by 2020.
investment. The MDB relationship would carry with it advantages with respect to project risk mitigation, as well as fundraising. This model has also been extensively, and profitably, used by the European Bank for Reconstruction and Development and the European Investment Bank (EIB). The private-equity model has been shown to enable professional management of funds and nimble deployment of investment capital.

- **Integrate MIGA into the IFC:** World Bank shareholders should consider the merger of the Multilateral Investment Guarantee Agency (MIGA) into the IFC. The result would be a consolidation of their private-sector guarantee operations, in order to provide greater stimulus to private investment, particularly in large infrastructure projects. MIGA is constrained by its small capital base, and consolidation within IFC would provide greater overall guarantee capacity for private investment within the World Bank Group.

- **Subnational and regional financing approaches:** There are infrastructure-financing needs that are at the subnational or local-government level (though also not private in character), and thus not backed by a sovereign guarantee. There are also infrastructure-financing needs that have a multinational character and involve multiple country actors. The World Bank and IDA are constrained by their charters from supporting these projects, although IDA may have some flexibilities that the World Bank does not. Thus, provincial or municipal projects are not within their mandates. The IFC and ADB, on the other hand, are able to lend into subnational and regional projects without a sovereign guarantee. The IFC, in particular, has a track record for lending to municipal entities. The IFC and ADB should consider broadening subnational financing, and the shareholders of the World Bank and IDA might also explore flexibilities within their legal framework that could permit subnational lending. Such financing might also more directly engage local governments where governance practices can have a significant bearing on infrastructure-project viability.

### iii. Innovation and Greater Leverage of Existing Resources within the Sovereign-Lending Model

As demand for infrastructure financing has increased, the question of whether the capital base of the World Bank and ADB should be expanded has received more attention. At this point, the case for a General Capital Increase (GCI) has not been persuasively made by the institutions themselves, nor any of their primary shareholders.44 It should be noted, however, that the grant-based approach of the IDA provides less financial leverage than shareholder contributions to core capital. The US annual contribution to IDA and its concessional program (much of which is grants) is approximately $1.5 billion annually, whereas US participation in the 2010 GCI for the World Bank ($86 billion) was a little less than $200 million annually, yet the GCI as a whole substantially boosted the World Bank’s capacity for additional financing. Nonetheless, at this moment, GCIs appear premature, as there are steps the MDBs can take to better leverage existing capital and increase lending capacity. There are also innovations within the MDB sovereign-lending model that have the potential to enlarge the scope and effectiveness of these institutions.

- The World Bank and the ADB have, in recent years, moved to better leverage existing capital. In 2014, financial reforms at the World Bank enabled it to approximately double its lending capacity without a GCI while seeking to respond to greater infrastructure-investment demand. Moreover, the ADB has taken the initiative to strengthen its capital base by integrating the concessional Asian Development Fund (ADF) into its ordinary capital account—due to be completed in 2017. This will strengthen its capital base for expanded lending without a GCI. The World Bank and IDA are probably not in a position to follow the ADB’s precedent. There are legal difficulties in combining the capital structure of the two institutions, which also have implications on countries’ voting shares. However, these initiatives do not exhaust the room these institutions have to find greater leverage within their current capital structure.

- **More leverage of existing capital:** Within the bounds of prudent MDB management practices, and without risking either their AAA bond ratings or the need to draw on callable capital, MDBs could modestly lower their equity-to-loan (E/L) ratios and gain the ability to substantially increase their lending.45 While it is probably not advisable to reduce E/L ratios to the level of healthy commercial banks, lowering these ratios to the 20 percent range (still 30 percent higher than those of strong commercial banks) would provide

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44 One of the problems faced by MDBs has been that, because the demand for public-sector financing has been weak, the banks have been lending at below-market rates. As a result, institutions that intended to pay their own way have struggled to do so.

significantly expanded lending capacity. Recently, the World Bank officially lowered its target E/L to 20 percent, though, in practice, it operates in the upper 20 percent range.

- **Trust funds created by MDB shareholders:** Trust funds provide flexibility outside the sovereign-lending model. The trust-fund model does not alter the shareholding structures of these institutions, but trust funds can apply the policies of the MDB without requiring a sovereign guarantee of the borrower, and can fashion their own governance structures. Shareholders contribute directly to the fund. These may include new emerging donors in Asia, such as China, private funding, or monies from sovereign wealth funds.

- In addition, there are a host of other methods and financial instruments that MDBs can utilize to catalyze infrastructure-project lending and mobilize financial institution resources, including more active use of loan guarantees, loan syndications, and co-financings with private sector partners. Co-financing by the World Bank and ADB with newly created institutions, such as the AIIB and New Development Bank, may serve to align lending practices and increase these institutions’ overall governing transparency. MDBs should consider aggressively blending their financing with the private sector—a rethink of loan pricing. In many instances, MDBs provide loans below the cost of capital to borrowing governments. MDBs should consider increasing the interest rates to borrowers for sovereign loans (with rates varying depending on the borrower, just as they would in the marketplace), and co-finance them with private-sector investors.

### iv. Addressing the Enabling Investment Environment

It is widely recognized that the availability of capital is less an impediment to infrastructure development than is the investment environment. In other words, there is a shortage of “bankable” projects. More often than not, the difficulty of attracting financing lies in the investment environment, and in a host of related issues such as regulatory instability, absence of rule of law, a weak judicial system, and corruption as a way of doing business. The stability of the political regime itself has a significant impact. All of these elements drive up the risk associated with a project and increase the cost of financing—frequently more risk than mainstream financial institutions are willing to bear. These challenges are widely recognized, but how to mitigate these risks is a fundamental issue in infrastructure development and financing. Many efforts have been made, including sector-reform programs of the World Bank and ADB, in which the national government formally signs onto an investment-reform program. In addition, components of the investment environment, such as corruption, have frequently risen onto leadership agendas, such as that of the G20. However, reforms in areas such as political corruption require internal political will, rather than outside pressure—particularly as sensitivities to foreign interference in sovereign domestic matters may be pronounced.

In the long term, the market itself and the need to attract investment capital to infrastructure projects will provide the most effective discipline on the investment environment. However, there are still steps that the United States and its like-minded allies can take, in the context of a more comprehensive infrastructure-development agenda that might give push to higher-quality investment environments. These would include the following:

- higher priority on the bilateral agenda, with selective countries pursuing serious infrastructure agendas
- greater regulatory and data transparency, through MDB disclosure requirements on all shareholders—markets, in turn, will utilize this information in assessing project risk
- higher placement on the agenda of regional mechanisms—such as APEC, ASEAN, and the East Asia Summit

### v. Internal Administrative/Process Efficiencies

- The World Bank Group and the ADB should make concerted efforts to reduce the time for project design, preparation, and approval. Beyond resource-related issues, there are some key process-related issues that traditional MDBs need to address in order to increase their attractiveness to prospective borrowers. Even after streamlining to expedite the process in recent years, the timeframe required to finalize loan approval from the World Bank (fourteen months) or ADB (eleven months)—along with the multilayered process of screening, pre-appraisals, appraisals, and multiple internal reviews—has made prospective borrowers wary and likely to seek less cumbersome lending sources, even if they are more expensive. The faster procedural timeframes of the AIIB may

vi. Safeguards Reform
Safeguards on the environmental and social impact (e.g., relocation and/or resettlement) of loan projects, particularly in energy and transport-related projects—while important in terms of setting standards and ensuring project quality—have drawn criticism from many developing countries. Some argue that they are being asked to meet standards of advanced industrial nations, rather than their own laws and social norms. They are sometimes put off by the requirement of time-consuming studies by outside experts, for which they shoulder the expense. Over time, however, the differences in standards in regard to environmental impact and social dislocation employed by the World Bank and other MDBs have narrowed. The AIIB and NDB, as noted above, claim they will absorb lessons from MDB practices and further streamline them. This may increase their attractiveness to prospective borrowers. Depending on the performance of the AIIB, NDB, and other OBOR infrastructure projects, traditional MDBs may need to consider altering their approach to safeguards, to find a balance between satisfying shareholders’ concerns about project outcomes and remaining attractive sources of finance for developing nations.

vii. Internal Governance Reform
For many years, developing countries have sought reforms in governance of the MDBs, commensurate with their growing economic weight. Change has been slow, as non-borrowing shareholders have been reluctant to see dilution of their voting percentages. This is also linked to the reluctance of non-borrowing shareholders to support new capital increases for the institutions, because of concerns the GCI may alter shareholding position. The United States itself is less vulnerable than certain European countries, which are overrepresented given their economic weight, particularly with the rise of Asian countries. In fact, one might argue that the US position within the MDBs is, in general, lower than its economic weight, as its shareholding position in all MDBs is smaller than its percentage of global economic output. The same cannot be said for a number of European countries. However, economic weight is only one determinant. The historic support shown by a country for the institution must also be considered. Countries recognize the bargaining nature of any process for reconfiguring shareholding positions, and the fact that radical change is not possible in a zero-sum game. To some extent, shareholding position has been overplayed as a concern, as the MDBs more often than not seek to work by consensus in their decision making. At present, shareholder voting position is not posing issues of immediate institutional legitimacy, though the United States should be open to periodic review of voting structure within MDBs.

As to the selection of the senior leadership positions within the MDBs, there has been a practice of nationality determining the choice. While there is grumbling about this practice, and a widening view that the merit of individual candidates should override national identity, there has not, to date, been a profound enough dissatisfaction with the practice to overturn it. In fact, with a Chinese national having just taken the presidency of the AIIB, the pressure to depart from long-standing practice within the various MDBs has probably lessened. It would be difficult for shareholding countries to argue that some, but not all, MDBs should eliminate the nationality practice. At some point, the global community may need to come to terms with country entitlement to the senior leadership position in MDBs, but the time is not now.
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From 1997 to 2001, he was Director of Asian Studies and a Senior Fellow at the Council on Foreign Relations (CFR). He led several CFR task forces, including the Korea Task Force and the Southeast Asia Task Force among others. Manning was previously an adviser for policy and public diplomacy to the Assistant Secretary of State for East Asian and Pacific affairs at the State Department and served as an adviser to the Office of the Secretary of Defense from 1988 to 1989.

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