Drift and Displacement: China’s Rise and a Changing International Economic Order

by

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The rise of China presents many challenges to the international order the United States and its allies created after World War II. Granted, China is far from catching up to the United States in military affairs, and it is also possible that it will never catch up (Brooks and Wohlforth 2015/2016). In the economic arena, however, China is much closer to equality with the United States, still the leading power in economic terms, prompting Robert Zoellick, at the time president of the World Bank, to characterize the world economy as multipolar (Wade 2011, 348). Given the size of the Chinese economy, it is quite likely that it will soon surpass the U.S. economy (see below). This paper explores some of the already discernible consequences of China’s rise for the international economic institutions created after World War II. Whether these institutions can survive a China powerful enough to challenge U.S. leadership and preserve an open international economy is an important question.

One consequence of the rise of China to economic prominence is that we are increasingly seeing a struggle between China and the United States for control of the institutions governing the international economic order. This struggle has manifested itself in two main ways. First, China has demanded a greater say in how international economic institutions are run, demands the United States has largely resisted. Second, the competition to shape the future international economic order has led China to create new international institutions designed to promote economic cooperation with other nations.

Thus, the struggle between the United States and China for influence is in many ways an institutional struggle taking place within and in parallel to existing institutions such as the World Trade Organization (WTO), the World Bank and the International Monetary Fund (IMF). Ameri-
can preponderance after World War II played a crucial role in creating the international economic order and it accounts for its persistence until the present. The rise of China threatens to upend the fundamental mechanism—American preponderance—by which this order is reproduced. The consequences that the rise of China will have for the current international economic order are hence predictable to some degree (Conran and Thelen 2016, 62). For one, China is unlikely to heed then U.S. Deputy Secretary of State Robert Zoellick’s call in 2005 for it to be a “responsible stakeholder” in the world economy if by that we mean preserving the current system as is with the United States at the helm.

In this paper, I draw on insights derived from recent work in comparative politics and international political economy that analyzes gradual institutional change. Unlike both power-based and institutionalist accounts, this work explicitly tries to take into account how relative power and institutions interact in driving institutional persistence and change (Steinberg 2002; Gruber 2000; 2005; Thelen 2004; Campbell 2004; Drezner 2007; Mahoney and Thelen 2010; Hall 2010; Fioretos 2011; Jupille et al. 2013; Kaya 2015; Conran and Thelen 2016; Zangl et al. 2016).

Although they offer no explanation for it, Morse and Keohane’s (2014, 386) concept of contested multilateralism, of which competitive regime creation is one type, captures at least some of the dynamic of the struggle between China and the United States.1 We still know relatively little about why institutional contestation takes the specific forms that it does, however.2 The

1 The other type is regime shifting whereby states shift to an alternative multilateral forum, using that as a launching pad for an attempt to challenge the original institution (Morse and Keohane 2014, 392).
2 For instance, it is not obvious why contestation should be multilateral, given that powerful states can choose from a menu that includes both unilateral and bilateral in addition to multilateral options (Morse and Keohane 2014, 388).
framework I present in this paper, derived from Mahoney and Thelen’s (2010) work in historical institutionalism, promises to give us a better handle on understanding strategies of institutional contestation. Their work explains the different forms strategies of institutional contestation takes in terms of two variables, the strength of veto possibilities (both veto players and veto points) and the level of discretion in interpretation/enforcement of institutional rules (Mahoney and Thelen 2010, 18–22). This leads them to identify four types of gradual institutional change, layering, drift, displacement, and conversion. I apply this framework to an analysis of two institutions, the International Monetary Fund (IMF) and the Asian Infrastructure Investment Bank (AIIB). I argue that institutional changes in the IMF can be analyzed as an example of drift because there are strong veto possibilities and a high level of discretion in interpretation and enforcement. The creation of the AIIB, in contrast, is an example of displacement. It took place in a political context in which veto possibilities were weak and there was a low level of discretion in interpretation and enforcement of the rules.

These cases allow me to discuss two (indirectly in the case of the AIIB) of the three main pillars of the international economic order (that is, the IMF and, indirectly, the World Bank). Alt- though these two cases do not allow me to explore all four types of institutional change, they do allow me to vary both veto possibilities and discretion (the independent variables) and modes of institutional change (the dependent variable).

In what follows, I explore my argument in greater detail. I begin by providing a brief overview of the relative economic power of the great powers. I then discuss different approaches to

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3 The third being the WTO.
explaining institutional change and institutional creation. The paper next provides an account of drift in the IMF. This is followed by a section discussing the creation of the Asian Infrastructure Investment Bank, an example of institutional displacement. The paper concludes by elaborating some of the broader implications of these discussions.

**Economic measures of power**

Whereas one can define power in many ways, for my purposes measures of economic power are the most relevant. These measures demonstrate that China is a great power in economic terms. As table 1 shows, China already has the world’s largest gross domestic product (GDP) in terms of purchasing power parity (PPP). As a share of world GDP, China accounts for 17 percent, the United States 16 percent. True, at market exchange rates there is still a considerable gap, with the United States accounting for 23 percent and China 14 percent of world GDP or roughly $11 trillion compared to the U.S.’s roughly $18 trillion (and the European Union’s approximately $16 trillion) (“The Sticky Superpower” 2015). In addition, China is far behind if we consider per capita GDP.

Turning to international trade, China has a slightly bigger share of world merchandise trade (see table 1) than the United States and is almost on a par with the European Union. Perhaps more important, the number of countries for which the United States is the biggest export market has declined from 44 to 32 since 1994. In comparison, China is now the biggest export market for 43 countries, up from two in the same time period (“The Sticky Superpower” 2015). The size of China’s domestic market, another measure of economic power (Steinberg 2002; Drezner 2007), draws other countries into China’s orbit, potentially undermining the current international economic order.
The tremendous growth in and the size of China’s foreign exchange and gold reserves, reflecting years of large current account surpluses, are another indicator of China’s rise to economic preeminence. Some of this capital needs to find outlets abroad, which explains the considerable increase in Chinese foreign aid and foreign lending in recent years. Among other things, it has enabled China to create the AIIB with China as the biggest shareholder. In short, China still lags the United States (and the European Union) on some measures (GDP at market exchange rates and per capita GDP), but on several others, it is now a leading power (share of world merchandise, foreign reserves) as table 1 shows.

Table 1
Measures of Great Power Status in 2015

<table>
<thead>
<tr>
<th>Measures of Economic Power</th>
<th>United States</th>
<th>European Union</th>
<th>China</th>
<th>Japan</th>
<th>India</th>
<th>Russian Federation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Population (millions)</td>
<td>321,368</td>
<td>513,949</td>
<td>1,367,485</td>
<td>126,919</td>
<td>1,251,695</td>
<td>142,423</td>
</tr>
<tr>
<td>GDP (market exchange rates, billions)</td>
<td>17,950</td>
<td>16,270</td>
<td>10,980</td>
<td>4,123</td>
<td>2,091</td>
<td>1,325</td>
</tr>
<tr>
<td>GDP (PPP, billions)</td>
<td>17,950</td>
<td>19,180</td>
<td>19,390</td>
<td>4,830</td>
<td>7,965</td>
<td>3,718</td>
</tr>
<tr>
<td>Per capita GDP (PPP)</td>
<td>55,800</td>
<td>37,800</td>
<td>14,100</td>
<td>38,100</td>
<td>6,200</td>
<td>25,400</td>
</tr>
<tr>
<td>Share of world merchandise trade (2014)*</td>
<td>13.3</td>
<td>14.8</td>
<td>14.2**</td>
<td>5.0</td>
<td>2.6</td>
<td>n/a</td>
</tr>
<tr>
<td>Central bank reserves (foreign exchange and gold, trillion $)</td>
<td>0.130****</td>
<td>0.741***</td>
<td>3.27</td>
<td>1.26****</td>
<td>0.371</td>
<td>0.378</td>
</tr>
</tbody>
</table>

Sources: CIA World Factbook: GDP (market rates, PPP), per capita GDP, population, central bank reserves; World Trade Organization: share of world merchandise trade; World Bank: merchandise trade as % of GDP

Notes:
* Excludes intra-EU (28)
** Excludes Hong Kong
*** 2014
The relevance of these measures is perhaps most obvious in the case of the IMF where economic factors play an important role in determining quota size and relative voting power. As for the AIIB, the surplus on the current account and the accumulated central bank reserves made it possible for China to launch the AIIB with itself at the helm.

Next, I discuss the implications of China’s economic rise, focusing on analytical perspectives that emphasize how power shapes the strategies of the hegemonic power and of the challenger. These perspectives ignore the possible role that international economic institutions might play in influencing their strategies.

Power in the absence of institutions

Power-based accounts, typically associated with various realist arguments, view all transitions as sharing the same characteristics. The leading power will try to preserve the status quo; the challenger will seek to change it. They are persuaded that the current transition will be no different and that the United States therefore needs to try to slow the rise of China (Mearsheimer 2014, chap. 10). More dynamic theories such as theories of hegemonic war argue that hegemonic powers come and go, their rise and decline driven by differential rates of economic growth (Organski 1968; Gilpin 1981; Kennedy 1987). Because economic resources can be converted into military strength, military power ultimately depends on the ability to create economic wealth. To catch up to a hegemonic power militarily, a rising power’s economic growth

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4 The 2008 formula included economic variables such as GDP at both market rates and PPP exchange rates; flows on current and capital accounts; and official reserves (Kaya 2015, 65).
rates must exceed the hegemon’s, and some of the wealth it creates must be converted into military power.

While this is a dynamic theory in that it explains shifts in the distribution of power as a function of differential growth rates, the theory offers a relatively rudimentary answer to the question of exactly what happens as the rising power catches up. Perhaps the most prevalent view is that the rising state will seek to alter the status quo and create an international order that better reflects its preferences. The leading power will resist and try to preserve the existing international order. In the past, this clash between leading power and challenger has eventually led to hegemonic war if the leading power’s attempts to stay on top fail (Gilpin 1981, esp. 187–97).

This, of course, is very undeveloped, offering little insight into both the kinds of strategies the challenger will employ to get to the top and the strategies the leading power will adopt in its attempt to remain top dog. In an attempt to put some meat on these theoretical bones, Randall Schweller (1999, 7–8) suggests that the declining hegemon can respond to the emergence of a rising power in a number of ways, ranging from preventive war to buckpassing. The choice among the options will be a function of the established power’s goals, which also cover a very wide spectrum (Schweller 1999, 8). A similar indeterminacy applies to emerging powers. Schweller and Pu argue that emerging powers such as China may act as supporters, spoilers, or shirkers. China’s policies, that is, might vary from support of the existing order to attempts to destroy it (2011, 42).

Whereas Schweller and Pu argue that nuclear weapons make hegemonic war unthinkable, classical realists view the rise of China with some trepidation but argue that war is not inevita-
ble. Were China to bid for hegemony, it would likely provoke an overwhelming counterbalancing coalition and thus sow the seeds of its own destruction. China might nevertheless launch a bid of hegemony (Kirshner 2012, 64). A number of factors will influence the course China will choose, including history, ideology, domestic politics, the nature of leadership, ideas, norms, and, crucially, American foreign policy (Kirshner 2012, 67–68, 70). Despite their more voluntaristic bent, even for classical realists, the existing international order ultimately reflects the underlying distribution of power.\(^5\) Although there may be lags, as the distribution of power changes, so eventually will the nature of the order. This is a belief classical realists share with other realists (Brooks and Wohlforth 2009, 49; Schweller and Priess 1997, 21; Kaya 2015, 3, 24).\(^6\)

The theoretical indeterminacy on display in these various arguments reflects historical evidence. While challenges are often associated with great-power war, they need not be, as demonstrated by the peaceful transition from British to American hegemony completed after World War II. Britain’s acquiescence to the rise of American power suggests that the leading power has several strategies available to it besides resistance and trying to preserve the international order. The same is true of the challenger: Germany challenged by going to war, the United States did not.

\(^5\) As Kirshner (2012, 69) notes, “[c]lassical realists see politics shaping the pattern of economic relations....”

\(^6\) Why the lags would exist at all is, however, unclear (Kaya 2015, 24).
Still, at a minimum, as China catches up to the United States, realists would expect cooperation to be more difficult. The growth of Chinese economic power will somehow have to be accommodated. This is not so much a question of Chinese intentions or strategy as simply a structural consequence of the growth in power. Although it is obvious that China has a long way to go before it can pose any significant military threat to the United States (Brooks and Wohlforth 2015/2016), in the economic arena the gap between the United States and China is a lot smaller (see table 1 above). While China is nowhere near as rich as the United States in per capita terms, it is already wealthy enough to be able to pose challenges to U.S. leadership of the international economy.

In short, power-based accounts all share the same weakness, their poorly developed notion of process. The reliance on comparative statics means it is very difficult to specify what leading states and challengers do as the distribution of capabilities changes, what challenge and resistance looks like. This, however, is not a problem unique to power-based accounts.

A more tractable, and hence perhaps more interesting, problem is that realism tends to define the strategic setting facing great powers exclusively in terms of the distribution of power. This is inadequate in today’s world, particularly in the international economic arena. The relatively deeply institutionalized character of the current international economic order means that it is quite different from those that have preceded it (Ikenberry 2001; Lanteigne 2005, 1). It follows that the strategic setting in which the current challenge takes place is very different from that characterizing past challenges. The goal may be the same, but the strategies are likely to be different. Challenge and resistance, that is, is likely to look different in an institutionalized setting than in a setting with very rudimentary institutions. The difference in setting matters
even if we conceive of the institutions of the current international economic order simply as another set of tools in the toolbox of great powers, as some realists are wont to do (e.g., Mearsheimer 1994/95). The tools available to today’s great powers are different than they were in the past. Presumably this will affect both U.S. and Chinese strategies as they compete over who will shape the international economic order in the future. Perhaps the strongest argument in favor of adopting some form of institutional perspective when analyzing the consequences of the rise of China for the current international economic order is that China’s challenge to this order is itself an institutional one, as in the demands for reforms of the IMF and the World Bank and in the creation of the AIIB. The American counter to the economic challenges posed by the rise of China has also been in part institutional. Thinking about the consequences of China’s rise for the international economy clearly requires that we pay attention not just to power but also to the role of institutions.

**Institutions in the absence of power**

Whereas power-based accounts focus too much on relative power, institutionalist theory ( neoliberal institutionalism) has not paid enough attention to it. Granted, neoliberal institutionalists acknowledge that relative power fundamentally shapes the creation of institutions (e.g., Martin 1992; Keohane 1993, 271, 292). Institutions do more than simply reflect relative power, however. Once created, institutions take on a life of their own, often surviving a change in the underlying power distribution necessary for their creation. Given that maintaining existing institutions is easier than creating new ones, institutions will persist as long as they provide net benefits to their members (Keohane 1984).
Obviously, there is a difference between acknowledging that power matters and incorporating it into analysis. Here the Rational Design of Institutions project can stand as representative of how neoliberal/rational choice institutionalism often, if not typically, downplays the importance of power.\(^7\)

The Rational Design project regards new institutional arrangements, such as those created at Bretton Woods, as being consciously designed to remove obstacles to cooperation. Although there are other sources of institutional change, “conscious design” is the “overriding mechanism” driving it. As conditions change, institutions evolve as a result of the “deliberate choices” states make in response (Koremenos et al. 2001a, 766–67). In short, the Rational Design project “emphasize[s] self-conscious rational design as central to the creation, maintenance, and further development of international institutions” (Koremenos et al. 2001b, 1077). In this perspective, the past is largely irrelevant and new institutional equilibria—that is, new institutions—emerge as a result of exogenous events (Jupille et al. 2013, 214; Conran and Thelen 2016, 54).

Noting that “nothing in the Rational Design framework precludes power from being incorporated as an additional independent variable,” Koremenos, Lipson, and Snidal allow that “‘power’ needs to be analyzed more fully and explicitly,” although they maintain that their analysis of who exerts control within an institution provides “at least a step in that direction” (Koremenos et al. 2001b, 1052, 1054, 1068).\(^8\) “[C]ontrol over an institutions relates to the actor’s

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\(^7\) The extensive literatures on global governance and globalization, with important contributions from neoliberal institutionalism, liberalism, and constructivism, is also vulnerable to the charge that it has ignored power in its various manifestations. See Barnett and Duvall (2005, 7); and Hurrell (2005).

\(^8\) The dependent variables are membership, scope, centralization, control, and flexibility (Koremenos et al. 2001a; Koremenos et al. 2001b, 1052). See also Koremenos and Snidal (2003, 437).
importance to the institution” (Koremenos et al. 2001a, 792). As Kaya (2015, 23) notes, however, “importance” remains undefined. It does not seem to be closely related to power since their “theoretical framework proceeds when all other factors, such as power, are being held constant” (Koremenos et al. 2001b, 1069). For proponents of the Rational Design framework, the incorporation of power as an independent variable is very much an afterthought, its possible role untheorized and to be addressed, if at all, “by empirical researchers ... on a case-by-case basis” (Koremenos et al. 2001b, 1069). Jupille, Mattli, and Snidal’s (2013, 215) conclusion that “rational choice institutionalism has neglected the role of power in shaping outcomes” thus seems warranted (see also Duffield 2003, 417; Kaya 2015, 22–24).

Holding power constant may perhaps be appropriate when analyzing the day-to-day operation of international institutions once they are created and the rules have been defined, but the utility of this approach is considerably more doubtful when analyzing institutional change and institutional creation.9 As Hurrell (2005, 37) argues, “we need to ask which institutions are chosen and why. Power, not effectiveness or efficiency, is often the central determinant of that choice.”

To better understand the impact that the rise of China has had and will likely have in the future, we need a framework that, in contrast to realism and institutionalism, takes both power and institutions seriously. Above all, we need a framework that tries to analyze how power and

9 Koremenos, Lipson, and Snidal (2001b, 168) note, for instance, the role U.S. power played during the Bretton Woods negotiations that laid the foundation for the postwar international economic institutions. See also Martin (1992, 783–89).
institutions interact in bringing about institutional change and institutional creation. I discuss such a framework next.

Power, institutional change, and institutional creation

The issue of how power and institutions interact in shaping institutional change and institutional creation has received the most sustained attention from historical institutionalists. In the following discussion, I draw on insights from recent work with roots in institutionalism more generally and in historical institutionalism more specifically. For my purposes, the distinction made in this literature between change as the result of external shocks and gradual change is particularly important. This is because many instances of institutional change and creation do not have a revolutionary character. Change is often incremental, continuous, and evolutionary, an observation that has led historical institutionalists in particular to try to find better ways to analyze gradual change (Thelen 2004; Mahoney and Thelen 2010, 3; Hall 2010, 5).

It is customary to distinguish between different forms of institutionalism. While the labels have varied somewhat, recent literature distinguishes among Rational choice institutionalism, Sociological institutionalism, and Historical institutionalism (Fioretos 2011; Hall and Taylor 1996).¹⁰ For my purposes, it is enough to note that, whereas their approaches to institutions differ, all three frameworks have traditionally adopted a punctuated equilibrium model (Conran

¹⁰ Immergut (1998) distinguishes among Rational choice, Organization theory, and Historical institutionalism, but some variations of organization theory bear a strong family resemblance to Sociological institutionalism (see, in particular, p. 15).
and Thelen 2016, 54).\textsuperscript{11} Still, it seems fair to say that this argument has been most fully developed by historical institutionalists.

In punctuated equilibrium models, long periods of institutional stasis are interrupted by exogenous shocks and crises such as economic depressions and war, so-called critical junctures. During these junctures old institutions are discredited and policymakers cast about for new institutional arrangements.\textsuperscript{12} These arrangements remain stable until the next revolutionary transformation. Change is discontinuous, swift, and deep (Krasner 1988; Campbell 2004; Hall 2010; Conran and Thelen 2016).\textsuperscript{13}

Change is difficult and, if and when it occurs, revolutionary because institutions are typically associated with large start-up or fixed costs, which generate increasing returns and lock-in (Pierson 2004, 26; Campbell 2004, 67). This means that the creation of institutions is subject to “an irreversible branching process” in which each move along a particular institutional path increases the cost of switching to a different path or branch (Pierson 2004, 21). The irony, however, is that the more one emphasizes the importance of path dependence and lock-in, the more difficult it is to explain institutional change. Institutional stability, not institutional change, becomes the expected outcome (Campbell 2004, 68; Mahoney and Thelen 2010). This is a major reason why some more recent work within this framework has tried to move beyond the

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\textsuperscript{11} Conran and Thelen (2016, 54) refer to punctuated equilibrium as “the default theory of change” in all forms of institutionalism.

\textsuperscript{12} James Mahoney notes that critical junctures are “moments of relative structural indeterminism” where actors make choices that “demonstrate the power of agency” (Mahoney 2002, 8). Descriptions of such moments tend to be non-institutionalist (Conran and Thelen 2016, 56), although they need not be (see Capoccia 2016, esp. 93; Conran and Thelen 2016, 60).

\textsuperscript{13} Alternatively, the pattern of change can be described as punctuated evolution, combining incremental change with crises that eventuate in institutional transformation (Campbell 2004, 34).
punctuated equilibrium model’s focus on revolutionary change and paid more attention to gradual or evolutionary change (Campbell 2004, 5, 11, 33–34, 68; Hall 2010, 5; Conran and Thelen 2016, 55). While significant advances, I argue next, these works, with one important exception, generally focus on changes within existing institutions and do not pay enough attention to institutional creation within an evolutionary framework. Although this may be sufficient for some types of analysis, to better understand the implications of the rise of China for the current international economic order, we need a framework that accommodates both institutional change and creation, and that conceives of institutional creation outside a punctuated equilibrium framework.

_Institutional change and creation_

I begin the discussion with a consideration of G. John Ikenberry’s path-breaking work on international orders.¹⁴ Ikenberry adopts a punctuated equilibrium framework, arguing that “[w]orld politics can be seen as a sequence of historical cycles or eras punctuated by great power wars” (Ikenberry 2016, 540). And, “short of another major war or a global economic collapse, it is very difficult to create the type of historical breakpoint needed to replace the existing order” (Ikenberry 2001, 71; see also Ikenberry 2011, 331).¹⁵ During these critical junctures, 

¹⁴ Order is defined as the “‘governing’ arrangements among a group of states, including its fundamental rules, principles, and institutions.” The “focus [is] on the explicit principles, rules, and institutions that define the core relationships between the states that are party to the order” (Ikenberry 2001, 23).
¹⁵ Ikenberry (2001, 71–72n57) does allow that a “particular set of postwar institutions might in fact be adaptable—capable of internal change and reform—and this will increase the cost advantage of the existing institutions in the face of potential rivals.
the old order is destroyed to such an extent that the “slate has been more or less wiped clean” (Ikenberry 2016, 541).

Ikenberry argues that the current international order created by the United States and its allies after World War II has strong constitutional characteristics “in which the power capabilities of the relevant state are highly constrained by interlocking institutions and binding agreements” (Ikenberry 2001, 35–37, 210). Through institutional binding and self-restraint, the United States and other powers have made political-military and economic commitments on which they will find it difficult to renege. Most important, institutional binding restrains the leading power, the United States, and therefore serves to assuage the worries weaker states might have about the arbitrary exercise of American power (Ikenberry 2001, chap. 2).

Ikenberry (2014, 89) maintains that while China is trying to increase its influence within this order, it is not trying to replace it. The constitutional characteristics of the current order mean that the incentives to try to replace it are just not there. And even if such incentives did exist, creating a new international order is simply not possible in the absence of hegemonic war, an increasingly unlikely event especially in light of the nuclear revolution (Ikenberry 2011, 344–46; Ikenberry 2008, 90–91, 110). These considerations lead Ikenberry to conclude that China is likely to integrate into an “expanded and reorganized liberal international order” (Ikenberry 2011, 344). Although the current order is suffering from a “crisis of authority,” the solution is “more—not less—liberal international order” (Ikenberry 2011, 336). The crisis is a “crisis of gov-

\[\text{16} \text{ For an argument that China (in a coalition of sorts with Russia and Iran) is a revisionist power that has so far been frustrated, see Mead (2014, esp. 74).}\]
ernance” but “not a crisis in the deep principles of the order itself” (Ikenberry 2011, 6). The future of a liberal international order depends on China’s support, which in turn will be greatly influenced by the willingness of the United States and other liberal democracies to “reform and renew existing rules and institutions” (Ikenberry 2011, 344). Presumably they will be willing to do so given Ikenberry’s prediction that “As China grows, it will gradually gain greater political voice within these status quo organizations [that is, the IMF and the World Bank]” (Ikenberry 2008, 107).

So far, however, the United States’ willingness has not been much in evidence. Moreover, while Ikenberry might be right that China prefers reforms of the current international order, some of China’s actions, particularly the creation of the AIIB (see below), shows that China is ready to create parallel institutions that better reflect its values if faced with U.S recalcitrance on institutional reform. In sum, while Ikenberry’s argument accommodates revolutionary changes well, besides calling for reform of the current order, in the end he has little to say about more gradual types of change or changes that occur in situations not characterized by deep crisis.

The intent of Jupille, Mattli, and Snidal’s (2013) USCC framework\(^{17}\) is to allow for more gradual types of institutional change. Nevertheless, institutional creation is rare and is typically a response to “systemic breakdown or in the face of a major crisis.” Thus, with respect to institutional creation, the USCC framework remains wedded to a traditional punctuated equilibrium framework. Although explicitly allowing for institutional change, institutional creation is still, as

\(^{17}\) USCC is short for Use, Selection, Change, and Creation. Of these institutional strategies, states will choose creation only when the other three strategies fail (Jupille et al. 2013, 15).
in Ikenberry, the result of systemic breakdown and crisis. Moreover, the USCC framework does not explicitly incorporate power; it does no more than “implicate ... distributional considerations, power and capabilities” (Jupille et al. 2013, 10).

Zangl et al.’s (2016, 174–76, 190) recent work developing an Institutional Power Shift Theory that links shifting power distributions to gradual institutional adaptations is another important advance. Such adaptations are expected, they argue, if emerging powers are able to undermine existing institutions and if their threats to do so are credible. This framework does not, however, seem to explain the creation of the AIIB, a situation in which ability and credibility are both present without producing any significant changes in how institutions such as the World Bank and the Asian Development Bank (ADB) operate (see below). Their framework is also designed to explain institutional adaptation in existing institutions, not institutional creation.

The same is true of Kaya’s adjusted power approach. Institutional change is incremental because of path dependence, which makes it costly to create new institutions, and because “institutionally dominant” states will seek to preserve the status quo (Kaya 2015, 39–40). Her framework “focuse[s] on the institutionally dominant states’ preferences,” arguing “that the expression of [the rising states’] preferences, to a great extent, remains contingent upon the room for maneuver the declining states provide” (Kaya 2015, 226). In short, institutions will mediate or adjust shifts in the distribution of economic power, thus limiting the extent to which the preferences of rising powers are accommodated within existing institutions. If we assume, as she does, that institutionally dominant states would prefer the status quo, her focus tend to ignore

18 Zangl et al. (2016, 174) argue that Jupille et al.’s theory links change to institutional efficiencies and not to shifts in the distribution of power (Zangl et al. 2016, 174).
strategies such as regime shifting (Helfer 2009) and regime creation available to rising states such as China. This limits the utility of her framework for my purposes.

The focus in Jupille et al. (2013), Zangl et al. (2016), and Kaya (2015) on gradual institutional change represents an important advance. For my purposes, however, these arguments remain too focused on change within existing institutions, leading them to ignore the importance of institutional creation. Because their framework allows one to try to accommodate both institutional change and creation, work by Thelen (2004), Mahoney and Thelen offer perhaps the most interesting and, for my purposes, the most useful attempt to analyze gradual change. They view institutions as “distributional instruments laden with power implications” (2010, 8; emphasis in the original). Because rules affect resource allocation, institutions have distributional consequences; they instantiate power (Thelen 2004; Mahoney and Thelen 2010, 8; Conran and Thelen 2016, 57, 61). The role of power in creating institutions is obvious. The more powerful have a greater ability to design rules that reflect their interests. Shifts in the balance of power, whether domestically or internationally, should therefore be an important cause of institutional change (Mahoney and Thelen 2010, 9). These shifts can be “either exogenous or they can be endogenously generated through feedback effects” (Mahoney and Thelen 2010, 10). Mahoney and Thelen abandon the view that institutions are self-reinforcing and emphasize instead the ambiguity of rules. As context and circumstances change, the application of rules is open to reinterpretations that may entirely escape the intentions of the people responsible for

\[19\] Thelen’s version of historical institutionalism abandons the traditional focus on critical junctures and focuses on how institutions change and evolve over time as a result of “ongoing political negotiation” and shifting coalitions (2004, 33, 35).
designing the rules. Because rules affect the allocation of resources, actors contest their meaning, application, and enforcement. Compliance is not a given and instead becomes a variable that can change over time (Mahoney and Thelen 2010, 10–11, 20; Conran and Thelen 2016, 64–65). The ambiguity of rules opens up possibilities for change, whereas the distributional implications of institutions motivate actors to exploit such possibilities (Mahoney and Thelen 2010, 14). This approach allows Mahoney and Thelen to conceive of institutional change and creation without invoking systemic breakdowns and crises.

Clearly, the focus on the ambiguity of rules allows for a much greater role for creativity and agency (Mahoney and Thelen 2010, 12). Institutions are more than just constraints on behavior; they are also strategic resources that enable particular kinds of action (Hall 2010, 217; Jupille et al. 2013, 4). In a similar vein, Campbell notes that although creativity is constrained by existing institutional arrangements, actors can create new institutions by “recombining and extending institutional principles and practices at their disposal” (2004, 72). In other words, institutions both structure behavior and can be transformed by behavior.20

In seeking to change institutions, states have several strategies at their disposal, which Mahoney and Thelen label displacement, layering, drift, and conversion.21 Displacement refers to a situation in which new institutions are introduced that “directly compete with (rather than supplement) an older set of institutions” (Mahoney and Thelen 2010, 16). It is likely to occur in situations where veto possibilities are weak, that is incumbent actors do not have the power to

20 Creativity is also limited by lack of information and by cognitive constraints on the ability of individuals to collect and process information, as emphasized in Jupille et al.’s (2013) USCC framework. Sociological institutionalists put cognitive limitations at the heart of their explanations (Conran and Thelen 2016, 60).
21 The following account relies on Mahoney and Thelen (2010, esp. 15–20).
block institutional changes, and where the opportunities for exercising discretion in the interpretation and enactment of rules are few. Layering is a type of institutional change which “grows out of the attachment of new institutions or rules onto or alongside existing ones” (Mahoney and Thelen 2010, 20). It similarly occurs when discretion is at a low level, but here, in contrast, veto possibilities are extensive. Drift is associated with situations where institutions are stable but the environment shifts in ways that influence how they function. Finally, conversion occurs when the rules remain stable but are interpreted and enacted in novel ways. Both drift and conversion are associated with a high level of discretion in interpretation and enforcement. The difference is that instances of drift are associated with strong veto possibilities, conversion with weak.

In short, because institutions have distributional consequences, actors are motivated to change them. Their ability to do so will be in part a function of relative power. Shifts in power will therefore increase the likelihood that institutions will change. In their efforts to change institutions, states can pursue strategies of institutional change that lead to displacement, layering, drift, and conversion. I next apply this framework to an analysis of two instances of institutional change and/or creation, as displayed in the changes taking place in the IMF and the creation of the AIIB. The emergence of the G20 forum influenced in various ways how the IMF operates and is an example of drift. The creation of the AIIB is an example of displacement, the creation of an institution that directly competes with institutions such as the Asian Development Bank and the World Bank. I discuss the relationship between the IMF and the G20 first.
Institutional drift: China, the G20 and the IMF

Like many other states, particularly in the developing world, China wants an IMF that serves as a forum for the discussion of ideas on economic development and financial regulation. Above all, they want an IMF that is less meddlesome and that allows countries to pursue policies tailored to their unique situations (Ferdinand and Wang 2013, 905). Moreover, whereas China’s commitment to the IMF is probably genuine, at least for now, this commitment has gone hand in hand with various Chinese attempts to increase China’s influence in the IMF and to reform the way the organization operates (see below). The 2008–09 economic crisis and the consequent need to adopt and coordinate stimulus policies and supplement the IMF’s inadequate coffers presented the emerging economies with a golden opportunity to increase their influence in the IMF (Momani 2013, 144–45).

In response to the crisis, the George W. Bush administration revived the G20 forum originally created in response to the economic crises in East Asia, Brazil, and Russia in the late 1990s. While it originally had been a deliberation group made up of finance ministers and central bankers, after the 2008 crisis the group would consist of heads of government. During the crises of the late 1990s, the G7 countries had realized that an adequate handling of these crises required bringing more countries into the deliberations. The new members were selected by the United States and Canada, and approved by the other members. There are no explicit criteria for membership, but the nineteen members plus the European Union are all relatively large.

22 Besides China, the biggest contributor of new capital, India, South Korea, and Brazil also contributed significant capital (Momani 2013, 148).
countries in terms of population and size of GDP. The G20 includes eleven members from the developing world, increasing the relative importance of this grouping. The Managing Director of the IMF and the president of the World Bank are represented at the G20 meetings in an ex officio capacity (Wade 2011, 354).

The communiqué from the third summit, held in in Pittsburgh in September 2009, announced that “We designated the G20 to be the premier forum for our international economic co-operation” (quoted in Wade 2011, 355). Besides superseding the G7, the revival of the G20 in the wake of the 2008–09 financial crisis in some ways also represented an end run around the IMF (and the World Bank). The G20 now assumed the role previously played by IMF (and the World Bank) as the premier forum for international economic cooperation. Indicative of this change, the call for modifications in IMF quota and voting shares was issued not by the IMF’s International Monetary and Financial Committee (IMFC), but by the G20 summit (Wade 2011, 356; Kaya 2015, 194).

The commitment to governance reform manifested itself in several different ways. In 2008, the members agreed to use a single formula to determine their respective quota votes. In addition, the number of basic votes was tripled and fixed at roughly 5 percent of the total number of votes. In 2010, an agreement was reached to double the IMF’s quota (Kaya 2015 118–19; 124, 142). Perhaps more important, the IMF’s governing body agreed in October 2009 to a change in quota shares. China’s quota share was set to increase from 3.99% to 6.39% and its voting power from 3.81% to 6.07%. With these realignments, China became the third largest

23 This counts both Russia and South Korea as developing countries.
shareholder in the IMF, after the United States and Japan. India, Russia, and Brazil joined the top ten shareholders. The increase in China’s and other emerging powers’ voting shares came largely at the expense of European powers, which also had to give up two seats on the Executive Board. Although the United States saw slight reductions in its shares as well, it retained its veto power. In all, these reforms were relatively moderate as emerging economies would still have less than fifty per cent of the votes and capital in the IMF (“Neither Leading nor Ceding” 2015; IMF 2011; Wade 2011, 364).24 While the need to strengthen the IMF’s credibility and to dissuade emerging economies from using their foreign exchange reserves to establish alternatives to the IMF gave impetus to the reforms, the United and the European countries also regarded the reforms as a way to improve IMF surveillance of emerging economies as well as increasing the latter’s financial commitments to the IMF (Kaya 2015, 120, 134–37).

The U.S. Congress, which had to sign off on the deal, dragged its feet for five years, however. Congress eventually relented, having achieved a commitment from the Administration to repeal the “systemic risk exemption” put in place in 2010, which allowed the Fund to bail out countries with unsustainable debts. Moreover, according to then Treasury Secretary Jacob J. Lew, two factors “crystallized” the argument that American credibility and leadership was indeed at stake, namely the need to secure aid for Ukraine and the prospects that China’s AIIB would fill the leadership vacuum created by Congressional obstreperousness on the IMF (Calmes 2016; He 2014b, 15).

24 Emerging market economies had pushed for a transfer of seven percent of voting rights from developed to developing economies, which would have given developing economies 50 percent of the voting rights. They eventually settled for five percent (Momani 2015, 271–72).
Despite the changes in quota and voting shares, neither the economic crises of the late 1990s nor the 2008–09 crisis led to fundamental reforms of the IMF. Although the 2008–09 crisis plays a role in explaining the timing of the changes in shares, “existing institutional routines” within the IMF remained unchanged (Kaya 2015, 121). While the United States and the European countries agreed to reallocate quota and voting shares, the United States retained its veto and thus ultimate control of the IMF.

Because the United States still retains its veto, China’s ability to change the way the IMF operates is limited even with Congress’s approval of the changes to quota and voting shares. China has nevertheless continued to push for various reforms, as I discuss next. The most noteworthy aspect of this attempt has been China’s ability to utilize the G20 to develop stronger relations with the other so-called BRICS countries (Brazil, Russia, India, and South Africa) and to employ it as a platform from which to push for reform of the IMF. As I show below, the use of the G20 for this purpose is a prime example of what historical institutionalists term drift, a type of institutional change characteristic of environments with strong veto players (cf. the U.S. veto in the IMF) and a high level of discretion in how rules are interpreted and enforced, that is, in how the G20 and the IMF functions. Thelen and Mahoney note that drift “do[es] not require making any direct changes to the old institutions and do not rely on altering the rules themselves or actively shifting their enactment” (2010, 19).

*China’s push for IMF reforms*

Besides criticizing the increasingly anachronistic and unrepresentative allocation of IMF quotas and voting shares, China and other emerging economies maintain that the legitimacy of the IMF was undermined by its mismanagement of the 1997 Asian financial crisis. What particularly
stuck in their craw was the IMF policy of conditionality, which inter alia linked loans to deep
cuts in public spending and to contractionary monetary policies. The perception in these econo-
mies was that the bailouts were mainly designed to protect Western creditors at the expense of
emerging economies. The IMF faced a legitimacy crisis as a result. To reduce their need for IMF
funds in the future, the emerging economies built up their foreign exchange reserves, drasti-
cally reducing their reliance on the IMF. This threatened to make the IMF irrelevant (Kaya 2015,
122–23; Momani 2015, 269–70; Ferdinand and Wang 2013, 905).  

China has also objected to the way the IMF’s managing director is selected. Instead of the
customary selection of a European to this post, Governor of the People’s Bank of China Zhou
Xiaochuan declared in 2011 that “the make-up of top [IMF] management should better reflect
changes in the global economic structure and better represent emerging markets” (quoted in
Momani 2015, 273). The Chinese Communist Party’s official newspaper, the People’s Daily, was
more direct, arguing in vain that the post should be given to a Chinese national (Momani 2015,
273). In the end, China ended up supporting France’s Christine Lagarde over a Mexican candi-
date, perhaps in return for the creation of a third deputy managing director position. Zhu Min,
deputy governor of the People’s Bank of China, was appointed to this position in July 2011, the
highest position ever held by a Chinese official in the IMF (Helleiner and Momani 2014, 67;

China has also sought to reform IMF surveillance, arguing that it has tended to focus too
much of its surveillance on developing and emerging markets while largely ignoring developed

25 China’s strategy of trying to increase the influence of other developing countries in IMF decision mak-
ing has also been followed in the World Bank (Helleiner and Momani 2014, 67; Momani 2013, 143–44).
countries. This makes little sense, Chinese officials contend, because the economic policies of developed countries, in particular the United States, pose a much greater risk to the health of the global economy (Momani 2015, 275). As Zhou Xiaochuan put it at a meeting of the International Monetary and Financial Committee of the IMF’s Board of Governors in April 2010, “[a]t present, the primary risks to the global economy come from developed countries. ... In recent years, the focus of Fund surveillance has been inappropriate” (quoted in Olson and Prestowitz 2011, 28).

In March 2009, Zhou Xiaochuan seized on concerns about dollar liquidity to argue for reforms of the international monetary system. Specifically, he contended that an alternative to the dollar as an international reserve currency was needed, and that the IMF’s Special Drawing Rights (SDR) could be that alternative, an idea the Chinese had pushed on several occasions in the past (Momani 2015, 282–83). A greater role for the SDR in the international monetary system would strengthen the IMF’s role in managing the international monetary system. Having raised the issue, Chinese officials in the Ministry of Foreign Affairs immediately pulled back, however, noting that replacing the dollar with SDRs or other currencies was an “academic” discussion and “not the position of the Chinese government” (He 2014b, 10).

The proposal to expand the role of the SDR as a reserve currency was subsequently linked to the issue of whether to include the renminbi in the SDR basket of currencies, which would contribute to internationalizing the renminbi and make it, at some future point, a reserve currency (Olson and Prestowitz 2011, 32; Momani 2015, 284). President Obama and President Hu agreed

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26 SDR is a unit of account created by the IMF in the late 1960s.
in 2011 that “the United States supports China’s efforts over time to promote inclusion of the RMB in the SDR basket” (quoted in He 2014b, 12).

Eventually, in October 2016, the IMF announced that yuan would join the dollar, the euro, the pound, and the yen in the basket of currencies making up the SDR. The decision did not reflect current economic conditions so much as current political and future economic conditions. While China meets the requirement that the issuing country be a major exporter, its currency does not meet the second criterion of being “freely usable,” that is used widely in international transactions and traded in global currency markets, or, in more technical terms, of currency convertibility on the capital account (“The Yuan Joins an Elite Currency Club” 2016; He 2014b, 12; Kaya 2015, 232). Although this decision met one of their objectives, the Chinese are nevertheless proceeding cautiously, putting the need to control inflation ahead of the internationalization of the renminbi (Momani 2015, 284).

While China is clearly dissatisfied with how the IMF operates, it seems uncertain about how far to push for reform. It argued in favor of changing how the IMF’s managing director is selected yet ended up supporting the traditional European candidate; it sought alternatives to the dollar, yet it remains unwilling to liberalize its own currency; and it pointed to the systemic risks posed by the economic policies of the developed countries yet refused to acknowledge that its trade policies may also pose risks (Momani 2015, 287–88). Jiang maintains that China’s “participation in monetary multilateralism is largely symbolic” because it seeks to protect its sovereignty. It does not support IMF conditionality for loans, it is very protective of its rights to pursue an exchange rate policy that reflects domestic rather than international economic considerations, and it generally seeks to avoid subjecting its economic
policies to international examination (2014, 175). In monetary diplomacy, China prefers bilateral to multilateral approaches because bilateralism gives the Communist Party the flexibility it needs to avoid domestic reforms that might create financial instability (Jiang 2014, 158–59, 165–66).

Nevertheless, China has pushed for reforms of the IMF, a multilateral institution. While the reforms it has sought have been designed to increase Chinese influence in the IMF, many of the changes it has advocated are probably inevitable and necessary if the IMF is to survive as an institution in an international economy no longer dominated by the United States and other developed countries. China’s efforts in this regard is better interpreted as a multilateral strategy designed to strengthen the IMF and, above all, China’s influence within it (He 2014b, 9).

**China and the G20**

The difficulty in reforming the IMF makes alternative institutional arrangements more attractive. Thus, China has pursued several institutional initiatives designed to increase its wiggle room vis-à-vis the IMF and, perhaps more important, its global influence (Ferdinand and Wang 2013, 906–10). Given its role as the principal forum for international economic cooperation, and given that it “is one of the most important reforms to global economic governance in recent history” (Kaya 2015, 194; Eichengreen 2009), I focus here on the G20.

China has used the G20 to forge stronger relations with other so-called BRICS states (Brazil, Russia, India, China, and South Africa), and has seen itself as providing a bridge between developing and developed countries in this forum (He 2014b, 11). More generally, China has utilized
the G20 to try to prod the developed countries into accepting reform of the international financial institutions and create an international financial system in which developing countries have greater influence (He 2014b, 15). This strategy makes sense given that, according to the IMF,

The IMF works closely with the G20, particularly on issues related to global economic growth and international monetary and financial stability. The IMF’s work often provides a platform for G20 deliberations, and vice versa, agreements reached at the G20 level are taken into consideration in the IMF’s decision making process, even though such agreements have no legal status or binding effects at the IMF. (IMF 2016, 4)

Thus, even though the G20 agreements are not binding, the G20 offers the potential to influence how the IMF operates. The G20 is an “informal grouping” or “club” (Wade 2011, 354), which delegates to formal international economic institutions such as the IMF and the World Bank particular tasks related to international economic governance (Kaya 2015, 196, 206, 210). It typically meets annually, with the host country, which rotates every year, providing both the chair of the meeting and the staff needed to run it. This gives the host country an opportunity to set the agenda and the topics of discussion. “What the G20 says and does,” Wade argues, “depends heavily on the chair, or on the ability of others to manipulate and incentivize the chair” (Wade 2011, 354; Kaya 2015, 199). Thus, there is significant discretion in how the annual meetings are run and what is on their agenda. On the whole, the annual rotation of the chairmanship, an emphasis on consensus building (reflecting formal equality), and the various working groups, in which both developed and emerging economies are represented, make for decision-making in which, in the G20’s own words, “members interact as equals” (quoted in

27 For a more detailed description of the institutional design of the G20, see Kaya (2015, esp. 197ff).
As Kaya notes, the relatively low “sovereignty costs” associated with membership in the G20 made it attractive to the G7 countries (Kaya 2015, chap. 7). It is not surprising, therefore, that there is substantial discretion in the extent to which the various agreements emanating from the annual meetings influence the IMF. The creation of the G20 thus increases the ambiguity of IMF rules and introduces, as we shall see, greater discretion in both the interpretation and the enforcement of IMF rules.

Following the schema laid out in Mahoney and Thelen (2010, 19), the combination of strong veto possibilities (cf. the United States’s role as a veto player) and a high level of discretion in the interpretation or enactment of rules (the G20) is associated with drift, a strategy of institutional change adapted to situations in which “formal rules are stable but the environment shifts in ways that alter their operation” (Conran and Thelen 2016, 63). It is a strategy well suited to a situation which “do not require making any direct changes to the old institution and do not rely on altering the rules themselves or actively shifting their enactment” (Mahoney and Thelen 2010, 19). As an example of how the creation of the G20 introduces ambiguities in the way the IMF operates, the G20 is encroaching on the IMFC’s ability to determine policies and strategies. Moreover, whereas the IMFC has 24 members, representing various groups of countries, the G20 of course has 20 members, representing therefore somewhat different groups (Eichengreen 2009).

One should perhaps not exaggerate the amount of drift in the IMF. At least in the early years, host countries would often consult with the United States prior to deciding on the agenda for the annual meeting and on the content of the communiqué (which is prepared be-
fore the meeting) (Wade 2011, 357). Nevertheless, developing countries have been able to issue informal vetoes, as in China’s insistence at the G20 that the IMF pay attention to “global imbalances” (that is, the imbalances of both developed and developing countries) (He 2014a).

Moreover, quota reform in the IMF was influenced by the work of one of the working groups in the G20, and it was put on the G20 agenda during China’s chairmanship of the G20 in 2005. The inclusion of economic development issues on the agenda likewise happened because of support from emerging economies despite opposition from the developed countries (Kaya 2015, 199, 201–03).

China has also used the G20 to resist IMF attempts to influence its exchange rate policy (Wade 2011, 358). China argues that countries should be allowed to set exchange rates in accordance with the needs of their domestic economies as long as this does not threaten global financial instability. The IMF’s Article IV does, however, prohibit members from manipulating exchange rates to achieve an unfair trade advantage, a fact American commentators and policymakers have used to chastise the IMF for not doing more to get China to liberalize its exchange rate policies. In their view, China’s exchange rate policy amounts to a blatant violation of the rules. Zoellick’s call for China to be a “responsible stakeholder” reflected this concern (Momani 2015, 276–78). Attempts by the IMF to strengthen its surveillance of China’s exchange rate policies have met with determined Chinese opposition to what it regards as efforts to undermine its sovereignty. China’s position is that exchange rate decisions are a domestic matter and do not negatively affect the international economy (Momani 2015, 279–80).

After the 2008 financial crisis, much of the struggle over China’s exchange rate policy has taken place at several G20 summits, particularly the Toronto and Seoul summits, both held in
2010. Anticipating that it would face pressure to appreciate the RMB, China announced just before the June Toronto summit that it would do just that. By doing so, China hoped to blunt the criticism it would face at the summit. Because the following months saw negligible appreciation of the RMB, however, Chinese policymakers faced renewed pressure. Trying again, policymakers this time did manage to engineer a 2.5 percent appreciation of the RMB vis-à-vis the dollar, successfully deflecting additional pressure at the November Seoul summit. The final summit communiqué simply pledged the members to “mov[e] toward more market-determined exchange rate systems, enhancing exchange rate flexibility to reflect underlying economic fundamentals” (quoted in He 2014a, 4).28 This was vague enough to allow China to pursue an exchange rate policy tailored to its domestic needs and not to the wishes of the United States (He 2014a, 4, 6).

More generally, China’s ability to evade pressure reflects the informal nature of the G20, which means that commitments lack specificity, allowing states to retain much of their sovereignty (Kaya 2015, 210–11). The ambiguities introduced by making an informal club like the G20 become “the premier forum” have chipped away at the role played by the IMF and Article IV in disciplining Chinese foreign exchange policies. Were China to face pressure from the IMF to adhere to Article IV, it could simply deflect this by pointing to its commitment at Seoul to move toward a more market-based exchange-rate system.

28 China renewed its pledge to move toward a market-determined exchange rate system at the 2011 Cannes G20 Summit (He 2014a, 5–6).
Whereas Article IV and the other formal rules embodied in the IMF agreement have remained stable, the environment in which the IMF finds itself has significantly changed, in particular because of the creation of the G20 (cf. Conran and Thelen 2016, 63). The G20 has been a forum in which China and other emerging economies have successfully pushed for changes in IMF quotas, put development issues and global imbalances on the international economic agenda, and, in China’s case, successfully evade IMF surveillance. The creation of the G20, with its ability to affect how the IMF operates, reflected the fact that international economic power had shifted in favor of the emerging economies, particularly China. Although the United States retained its veto in the IMF, the G20 introduced, very likely as an unintended consequence, a higher level of discretion in the interpretation and enactment of IMF rules, that is, it contributed to institutional drift. In other words, how the shift in power manifested itself was filtered through the institutional setting of the IMF and the G20.

Institutional displacement: The creation of the Asian Infrastructure Investment Bank

Whereas the strategy of drift relies on exploiting ambiguities in existing institutional rules, displacement is “present when existing rules are replaced by new ones” (Mahoney and Thelen 2010, 16). In this situation, the political context is one in which veto possibilities are weak and the interpretation and enforcement of the rules of the old institution remain stable. The replacement can be sudden or take place gradually over time. While sudden replacement is typical of revolutionary institutional change, displacement can also be a slow, gradual process in which “new institutions are introduced and directly compete with (rather than supplement) an
older set of institutions.” The more difficult it is for the defenders of the old institutions to prevent defections to the new rules, the likelier gradual displacement is (Mahoney and Thelen 2010, 16).

The creation of the AIIB is an example of a slow-moving process of displacement of the World Bank and the ADB in which China is exploiting its newfound economic power, in this case its considerable foreign exchange reserves, to introduce new rules to govern the disbursement of funds for economic development. I show in this section that, while the United States urged its allies not to sign on to the new bank and thus accept its new rules, it was in the end unable to prevent them from doing so. While the United States has managed to retain its veto within the World Bank, it could not prevent the creation of a parallel institution to the World Bank and with it a new set of rules governing the funding of economic development projects. The lack of discretion in how existing funding rules were interpreted and enforced by the World Bank and the ADB served as an incentive for China to strike out on its own and thus promote a new set of rules more in keeping with Chinese preferences.

Chinese President Xi Jinping proposed a multilateral AIIB at the Asia-Pacific Economic Cooperation Summit held in October 2013. It began operations in January 2016. The AIIB was originally intended to provide financial support for China’s “One Belt, One Road” (OBOR) initiative, which is designed to promote economic ties between China and a number of other countries. As European and other advanced economies joined the Bank, however, Chinese officials have

29 The Bank can also be considered part of a broader effort to increase China’s soft power, an indicator of power in which China likely lags far behind the United States (Shambaugh 2015).
deemphasized the AIIB’s links to the OBOR initiative, saying that the bank would support other projects besides those linked to the initiative (Weiss 2017, 2, 6). Together with the New Development Bank, the Free-Trade Area of the Asia-Pacific,\(^3\) and a number of regional organizations China has established in Asia, Africa, and the Middle East, the AIIB is part of a Chinese attempt to fashion a parallel international financial order (Shambaugh 2015, 100; Heilmann et al. 2014). These institutions are rooted at least in part in China’s dissatisfaction with the failure of its attempts to reform the governance structure of the International Monetary Fund and the World Bank (Anderlini 2014; Peng and Tok 2016). According to one individual with first-hand knowledge of the discussions to set up the AIIB, “China feels it can’t get anything done in the World Bank or the IMF so it wants to set up its own World Bank that it can control itself” (Anderlini 2014). As in the case of the IMF, the United States agreed to increase the voting shares of emerging economies in the World Bank at the expense of European members. But again, the changes in shares were minor, and the United States retained both its voting share and veto power. China was also unsuccessful in its attempts to increase its share of voting rights in the ADB, a bank China feels is too dominated by Japan (Anderlini 2014; “Neither Leading nor Ceding” 2015; Etzioni 2015; Peng and Tok 2016; “China’s Calls for Reform at the World Bank, IMF and ADB Cannot Be Ignored Any Longer” 2016).\(^3\)

\(^3\) Originally proposed by India, the New Development Bank or BRICS Bank was established by Brazil, Russia, India, China, and South Africa in 2014. Negotiations for the Free-Trade Area of the Asia-Pacific are ongoing.

\(^3\) Japan is the largest shareholder in the ADB with 15.7%, closely followed by the United States with 15.6%. The president of the ADB has always been Japanese. In comparison, China has a 5.5% share despite having a GDP that by now is four times larger than Japan’s (see table 1 above) (Anderlini 2014).
As its name implies, the bank will promote economic development by funding the construction of new infrastructure in Asia. The need for such investment in Asia is vast; the ADB estimates it to be on the order of $8 trillion between 2010 and 2020. Meeting this demand is beyond the financial capacity of the current international financial institutions such as the World Bank and the ADB (“The Infrastructure Gap” 2015; Watt et al. 2015; Kahn and Albert 2015; Etzioni 2016, 178–81).

The AIIB’s headquarters will be in Beijing, and it will have an initial capital base of $100 billion, of which 20 percent is paid-in and the rest is callable. In comparison, the ADB has a capital base of $165 billion, the World Bank $223 billion (Chin 2016, 18; Weiss 2017). By December 31, 2015, fifty-seven countries had signed the Articles of Agreement. Sixteen of the world’s twenty largest economies are members, the exceptions being the United States, Japan, Mexico, and Canada. In Western Europe, only Belgium and Ireland have not joined (Tiezzi 2015).

Members are divided into two groups, regional and non-regional. Regional members are located in Asia and Oceania. The influence of non-regional countries is limited, as China has made it clear that these countries can hold no more than twenty-five percent of the AIIB’s shares (Tiezzi 2015; Weiss 2017, 7). China’s subscription is $29.78 billion, giving it by far the largest share. India’s share of 8.37 billion is relatively modest but it nevertheless makes it the second largest shareholder, followed by Russia ($6.57 billion), and Germany ($4.48 billion) (AIIB 2015, 32).

32 Although originally holding out, Canada applied for membership in August 2016 (AIIB 2016). Whereas Canada argues that being part of the Bank makes it easier to ensure that it abides by international standards, Japan’s position is that it will not consider joining until the AIIB proves that it accepts these standards (Weiss 2017, 8).

33 Weiss (2017, 9) notes that the gap in voting shares between the largest shareholder, China, and the second largest shareholder, India, is far larger than at any other multilateral development bank.
China will have 28.79 percent of the votes, enough to give it veto power in decisions involving structure, membership, capital increases, and other important matters, that is, in decisions which require a super majority of at least 75 percent of the votes. Beijing will, however, not have veto power in day-to-day operations, a nod to those founding members concerned about its influence over the bank (Magnier 2015; Chin 2016; Peng and Tok 2016). One should perhaps not exaggerate the importance of these rules as the bank will only be a success if it is effective in meeting its objective of promoting economic development in Asia (Chin 2016, 20). Moreover, using the veto might very well undermine other countries’ commitment to making the bank work and will therefore probably not be in China’s interest (Chin 2016, 13).

Former U.S. ambassador to and member of the ADB’s board of directors, Curtis S. Chin, however, points out that “Money matters, and the shareholders that contribute the most have the most influence, regardless of explicit veto power.” The ADB board, he says, “almost always approves what is placed before it.” The ADB is led by Japan, which “maintains significant control over the ADB agenda despite having only about 16% of the bank’s shares” (Chin 2015). Chin’s experience is underscored by Stone (2011, esp. 21, 31–34) who argues that the structural power of the leading state—that is the outside options available to it and the benefits other states derive from its participation—implies that the behavior of the leading state cannot be completely circumscribed by the explicit rules of an institution. When core interests are threatened, a leading state such as China in the AIIB, will refuse to be constrained by explicit rules and
use its informal influence to intervene in the decision-making process and achieve its objectives.\(^{34}\)

It thus may not be surprising that the United States opposed the AIIB from the outset, seeing it as an attempt by China to extend its soft power in Asia (Watt et al. 2015). To justify U.S. opposition, the U.S. National Security Council argued in a statement to the Guardian newspaper that

> We believe any new multilateral institution should incorporate the high standards of the World Bank and the regional development banks. ... Based on many discussions, we have concerns about whether the AIIB will meet these high standards, particularly related to governance, and environmental and social safeguards .... (Quoted in Watt et al. 2015)

U.S. opposition also seems related to worries that China will able to use the bank to promote its political objectives (Kahn and Albert 2015). That the United States puts the bank in this broader strategic context is suggested by a U.S. official, who, in a statement to the Financial Times, declared that “We are wary about a trend toward constant accommodation of China, which is not the best way to engage a rising power” (Watt et al. 2015). U.S. attempts to put pressure on its allies not to join failed spectacularly, however, leading former U.S. officials such as former secretary of state Madeleine Albright, former U.S. treasury secretary Lawrence Summers, and former president of the World Bank, Robert Zoellick, to call U.S. opposition a major diplomatic mistake (Etzioni 2016, 174–75; Weiss 2017, 15).

\(^{34}\) This does not mean that the exercise of informal influence is unconstrained, however. If relied on too frequently, the exercise of informal influence eventually will undermine the legitimacy and significance of the organization and lead weaker states to seek to tighten the formal constraints on the leading state’s exercise of informal influence.
When it became clear the United Kingdom would join the AIIB, the White House responded that “We hope and expect that the UK will use its voice to push for adoption of high standards” (Etzioni 2016, 175; Kahn and Albert 2015). U.S. concerns about whether the bank will adhere to high standards are certainly not without foundation. China has greatly increased its lending activities since 2010. Most of these loans have been granted without the kinds of policy conditions imposed by the IMF and the World Bank. Although these conditions vary, loans are often tied to matters related to the rule of law, accounting standards, transparency, and the development of civil society (Olson and Prestowitz 2011, 18). Instead, China has substituted its own guiding principles, inter alia often tying the loans to contracts for Chinese construction firms.\(^35\) This suggests China is willing to set aside the standards of the current international order (“Rich but Rash” 2015). A Chinese government Foreign Aid White Paper from 2014 makes it clear that when providing foreign assistance, China adheres to the principles of not imposing any political conditions, not interfering in the internal affairs of the recipient countries and fully respecting their right to independently choosing their own paths and models of development. The basic principles China upholds in providing foreign assistance are mutual respect, equality, keeping promise, mutual benefits, and win–win. (Quoted in Peng and Tok 2016)

These principles—no political strings attached; non-interference in internal affairs; mutual benefit—will also inform the policies of the AIIB (Peng and Tok 2016). What this means in practice is well illustrated by China’s aid to states such as Zimbabwe. Whereas the United States in 2008 reacted to the Mugabe regime’s alleged violations of human rights by pushing for mandatory international sanctions, China’s special envoy for African Affairs, Liu Guijin, simply noted that

\(^{35}\)These principles have remained essentially unchanged since Premier Zhou Enlai formulated them in the 1960s (Peng and Tok 2016).
We don’t attach political conditions [to aid]. We have to realize the political and economic environments are not ideal. But we don’t have to wait for everything to be satisfactory or human rights to be perfect. … While we are not satisfied with the environment in many developing countries, we don’t have to wait [for it] to be perfect. (Quoted in Morris 2008)

The goal of China’s aid policy, he elaborated, was to create a win-win situation in which both donor and recipient would benefit. This goal has informed its investments in infrastructure and mining in Africa and elsewhere (Morris 2008).36 It comes as no surprise, therefore, that the AIIB will offer loans with fewer political strings attached than does the World Bank. For instance, the AIIB will refrain from requesting that borrowers privatize or deregulate businesses as a condition for loans (Qing 2015; Peng and Tok 2016). Jin Liqun, the President of the AIIB, notes that… excessive conditionality has turned out to be counterproductive. Development programmes and projects certainly have to measure up to certain standards. But sound macroeconomic policies and environmental protection have to be adopted willingly by the borrowing countries, not imposed upon them. (Liqun 2017)

Although co-financing with other development banks37 and the multilateral structure of the AIIB may give other countries influence over lending decisions, it is clear that, at least so far, the AIIB largely reflects Chinese principles. Moreover, many of these projects are designed to develop the so-called China-Pakistan Economic Corridor, an integral part of OBOR (Weiss 2017, 6;

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36 Much of this aid has been disbursed by the People’s Bank of China, which is six times larger than the World Bank (Halper 2012 [2010], xii).
37 Of the fourteen projects founded to date, four are co-financed by the World Bank. Many of the others are co-financed by the ADB and other development banks. See https://www.aiib.org/en/projects/approved/index.html and Weiss (2017, 14).
Peng and Tok 2016). It is too early to gauge the degree to which the AIIB will adhere to international standards Weiss (2017, 13). As then US Treasury Secretary Jacob Lew noted in March 2016

> [the Chinese] have now adopted operating rules that are very much leaning towards observing the kinds of norms that we support in the multilateral institutions that we contribute to. But now the question is what the actions will be. And we'll start to know when they make loans. The more they partner with the multilateral institutions that have high standards, the more likely they are to operate in a way that's consistent with the kinds of norms that are good for a growing, global economy and other values that we pursue in the multinational space. (Quoted in Weiss 2017, 15–16)

In sum, the creation of the AIIB is an example of displacement. Although, just as in the case of the IMF, the United States kept its veto in the World Bank (and Japan kept its veto in the ADB), it could not veto the creation of the AIIB. Moreover, at least so far, there is a marked contrast between the rules adhered to by the World Bank and those proclaimed by China. It would be surprising if the AIIB does not embody long-standing Chinese principles of no political strings attached, non-interference in internal affairs, and mutual benefit. These principles clearly differ from “the high standards” of the World Bank and the ADB, explaining U.S. opposition to Western participation in the Bank. The World Bank and ADB rules as they affect assistance are not ambiguous and thus offer little room for interpretation and the rules are generally adhered to, that is, enforcement of the rules is generally straightforward. Had China chosen to distribute its aid through the World Bank and the ADB instead, the rules (high standards) it would have had to follow are quite unambiguous. Unwilling to follow these rules, it chose an alternative strategy likely to lead to institutional displacement. Because ambiguities about rule interpretation and enforcement do not exist or are much more difficult to exploit in the case of development funding, the strategy of drift was not a viable strategy the way it has turned out to be in the
IMF/G20. How successful China will be in its endeavor to replace the governance rules of international financial institutions remains to be seen, but the large number of defections by U.S. allies gives the defenders of the old rules reason to worry.

As was true of the IMF, the AIIB is evidence that institutional change is fundamentally influenced by shifts in the distribution of power. Just as the creation of the G20 is a response to the need for additional financial resources to deal with economic crises, so the creation of the AIIB is a response to the great need for additional infrastructure investments in Asia. Thus, in both cases, shifts in power drives institutional change and creation, as it did when the United States with the help of its allies created the post-war international economic order. Both cases also demonstrate that institutional creation is possible even in situations not characterized by crisis and war. Also important, the AIIB show how institutions shape state policy. As noted, the struggle between the United States and China in the international economy is to a significant extent a struggle over institutions and who gets to define the rules of future economic exchange.

China could have joined its development aid efforts to those of the ADB and the World Bank, but given the rules that govern such aid, chose to circumvent these institutions and create its own.

This, of course, raises the question of why we cannot regard the differences between China’s strategies in these two cases simply as a reflection of economic power. That is, whereas China had the economic resources necessary to create a parallel institution to the ADB, it lacked the resources needed to create an institution that could challenge the IMF. First, it should be noted that China committed $43 billion to the bailout of EU countries in 2011, a sum much greater than the roughly $30 billion committed to the AIIB. Second, the U.S. quota in the IMF is roughly
SDR 83 billion, a large sum, but not outside the reach of a country such as China with nearly $3 trillion in foreign exchange reserves\(^{38}\) and over $71 billion in gold reserves (as of January 2017) (Trading Economics 2017). It would thus seem China possesses the requisite economic might. Third, and perhaps most important, whereas the AIIB can play an important role as an alternative to the World Bank and especially the ADB, creating a parallel to the IMF makes little sense without the participation of the United States. As conclusively demonstrated by the 2007–08 financial crisis, management of the international economy increasingly requires the participation of both the United States and China in the IMF. This means that even if the United States could not formally veto the creation of a parallel institution, it would have a de facto veto because defection to the new rules would be unlikely. Reforming the rules by which the international economy operates thus in part means working to reform the IMF from within, not replacing it as a strategy of displacement would imply.

**Conclusions**

I have argued that understanding the consequences of China’s rise to economic great power status and possible preeminence requires that we pay attention to how both power and institutions affect state behavior. The discussion of how China and the United States have responded to the shift in relative economic power adds to our understanding of the kinds of strategies hegemons and challengers adopt in response to such shifts. The Chinese seem to be following a two-pronged strategy of, first, seeking greater influence within the current order, and, second,

\(^{38}\) This is a drop from almost $4 trillion in June of 2014, which was an all-time high.
as suggested by the creation of the AIIB, laying the groundwork for a parallel international economic order in which China writes the rules. The United States, for its part, has been reluctant to grant China the increased influence it demands, and has thus been unwilling to modify current institutions to reflect the shift in relative power. In the future, the international economy likely will become a locus of conflict rather than cooperation as attention shifts from its day-to-day operation to the rules underpinning its management. The considerable faith U.S. policymakers and analysts so far have placed in the ability of economic interdependence and international economic institutions to shape the rise of China and promote a peaceful transition from American to Chinese hegemony thus seems misplaced.

These developments reveal the extent to which relative economic power shapes the international economic order. International economic institutions matter, but when they cease to reflect underlying power realities, the rules they embody will either change or the institutions will atrophy and become increasingly irrelevant, giving way to a new set of institutions more reflective of the underlying distribution of power. As China catches up to the United States, cooperation will be more difficult and the rules of the international economic order will be apt to change. In short, in the final analysis, the institutions are likely to be endogenous to the power transition were such a transition to take place. Institutions may have an afterglow but eventually the glow fades.

This account, by emphasizing the importance of the distribution of international economic power in shaping behavior, is one realists should have no trouble accepting. Institutions will, in the end, reflect the underlying distribution of power. From this point of view, it does not matter that China’s (possible) rise to economic preeminence takes place in the heavily institutionalized
environment of the current international economy. Nevertheless, as noted above, realism and other analyses relying on comparative statics, have very little to say about what the process of change looks like. As Jupille et al. (2013, 12) note, “[e]nd-points ... are only part of the story.”

We also want to know how we get to those end-points. This requires that we pay attention to the institutions of the current international economic order. These institutions shape the behavior of both the United States and China. The struggle between them is in large part a struggle over who gets to write the rules of the future international economy.

For institutionalists of various ilks, perhaps the most interesting aspect of the struggle for power is the extent to which China’s rise has led to institutional change and institutional creation (IMF/G20, AIIB) in an environment not characterized by either crisis or systemic breakdown. It is also striking how these acts of creativity represent variations on institutional themes that are integral parts of the current international economic order. This is perhaps most evident in the extent to which the AIIB is modeled on other development banks (although it also deviates in important ways from those). The creation of the G20 demonstrates how institutional innovations intended to preserve the current order can become platforms from which to try to change that order better to reflect current power realities. The institutional changes currently taking place in the international economic order are gradual and evolutionary, not revolutionary.

It is difficult, if not impossible, to make sense of the nature of the struggle for power between China and the United States if we simply regard institutions as epiphenomenal reflections of an underlying distribution of power as some realists are wont to do (e.g., Mearsheimer 1994/95). So, from this point of view, it does matter that China’s rise takes place in the heavily
institutionalized environment of the current international economy. In short, we need to pay attention to both power and institutions if we are to understand fully the changes currently taking place in the institutions governing the international economy.

Finally, it is worth noting that because the current economic transition takes place in an environment that is much more deeply institutionalized than was true in the past, past transitions (such as the passing of the mantle from the United Kingdom to the United States) are of limited relevance to thinking about the current transition. Moreover, the way the current transition plays out in the much less institutionalized military realm is likely to be different from the way it plays out in the economic realm.

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