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**GAME OF INSTITUTIONAL BALANCING
CHINA, THE AIIB, AND THE FUTURE OF GLOBAL GOVERNANCE**

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SINGAPORE**

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Abstract

The establishment of the Asian Infrastructure Investment Bank (AIIB) has signified a “charm offensive” by China towards multilateral institutions and existing global financial governance. If the rise of China is inevitable, what will the future world look like and what should other countries be prepared for? Borrowing insights from institutional balancing theory and role theory in foreign policy analysis, this project introduces a “leadership transition” framework to explain policy dynamics in global governance with the AIIB as a case study. It suggests that China, the US, and other countries have employed different types of institutional balancing strategies, i.e., inclusive institutional balancing, exclusive institutional balancing, and inter-institutional balancing to compete for influence and interest in the process of establishing the AIIB. A state’s role identity as a “leader,” a “challenger,” or a “follower” will shape its policy choices regarding different institutional balancing strategies in the process of leadership transition in global governance. Institutional balancing is a new form of balancing among states in the future of global governance. China’s institutional rise in global governance might be more peaceful than widely predicted.

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Game of Institutional Balancing: China, the AIIB, and the Future of Global Governance

The Asian Infrastructure Investment Bank (AIIB) is one of the hottest topics in today's world politics. Ever since the idea was conceived by China in 2013, the development of the AIIB has been full of suspicions and surprises. When the AIIB was officially established in March 2015, 57 states joined as founding members, including developed economies such as the UK, Germany, France, Italy, Australia, and South Korea. On 31 August 2016, Canada officially applied to join the AIIB and became the first North American country to seek membership. To date, the US and Japan still say "no" to the AIIB.

The AIIB case entails both policy relevance and academic importance for policy makers and scholars.¹ Some scholars have pointed out that China's initiation of the AIIB represents the start of China's challenge to the US-led global economic governance as well as the post-war international order.² If the rise of China is inevitable, the AIIB will be the first test of China's leadership potential in future global governance and international order. Policymakers will be observing China's performance in the AIIB as well as its implications for US hegemony in world politics.

For scholars, the AIIB poses several intriguing questions regarding the different responses and policy choices states have toward the AIIB. First, why did China initiate the AIIB in the first place? If China wanted to challenge the US in global economic governance, why did China keep the AIIB open to all states in that the US was also eligible to join? Second, why did the US reject the AIIB idea and tried to dissuade its allies such as Japan, Australia, South Korea, and its European allies from joining? Finally, why did some states (e.g., the UK, Australia, and South Korea) join, while others, notably Japan, choose not to?

There are two existing arguments about the AIIB case. While some scholars lay out various "faults" of the US, others focus on elements of "China's victory" in the AIIB. One of the most popular arguments regarding the US' failures in the AIIB can be traced back to the International Monetary Fund (IMF) quota reform. The failed IMF reform, due to the block by US Congress, is widely seen as a major

¹ Rebecca Liao, "Out of the Bretton woods: how the AIIB is different," *Foreign Affairs* June 27, 2015; Phillip Y. Lipsky, "Who's Afraid of the AIIB: Why the United States Should Support China's Asian Infrastructure Investment Bank." *Foreign Affairs* May 7, 2015; Helmut Reisen, "Will the AIIB and the NDB Help Reform Multilateral Development Banking?" *Global Policy* 6, no. 3 (2015); Xiao Ren, "China as an institution-builder: the case of the AIIB." *The Pacific Review* 29, no. 3 (2016); Mike Callaghan and Paul Hubbard, "The Asian infrastructure investment bank: Multilateralism on the silk road." *China Economic Journal* 9, no. 2 (2016); Gregory T. Chin, "Asian infrastructure investment Bank: governance innovation and prospects." *Global Governance: A Review of Multilateralism and International Organizations* 22, no. 1 (2016); Silvia Menegazzi, "Global economic governance between China and the EU: the case of the Asian infrastructure investment bank," *Asia Europe Journal* 15, no. 2 (2017).

² Cary Huang, "China-led Asian Bank Challenges US Dominance of Global Economy," *South China Morning Post*, April 11, 2015; Daniel McDowell, "New Order: China's Challenge to the Global Financial System," *World Politics Review*, Feature Report, April 14, 2015; Stephen Roach, "China's Global Governance Challenge," *YaleGlobal Online*, June 6, 2015; Ming Wan, *The Asian Infrastructure Investment Bank: The Construction of Power and the Struggle for the East Asian International Order*. New York: Palgrave Macmillan. 2015.

trigger for China's decision to initiate the AIIB.³ Another mistake committed by the US government regarding the AIIB is its firm rejection of the AIIB idea in the first place. Although not admitted publicly by the US, as Stephen Roach had pointed out, "the US opposed the AIIB simply because it was a Chinese initiative, full stop."⁴ This attitude has unintentionally backfired, hurting its own reputation and legitimacy in global economic governance. Last but not least, US pressure on other states, especially its allies on the AIIB issue, is seen as unwise or even "churlish."⁵ As former Secretary of State Madeleine Albright later admitted, "We (the United States) should not have done it this way."⁶

Instead of attributing it to US policy failures, some scholars suggest that it is China's astute diplomacy that has led to the success of the AIIB. First, China's AIIB initiative fills a niche in global finance governance. According to an estimate by the Asia Development Bank (ADB) in 2009, the total infrastructure financing requirement in developing Asian economies will be around US\$8 trillion from 2010 to 2020, while the current infrastructure financing in Asia from the ADB and World Bank is only about US\$20 billion per year.⁷ China's AIIB initiative, to a certain extent, aims to bridge this financing gap. China's second success is its inclusive institutional design of the AIIB, of which any country is eligible to join. This inclusivity has helped China allay distrust from other states, especially European countries. Another notable success is the winning of support from the UK, where China's charm offensive has led to diplomatic success for the AIIB.

Although both the "US faults" and "China's victory" arguments reveal some elements of truth about the dynamics of the AIIB, they suffer two analytical weaknesses. First, both existing arguments are based on problematic assumptions. For example, the former assumes that the US should accept China's AIIB initiative or at least not try to "squash" it.⁸ However, it is unclear why the US should accept the AIIB in the first place. Will it be a grave diplomatic mistake or an inevitable policy choice for the US? For the latter, the underlying assumption is that China provides public goods through the AIIB that rightfully no one should reject. It is true that the AIIB has created its own niche in financing the much-needed infrastructure development in Asia. However, this public good-rooted altruism is apparently not the whole story behind the initiative. Moreover, how China will use the AIIB or other institutions to challenge existing global governance is unknown.

³ See Anna Yukhananov, "US Congress will not pass IMF reforms this Year," *Reuters*, December 10, 2014; Daniel Drezner, "Anatomy of a whole-of-government foreign policy failure," *The Washington Post*, March 27, 2015.

⁴ Stephen Roach, Zha Daojiong, Scott Kennedy, and Patrick Chovanec, "Washington's Big China Screw-up," *Foreign Policy*, March 26, 2015.

⁵ Jonathan Pollack, "Joining the club: How will the United States respond to AIIB's expanding membership?" www.brookings.edu, 2015.

⁶ David R. Sands, Democratic titans say Obama 'screwed up' and gave rise to China's new bank. *The Washington Times*, April 1, 2015, <http://www.washingtontimes.com/news/2015/apr/1/efforts-to-head-off-china-development-bank-called/>.

⁷ Economist, "Why China is creating a new 'World Bank' for Asia" *Economist*, November 11, 2014, <http://www.economist.com/blogs/economist-explains/2014/11/economist-explains-6>.

⁸ Zachary Keck, "Why the US is trying to squash China's new development bank," *The Diplomat*, Oct 10, 2014.

Second, both existing arguments focus only on the US and China, and fail to explain the diverse policy choices of other states. For example, despite US pressure, Australia and South Korea decided to join the AIIB. In contrast, Japan chose to stand with the US. Since all three countries are US allies in the Asia Pacific, an unanswered question remains: why did they adopt different policies toward the AIIB? In addition, why did the UK and other European powers make an earlier decision to join than Australia and South Korea regarding the AIIB? The AIIB will not be the last institutional challenge posed by China toward the US. How other states respond to a similar situation will directly influence the outcome of US-China competition in the international system. Merely critiquing the US or praising China will not provide a satisfactory answer to these system transition-related questions.

In this paper we attempt to answer the above through a new theoretical perspective — a “leadership transition” argument. Integrating institutional balancing theory and role theory in foreign policy analysis, we suggest that the AIIB represents a leadership transition dynamic in global economic governance through which the US and China have competed for leadership and other states have had to pick sides between these two great powers. Depending on their different role identities in this leadership transition game, states choose different types of institutional balancing strategies, including inclusive institutional balancing, exclusive institutional balancing, and inter-institutional balancing, to pursue their interests in this evolving and transitional process of global governance.

In particular, we suggest that as the existing supreme global power, the US will not easily give up its leadership role, and is thereby more likely to adopt an exclusive institutional balancing strategy to reject any efforts that challenge the existing system. As the challenger of the existing system, however, China needs to seek recognition and legitimisation of its rising role and status in the system. This is why China is more likely to choose an inclusive institutional balancing strategy to invite as many supporters as possible, including the US, to join the institutions that it has initiated. For states that are followers in this leadership transition game, their policy choices will be shaped by their “balance of interests” considerations. If a state highlights its security interests over economic ones, it is more likely to hop on the “bandwagon for security” — standing with the existing leader to retain the status quo in the system. If a state values its economic interests more, it is more likely to jump on the “bandwagon for profit” — joining the new institution initiated by the challenger for economic benefits that the old system cannot provide.⁹

In this paper, we introduce our leadership transition argument through integrating institutional balancing theory and role theory to shed some light on how states use different institutional strategies in the dynamics of global governance. We also test our leadership transition model through examining the diverse policy choices of the US, China, the UK, and Japan in the AIIB.

⁹ For “bandwagoning for profit,” see Randall L. Schweller, “Bandwagoning for profit: Bringing the revisionist state back in,” *International Security* 19, no.1 (1994). For “bandwagoning for security,” see Stephen M. Walt, *The Origins of Alliance*, Cornell University Press, 1990.

The Leadership Transition Argument — A New Framework

In this paper we suggest a new analytical framework — a leadership transition argument — to understand the dynamics of the AIIB as well as future US-China competition in global governance. The leadership transition argument borrows insights from institutional balancing theory and role theory in the areas of international relations and foreign policy analysis. Institutional balancing theory suggests that states can use different institutional strategies to pursue their realist interests, such as power and influence, in the international system.¹⁰ The diverse policy choices of states towards the AIIB entail different institutional balancing strategies in the realm of global governance. Role theory, on the other hand, examines how the role identity of an individual state shapes its policy choices regarding different institutional balancing strategies.¹¹

In institutional balancing theory, there are three types of institutional balancing strategies: (i) inclusive institutional balancing; (ii) exclusive institutional balancing; and (iii) inter-institutional balancing.¹² Inclusive institutional balancing involves including a target state into an institution, through which the target state is constrained by rules and norms of the institution. One example of successful inclusive institutional balancing is how Association of South East Asian Nations (ASEAN) states used norms and rules of the ASEAN Regional Forum, especially multilateralism and cooperative security, to constrain China's behavior in the 1990s.

Exclusive institutional balancing means excluding the target state from an institution. The target state is excluded and pressured by the cohesion and cooperation of states inside the institution. An example of exclusive institutional balancing is the Trans-Pacific Partnership (TPP), a regional trading bloc led by the US. Due to its high entry standards, China has been intentionally excluded by the TPP. Although the success of the TPP is questionable given the opposition from the US Congress, in the eyes of Chinese leaders, the TPP is an instance of US institutional balancing against China through which the US can utilise the unity and cohesion among the TPP countries to alienate and further undermine China's influence in the region.

Inter-institutional balancing is an extension of exclusive institutional balancing. When a state is excluded by a particular institution, it can support another or initiate a similar institution to counterbalance the pressure from the institution that has excluded it. For example, facing pressure

¹⁰ Kai He, "Institutional Balancing and International Relations Theory: Economic Interdependence and Balance of Power Strategies in Southeast Asia," *European Journal of International Relations* 14, no. 3 (2008); Kai He, *Institutional Balancing in the Asia-Pacific: Economic Interdependence and China's Rise*, London and New York: Routledge, 2009.

¹¹ K. J. Holsti, "National Role Conceptions in the Study of Foreign Policy," *International Studies Quarterly* 14, no. 3 (1970); Stephen G. Walker, ed. *Role Theory and Foreign Policy Analysis*. Durham, NC: Duke University Press, 1987; Cameron G. Thies, "Role theory and Foreign Policy," In *The International Studies Encyclopedia*, edited by Robert Denmark. Oxford: Blackwell, 2010.

¹² See He, "Institutional Balancing and International Relations Theory"; He, *Institutional Balancing in the Asia-Pacific*. Also Seungjoo Lee, "Institutional balancing and the politics of mega-FTAs in East Asia," *Asian Survey* 56, no. 6 (2016).

from the TPP, China supports the Regional Comprehensive Economic Partnership initiated by ASEAN to counter the pressure from the TPP. Moreover, during the 2014 Asia-Pacific Economic Cooperation meeting, China advocated the establishment of the Free Trade Agreement in the Asia Pacific (FTAAP). The FTAAP proposal can also be seen as an inter-institutional balancing effort by China against the US-led TPP through which the success of the FTAPP can reduce negative impacts of the TPP on China.

Institutional balancing theory provides a new perspective in explaining the dynamics of state behavior in the AIIB. However, it cannot explain why states choose different institutional balancing strategies during a potential leadership transition in global governance. The theory suggests that economic interdependence and power polarity in the system are two important factors that shape a state's balancing behavior. In global governance, however, the variations of these two system-level variables are not significant enough in explaining the different institutional strategies a state adopts. For example, in the AIIB case, why did the US say "no," while the UK embraced the AIIB? Why did China select an inclusive institutional design to invite all countries even if it meant a possible dilution of China's influence? The two system-level variables — economic interdependence and power polarity among states — cannot explain an individual state's policy choices. Therefore, we integrate role theory — an agent-driven theory in foreign policy analysis — with institutional balancing theory to shed light on how a state will respond to the potential leadership transition in global governance.

Role theory is a research programme that includes many theories and perspectives sharing a similar view on the importance of the concept of role in social life. The "role" concept is a metaphor borrowed from the theatre. Role theorists suggest that everyone plays a certain societal role or roles through which society functions as a web composed of the parts of individuals. Role theory was introduced to foreign policy analysis and international relations in the 1970s, providing a unique framework to integrate different theoretical perspectives into the study of foreign policy.¹³ According to Thies, role theory has the potential to link different levels foreign policy analysis as well as to connect agents and structures in international relations, although the intellectual value of role theory is often overlooked or questioned in said field.¹⁴

One major argument of role theory is that the role identity of a state shapes its policy choices. In other words, how a state perceives its role in an international society will influence its policy. For example, when the Soviet Union perceived itself as leader of the international communist movement, it got involved in the domestic affairs of Eastern Europe during the Cold War. Similarly, because the US

¹³ Marijke Breuning, "Role Theory Research in International Relations," in *Role Theory Research in International Relations: Conceptual Challenges and Political Promise*, eds. Sebastian Harnisch, Cornelia Frank, and Hanns W. Maull, London and New York: Routledge, 2011; Stephen G. Walker, *Role Theory and the Cognitive Architecture of British Appeasement Decisions: Symbolic and Strategic Interaction in World Politics*. New York: Routledge, 2013; Sebastian Harnisch, "Conceptualizing in the Minefield: Role Theory and Foreign Policy Learning," *Foreign Policy Analysis* 8, no.1 (2012); Kai He and Stephen Walker, "Role Bargaining Strategies for China's Peaceful Rise," *Chinese Journal of International Politics* 8, no. 4 (2015).

¹⁴ Thies, "Role theory and Foreign Policy."

saw itself as the leader of global anti-communism during the Cold War, it fought the Vietnam War to prevent the spread of communism in Southeast Asia.

Since the establishment of the AIIB is widely seen as an institutional challenge to the existing global economic governance, we argue that the AIIB represents a case of leadership transition. Just like power transition in the international system, a leadership transition process in global governance is triggered when a state initiates a new institution that is perceived as a threat to existing patterns. Therefore, according to role theory, we can categorise three types of roles in the leadership transition process: (i) the leader; (ii) the challenger; and (iii) the follower. Differing from power transition theory which predicts military balancing in conflicts between a rising power and a hegemon, a leadership transition process in global governance takes place through the means of institutional balancing, including inclusive institutional balancing, exclusive institutional balancing, and inter-institutional balancing.

All states need to calculate the costs and benefits when engaging in this transition. For the leader state of the existing system, its authority and legitimacy will face the biggest threats from the challenger state. Therefore, it is rational for the existing leader to minimise the institutional impacts of the rival on the existing system. The easiest and best way to achieve this goal is to reject the legitimacy and downgrade the value of the new institution. Exclusive institutional balancing, i.e., refusing to endorse or join the new institution, becomes a logical policy response for the leader. Moreover, the leader state will need to dissuade others from joining as well, because the fewer the members in the new institution, the weaker the influence or impact on the existing system.

For the challenger state, its immediate goal is to use a new institution to improve its power and value in the existing system. In the long run, this new institution can become an institutional base for the challenger to take over the leadership position in global governance. However, the challenger must first make the new institution relevant. In other words, the challenger has to prove that the new institution can provide benefits that the existing system cannot. To do so, the challenger has to forgo some short-term economic gains to make it work. Inclusive institutional balancing is a rational policy choice for the challenger state to pool support from states in the existing system. While more members in the new institution may mean greater constraints for the challenger state, the success of the institution will serve in its long-term goal of establishing a new leadership position in the future global governance.

For other states, their role is to be the follower in this institutional competition between the existing leader state and the challenger state. They must pick sides between the two. They can follow the existing leader and stay away from the new institution, or they can support the challenger state and join the new institution. As mentioned above, to attract followers, the challenger will offer perks which the existing leader state cannot provide. Therefore, if a state prefers economic benefits over security ones, it will choose to support the challenger state by joining the new institution. If a state values its

security interests more than economic benefits, it will follow the existing leader state because the status quo situation will offer more stability and security in the system.

Integrating role theory with institutional balancing theory, our “leadership transition” argument suggests the following three hypotheses:

1. If a state identifies its role as a leader state in global governance, it is more likely to adopt exclusive institutional balancing and/or inter-institutional balancing strategies to undermine the influence and value of any new institution initiated by others in the system.
2. If a state identifies its role as a challenger state in global governance, it is more likely to adopt an inclusive institutional balancing strategy to pool support from other states to ensure the success of the institution it has initiated.
3. If a state identifies its role as a follower in global governance, it will have two options, either to follow the challenger or to support the leader. If the state values economy more than security, it is more likely to support the challenger state’s new institution, i.e., to follow the challenger’s inclusive balancing strategy. Otherwise, it will follow the leader and stay away from the new institution, i.e., to adopt an exclusive balancing as the leader state does.

We performed a congruence test to examine the validity of these hypotheses. In the congruence test, we explored four countries’ policy choices toward the AIIB. These four countries are the US, China, the UK, and Japan. In each case, we examined the relationship between these states’ role identities and their policy choices toward the AIIB. If a state’s role identity is convergent with their policy choice as per the hypotheses, then our model passes the congruence test. If not, our hypotheses are falsified and we need to explore other variables to explain this divergent outcome.

Two caveats are worth noting. First, our model suggests the “most likely” institutional strategy for a state based on their role during a leadership transition of global governance. The model does not rule out the possibility that a state might use different institutional strategies simultaneously. However, we suggest that the “most likely” institutional strategy in our model will be the state’s dominant strategy. Second, the AIIB case is a preliminary test of the leadership transition model. Our model has the potential to be generalised to other cases. We encourage other states to apply or modify our model to explain the dynamics and transformations of global governance in other arenas.

The Game of Balancing in the AIIB

According to role theory, there are two steps a state must take to identify its role. First, a state or leaders of the state need to go through a role identification process for the self to specify which role the state will perform. Second, this role identity for the self must be confirmed by the outside world. If the outside world confirms the state's self-identified role, the state finalises its role identification process. If the outside world rejects the state's self-identified role, the state will need to renegotiate its role with the outside world. The difference between the self's role identification and role confirmation sometimes leads to policy failures as well as confrontations between the state and the outside world.¹⁵

US Existing Hegemon Role and Exclusive Institutional Balancing

The US has seen itself as the leader of the international system since the end of World War Two. As mentioned above, its leadership is built on its military strength as well as the Bretton Woods system, including the World Bank and International Monetary Fund, in global economic governance. In its 2015 National Security Strategy document, the US clearly states that "strong and sustained American leadership is essential to a rules-based international order that promotes global security and prosperity as well as the dignity and human rights of all peoples. The question is never whether America should lead, but how we lead."¹⁶ In this 35-page document, "leadership" was emphasised 15 times. In other words, the US is not shy about its presumed global leadership role.

This self-identified role of the US as the leader in global governance is also confirmed by the outside world. For example, in a recent interview with the *Wall Street Journal*, Singapore Prime Minister Lee Hsien Loong pointed out that "the US might be roiled by politics, but its leadership on trade and security is indispensable...and the world simply has found no substitute for American leadership."¹⁷ More importantly, China has also publicly affirmed that the US is still the global superpower. In late 2014, Chinese Vice Premier Wang Yang made a public speech saying "it is the United States that leads the world. We have a clear understanding of this...China does not have any ideas or capabilities to challenge the US as the world's leading superpower."¹⁸ Scholars and policymakers have questioned the true meaning of Wang's statement. For example, David Shambaugh suggests that Wang's statement is just a disguise for China's ambition and Washington "must not confuse rhetoric with reality."¹⁹ Some top Chinese international relations scholars, however, suggest that

¹⁵ Cameron G. Thies, "International socialization processes vs. Israeli national role conceptions: can role theory integrate IR theory and foreign policy analysis?" *Foreign Policy Analysis* 8, no.1 (2012).

¹⁶ The White House. 2015b. *National Security Strategy*. Washington D.C. The White House.

¹⁷ William McGurn, "Lee Hsien Loong's American Exceptionalism," *The Wall Street Journal*, March 31, 2016. <http://www.wsj.com/articles/lee-hsien-loongs-american-exceptionalism-1459464855>.

¹⁸ Peter Ford, "A newly modest China? Official's reassurances raise eyebrows in US," *The Christian Science Monitor*, January 7, 2015.

¹⁹ *Ibid.*

Wang's comments reflect what Chinese leaders really think. No matter whether China has ambitions or not, it is clear that Chinese leaders acknowledge who the leader of the existing system is.

As the leader state in global governance, the US is more likely to choose an exclusive institutional balancing strategy toward China's AIIB initiative according to our leadership transition argument. In reality, the US adopted three "no" policies toward the AIIB. First, it did not endorse the idea. It argued that the AIIB is redundant because the existing system already has the World Bank, IMF, and ADB. Second, the US did not join the AIIB. Although China has lobbied hard and many US scholars and policy advisors have also advocated joining the AIIB, Washington has persistently refused. Third, the US tried to convince its allies to reject the AIIB and attempted to employ a "containment strategy" against the AIIB within the Group of Seven members. Through these three "no" policies, it is the US' goal to alienate, undermine, and even delegitimise the value of the AIIB in global economic governance. If only small Asian countries join the AIIB, the relevance and power of the AIIB as well as China's challenge toward the existing system will be discounted and reduced.

To be fair, it is not the only time the US has crusaded against institutional challenges to its leadership in global governance. In 1990, Malaysian Prime Minister Mahathir Mohamad proposed a free trade zone — the East Asian Economic Caucus (EAEC) — to encourage trade and economic cooperation among ASEAN states and three East Asian countries, namely Japan, China, and South Korea. Because the US strongly opposed the EAEC idea, Japan refused to join; consequently the EAEC idea was killed in its infancy.²⁰ After the 1997–1998 economic crisis, Japan proposed to establish an Asian Monetary Fund (AMF), a regional monetary organisation as an institutional response to the inadequate actions of the IMF in helping Asian countries during the crisis. Once again, due to strong opposition by the US, Japan eventually dropped the idea.²¹

The EAEC and AMF cases further vindicate the leadership transition argument regarding policy choices for the existing leader state when it faces an institutional challenge in global governance. It is rational for the US to stay away and oppose the establishment of any new institution which might potentially challenge its leadership position in the system. Therefore, it might not necessarily be a policy failure for Washington to refuse the AIIB in the first place because exclusive institutional balancing is what a leader state normally does in a leadership transition situation. It worked in both the EAEC and AMF cases. The failed outcome of exclusive institutional balancing toward the AIIB is not because the US has chosen the wrong strategy, but because it has picked the wrong adversary this time.

²⁰ Takashi Terada, "Constructing an East Asian concept and growing regional identity: from EAEC to ASEAN+3," *The Pacific Review* 16, no. 2 (2003).

²¹ Phillip Y. Lipsky, "Japan's Asian monetary fund proposal," *Stanford Journal of East Asian Affairs* 3, no.1 (2003); Y.W. Lee, "Japan and the Asian Monetary Fund: an identity–intention approach," *International Studies Quarterly*, 50, no. 2 (2006).

It is worth clarifying that the self-identified leadership role of the US does not always lead to an exclusive institutional balancing strategy. As mentioned before, when the US first established the Bretton Woods Institutions after the Second World War, its strategy is not an exclusive but an inclusive one. In a similar vein, the US used to encourage China to join the World Trade Organization (WTO) in 2000. Through inclusive institutional balancing, the US intended to use the rules and norms of the WTO to socialise China's behavior in the global trading system. The above cases, however, do not refute the leadership transition model because our model only applies to a potential leadership transition in global governance. In other words, our model does not claim to explain all institutional strategies at all times. When the US established the Bretton Woods Institutions and let China into the WTO, there was no leadership transition in global governance. Instead, the US was an unquestionable leader in global governance. As the leader of these institutions, it is rational for the US to include others in the institutions it created and dominated. However, when its leadership is challenged, the US will choose different institutional strategies to cope with these threats as explained through our leadership transition model.

China's "Challenger" Role and Inclusive Institutional Balancing

While the US confidently declares what it wants to be, China on the other hand often denies what it is normally perceived to be in the international system. Since the 1990s, China has been perceived as a "threat" to the international system. Chinese leaders have tried hard to convince the world that the rise of China will be peaceful. To ease their suspicions, the Chinese government even changed its official slogan from "peaceful rise" to "peaceful development" in 2004.²² In global governance, however, China was a latecomer that was seen as too weak to pose threats to the existing system. The major discourse regarding China's participation in the existing international institutions is how to socialise China with prevailing western rules and norms.²³

China's passive role in global governance started to change after the 2008 global financial crisis, during which China became the world's only power house of economic growth. At the 2009 Davos World Economic Forum, Chinese Premier Wen Jiabao harshly criticised "inappropriate macroeconomic policies" of some unnamed countries and the "unsustainable model of development characterized by prolonged low savings and high consumption."²⁴ Given the origin of the financial crisis, everyone knew which country was in Wen's mind. Echoed by Russia, China started to demand a bigger role in a new economic order. In March 2009, Chinese Central Bank Governor Zhou Xiaochuan publicly called for the replacement of the US dollar as the dominant world currency and the

²² B. Glaser, and E. Medeiros, "The changing ecology of foreign policy-making in China: the ascension and demise of the theory of peaceful rise," *The China Quarterly* 190 (2007): 291–310;

²³ A.I. Johnston, *Social states: China in international institutions*, 1980-2000. Princeton University Press, 2014.

²⁴ Andrew Edgecliffe-Johnson, et. al. "Wen and Putin lecture western leaders: Chinese premier attacks 'blind pursuit of profit,'" *Financial Times*, January 29, 2009.

creation of “an international reserve currency that is disconnected from individual nations and is able to remain stable in the long run.” It was clear that Zhou’s talk targeted the US.²⁵

Since current Chinese President Xi Jinping came to power in late 2012, Chinese foreign policy is moving in a new direction, as reflected in China’s policy preference of “striving for achievement” in recent years. In global governance, China has gradually begun to identify itself as a challenger to the US, the existing leader or hegemon in the international system. For example, at the 2014 Conference on Interaction and Confidence-Building Measures in Asia, Xi advocated, “it is for the people of Asia to run the affairs of Asia, solve the problems of Asia and uphold the security of Asia.”²⁶ Xi’s talk was interpreted as a public statement asking the US to leave the region. At the 2015 Boao Forum for Asia, Xi further proposed establishing a “community of common destiny” — a Chinese vision of new security and economic order in Asia. As some commentators have pointed out, Xi’s call represents “a change from recent decades when Beijing largely worked within a US and Western-dominated international system.”²⁷ In other words, Xi has identified China as a challenger, if not *the* challenger, to the US-led world order.

China’s role as a challenger to US leadership in the international system is also confirmed by the outside world. For example, in his 2015 State of the Union speech, President Barack Obama singled out China as the challenger to the US in global governance by stating that “China wants to write the rules for the world’s fastest-growing region...Why would we let that happen? We should write those rules. We should level the playing field.”²⁸ Even more alarmingly, two leading policy analysts in Washington have asserted that the “long-term strategic rivalry between Beijing and Washington is high” and China is “the nation most capable of dominating the Asian continent and thus undermining the traditional US geopolitical objective of ensuring that this arena remains free of hegemonic control.”²⁹

Besides the US, other nations also treat China as a challenger to the existing US-led system. In the eyes of Russian leaders, China is at least Russia’s counterpart in challenging the US in the international system. In April 2015, Indonesian President Joko Widodo also joined the club to call for a new global economic order that “is open to emerging countries and not dominated by any particular group of nations.”³⁰ Although Widodo did not mention China or the US by name, Indonesia support for

²⁵Jamil Anderlini, “China calls for new reserve currency,” *Financial Times*, March 24, 2009. .

²⁶ Xi Jinping, “New Asian Security Concept For New Progress in Security Cooperation,” Remarks at the Fourth Summit of the Conference on Interaction and Confidence Building Measures in Asia, May 21, 2014.

²⁷ Charles Hutzler, “China Banks on Sharing Wealth to Shape New Asian Order,” *The Wall Street Journal*, March 29, 2015.

²⁸ The White House, “President Obama’s Remarks in State of the Union Address,” January 20, 2015, <https://www.whitehouse.gov/the-press-office/2015/01/20/remarks-president-state-union-address-january-20-2015>.

²⁹ Robert D. Blackwill and Ashley J. Tellis, *Revising US Grand Strategy Toward China* (New York: Council on Foreign Relations, 2015).

³⁰ Zakir Hussain, “Indonesian President Jokowi calls for new, more equal global economic order,” *The Straits Times*, April 23, 2015.

the former to challenge the latter in the foreseeable transformation of global governance was understood.

China's self-identified role as a challenger to US-led global governance is further confirmed by the outside world. According to the leadership transition argument, China is more likely to choose inclusive institutional balancing to challenge the existing hegemon. The AIIB is a classic case of inclusive institutional balancing. First, China designed an inclusive multilateral institution to attract support from both developing countries and developed economies. As mentioned previously, the AIIB fits into a niche for the dearth of infrastructure development in developing Asia. Moreover, China did not limit the AIIB membership to Asian countries only. It instead actively invited European countries and rich Arab nations to join the bank based on two considerations.

First, the multilateral design can help China overcome some of the inefficient financing practices weighted down by bureaucratic procedures.³¹ More countries, especially from the West, will boost the influence and relevance of the AIIB as well as China in the new setting of global governance. China even tried hard to get Japan to join the AIIB because its participation would facilitate the credit rating of the AIIB. It was reported that China even promised a Vice President position to Japan to win its support.³²

Second, besides the inclusiveness, the key feature of the institutional balancing strategy lies in its "balancing" function through which China can use the rules and norms of the institutions to maximise its interests. Balancing is a military-oriented term in international relations, which originally meant to achieve an equilibrium of military capabilities between two states. In global governance it refers to a state's policy behavior of setting rules and norms in order to maximise its interests and constrain the behavior of others in multilateral institutions. Regarding the AIIB, China engaged in a "principled negotiation" with other members in setting the rules and norms of the institution. On the one hand, China agreed to negotiate with other members on institutional mechanisms, such as the shareholding structure and the decision-making process. On the other, China insisted on its own principles in designing the AIIB.

It was reported that China originally intended to take up to 50 per cent of the shares given the size of its gross domestic product as compared to other members. After some developed economies joined the AIIB, China agreed to reduce its shares in the AIIB. Eventually, China obtained 26.6 per cent of the voting power when the AIIB opened for business in January 2016. Although it is still the largest shareholder of the bank possessing a de facto veto power, China insists that it has no intention of keeping that power. As Jin Liqun, president of the AIIB, explained, "There are still many countries on

³¹ Injoo Sohn, "AIIB: A plank in China's hedging strategy," May 11, 2015, Brookings East Asia Commentary Series, <https://www.brookings.edu/opinions/aiib-a-plank-in-chinas-hedging-strategy/>.

³² Nikkei News, "The AIIB Storm: Japan lost its first vice president position," Online (in Chinese), April 20, 2015.

the waiting list, and when the new members join, China's voting power will be reduced. Such de facto veto power will be lost gradually."³³

Following two years of negotiation with other members, the AIIB set up a crucial decision-making process by introducing a "fixed" special majority comprising two-thirds of the members who represent three-quarters of the voting power. This "fixed" version of a special majority is the main difference between the AIIB and the World Bank. As no country is allowed to change the special majority in the AIIB, it means that China cannot do what the US normally does with the World Bank — increase the special majority to keep its veto power when its voting power is reduced when new members join. In other words, China has voluntarily constrained its influence in the AIIB. Jin explained that this behavior signifies China's earnestness in "gaining credibility and building up mutual trust by collective consultation and making decisions on democratic approaches."³⁴

For the governance structure, however, China has insisted on its own principle for designing a "lean, clean, and green" AIIB. For example, the AIIB Secretariat plans to have just 700 personnel, substantially less than the 2,000 employees at the ADB headquarters. Unlike the World Bank and ADB, which have sometimes set up offices in different countries, the AIIB will only assign experts and staff members to projects. This practice will not only reduce unnecessary spending, but also avoid overlaps between headquarters and regional hubs in decision making.

More importantly, the AIIB does not have a resident board of directors to run everyday business. While most development banks believe a resident board is necessary for efficient oversight, China argued that it is not just a redundant cost but also a hindrance to the decision-making process.³⁵ However, in the eyes of others, this lack of oversight by a resident board only facilitates the bank president's control of the bank. This has been a controversial issue, because this alleged less-than-transparent governance structure was one of the reasons why Japan rejected the AIIB. Although it tried to convince Japan to join the AIIB, China did not change its position on the resident board issue. Since the AIIB only began operating in early 2016, whether this non-resident board arrangement will work as expected is still in question. However, from a governance structure perspective, this principle will benefit China's balancing efforts in dealing with other members in the AIIB.

The last feature of China's inclusive institutional balancing lies in its leadership competition with the US through providing public goods via the AIIB. Joseph Nye Jr. suggests that a major reason for the success of the "American century" that emerged in the 1940s was partly due to its unique capacity to provide the global public goods that others needed.³⁶ Therefore, any challenger to the US needs to do

³³ Jing Fu, "AIIB chief rules out China veto power," *China Daily*, January 27, 2016, http://www.chinadaily.com.cn/business/2016-01/27/content_23265846.htm.

³⁴ Fu, "AIIB chief rules out China veto power."

³⁵ Robert M. Orr, "The Asian Development Bank and the Asian Infrastructure Investment Bank: conditional collaboration?" PacNet #39, May 4, 2016.

³⁶ Joseph S. Nye, Jr. *Is the American century over?* New York: John Wiley & Sons, 2015.

the same if it wants to replace the role of the US in the system. China to a certain extent has competed with the US in offering public goods through the AIIB and other multilateral institutions.

In August 2014 during his visit to Mongolia, Xi made a speech offering “free rides” to other countries in economic development. Xi stated, “China is willing to offer opportunities and room to Mongolia and other neighbours for common development. You can take a ride on our express train or simply hitchhike. All are welcome.”³⁷ Xi’s statement was seen as a direct response to Obama’s earlier criticism of China being a “free rider” in the international system for 30 years.³⁸ In comparison with the US’ resentment at free riders, China seems ready to provide public goods to all in the future international system.

For example, in October 2013, China proposed its One Belt, One Road (OBOR) initiative to build the “Silk Road Economic Belt” and the “21st-Century Maritime Silk Road” that encompasses many Asian, European, and African economies. China’s OBOR initiative emphasises reviving an ancient trading route stretching from Asia to Europe as well as strengthening the interconnectivity, trade, and investment among countries worldwide. It is seen as the Chinese version of the Marshall Plan, a US initiative which provided economic assistance to rebuild Western Europe after World War Two. In comparison, China’s OBOR will be much bigger and more ambitious than the Marshall Plan³⁹ with claims that it could benefit the entire world. In December 2014 China announced a US\$40 billion Silk Road Fund to improve infrastructure along its OBOR countries. For the AIIB, China has committed US\$50 billion. In addition, China pledged US\$41 billion to the US\$100 billion Contingency Reserve Arrangement (CRA) among the Brazil, Russia, India, China, and South Africa (BRICS) economies. Like the IMF, the CRA is designed to provide emergency credit to BRICS members in financial duress. A similar arrangement among Asian countries is called the Chiang Mai Initiative (CMI) established in 2000 after the Asian financial crisis. China contributed US\$77 billion to the CMI. Although China contributes a large share of funds to both the CRA and CMI, it voluntarily limits its drawing rights to just US\$40 billion and US\$20 billion respectively.⁴⁰ All these commitments, however, remain on only paper since no country has ever used these emergency funds. These financial contributions and commitments at least show China’s willingness to provide public goods to the rest of the world, just as the US used to do in the past.

³⁷ Xinhua, “Welcome aboard China’s train of development: President Xi,” *Xinhuanet.com*, August 22, 2014.

³⁸ New York Times, “Exclusive Interview: Obama on the World,” *New York Times*, August 8, 2014, <http://www.nytimes.com/video/opinion/10000003048414/obama-on-the-world.html?playlistId=1194811622299>.

³⁹ [Enda Curran](#), “China’s Marshall Plan,” *Bloomberg*, August 8, 2016.

⁴⁰ McDowell, *New Order: China’s Challenge to the Global Financial System*.

Followers' Roles and Balance of Interests through Institutional Balancing

Differing from the leader state and the challenger state, other states do not need to identify their roles, but become follower states by default. However in this leadership transition situation, they will need to decide on which one to follow: the existing leader state or the challenger state. A follower's role is further divided as the leader's follower or the challenger's follower. As mentioned, a state will support the existing hegemon or leader if they are more concerned about security than economic interests. On the contrary, a state will become the challenger's follower if it wants to pursue greater economic benefits instead of a security guarantee.

Both the UK and Japan are close military allies and economic partners of the US. However, they have distinct perceptions of China as well as different strategic priorities. For the UK, although it occasionally raises concerns about China's military modernisation programme and defense budget transparency, it does not see China as a threat to the UK. Instead, the UK's bilateral relationship with China used to be influenced heavily by political and human rights issues. The UK's Foreign and Commonwealth Office (FCO) had set many ambiguous and unrealistic expectations in its policies toward China. For example, one of the objectives of UK policy toward China was to help China with internal legal and political reform.⁴¹ Consequently, the UK had played a "lecturer" or "savior" role in helping China through criticising its human right records as well as involving itself in Hong Kong's democratic movement.

In mid-2012, UK Prime Minister David Cameron's meeting with the Dalai Lama led to a diplomatic row between the UK and China. Because he did not "apologise" for hosting the meeting with the Dalai Lama, Cameron was reportedly banned from visiting China.⁴² In late 2013, Cameron eventually visited China for a business trip after the UK government publicly stated that it has "turned a page" on the Dalai Lama and that he has no plans to meet him again in the foreseeable future.⁴³

Starting from Cameron's 2013 business trip to China, the UK's China policy was dominated by the Treasury instead of the FCO. Former Chancellor of the Exchequer George Osborne is a strong advocate for forging close economic ties with China. Consequently, the UK started to shift its policy priorities with China from politics and human rights to investment and economic cooperation. The Dalai Lama harshly criticised Cameron, saying that he had placed "money over morality" in dealing with China.⁴⁴ However, due to domestic election pressures, Cameron's eagerness to boost the UK's

⁴¹ Kerry Brown, "The UK Shows Leadership, and Strategic Clarify, in Joining AIIB," *Chatham House Commentary*, March 20, 2015.

⁴² Malcolm Moore and James Quinn, "David Cameron's rift with China could cost UK billions," *Telegraph*, May 6, 2013, <http://www.telegraph.co.uk/news/politics/david-cameron/10040319/David-Camerons-rift-with-China-could-cost-UK-billions.html>.

⁴³ Nicholas Watt, "David Cameron to distance Britain from Dalai Lama during China visit," *The Guardian*, November 30, 2013.

⁴⁴ Andrew Marszal, "Dalai Lama criticises David Cameron for 'money over morality' snub," *Telegraph*, September 23, 2015.

domestic economy with China's investment and trade was not surprising. The AIIB, therefore, became an attractive business offer that Cameron could not reject.

The AIIB is set to provide many economic benefits to the UK. To start with, British companies will get more business opportunities and even favorable treatment on large infrastructure deals in Asia funded by the bank. It is worth noting that the UK is not the only country that cares about economic gains from the AIIB. Germany and other European countries also want a piece of the pie, and are eyeing the massive infrastructure projects funded by the bank because the European Union is a leading exporter of construction services.⁴⁵ Another attraction for the UK is that its support for the AIIB will facilitate an agreement with China to designate London as an offshore renminbi (RMB) trading clearance centre.

In February 2014, Osborne met with Chinese officials to discuss the possibility of setting up a RMB clearing center in London. According to Osborne, this deal would recognise "London's role as the Western centre of offshore RMB trading."⁴⁶ Since the RMB has overtaken the Singapore dollar and Hong Kong dollar to become the eighth most-used world payment currency, a burgeoning RMB business will bring huge financial gains to the UK. It is not clear how the UK's AIIB decision is associated with the negotiation of establishing an RMB clearing center in London. In April 2016 (about one year after London joined the AIIB), London passed Singapore to become the largest offshore RMB hub outside Hong Kong, accounting for 6.3 per cent of all offshore transactions using the Chinese currency.⁴⁷

The UK's decision to join the AIIB is an inclusive institutional balancing effort toward China's ambition. On the one hand, London's participation is well appreciated and rewarded by Beijing. In addition to the RMB clearing center, the UK secured a vice president position in the AIIB. On the other, the UK claimed that it would use its own influence and power to constrain China's behavior in the bank so that the AIIB can maintain "best practices". As UK officials have pointed out, one of the reasons why the UK joined the AIIB is to ensure that "Britain will be able to shape the new institutions."⁴⁸ In other words, the UK will not always say "yes" to China in the AIIB. Instead, it will use its influence and voice to ensure the AIIB sustains international standards in financing infrastructure projects and to prevent the AIIB from becoming China's diplomatic tool to expand its own interests.

Other western powers are expected to do the same because the multilateral setting provides a mechanism for them to constrain or even undermine China's influence in the AIIB. It is still too early to assess whether and how the counter-balancing role of the UK and other European powers will work in

⁴⁵ Mikko Huotari, "What Went Wrong with US strategy on China's New Bank and What should Washington Do now?" A China File Conversation, www.chinafile.com.

⁴⁶ Grace Li and Michelle Chen, "China, UK discuss setting up yuan clearing bank in London – Osborne," *Reuters*, February 20, 2014, <http://uk.reuters.com/article/uk-markets-offshore-yuan-idUKBREA1J06A20140220>.

⁴⁷ "UK becomes second-largest offshore Rmb clearing centre," *Financial Times*, April 20, 2016.

⁴⁸ Nicholas Watt, Paul Lewis, and Tania Branigan, "US Anger at Britain Joining Chinese-led Investment Bank AIIB," *The Guardian*, March 13, 2015.

the AIIB. It is clear that the UK, as an insider of the AIIB, will play a much larger role than outside powers such as the US and Japan in monitoring and shaping the future of the AIIB.

Although China was the largest trading partner of Japan, the bilateral relations between the two nations have been shadowed by territorial disputes, differences in historical interpretations, and security competition since the late 2000s. The 2010 boat collision incident involving a Chinese trawler and Japanese Coast Guard's patrol boats intensified the territorial disputes over the Senkaku/Diaoyu islands. Japan's official purchase of the islands in 2012 further deteriorated its relationship with China. Nationalism and historical memories have also added fuel to the fire, aggravating the troubled relations between the two nations. Since 2010, China has overtaken Japan to become the second largest economy in the world after the US. The economic and military power transformation has also deepened Japan's security concerns over China. For example, in the 2014 Japanese Defense White Paper, Japan singled out China and North Korea as two of the biggest threats to its national security. In particular, Japan expressed strong concerns over China's military build-up and assertive activities in both the East and South China Seas, including China's intent to establish the Air Defense Identification Zone over the Senkaku/Diaoyu islands in late 2013.⁴⁹

In global governance China's AIIB also poses a direct challenge or threat to Japan's regional status. The latter has held a leadership position in the ADB in the US-led Bretton Woods system in the post-war era. China's AIIB not only threatens US leadership in general, but also targets Japan's role in the ADB. The AIIB's quick rise is rooted in the dissatisfying performance of the ADB in financing infrastructure development in Asia. The success of the AIIB will weaken the relevance of the ADB as well as Japan's sub-regional leadership in Asia. Therefore, just like the US, Japan will not accept the AIIB.

Japan's security-oriented concerns plus its competition with China in Asia's regional governance have encouraged Japan to adopt an exclusive institutional balancing strategy against the AIIB. Just as the US did, it firmly refused to join the AIIB no matter how hard China tried to negotiate terms for Japan's possible membership. Xi even scheduled a special meeting with Prime Minister Shinzo Abe in April 2015 to persuade Japan to join the AIIB.⁵⁰ However, Japan decided to stick with the US and stay away from the AIIB.

Japan also employed an inter-institutional balancing strategy, an extension of exclusive institutional balancing, to undermine the potential influence of the AIIB. In May 2015 (about one month after the establishment of the AIIB), the ADB led by Japan announced that it would raise its funds for infrastructure and other projects by nearly 40 per cent to US\$18 billion.⁵¹ Some commentators

⁴⁹ Matthew Carney, "Japan's defence white paper reveals concerns over China, North Korea," *ABC News*, August 5, 2014, <http://www.abc.net.au/news/2014-08-05/japan-releases-2014-defence-white-paper/5650536>.

⁵⁰ "Xi and Abe meet with smile," *Nikkei News* (in Chinese), April 23, 2015.

⁵¹ "Asian Development Bank pledges to increase lending, cooperate with China-led bank," *Japan Times*, May 5, 2015.

suggest the ADB's decision was not a coincidence.⁵² It will serve the interest of Japan if the ADB can “steal the thunder” from the AIIB. Moreover, in the same month, Japan announced that it planned to provide US\$110 billion in aid for Asian infrastructure projects over five years,⁵³ exceeding the expected US\$100 billion capital of the AIIB. There is no doubt that Japan has tried to use its own institutions, such as the ADB and this huge aid programme, to counteract China's challenge to its regional leadership in the finance domain in the Asia Pacific.

It is worth noting that Japan is not the only country in Asia that has territorial disputes with China. Other countries, such as India, the Philippines, and Vietnam, also have different kinds of maritime and territorial conflicts with China. Unlike Japan, they seem to be able to separate their security concerns with economic benefits in the AIIB case. As mentioned, Japan's “security concern” over China is multifaceted. The dispute over the Senkaku/Diaoyu islands is just one factor. China's rise, in both economic and security dimensions, has deepened the suspicions and worries of Japan. The US-Japanese alliance also constrained Japan's policy options. Moreover, China's AIIB also challenged Japan's established leadership in global financial governance. To an extent, Japan's refusal to join the AIIB can also support the first hypothesis which suggests that a self-identified leader will choose exclusive institutional balancing to delegitimize a potential challenger. Therefore, our model only highlights the most important factors that lead to Japan's rejection of the AIIB, but not tell the whole story behind Japan's decision-making process.

Conclusion

Integrating role theory and institutional balancing theory, our “leadership transition” argument explains the diverse policy responses of states toward the AIIB. This argument suggests that states identify their different roles during a potential leadership transition in global governance. The leadership transition will take place when a challenger state proposes a new institution, through which the challenger state has the potential to replace the leadership position of the existing leader state in the system. To pool support and strengthen legitimacy of the new institution, the challenger state is more likely to conduct an inclusive institutional balancing strategy to provide extra benefits as public goods, which the old system cannot provide, through the new institution. China's inclusive design of the AIIB as well as its generous funds for infrastructure development vindicate this argument.

The existing leader state in the system, however, is more likely to reject the new institution initiated by the challenger state through an exclusive institutional balancing strategy, as illustrated through the US' strong opposition against the AIIB and its subsequent failed containment efforts in Europe and Asia. For other states the leadership transition model suggests that they have to pick between the challenger state and the leader state in the current system. If they value economic interests over

⁵² Deniel Runde, “Britain Launches European Rush to Join AIIB, Now What?” *Foreign Policy*, March 17, 2015.

⁵³ Leika Kihara and Linda Sieg, “Japan unveils \$110 billion plan to fund Asia infrastructure, eye on AIIB,” *Reuters*, May 21, 2015.

security concerns, they will choose to support the challenger state because of the attraction of the “goodies” from the new institution, as seen in how the UK changed its mind to support the AIIB. However, if a state is concerned more about security rather than economic benefits, it is more likely to stick with the existing leader that can provide security and stability through the existing system. Japan’s rejection of the AIIB is caused by the insecure perception regarding the rise of China in both economic and security domains.

Whether the AIIB eventually succeeds or fails, it is clear that the AIIB is China’s first attempt at challenging the US leadership in global financial governance. It does not mean however that the AIIB will be the rival institution to replace the Bretton Woods Institutions, such as the WTO and IMF. The AIIB might be more complementary than competitive to these existing institutions. If China can successfully lead the AIIB, it will have the potential to lead existing institutions. Our leadership transition model suggests that institutional balancing among states will be more dynamic and dramatic in the future. Differing from what traditional power transition theory predicts about a possible conflict between the US and China, we suggest that the leadership transition between the two states in global governance can be peaceful through institutional competition.⁵⁴ The existing hegemon and beneficiaries of the present system will need to consider how they can accommodate China’s legitimate requests to achieve a peaceful transformation of the international system.

Lastly, institutional balancing is by no means the only game in town. The hegemon can still use military-based balancing strategies to take down the rising power. We have seen military-based balancing efforts of the US toward China in the Asia Pacific through its “pivot” or “rebalance” strategy. We argue that a relatively peaceful leadership transition through institutions is still possible if policymakers in China and the US are wise enough to overcome the temptations and fears rooted in traditional military balancing and the employment of hard power.

⁵⁴ For power transition theory, see A.F.K. Organski, *World Politics*. New York: Knopf, 1958. For applications of power transition theory to the US-China competition, see Ronald L. Tammen, and Jacek Kugler, “Power transition and China–US conflicts,” *The Chinese Journal of International Politics* 1, no. 1(2006). For a criticism, see Steve Chan, *China, the US and the Power-transition Theory: A Critique*. Routledge, 2007.

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