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China's "Great Leap Outward": The AIIB in Context

*By Stuart Larkin**

EXECUTIVE SUMMARY

- The Asian Infrastructure Investment Bank (AIIB) is one of two new China-led multilateral development banks launched during 2014, along with the US$ 40 billion Silk Road Fund. They join an existing array of institutions for China to export capital and together they signal a quantum step up in the country's international financial expansion.

- The Silk Road Economic Belt and the 21st Century Maritime Silk Road together envisage a comprehensive trans-Eurasian network of economic corridors and maritime trade routes (with the inferred market penetration), with the countries of Eurasia and the maritime Asia Pacific invited to join a "community of shared destiny".

- The AIIB's purpose is to lead on implementing this "Belt and Road" vision, and become an instrument of "soft power" by providing "public goods" to address the region's "funding gap" with its infrastructure loans. AIIB's multilateral structure is for inclusiveness to help alleviate political opposition and fear of China's rapid rise.

- The AIIB plays a role in China's domestic economic restructuring by exporting capital. The country needs to drain its domestic economy of surplus savings to improve returns on investment and raise the efficiency of resource allocation at home.

- China's US$ 4 trillion of foreign exchange reserves can be drawn on to finance infrastructure development for a return superior to those of US Treasury bonds. But the

AIIB will also play a role in channelling renminbi savings overseas by selling its own bonds in the home market as well as developing the offshore renminbi market by securitizing its project loans.

- Effective redress of regional (and global) infrastructure finance markets requires considerable managerial, technical and diplomatic skill. If successful, China will become a major player in global finance.

** This is the second in a three-part series on the AIIB by **Stuart Larkin**. Stuart Larkin was Visiting Fellow at ISEAS from 26 May 2014 to 25 September 2014, and 20 October 2014 to 19 April 2015.*

INTRODUCTION

After some thirty years of double-digit economic growth, China has become dependent on the world economy with one of its two key drivers having been labour-intensive manufacturing exports. The other is domestic infrastructure and real estate development. Xi Jinping is regarded as China's strongest president since Deng Xiaoping which is fortuitous because China now faces considerably changed circumstances both at home and abroad which require talented leadership and a much more pro-active approach. Thanks to an inappropriate response in western countries to the 2008 global financial crisis that continues to this day, weak consumer demand in developed country markets coexists with massively inflated values in asset markets and a glut of investment capital in a very low interest rate environment (with negative nominal interest rates in some countries). In short, China can no longer rely on the US to lead the world economy with consumption growth, and instead it must pro-actively foster new sources of growth by further promoting the rise of Asia. It can do this most effectively by spurring regional infrastructure development – because of the scale factor as well as the demand multiplier effect – which promotes future growth by complementing, and increasing the returns to, the further integration of trade and investment within the Asia Pacific region.

The Asian Infrastructure Investment Bank (AIIB), along with the creation of other institutions such as the New Development Bank, (NDB), the Contingency Reserve Fund and the Silk Road Fund, are major initiatives for China although they will play a complementary role with existing institutions that manage capital exports. There is a tendency to see the AIIB as having two key roles: as a leading agency for implementation of the "Belt and Road" vision expounded by Xi Jinping and as an instrument of "soft power" delivering "public goods" which address the region's infrastructure financing requirement. However, AIIB can only really be understood when placed in the context of the economic circumstances that confront China at home and abroad. Partly out of necessity and partly out of opportunity, Beijing is now laying the foundations for the next stage of China's rise. However, the logic of the "great leap outward", along with the ability to execute, is undermined if the financial surpluses go into reverse due to deterioration in the domestic economy. Xi Jinping's strategy is not without its risks.

THE WORLD ECONOMY AS THE DEFINING CONTEXT FOR CHINA

National Revival; "Belt and Road"

With China having the second largest economy in the world, and destined to become the largest[1], it is understandable that it should aspire to eventually attain global superpower status to match the USA. Becoming a regional great power is a necessary intermediate step, and

[1] China has already overtaken the USA as the world's largest goods trader, with total imports and exports of over US$ 4 trillion in 2013. Jamil Anderlini and Lucy Hornby, China Overtakes US as World's Largest Goods Trader, Financial Times, 10th January 2014, http://www.ft.com/intl/cms/s/0/7c2dbd70-79a6-11e3-b381-00144feabdc0.html#axzz3RVdkoAQF

Beijing often couches its rapid rise in terms of "national revival", restoring its status to that which it once enjoyed in the past.

The "Belt and Road" is a far-reaching economic development plan which focuses on improving trade, infrastructure and connectivity in the Asia Pacific region and beyond. The Silk Road Economic Belt is a programme to build land transportation corridors that connect China to Europe and all other major Eurasian sub-regions, including Indochina, South Asia and Southwest Asia. The 21st Century Maritime Silk Road is a port development initiative to broaden Chinese trade channels targeting the maritime regions of Southeast Asia, South Asia, the Middle East, East Africa and the Mediterranean[2]. China is planning to build highways, express railways, pipelines and ports and to use these new outlets to bind China with other countries in the region. Connectivity has a compelling economic and commercial logic to it – to gain access to global natural resources and overseas markets to sustain China's economic expansion – but it also easily takes on geostrategic and security connotations. However, what is less well appreciated is the role domestic economic circumstances play in the motivation for China's "Great Leap Outward".

China's Economy

Beijing's top priority at the moment is to manage the slowdown of the Chinese economy, which has slowed to around 7 per cent GDP growth but has not yet troughed, and facilitate a structural transition. Dependence on exports to rich country markets for growth when these markets have stagnated must be reduced, along with reduced dependence on domestic infrastructure and real estate development for growth. There needs to be a re-orientation towards greater domestic consumption as a driver of growth. But this is easier said than done since many citizens still face economic insecurity and the savings rate remains stubbornly high at around 40 per cent.

Given strict capital controls, China's high savings rate causes another problem – a domestic savings glut resulting in weak resource allocation. The marginal productivity of domestic investment has fallen so low that in the macro-economy it now takes RMB 5 of investment to produce RMB 1 of GDP growth[3]. The slowdown has revealed a glutted real estate market and overcapacity in many capital intensive sectors such as cement and iron and steel. China has to drain off surplus savings from its domestic economy to improve resource allocation and returns on investment. China's export of capital in the modern era can be traced to the "Going Out" policy from 2002 but a quantum step-up is now in prospect; (see later section on China's capital exporting institutions).

After years of trade surplus and net inward capital flows China has accumulated a high level of foreign exchange reserves, which stood at US$ 3.84 trillion in December 2014[4]. Foreign

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[2] David Arase, China's Two Silk Roads Initiative: What It Means For Southeast Asia, unpublished draft, February 2015

[3] David Arase, China's Two Silk Roads: Implications for Southeast Asia, ISEAS Perspective, 22nd January 2015

[4] Trading Economics, China's Foreign Exchange Reserves, accessed 17th February 2015, http://www.tradingeconomics.com/china/foreign-exchange-reserves

exchange reserves need to be redeployed from low-yielding foreign government bonds, such as US Treasuries. After more than a decade of the “Going Out” policy to secure outside sources of energy and minerals, China has given careful consideration to what other asset classes have the potential scale to accommodate a significant proportion of reserve assets in the medium to long term. However, should the Chinese economy move into trade deficits that diminish foreign exchange reserves, and should its domestic savings surplus serious decline, then the very logic of “Belt and Road” will be undermined, along with the capability to execute it. Assuming this doesn’t happen, the search will continue for overseas financial assets that can be invested in that also deliver benefits to China’s real economy, (such as exports of construction services and building materials). With this in mind we shift our focus to the current circumstances in the world economy.

Global Economic Conditions and the Opportunity in Infrastructure Finance

China’s export growth has slowed as consumer markets in developed economies have remained weak since the 2008 Global Financial Crisis (GFC). Bank bailouts spurred national debt to high levels in many countries and the general response has been to cut public spending rather than raise taxes especially on the rich. The result has been continued weak demand, high unemployment and downward pressure on wages, particularly in middle-class occupations under continued pressure from technology and off-shoring. Rather than stimulate bank lending to real economy businesses, Quantitative Easing (QE) has just stoked asset prices, particularly in real estate and equities. This has further widened inequality which has suppressed economic recovery since the wealthy save proportionately more. Apart from the US economy which is boosted by lower energy costs through fracking, recovery in other developed economies is weak or non-existent (although they will benefit from lower oil prices).

In the continued absence of Keynesian demand stimulus policies, growth prospects in the developed world are poor. China’s economic slowdown, which prompted an end to the 15-year commodity super-cycle, is lowering growth rates of economies in the region who are also negatively impacted by the withdrawal of foreign capital resulting from the announcement of QE tapering. In short, growth prospects globally are “moderate”[5] and interest rates are likely to remain low for some considerable time to come. Ordinarily, this should be good for financing infrastructure, were it not for the longstanding failure in the existing global financial architecture to intermediate savings into infrastructure investment.

Globally, and regionally, there is clearly a need for infrastructure investment. The global infrastructure financing requirement is estimated at US$ 1.0-1.4 trillion annually with current annual spending on infrastructure of US$ 0.8-0.9 trillion[6]. Government budgets provide around half the funding and national development banks US$ 570-650 billion annually. Private sources account for US$ 150-250 billion; Official Development Assistance, (ODA),

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[5] Global growth to remain 'moderate' in 2015, says IMF, BBC News, 14th April 2015. http://www.bbc.com/news/business-32303683

[6] Elek, Andrew, Boosting infrastructure investment can prove G20’s value to the world, The Conversation, 21st February 2014, http://theconversation.com/boosting-infrastructure-investment-can-prove-g20s-value-to-the-world-23472

and MDBs provide only an estimated US$ 40-60 billion annually, and South-South flows are estimated to finance US$ 20 billion or less annually[7]. On the regional level, the "funding gap" is just as bad. Asian nations need infrastructure investments of US$ 750 billion per year through 2020 (ADB) whereas ADB and World Bank combined are making infrastructure investments of just US$ 20 billion a year worldwide[8].

Some specific causes of the funding gap can be identified. Financing from national budgets is subject to macroeconomic constraints and the debt levels and budget deficits of the developed countries limit their ability to contribute. Also, the availability of credit from the private sector is constrained by tough regulatory reforms like Basel III. However, a more fundamental systemic failure is occurring. Despite very low interest rates, huge gaps in infrastructure coexist with comparably massive accumulation of savings and underused global capacity. The world's capital is concentrated in vast pools of value with US$ 80 trillion plus in global bond markets, US$ 60 trillion held in worldwide bank deposits, upward of US$ 50 trillion captured in equity markets and US$ 47 trillion plus controlled by 10 million high net worth individuals[9]. So it is not the case that there is inadequate savings to finance the world's infrastructure requirement but rather that there is a massive failure in the *intermediation* of savings into investment.

Given the consumption weakness and investment surplus globally, developing necessary infrastructure is essential to realize global growth potential. Infrastructure projects produce an impressive demand stimulus during the construction phase, for labour, building materials etc. which is particularly marked in the developing world. The IMF found that the long term fiscal multiplier for government investment in infrastructure is around US$ 1.6 for every US$ 1 of investment in developing countries, much higher than in developed countries[10]. If ways can be found to intermediate savings into infrastructure investment, with momentum being generated to get a large number of projects underway, then infrastructure development will become a driver of regional and world growth. If AIIB and her sister institutions succeed, and play a key role in this, then the leadership of global finance will eventually pass to China.

AIIB AMONG CHINA'S CAPITAL EXPORTING INSTITUTIONS

Although there are many opportunities for China to successfully invest abroad, and it is not that hard to exceed the low rates of return at home, I have already mentioned the need to drain the domestic economy of excess savings. In the West, resources are allocated freely, domestically or internationally, through a "trillion" individual investment decisions. However, in China four particular factors give rise to strong state control over allocative decisions that permit a highly focused and strategic engagement with the world economy. There are strict capital controls; much of the economy still consists of state-owned enterprises, (SOEs); most domestic savings are deposited in a handful of huge commercial banks; and the policy banks play a big role in allocating resources.

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[7] Ibid.

[8] Gallagher, Paul, U.S. Suicidal War on New Chinese Infrastructure Bank, Executive Intelligence Review, July 7th 2014; http://www.larouchepub.com/other/2014/4127us_v_china_bnk.html

[9] Global Energy Basel, Infrastructure for a Changing World, 2012.

[10] Miriam L. Campanella, AIIB to Help Fill Infrastructure Finance Gap, Asia Sentinel, 9th April 2015.

China is now a net capital exporter. Chinese investors channelled capital into 6,128 overseas firms in 156 countries and regions in 2014 with outward direct investment (ODI) reaching US$ 102.89 billion, up 14.1 per cent according to PRC Ministry of Commerce, (FDI was US$ 119.6 billion, up only 1.7 per cent); if including Chinese firms' investment through third parties, total ODI reached US$ 140 billion, making China a net outbound investor. It is estimated that in the next decade, outbound investment will total US$ 1,250 billion[11]. Chinese outbound mergers and acquisitions (M & A) investments and greenfield FDI in the first 5 months of 2014 were up 24 per cent on the same period in 2013 to US$ 54.2 billion[12]; and the sector mix of ODI was less resource driven and more diversified[13]. To encourage ODI as well as inward FDI is an important policy shift for Beijing who has also been working on plans for more outbound investment funds, e.g. one that targets Chinese-Arab cooperation with China Development Bank, (CDB) investing alongside the Abu Dhabi Investment Authority.

I have already mentioned that China's enormous financial surpluses are made up of domestic savings and foreign exchange reserves. Renminbi savings are largely held as deposits in state-owned banks which lend to, among others, the policy banks such as CDB who finance the infrastructure projects which have powered China's phenomenal growth rate alongside manufacturing exports. China now intends to draw on each of these two sources and lend very large amounts to finance infrastructure projects in the region. Because of this, China's strategic move into regional infrastructure finance markets should be characterized as a "great financial expansion" rather than as a mercantilist-driven one as the "Belt and Road" vision suggests, (although there are intended benefits for China's corporates as well). Should it be difficult to identify "bankable" projects in Southeast Asia, where returns will be greatest, "Belt and Road" provides a broad canvas for face-saving investments elsewhere in order to still make rapid headway in exporting capital.

Given the size of the challenge, AIIB is only one of an array of financial institutions being deployed for China's capital exports. The largest of these is CDB, one of three policy banks established in 1994, along with the Export-Import Bank of China (Eximbank of China)[14] and the Agricultural Development Bank of China. CDB's outstanding foreign currency loans were US$ 97.4 billion in 2009, accounting for 17 per cent of its outstanding loans (China Development Bank Annual Report 2009); in 2010 CDB's outstanding foreign exchange loans were US$ 141.3 billion (Peoples' Daily Online, February 14, 2011). The Chinese Investment Corporation (CIC) is a sovereign wealth manager modelled along the lines of Singapore's Temasek Holdings. China International and Trust Investment Corporation (CITIC), the state-owned investment company, has extensive international financial experience and will also play a leading role in redeploying China's vast surplus capital abroad. These institutions are augmented by some major new ones.

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[11] Xinhua, China's 'New Normal' of Investment Brings New Win-Win Opportunity, 21st January 2015, http://news.xinhuanet.com/english/china/2015-01/21/c_133936220.htm

[12] PwC, Greater China Outbound M & A Spotlight, 2014.

[13] Tong, Sarah Y., China's Outward Direct Investment: Recent Development and Government Policies, East Asia Institute Background Brief No 935

[14] Although it shares CDB's mandate to help ease China's energy and natural resource bottlenecks and to help Chinese firms expand overseas, Eximbank is a much smaller institution with assets of RMB 792million in 2009 against CDB's RMB 4.5 billion, (Downs, 2011).

The New Development Bank (NDB), is a new multilateral with Brazil, Russia, India, China and South Africa (the BRICS countries) as founder members. It will focus on infrastructure and lend to BRICS countries themselves but also to other developing countries. Assuming a capital endowment of US$ 100 billion of which 20 per cent is paid in, and if lending 50 per cent of project value, after 20 years there could be a total stock of loans of US$ 350 billion with annual lending of US$ 34 billion to investment projects totalling US$ 68 billion annually[15]. There are also Contingency Reserve Arrangements (CRA) of US$ 100 billion, of which China will contribute US$ 41 billion[16]. Another major initiative is the US$ 40 billion Silk Road Fund announced in November 2014 to provide investment and financing support to carry out infrastructure, resources, industrial cooperation, financial cooperation and other projects related to connectivity for countries along the "Belt and Road"[17]. Foreign exchange reserves will be tapped for 65 per cent of the fund, China Investment Corporation and the Export-Import Bank of China will chip in 15 per cent each, and CDB will invest 5 per cent[18].

How important the AIIB will be among such an impressive array of outbound investment institutions cannot yet be determined. While the AIIB has not been capitalized yet, in the course of his five tours, Li Keqiang signed bilateral and multilateral cooperation agreements worth some US$ 140 billion[19]. It will take the AIIB some time to build up its capital base to support a massive lending portfolio so in the short term it may be eclipsed by institutions like CDB in terms of volume of lending. But the AIIB will have OECD countries as shareholders and this will be important in mobilizing capital from non-China sources. The AIIB's multilateral character ensures that it will have a different style from the others (along with NDB). It seems likely that China's top leadership will focus on overall strategy and, while avoiding micromanagement, will foster competition between the country's various outbound investment players to improve overall performance.

The AIIB has a role to play in the development of China's domestic finance sector and in its integration with the global finance sector. China favours gradually moving towards full convertibility for the yuan for at least three reasons: China's growing status in the world economy; US debasement of the dollar by quantitative easing (monetary expansion); and US abuse of its global trading currency status by imposing sanctions on certain dollar payments for political purposes. Development of the offshore renminbi market is an important intermediate step towards convertibility and the AIIB can help in at least two important ways. First, it can sell its own renminbi bonds to finance its loan portfolio for infrastructure projects, so creating an important new internationally traded benchmark issue. Second, when construction is completed on individual projects those project loans can be securitized into

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[15] Griffith-Jones, Stephany, A BRICS Development Bank: A Dream Coming True? United Nations Conference on Trade and Development, Discussion Paper No. 215, March 2014.
[16] Wikipedia. http://en.wikipedia.org/wiki/New_Development_Bank
[17] Xinhuanet, Chronology of China's "Belt and Road" Initiatives, February 5th 2015. http://news.xinhuanet.com/english/china/2015-02/05/c_133972101.htm
[18] Caixin Online, Government Said to Name Three to Silk Road Fund Management Team, 5th February 2015.
[19] Guangzhou Daily, China's Super-Salesman Closes Deals Worth US$ 140 billion, 29th December 2014.

yuan-denominated bonds. This will create an important new yuan-denominated asset class which when internationally traded adds depth to the offshore renminbi markets.

AIIB IN THE GLOBAL FINANCE SECTOR

China has been careful not to directly challenge the world's hegemonic institutions but to create some new ones that can play a complementary role. AIIB will have substantial proprietary capital resources as well as easy access to China's huge savings surplus while the World Bank and ADB are actually relatively cash-strapped[20]. But the latter have long experience of working multilaterally and also have extensive networks into the private sector. They also have tremendous institutional knowledge and expertise in infrastructure lending in the region. The AIIB can benefit greatly by drawing on that wealth of experience which translates into capacity for loan origination. The AIIB will certainly want access to the deal flow and the World Bank and ADB are always looking for co-investors as a means of leveraging their own limited capital. Some institutional rivalry is inevitable but most likely competition and cooperation will coexist as they do elsewhere in the finance sector where, for example, banks compete fiercely for advisory mandates and then sit on the same underwriting syndicates.

From its inception, the AIIB will want to maximize its impact on the infrastructure finance market. It will want to leverage its intermediation role by drawing in co-investors to help finance the projects it takes the lead on. It will obviously be well placed to draw on China's other outbound investment institutions and its commercial banks but it would also be wise to engage the private investment institutions of the global financial system for two reasons. First, that public private partnership (PPP) is the key to plugging the "funding gap" is established orthodoxy in infrastructure finance circles these days. Second, political resistance to excessive Chinese influence through its project lending can be overcome if the project loans are syndicated to institutions from a range of countries. It will make sense for the AIIB and its array of sister institutions to each pursue multiple points of engagement with the global financial system – to mix up China's money with everybody else's – in order to downplay the sense of China's rise. This may seem counterproductive when China is seeking enhanced political influence but too overt an assault on infrastructure markets will create nationalistic backlashes. AIIB can build its international private sector network by drawing on its OECD country memberships.

There are approximately 8,000 institutional investors worldwide but only about 300 that are dedicated to infrastructure. As at 4th November 2014, there are 148 private infrastructure funds currently in the market[21]. The demand for infrastructure assets with a dependable, existing income stream now exceeds supply. The asset class has such a brief investment history, just over 20 years. Last year saw record fund raising of US$ 50 billion but this is still a tiny fraction of global savings. World Bank Group data shows that private sector infrastructure investment in Emerging Markets and Developing Economies (EMDEs) declined from US$ 183 billion in 2012 to US$ 146 billion in 2013. And this is only around 15

[20] For example, World Bank and ADB together only have capacity to funnel about US$ 20 billion into Asia each year.
[21] GIB Summit Report 2014, Op Cit.

per cent of total infrastructure investment[22]. Clearly there is much more that can be done to mobilize private sector investment in infrastructure.

But the key for the AIIB is to help host governments, i.e. clients, develop the project pipelines of "bankable" projects. Infrastructure finance can be seen as a tremendous market opportunity left open by the failure of the US-led global financial architecture to provide intermediation. China's institutions can also hope to benefit from a more profound sense of western failure in finance. Massive bank bailouts in 2008 have left an enduring legacy of sovereign indebtedness, "austerity" policies and economic stagnation in many western countries while banking culture has been exposed time and again as rotten to the core. Money laundering, misrepresentation of risk on securities, manipulation of benchmark interest rates and currency markets, aiding and abetting tax evasion are just some of the criminal activities undertaken by officials of the world's top banks without criminal prosecution. "Too big to fail" and "too complex to regulate", the banks have achieved regulatory capture. In such a setting, AIIB's entrée into global finance will be seen by many as a blessing.

CONCLUSION

The AIIB lies at the intersection of many different themes. It is seen as the leading agency for implementation of the "Belt and Road" vision expounded by Xi Jinping and as an instrument of "soft power" delivering "public goods" which addresses the region's infrastructure financing requirement. It is cited by some as a prime example of China's "new multilateralism" although the multilateral approach is not new to China. Along with NDB, the AIIB is seen as a rival to the World Bank and ADB, mounting a challenge to the post-war international order established by the Bretton Woods institutions. The AIIB is a prominent new international financial institution appearing on the world stage, not at a time when the World Bank and IMF have faced the most hostile criticism, but when the private global finance sector is not trusted and where bankers in many Western countries are despised.

The AIIB is coming into being at a time of considerable structural change in the world economy. The US can no longer power the world economy with consumption growth and while it has entered cyclical recovery, not least because of cheap energy, the other developed economies of the West and Japan remain moribund. As world demand slumped following the 2008 GFC, China didn't depreciate its currency and provided stimulus that helped to maintain Asian growth. But now China is slowing considerably (and undergoing restructuring) and the 15-year commodity super-cycle has turned down; other Asian economies are adversely affected by that but also by the announcement of QE tapering that has caused the repatriation of capital to developed economies, fuelling their asset bubbles. Meanwhile, tapering of the QE taper adds another dimension to the distorted Western economies characterized by weak consumer demand coexisting with high asset prices and rising inequality. In the midst of this, China unveils its full array of financial institutions and corporates aligned to execute a tidal wave of capital exports destined for Asian economies, with AIIB destined to lead, or at least showcase, the charge.

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[22] World Bank, Public Private Partnerships: Global Infrastructure Facility (GIF), 17th November 2014, http://www.worldbank.org/en/topic/publicprivatepartnerships/brief/global-infrastructure-facility-gif

If the AIIB and her compatriot institutions can successfully intermediate China's – and global – savings into infrastructure finance then they will create a much needed new driver of world growth. While this may take some time to achieve it may ensure a prominent role for China in global finance while facilitating the country's continued rise.

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