CHINA ECONOMIC UPDATE MAY 2017

Belt and Road Initiative – can the reality of the program meet China's grand ambitions?

NAB Group Economics

In May, China hosted a summit for a range of global leaders to promote the Belt and Road Initiative – the multi-decade, global infrastructure plan first outlined in 2013. Despite positive rhetoric surrounding the initiative, it has achieved only modest results to date – with competing priorities both domestically and internationally impacting on the project.

WHAT IS THE BELT AND ROAD INITIATIVE?

The Belt and Road Initiative (BRI) is a broad (and somewhat loosely defined) infrastructure program (including roads, railways and ports along with power generation and fuel pipelines) linking China and a broad range of countries in Asia, Europe and Africa. It is intended to develop land based trade links across Asia to the Middle East and Europe (which has been likened to the Ming Dynasty's Silk Road) and maritime links with South East Asia and East Africa.

The initiative has economic and political goals – supporting growth and development (particularly in underdeveloped parts of Asia and Africa) and fostering closer relations between these countries and China. The decision by the United States to withdraw from the Trans Pacific Partnership and the likely increased importance of the Regional Comprehensive Economic Partnership may support these efforts.

Finally, the BRI also has a role in China's domestic policy as well – aiming to address excess industrial capacity through both increased demand for Chinese products in neighbouring countries (although this may only occur over the longer term), as well as the potential to transfer excess industrial capacity to these regions – similar to the early stages of China's industrial development in the 1980s, when it imported surplus capital equipment from Germany and Japan among others.

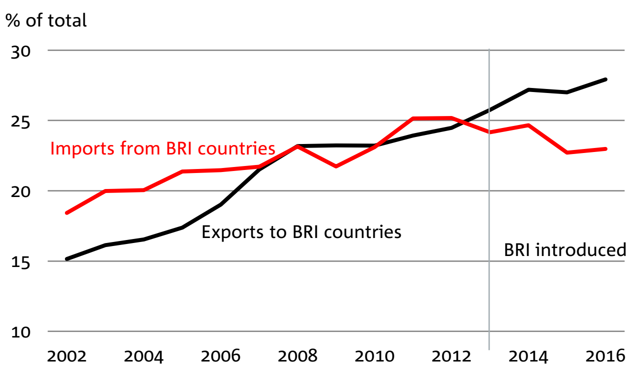
HOW EFFECTIVE HAS THE INITIATIVE BEEN?

The relatively short history of the Belt and Road Initiative makes it difficult to objectively assess the success of the program. This is particularly the case where political and economic objectives of the initiative can diverge.

From a trade perspective, there has been limited increase in trade values since the BRI was introduced. Two-way trade with BRI countries rose from 24.8% of the total in 2012 to 25.8% in 2016 – albeit this was slightly below a peak of 26% in 2014. The share of exports has gradually risen over time – up from 24.5% in 2012 to 27.9% in 2016 – while import values from BRI countries have fallen. At least some of this decline reflects commodity price trends over this period.

TRADE WITH BRI COUNTRIES

Import share has fallen, likely price related



Source: CEIC, NAB Economics

Similarly, investment in BRI countries is yet to substantially increase – with total non-financial investment in 53 BRI countries falling by 2.0% in 2016 and contracting further in early 2017 (down by 19% yoy in the first four months of the year). This may reflect the competition between short and longer term priorities at a governmental level – with Beijing implementing tighter controls last year to curb capital outflows. It is also worth noting that the large

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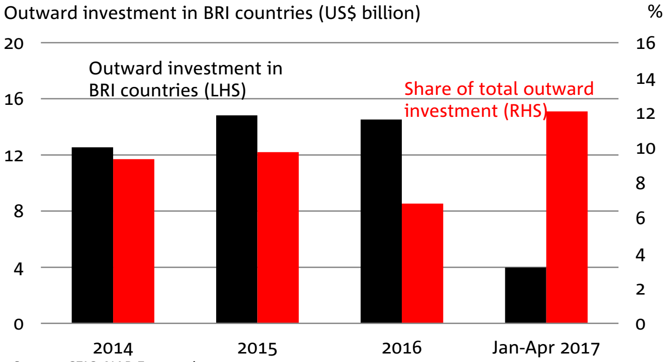
cost and long lead times of major infrastructure projects means that year-on-year comparisons may not provide the most accurate picture of growth in the BRI.

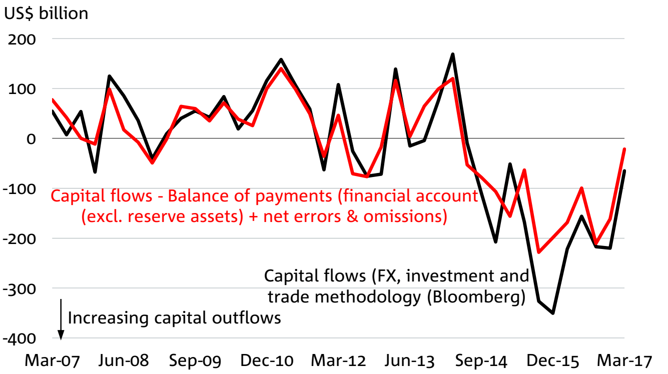
INVESTMENT IN BRI COUNTRIES

Investment weaker than 2015 peak…



Source: CEIC, NAB Economics

…with capital outflow restrictions a potential constraint



Sources: Bloomberg, IIF, CEIC, NAB Economics

Investment in BRI countries is not entirely infrastructure related. Singapore received the largest level of investment for a BRI country in 2016 – despite the country's highly developed and sophisticated infrastructure. Similarly, authorities have recently cracked down on investment by Chinese firms in unrelated sectors – most notably the purchases of European football clubs. More generally, poorly invested funds increases the risks associated with China's already high debt levels, along with the often higher levels of sovereign risk associated with some BRI countries.

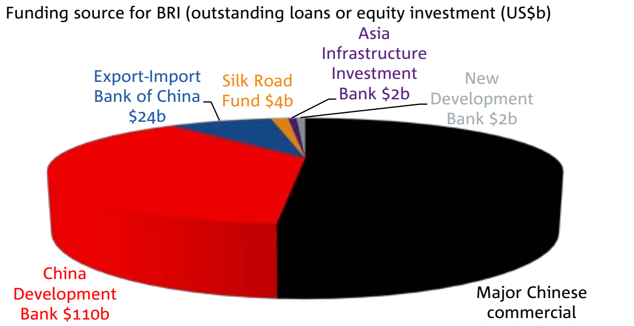
China's state-owned enterprises have been heavily involved in BRI investment, with data from the State-owned Assets Supervision and Administration Commission noting that 47 central government SOEs have been involved in almost 1700 projects in BRI countries since 2013. There have been concerns that government pressure has influenced SOEs to invest in unprofitable projects – raising long running concerns around both the sustainability of Chinese debt and the reform of SOEs. This means that there are substantial risks (in addition to the much touted benefits) to China's economy from the initiative.

WHO IS SUPPLYING THE FUNDING?

Data published in the Financial Times suggests that the China Development Bank – one of the three state-owned policy banks – is the single largest source of funding for BRI investment – with outstanding funding of US$110 billion at the end of 2016 – around 38% of the total. The four major state-owned commercial banks have lent a combined US$150 billion – just over half of all BRI lending. Perhaps surprisingly, relatively little funding has come from either the Asia Infrastructure Investment Bank (AIIB) (US$2 billion) – the Chinese established multi-national development bank – or the Silk Road Fund (US$4 billion) – a state-owned investment fund established to support the BRI.

FUNDING SOURCES FOR BRI INVESTMENT

Burden falls heavily on China's major banks



Source: Financial Times, NAB Economics

At the recent BRI summit, President Xi announced a further US$113 billion of funding, which is likely to be delivered via the Silk Road Fund, the China Development Bank and the Export-Import Bank of China. However, the Chinese government needs other countries to provide funding via the AIIB; it cannot afford the vast sums reported (as high as US$8 trillion in coming years) on its own.

CONCLUSIONS – WHAT DOES THE BRI MEAN FOR AUSTRALIA?

Based on current data, the BRI has had only a modest impact in boosting China's trade and investment links – compared with the considerable ambition of China's government. There remain long term challenges, balancing competing political and economic objectives that may run counter to each other.

Australia is not currently considered one of the BRI countries; however as a signatory to the Asian Infrastructure Investment Bank, it has a direct link into the initiative. Some have called for greater involvement in the project, including suggestions that BRI could fund infrastructure and development projects in Northern Australia. That said, the history of previous attempts to develop this region have been patchy at best.

Others have suggested that the input demands for infrastructure construction could underpin longer term demand for Australia's resource exports. We would urge caution in such an assessment – as China's vast overcapacity in sectors such as steel production are too large to be absorbed by near neighbours, while the longer term outlook for China's domestic demand is likely to be relatively weak. We would argue that the BRI is unlikely to provide another mining boom for Australia.

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