

# Xi's New Silk Road plan

China further increases funding for overseas infrastructure investment



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- ▶ **An additional USD40bn from China for overseas infrastructure investment increases demand and reduces slack**
- ▶ **For Asian economies, this should provide another source of funds to plug infrastructure gaps and boost trade**
- ▶ **Our analysis shows that trade in Australia, Indonesia, Japan and Korea would increase the most**

The recent Asia-Pacific Economic Cooperation (APEC) meeting in Beijing resulted in deals that will have long-lasting effects. President Xi Jinping pledged USD40bn for infrastructure investment to build a New Silk Road in the spirit of the centuries-old trading route, comprising a land-based economic belt and a maritime route. This follows recent agreements to establish the Asian Infrastructure Investment Bank (AIIB) and the BRICS bank and is in line with the rapid growth of China's outward investment, which is likely to surpass inflows in 2014.

China's infrastructure sector has the capacity to meet needs in Asia and further abroad. That investment overseas should also generate demand for China's exports and help reduce economic slack and disinflationary pressure. The New Silk Road plan should also mean more investment for the less-developed central and western parts of the country and generate better long-term returns on foreign reserves.

As we pointed out previously, the still-significant infrastructure gaps in Asia can be met by China's outward direct investment (ODI) push (see [Building on China's overseas investment](#), 8 August 2014). The region as a whole should also benefit from increased demand and lower trading costs. Our analysis shows that trade in Australia, Indonesia, Japan, and Korea would increase the most as a result of China's new strategy.

So, while the deals on trade, tariffs and emissions made the headlines at APEC, we believe the New Silk Road plan is likely to have a profound impact on the region.

# Two routes

- ▶ China's investment in infrastructure along the new land and sea silk roads should boost demand and trade flows
- ▶ Its own infrastructure boom means the Chinese economy is well-positioned to export its capacities as well as capital
- ▶ As China becomes more connected both internally and externally, the gains from trade can benefit the whole of Asia

## Making connections

China's "one belt, one road" strategy through investing in land and maritime "silk roads" to Central Asia and Europe and South Asia was flagged up last year when President Xi visited Kazakhstan. Since then, we have had the AIIB, the BRICS bank and now the New Silk Road, which means there is now some serious financial firepower aimed at the region's infrastructure gap.

The Asian Development Bank estimates that Asia infrastructure financing demand will be around USD8 trillion between 2010 and 2020, so there is still a long way to go. But Asia needs the investment and China has both the funding power as well as the capacity to meet that demand. This is why China has agreed to fund most of AIIB and the BRICS bank (USD50bn each), and all of the New Silk Road plan (USD40bn) investment,

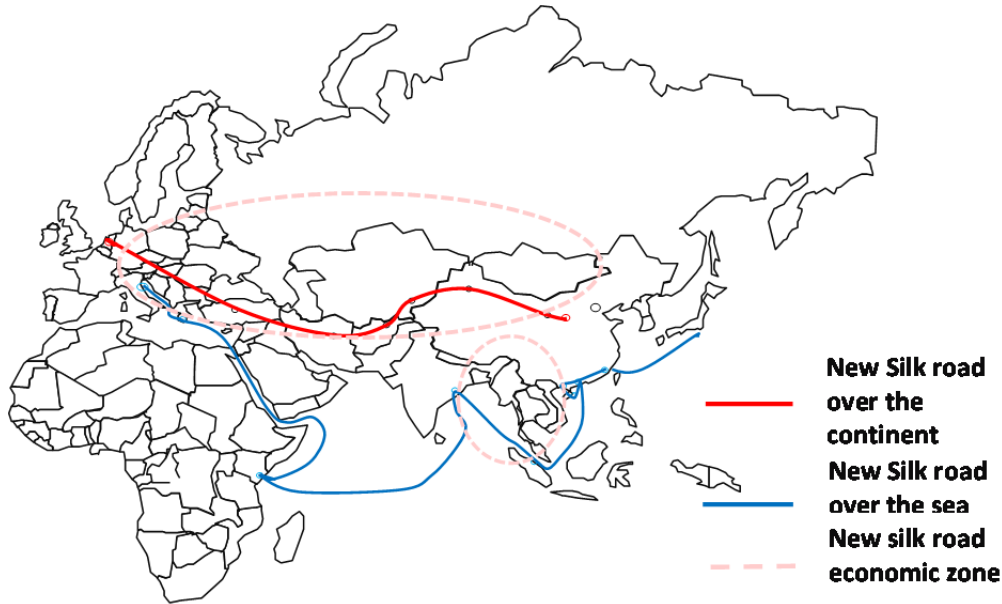
### 1: Summary of the "one road, one belt" strategy

The "one road, one belt" strategy	
Goals	Improving connections among China, Asia and European countries, promoting international cooperation, trade, and overseas development
Four major parts	China-Mongolia-Russia economic belt Europe-Asia continental bridge (China, central and West Asia, Middle East and East Europe) China-South Asia-West Asia economic belt Maritime route: links between China and countries through the Pacific and Indian Ocean
Major railway projects (planned or under construction)	<ol style="list-style-type: none"> <li>1) Yunnan-Vietnam-Cambodia-Thailand-Malaysia-Singapore</li> <li>2) Xinjiang-Central Asia-Iran-Turkey-...-Germany</li> <li>3) UK-France-Germany-Poland-Ukraine-Moscow-Central Asia-Russia-Northeast China</li> <li>4) Northeast China- Russia-US-Canada-US</li> </ol>

Comparison two new institutions:		
	AIIB	New silk road
Starting capital amount	USD50bn	USD40bn
Source of funding	Mostly China, with contributions by members according to relative economic size.	China
Investment limitations	Infrastructure construction projects in member countries only	Unrestricted, but likely to focus on countries along the New Silk Road
Common objectives	<ol style="list-style-type: none"> <li>1) Providing cheap long-term financing support to infrastructure projects in Asia</li> <li>2) Relieve current over-capacity, improve manufacturing capacity utilisation</li> <li>3) Promote infrastructure and equipment exports, overseas direct investment</li> </ol>	

Source: HSBC

2: The New Silk Road: an economic belt and a maritime route



Source: CEIC, HSBC

in addition to a separate USD100bn reportedly earmarked for domestic infrastructure investment (source: *Bloomberg*). Since the investment will be in roads, railways, ports and airports, it should also benefit all parties due to lower trade costs. Investing in infrastructure along these routes will serve to develop new export markets for China, generate better and longer-term returns on its

foreign reserves, and act as another channel through which China can internationalise its currency, the renminbi (RMB), complemented by the likely boost to trade flows due to ODI.

**We need more demand**

Recent economic activity data suggests growth in China is still facing downward pressure. The HSBC

3: Major railway projects planned along the “One road, one belt” region



Source: CEIC, HSBC

China PMI has stabilised in recent months, but is hovering at around the 50 break-even level at best, rather than moving up a gear (chart 4). With growth subdued, the output gap is not being closed (chart 5). This excess capacity is leading to the persistent disinflation that has seen CPI fall to 1.6%, significantly below the government's forecast.

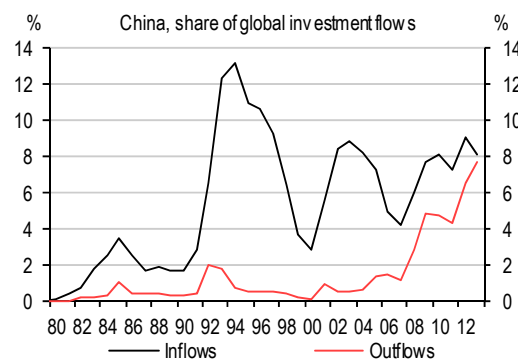
Unfortunately, the external demand picture is not promising either, given the weak recovery of some of China's main trade partners, especially the EU. The recent appreciation of the real effective RMB exchange rate, exacerbated by lower domestic inflation, makes China's export outlook even more challenging.

Given that this is effectively a problem of insufficient demand, the logical prescription would be for fiscal policy to stimulate demand. Of the many ways governments can do that, investment in infrastructure is usually considered by economists as one of the best. Not only does it push up demand and growth in the short run, but it also has supply effects, improving potential growth in the long run.

## Two birds, one stone

The bulk of the New Silk Road plan is reportedly going to be funded through China's foreign currency reserves (source: *Reuters*). This serves China's need to find higher and more diversified returns on these reserves. This is also in line with the rapid growth of China's outward direct investment (ODI), which is likely to surpass inflows in 2014.

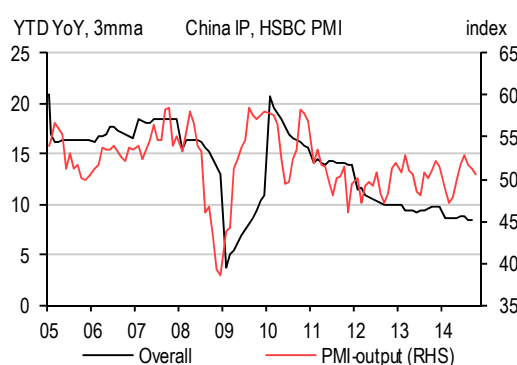
6. China's outward investment is catching up fast



Source: UNCTAD

China's total ODI reached USD108bn in 2013, so the New Silk Road would in theory boost that by 37%. There are of course plenty of challenges ahead with actually making the investments themselves. But China has the capacity and demand for infrastructure is still massive. We believe such a win-win situation does not come around often.

4. Growth momentum has remained weak



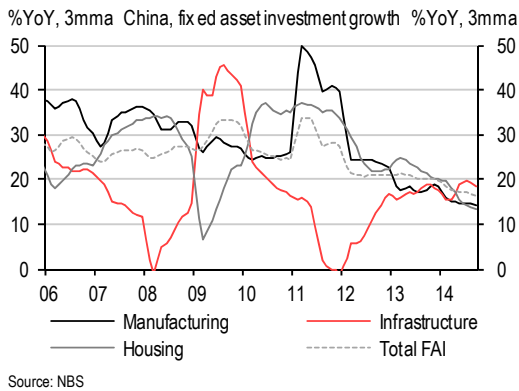
Source: NBS, Markit/HSBC

5. There is still a significant degree of slack in the economy



Source: PBoC

**7. Investment in infrastructure has been resilient**



**8. But industry as a whole has become less export-driven**



**Specialising in infrastructure**

It is well known that China's fixed asset investment has been rebalancing away from manufacturing and housing, and towards infrastructure (broadly defined as utilities and transport networks). We think this is a healthy development, given the relatively weak prospects for world trade and the domestic housing market, and the fact that China's current infrastructure could still use a lot more investment.

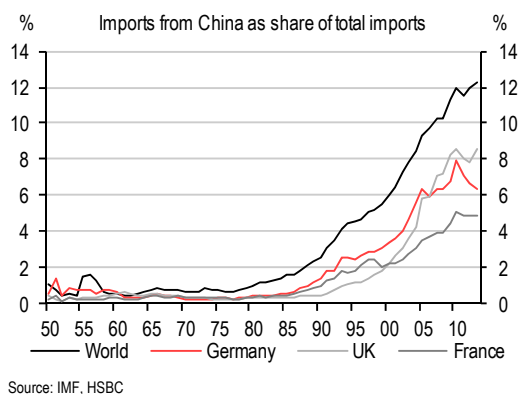
However, although infrastructure investment growth is robust, its share of total FAI is still relatively low at around 12% compared with 33% for manufacturing and 28% for housing, and so cannot halt the overall decline in FAI (chart 7).

**Seeking other buyers**

To offset a sustained decline in manufacturing and housing investment growth, infrastructure investment will need to grow faster.

The problem is that domestic infrastructure FAI growth seems to have peaked. The solution may be to focus on external demand but this is not easy given the slow growth in global exports, which has also hit Chinese producers (chart 8). Nevertheless, the quality of China's trade infrastructure is reasonably high (chart 10) and could be a good match for the infrastructure investment needs across a significant part of Asia, and indeed in much of the world at large.

**9. China's export share with Europe has stagnated**



**10. China's trade infrastructure is of high quality**

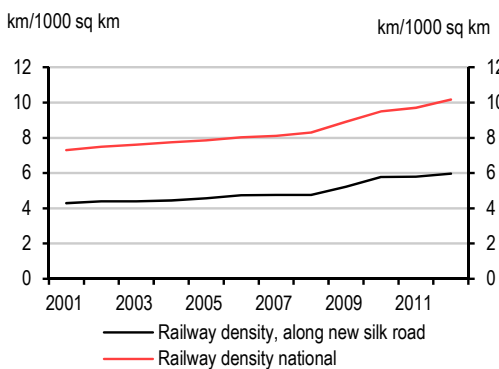


## Developing inwards

From a regional perspective, the “one road, one belt” strategy coincides another national strategy – spreading growth from the coastal region to inland areas. The nine provinces along the New Silk Road plan are based mainly in the western part of China, where GDP per capita is relatively low and infrastructure is lacking.

We estimate that all nine provinces along the land route combined cover an area of more than a third of China, and a fifth of its population. Yet, their combined GDP level was just a sixth of national total (see [Growth spreads inland](#), 11 September 2014). The low level of infrastructure sophistication is an obvious target for investment.

### 11. Railway density in China



Source: CEIC, HSBC

The performance of the external sector in these regions is also relatively weak due their geographic remoteness. The export share of all nine provinces combined was only 5% of the national total in 2013, while the share of foreign direct investment (FDI) was around 18%.

Financial constraints have been a major drag on growth for these provinces. Most rely on central government transfers and land sales to finance infrastructure projects but that has proved to be unsustainable, especially during a period of economic slowdown coupled with a property market contraction.

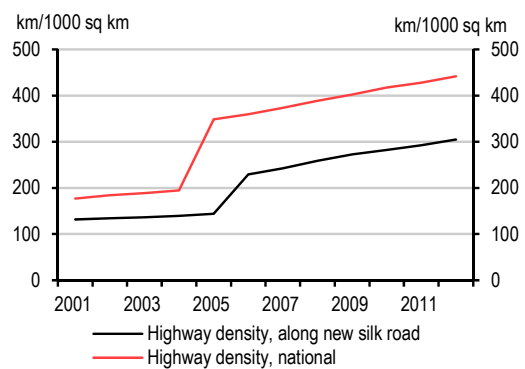
### Key economic indicators of provinces along the New Silk Road

	GDP/capita		Urbanisation		Exports (USDm)	FDI
	RMB	Rank	Level	Rank		
Xinjiang	37,181	18	43%	24	15935	481
Qinghai	36,510	20	45%	19	351	94
Gansu	24,296	30	36%	28	1411	80
Ningxia	39,420	15	48%	17	1806	148
Shaanxi	42,692	13	46%	18	10222	3,678
Chongqing	42,795	12	53%	12	38201	4,144
Sichuan	32,454	24	40%	25	32764	10,358
Yunnan	25,083	29	35%	29	8798	2,515
Guangxi	30,588	27	40%	26	9395	700

Source: CEIC, HSBC

We think the establishment of a dedicated infrastructure investment fund will readdress this infrastructure imbalance and allow these regions to trade much more with neighbouring countries. According to the preliminary blueprint, the economic belt has three elements – the transport system that links Asia and Europe, natural gas pipelines connecting central Asia and China and international highway projects.

### 13. Highway density in China



Source: CEIC, HSBC

There has already been some progress. Around 78% of total railway investment in 2013 by the central government went to the western part of China. In November 2014, the National Development and Reform Commission, the key economic planning agency, approved an additional 21 infrastructure projects including five airports and 16 railways. The total investment could reach RMB700bn.

## Easier said than done

Challenges lie ahead. Details about the allocation and management of the fund are yet to be determined and financing and operational risks could endanger the implementation of the “one belt, one road” strategy.

### Financing challenges

The key to the “One road, one belt” strategy is providing infrastructure projects with cheap and long-term sustainable finance.

Infrastructure investment tends to come with large upfront investment costs, but also generates a lot of positive externalities (reduced congestion, lower pollution, healthier population and so on). However, it will be undersupplied by the private sector, which cannot capture all of the positive returns from the investment, or borrow at the lowest rates.

However, as trade-related infrastructure investment should also cut across national boundaries and the benefits are shared, no single government will take the entire burden either. All of which means that investment demand (up to USD800bn per year, according to ADB estimates), will not be met by relying on government funding alone, especially as many Asian countries already suffer heavy external debt burdens.

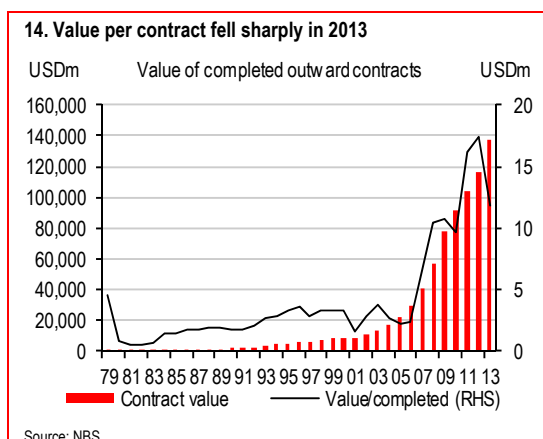
Private investments are also likely to be more focused on short-term returns and are more procyclical – not the best mix given the current uncertain economic outlook and the long-term nature of infrastructure investment. On the other hand, there is value in attracting cost-sensitive and efficient private firms. How then, to share the burden?

Both AIIB and the Silk Road Fund encourage the involvement of private capital in infrastructure construction, operation and management via a Public-Private-Partnership<sup>1</sup> (PPP) model. This inevitably involves risks. The revenue of a PPP project largely depends on the user fees collected after construction. Therefore, any Chinese enterprises investing in overseas infrastructure projects are also subject to idiosyncratic country risks. The increase in risk aversion may be one reason why the value per project declined in 2013.

Finally, PPP and project financing in general require a sophisticated and mature financial market and low transaction costs. In our view, China’s financial market still has to prove that it can handle these challenges.

### Other risks

Foreign direct investment can be a complicated business, with no shortage of examples of sudden losses for a variety of unpredictable reasons. Political risk remains high and the possibility of regional conflicts persists. In some cases, decisions taken by governments at individual project level can affect investor interests.



<sup>1</sup> A PPP contract bundles the investment and service provisions of an infrastructure project into a single long term contract. A group of private investors finances and manages the construction of the project, then maintains and operates the facilities for a long period of usually 20 to 30 years.

**15. Recent examples of problems besetting China's outbound infrastructure investment**

Time	Project	Problem	Reason
2014	Mexico high-speed railway	The incumbent government invalidated China's bid	Protests from the opposition party
2005-10	Turkey high-speed railway	Extended construction period (8 years building a 158km high speed railway)	Changes to project planning, poor preparation work
2010	Saudi Arabia light railway	A loss of RMB4.153bn	Underestimated costs of labour and materials. Contract vague on details
2014	Thailand high-speed railway	Project cancelled	Change of government

Source: HSBC

These risks are by no means restricted to developing countries. User fees for infrastructure projects such as water, electricity and rail can become political issues and often involve heavy government subsidies. The actual fee paid by users may not be enough to compensate for the initial investment, threatening the long-term profitability of the project.

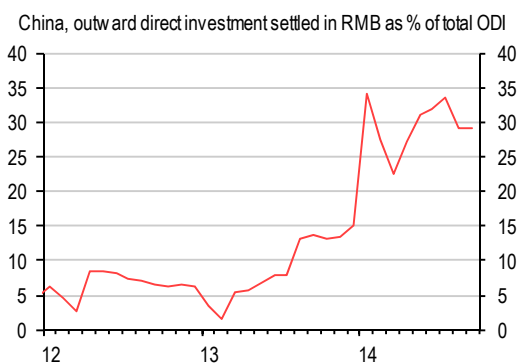
Currency movements can also be a significant source of risk. For one thing, there could be revenue losses due to exchange rates fluctuation. For another, access to long-term local currency financing may be limited in countries where financial markets are not well-developed.

**Operational challenges**

Even with the technical and cost advantages they have in many areas of infrastructure construction, Chinese companies still face difficulties such as local regulations, political instability and cultural conflicts. Table 15 gives some examples of recent Chinese overseas investment projects that have encountered problems.

As most Chinese enterprises are still at the early stage of overseas investment, we believe there is ample room for improvement in areas such as due diligence, environmental protection and working standards. But more, not less investment is the solution. We expect there will continue to be a lot of scrutiny of Chinese investment overseas and the firms carrying out these projects will often have to adapt quickly to very different business environments. The learning curve may be steep but China's companies have much to gain from venturing further abroad.

**16. A third of China's ODI is now settled in RMB**



Source: NBS

This is one reason why China is increasingly settling more of its ODI in its own currency, the renminbi. By our estimates, around a third of ODI is now settled in RMB. This is another part of the RMB-internationalisation process, and should complement the focus on increasing trade flows.



# Not another Marshall Plan

- ▶ China has committed large sums to fund infrastructure investment overseas in a short space of time
- ▶ This has led to comparisons with the US's European Recovery Program after World War II, known as the Marshall Plan
- ▶ Although there are some superficial similarities, the key difference is that China is offering investment, not aid

## A different plan

The rapid increase in outward investment by China has led to some comparisons with the US Marshall Plan after World War II. However, there are important differences, and a simplistic comparison does a disservice to the merits of both programmes.

The US helped the reconstruction of Europe through a programme of aid, lending and technical support. The US sent a total of USD13bn, or an average of 1.1% of US GDP per year over 1948-1951. This helped restore financial and exchange rate stability and alleviate resource shortages during a difficult period for Europe. Overall, the Marshall Plan is generally considered a success, although some economic historians stress the importance of the conditions attached<sup>2</sup> to the aid programme which spurred structural reforms in favour of market liberalisation and international trade, helping to provide a platform for sustained growth in productivity.

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<sup>2</sup> DeLong and Eichengreen (1993), 'The Marshall Plan: History's most successful adjustment program'

## Investment, not aid

There are some similarities between the Marshall Plan and China's growth in ODI – for example, China's total ODI in 2013 was also 1.1% of GDP. However, the first difference is that the Marshall Plan was in large part an aid programme, while China is making direct investments.

Europe's agricultural sector was badly damaged by World War II, as was its ability to pay for imports. It ran a large current surplus and was unable to borrow from international capital markets during a time when capital mobility was low and currencies were not freely convertible.

That meant much of the Marshall Plan was spent on necessities, rather than investment. Over 60% was spent on primary products and intermediate inputs (e.g. food, fertiliser, fuel and industrial raw materials). Only 17% was spent on capital goods like machinery and vehicles<sup>3</sup>. Some countries, particularly the UK, used funds to reduce national debt.

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<sup>3</sup> Crafts (2011), 'The Marshall Plan: A reality check'

China's outward investment flows are likely to generate more imports, simply because countries that experience net inflows of capital must also import more. This is different from the Marshall Plan, which worked to reduce the US current account surplus with Europe by effectively subsidising European imports of US goods.

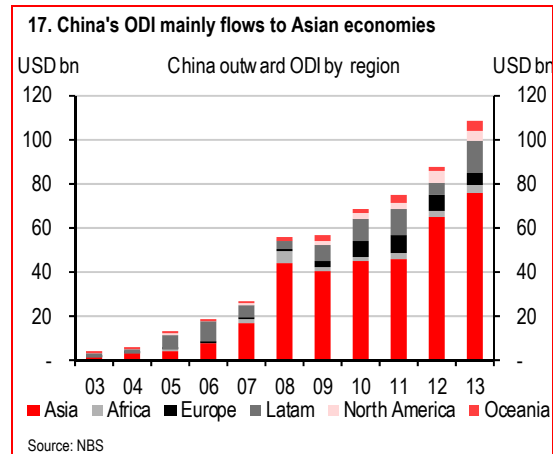
### Fewer conditions

China's foreign investment is unlikely to come with the kind of conditions attached to the original Marshall Plan. For example, recipients of Marshall Plan aid had to sign a bilateral treaty with the US committing them to follow policies of financial stability and trade liberalisation. And in return for aid, the money countries needed to pay for US imports was instead put into a "counterpart fund", which could be released for public spending, but which meant the US also had some say over fiscal policy.

This is not to suggest that these policies were harmful – indeed, most economists credit the Marshall Plan with promoting intra-European trade, which led to more efficient allocation of resources as well as technology transfer. The point is that such strong conditionality is unlikely to be a feature of Chinese overseas investment which, unlike aid, is a means to generate returns rather than prompt structural reforms.

### Less limited in geography

One final difference is that the Marshall Plan was limited to Western Europe. The scope of China's plans is broader as the aim is to improve trade connections (roads, railways, ports, airports) to its closest trading partners in Central and South Asia.



### Conclusion

The aims of China's outward investment that we have outlined in this report – generating demand, better return on reserves and developing the western part of the country – are quite different to the goals of the Marshall Plan. The world today is very different and requires different kinds of investment.

# Benefits for Asia

- ▶ When China boosted its own infrastructure spending between 2009 and 2011, its imports of related capital goods almost doubled
- ▶ China's New Silk Road plan will gradually increase demand for infrastructure-related capital goods and support trade in Asia
- ▶ Our analysis shows that trade in Australia, Indonesia, Japan, and Korea will increase the most as China implements its new strategy

## An immediate impact

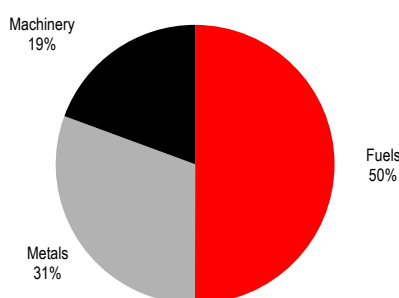
China's New Silk Road plan aims to build on its expertise in infrastructure development in order to boost trade with economies near and far. Yet, global trade should feel the benefits almost immediately. The construction will increase demand for infrastructure-related capital goods such as fuel, machinery, and metals (Chart 18). We think Asia is well-positioned to benefit from China's New Silk Road plan from the start.

We believe the potential boost to trade in Asia is significant. When China invested in its own infrastructure after the global financial crisis, its imports of infrastructure-related capital goods

almost doubled between 2009 and 2011 (Chart 19). The economic spill-over effects for the region were clear: trade drove the growth recovery and generated demand-pull inflation.

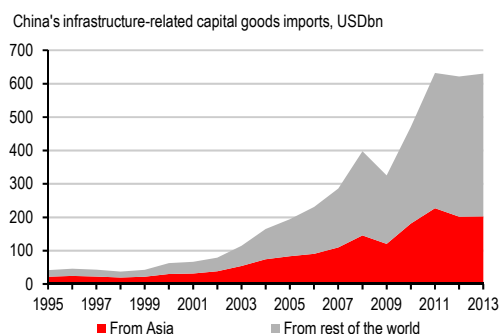
The pace of infrastructure investment from the New Silk Road plan is unlikely to be as fast as that recorded in China between 2009 and 2011 for two reasons. First, the strategy is a multinational initiative and decisions will not be unilaterally determined by Beijing. Second, the New Silk Road fund has a capital base of only USD40bn. This suggests that the magnitude of the benefits would build over time and filter through in a more sustainable manner.

18. China's imports of infrastructure-related capital goods



Source: HSBC, UNCTAD

19. Strong boost in China's capital goods imports in 2009-11



Source: HSBC, UNCTAD

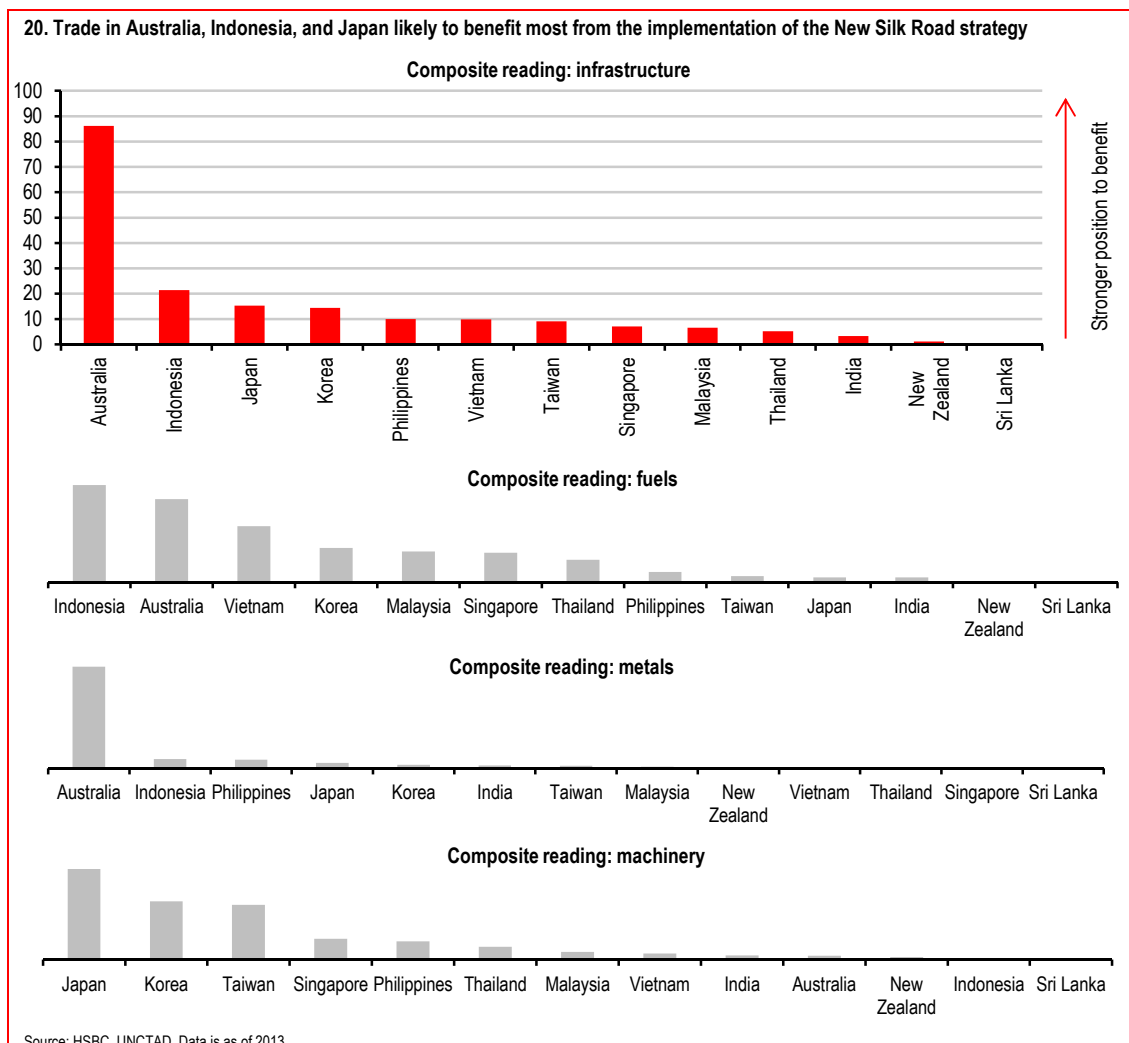
We analyse which economies in Asia will benefit most from higher exports to China as the New Silk Road plan is implemented. Our focus is on three groups of infrastructure-related capital goods: fuels, metals, and machinery. For each group in each economy, we calculate two statistics (see Appendix for more details):

Revealed comparative advantage (RCA): An economy that is more competitive in infrastructure-related capital goods will be in a stronger position to satisfy the higher demand.

China's share of the capital goods exports: Economies that already sell most of its capital goods to China are likely to be more established in

the Chinese market. This places them in a stronger position to capture the increase in demand.

To obtain the combined effect of an economy's competitiveness and its exposure to China, we take the product of the two statistics. A larger composite reading shows that an economy is in a stronger position to benefit from the New Silk Road plan through the export channel. Taking into account of all three groups of infrastructure-related capital goods, our results show that **trade in Australia, Indonesia, Japan, and Korea would increase the most as China implements its New Silk Road plan** (Chart 20).



## Appendix

### Definition of the three groups

The three groups used in our analysis are composed of goods classified under the Standard International Trade Classification (SITC). The respective SITC codes are given in parentheses.

Fuels: Coal, coke, briquettes, petroleum, gas, and electric current (3.32, 3.33, 3.34, 3.35).

Metals: metal ores (2.28), iron and steel (6.67).

Machinery: Power-generating machinery and equipment (7.71), machinery specialised for particular industries (7.72), metalworking machinery (7.73), and general industrial machinery and equipment (7.74).

### Revealed comparative advantage

The revealed comparative advantage (RCA) states that countries derive a greater share of exports from goods in which they are competitive, relative to the global average. For example: in Australia, fuels accounted for 25.9% of the country's exports in 2013 while globally, fuels made up only 18.1% of world exports. Thus, Australia's RCA in fuels is  $25.9\%/18.1\% = 1.4$  (see Table 21 for all results). When an economy's RCA value for a certain good is greater than one, then that economy has a comparative advantage in that area.

### China's share of capital goods export

For each group of capital goods, we calculate the export share that is sold to China. For example: in Australia, the export value of fuels from Australia to China was USD9.7bn while globally, fuel exports were valued at USD65.2bn. Thus the share is  $USD9.7bn/USD65.2bn=14.9\%$ .

### Definition of infrastructure

The infrastructure reading is obtained by summing up the underlying export values for all three types of goods: fuels, metals, and machinery before computing the RCA and share values.

### Composite reading

The composite reading is the product between the RCA and China's share of the capital goods export.

21. RCA, China's share of export, and composite reading of infrastructure-related capital goods in each economy

	RCA				Share				Composite reading			
	Infrastructure	Fuels	Machines	Iron	Infrastructure	Fuels	Machines	Iron	Infrastructure	Fuels	Machines	Iron
Australia	2.0	1.4	0.2	8.0	42.6	14.9	7.6	65.3	86.2	21.3	1.7	522.4
India	1.0	1.1	0.5	1.1	3.3	1.1	3.5	13.3	3.2	1.2	1.8	14.4
Indonesia	1.3	1.7	0.3	1.3	16.8	14.3	2.3	37.3	21.5	25.0	0.6	47.3
Japan	0.9	0.1	2.1	1.4	17.8	9.5	18.3	19.5	15.3	1.2	38.9	28.2
Korea	0.8	0.5	1.1	1.1	18.9	16.5	23.7	15.1	14.4	8.8	25.0	17.2
Malaysia	0.9	1.2	0.5	0.3	7.3	6.4	7.3	21.5	6.6	7.9	3.3	7.3
New Zealand	0.3	0.2	0.3	0.4	4.1	0.1	3.4	13.9	1.1	0.0	1.2	5.5
Philippines	0.4	0.2	0.5	1.2	23.1	12.3	15.3	38.4	9.9	2.7	7.9	44.3
Singapore	0.9	1.0	1.0	0.2	8.2	7.8	9.2	6.4	7.1	7.6	8.9	1.6
Sri Lanka	0.0	0.0	0.1	0.0	2.4	0.4	0.1	34.2	0.1	0.0	0.0	0.8
Taiwan	0.6	0.4	0.8	0.9	15.1	3.7	28.4	13.8	9.0	1.6	23.5	12.4
Thailand	0.5	0.3	1.0	0.4	10.0	16.5	5.7	6.3	5.2	5.7	5.5	2.2
Vietnam	0.5	0.6	0.3	0.5	19.1	23.4	8.8	9.4	9.9	14.4	2.6	4.8

Source: HSBC, UNCTAD. Data is as of 2013.

# Disclosure appendix

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