Financing China's Global Dreams

By Arthur Kroeber

Beijing has promised to put a lot of money to work building infrastructure across Eurasia, although the actual amounts will be far smaller than the headline numbers. A bigger question is how many viable projects there are to finance.

One reason that China's outward ambitions have sparked such anxiety is that a bottomless pit of money seems available to finance them. With no apparent funding constraint, what stops Beijing from ignoring commercial considerations and pushing projects whose main purpose is to cement its political influence in Asia? This freedom of action also prompts the worry that breakneck infrastructure spending through the Belt-and-Road Initiative will lead to environmental damage, abuse of worker rights and social disruption, just as it did during the past two decades of China's domestic building spree. Finally, some fret that Beijing's money muscle will enable it to build a new set of multilateral institutions, such as the Asian Infrastructure Investment Bank (AIIB), that will shift the rules of the game for the international economic order.

These concerns are all legitimate to some degree; the tough question is, to just what degree? To answer, we need to assess how much money China really has to throw at international projects, understand the institutional channels through which the cash will flow, and take stock of the political and economic obstacles likely to impede full realization of the Belt-and-Road blueprint.

Three conclusions stand out. First, the amount of international investment finance China is likely to mobilize in the next several years, though impressive, is much less than the extravagant headline figures. Second, the biggest constraint on Belt-and-Road projects is not the availability of finance but the ability of target countries to absorb it. Last, the notion that China-backed financing institutions pose a threat to the international rules of the game is overblown. For the most part, these institutions will simply create more competition. This might discomfit the incumbents, but the economic impacts will on balance be beneficial.

Please, *please* ignore the headline numbers

At first glance, Beijing has conjured up vast sums to support the Belt-and-Road in the last two years: US$100bn for the AIIB, another US$100bn for the New Development Bank (NDB, formerly the BRICS Bank), and US$40bn for its Silk Road Fund. The combined total of nearly a quarter of a trillion dollars is almost as large as the outstanding loan balances of the World Bank's two main lending arms, built up over six decades.

These figures must be substantially discounted: the working capital of these three new funds will actually be just US$40bn, one-sixth the headline figure. The headline numbers represent *authorized* capital, not the amounts that shareholders will actually pay in. At most multilateral development banks, authorized capital far exceeds the paid-in amount. Its main function is to reassure rating agencies and the buyers of the banks' bonds that shareholders stand ready to backstop any loan losses. This enables the banks to borrow large amounts at very low rates, despite the razor-thin margin they earn on their portfolio.

The total investment finance China will mobilize in the next several years will without doubt be far less than recent headline figures

The paid-in capital for the new China-sponsored development banks will likewise be a fraction of the authorized amount. For AIIB it will be US$20bn and for the NDB only US$10bn, and these amounts will be paid in over five years. In other words: by 2020, AIIB will have an equity base on a par with the Asian Development Bank (ADB) and the Inter-American Development Bank (IDB). The New Development Bank will command resources comparable to the smaller African Development Bank (AfDB) and the CAF Development Bank of Latin America. These are substantial but not world-changing amounts.

How might this capital base translate into lending activity? Here a number of variables come into play, notably how much bond finance the new banks can raise to supplement their capital, and the availability of worthy projects. As a first approximation, we observe that the old-line development banks (World Bank, ADB, IDB and AfDB) disbursed amounts equal to 40-50% of their equity in 2014. CAF, a younger bank

How The New Kids Stack Up (I)
Multilateral banks and Silk Road Fund: capital structure, US$bn

	Capital			Usable	S&P credit
	Authorized	*Subscribed*	*Paid-in*	equity	rating
World Bank (IBRD)	283	253	15	40	AAA
Inter-American Development Bank	144	144	5	24	AAA
Asian Development Bank	154	153	8	17	AAA
EBRD	33	33	7	16	AAA
African Development Bank	97	94	7	9	AAA
CAF Dev Bank of Latin America	15	10	6	9	AA-
Asian Infrastructure Investment Bank	100	100	20*	20*	na
New Development Bank	100	50	10*	10*	na
Silk Road Fund	40	40	10	10	na

***Projected for 2020**
Gavekal Dragonomics research

How The New Kids Stack Up (II)
Multilateral banks and Silk Road Fund: lending

	Loan balance US$ bn	Loan-to-equity ratio	2014 disbursements US$ bn	Disbursements/ equity, %
World Bank (IBRD)	160	4.0	19	47%
World Bank (IDA)	127	na	13	na
Inter-American Development Bank	75	3.1	9	39%
Asian Development Bank	56	3.3	7	43%
EBRD	22	1.4	9	57%
African Development Bank	31	3.5	5	52%
CAF Dev Bank of Latin America	19	2.2	6	70%
Asian Infrastructure Investment Bank*			10-14	45-70%
New Development Bank*			5-7	45-70%
Silk Road Fund*			2	20%

***Projected for 2020**
Gavekal Dragonomics research

that shares some characteristics with AIIB, prides itself on using its capital more effectively than other development banks: it disbursed 70% of its equity last year. Taking 45-70% as a plausible range of disbursement rates, AIIB and NDB by the early 2020s together might be lending out US$15-20bn a year, roughly as much as the World Bank's non-concessional arm does today, and two or three times as much as ADB. Assuming that annual disbursements at all other multilateral development banks rise by 10% between now and then, the two new Chinese-backed banks could

A bevy of lenders

Actual and projected international lending by selected Chinese financial institutions

Institution	Description	US$bn
China Exim Bank	Total non-trade related disbursements, 2014	80
	Export seller's credits, 2014	29
China Development Bank	Net international lending, 2014	(22)
	Average annual net int'l lending, 2008-2014	23
Bank of China	Declared annual Belt-and-Road lending, 2015-17	20
AIIB	Projected annual disbursement after 2020	10-14
New Development Bank	Projected annual disbursement after 2020	5-7
Silk Road Fund	Projected annual disbursement, 2015-2020	2
China Africa Development Fund	Total disbursements, 2009-2015	2.4
CIC Capital	Proposed US$100bn direct investment fund	na

Gavekal Dragonomics research

account for as much as quarter of non-concessional development lending by multilaterals.

That is probably a high-end estimate. A host of factors could slow the takeoff of the new banks. One is governance. This is not much of an issue for AIIB, which has a governance structure similar to CAF's, an experienced chairman in Jin Liqun (who spent five years at ADB and another five as the supervisory board chairman at sovereign wealth fund CIC), and a clear-cut mission to finance infrastructure in developing Asia. It could be a big one for NDB, which has an unwieldy shareholding structure—equal shares for the five founding members: China, India, Brazil, Russia and South Africa—and no clear mandate.

A second problem is funding. Development banks depend on raising a lot of bond finance at low rates. It is possible that as the new kids on the block, AIIB and NDB will get lower credit ratings and so pay a higher cost of funds than banks with a longer track record. AIIB chairman Jin has tried to forestall this possibility by telling rating agencies in his roadshows that he has several Asian financial institutions lined up ready to pay AAA rates for his bonds, regardless of what rating the agencies assign. Borrowing in renminbi on China's domestic bond market would spare the bother of placating the international rating agencies, but carries its own risks. Interest rates are higher in China than elsewhere, yuan funding would pose currency risk given that AIIB will lend in US dollars, and avoiding the international bond market would make it hard for AIIB to establish credibility as a high-standard multilateral bank, which is its stated aspiration.

Probably the biggest obstacles are the capacity of the new banks to manage their portfolios, and the capacity of target countries to absorb their loans. Jin says he wants AIIB to be nimbler and less bureaucratic than the World Bank and ADB, and aims to limit staff positions to 300-400, about one-tenth the World Bank number. The goal of running an international loan book the same size of the World Bank's on a tenth the staff is laudable, but probably unrealistic. Most likely, AIIB will ramp up its lending more slowly than our high-end estimate implies. This is all the more so since the value of viable projects for it to finance is almost certainly far below the gigantic sums casually tossed about by regional development boosters—a point to which we will return below.

Yet more numbers to ignore

Of course, the new multilateral banks are not the only channel through which China proposes to fund its excellent infrastructure adventure. Let us consider three others: sovereign wealth funds, commercial banks and policy banks.

The Silk Road Fund is a new sovereign wealth fund established by Beijing in December 2014 specifically to catalyze finance for Belt-and-Road projects. Its headline capitalization is US$40bn, but once again this is authorized capital. Actual paid-in capital is US$10bn, of which US$6.5bn comes from the foreign exchange reserves controlled by the People's Bank of China, US$1.5bn each from the existing sovereign wealth fund CIC and the China Export-Import Bank (Exim), and US$500mn from China Development Bank (CDB).

The Silk Road Fund is designed as a private-equity magnet fund, similar to the World Bank's International Finance Corporation. It will not fully fund projects on its own, but will provide anchor equity financing (and some debt), with the idea that its stamp of approval will encourage other institutions (both Chinese and non-Chinese) to stump up additional finance. The IFC itself is impressed; it has agreed to explore co-investments with the Silk Road Fund.

Obstacles include the capacity of the new banks to manage their portfolios, and of the target countries to absorb loans

Assuming the Silk Road Fund invests its initial capital over a five-year period, it could provide US$2bn a year in Belt-and-Road equity finance, scarcely an earth-shattering figure. It will be interesting to see if it can avoid the fate of a similar effort, the China-Africa Development Fund (CADF), which was established in 2009 to catalyze Chinese investment in Africa. CADF's original target was to invest US$5bn. Even though the fund is in essence a subsidiary of China Development Bank, meaning that its equity investments ensure debt finance by CDB, CADF by mid-2015 had succeeded in putting only US$2.4bn to use, less than half its target. Once again, this points to the fact that headline commitments are meaningless without good projects to finance.

Other commitments from sovereign wealth funds and commercial banks are harder to pin down. China's main sovereign fund, CIC, has traditionally focused on portfolio investment in public equities and bonds. In January 2015 it set up a subsidiary, CIC Capital, to manage direct investments, which will probably include some infrastructure projects. CIC Capital is reportedly planning to raise a fund of up to US$100bn, but at the moment this is a notional figure.

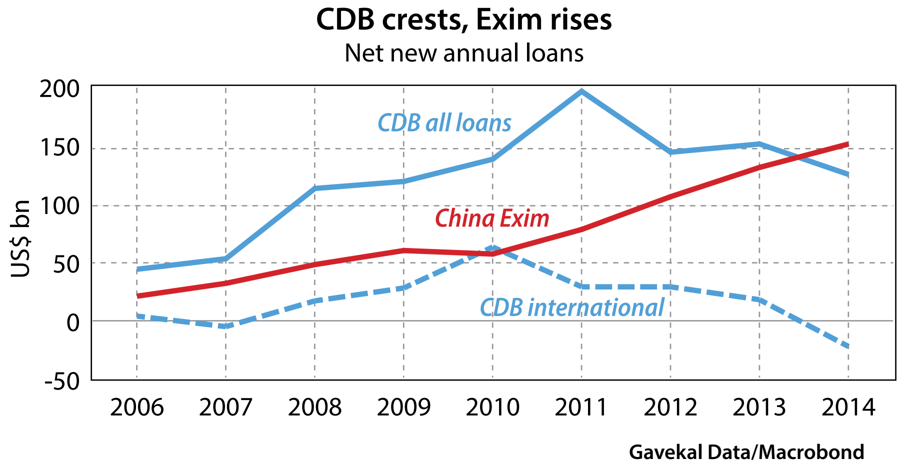
The investment commitments of China's sovereign fund and commercial banks are notional figures, unlikely ever to be realized

Similar cautions apply to the public commitments by Chinese commercial banks. Bank of China has indicated it will lend US$20bn a year for the next three years on Belt-and-Road projects; CITIC has pledged total lending of US$113bn over an unspecified time frame. It is doubtful what these pledges mean. Chinese financial institutions obviously face intense political pressure to show loyalty to Xi Jinping's signature foreign policy initiative. It costs them little to put out press releases touting their future plans, especially if they have lending projects in the pipeline that can be plausibly be rebranded "Belt-and-Road."

The really big kahunas: policy banks

This leaves the policy banks. Beijing set up three policy banks in 1994, to handle lending that commercial banks were unlikely to touch because the profits were too low or the time lines too long. Two are already active in international financing: CDB and Exim.

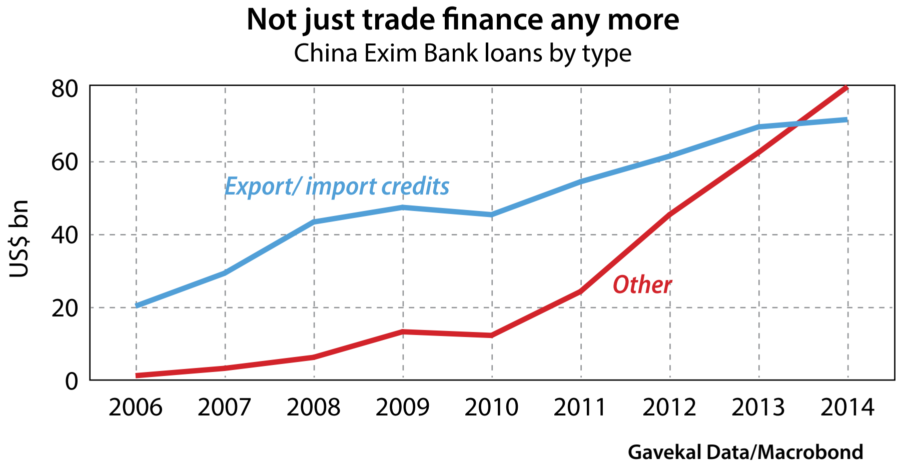
CDB's original mandate was to support domestic infrastructure, but under its long-serving and powerful chairman Chen Yuan (1998-2013), it became known for aggressively pursuing global resource deals, starting in 2008. It funded state-owned enterprises (SOEs) to buy mines and oil wells and set up factories in Africa, and was the financier for a number of state-to-state deals, including ones in which arms of the governments of Venezuela, Russia and Brazil secured loans in exchange for guaranteeing oil supplies to China. Its portfolio of international loans rose from nearly nothing in 2007 to US$187bn in 2013.



CDB's wings were clipped after Chen's retirement in April 2013. Last year its net international loans fell by US$22bn, even as its domestic lending picked up. Accounts in the Chinese press suggest that CDB has been instructed to be less adventurous overseas and stick to its domestic development tasks. It is likely that CDB will continue to lend abroad under the Belt-and-Road banner, but given the reduction in its net international portfolio last year it is hard to know how big a force it will be.

As CDB's star has fallen, however, Exim's has quietly risen. Traditionally a supplier of trade credits to facilitate exports and imports, since 2010 it has rapidly expanded its portfolio of other lending, much of which (based on anecdotal reports) seems to be infrastructure or development-related finance in low-income countries. Some of this is concessional lending under China's foreign aid programs and some of it is on commercial terms. Some is disbursed abroad and some is probably spent in China, in the form of loans to Chinese engineering firms and materials companies selling goods and services abroad. Exim's sparse financial statements make the exact proportions a matter of guesswork.

Whatever the nature of the lending, the amounts are large: in 2014 Exim passed CDB to become the largest policy bank, with US$151bn in disbursements to CDB's $125bn. In the same year, Exim's "other lending" portfolio exceeded its trade credit business for the first time, totaling US$80bn in disbursements—more than the combined lending of all seven major multilateral development banks, from the World Bank to CAF (although remember that we do not know what proportion of Exim's portfolio is disbursed outside China). Exim's contribution to China's international development schemes, including Belt-and-Road, may already exceed the contribution that AIIB and NDB are likely to make even a decade from now.



What does all this add up to? We can make a few straightforward generalizations. First, for all the media hoopla around the AIIB caused by the Obama Administration's misguided effort to prevent its allies from joining, China-sponsored multilateral lending institutions are a relatively small part of the financing plan for the Belt-and-Road dream. By the early 2020s the AIIB and NDB combined will lend out at most US$20bn a year. Throw in the US$2bn or so in annual equity investments from the Silk Road Fund, and the projected annual flow from China's three new finance entities will only be a quarter of global multilateral development finance. The relatively modest scale of these new multilaterals, and their evident inability to compete with the extensive intellectual influence the World Bank and IMF wield through their research departments, refute the fear that China is building a credible alternative to the old Bretton Woods architecture.

Second, the policy banks remain Beijing's instrument of choice for financing international infrastructure projects. CDB's annual net new international lending of US$23bn over the past seven years exceeds the projected flows from the new Chinese-backed development funds; and although CDB is being curbed, Exim is assuming a larger role. But the extreme opacity of Exim's accounts makes it hard to know exactly what proportion of its activity is relevant to the Belt-and-Road Initiative. The murkiness of the policy banks' activities abroad demands fiercer scrutiny by media and watchdog NGOs.

Finally and most important, the amount of money Chinese institutions say they are willing to put into Belt-and-Road projects is in the end less important than the size of the addressable market. How many viable infrastructure projects are really buried out there, ignored by the plethora of existing lenders, but ready to blossom with the application of the fertilizer of patient Chinese capital?

Boosters reflexively cite a 2012 ADB study asserting a need for $8 trillion in infrastructure investment in the Asia-Pacific region in the 2010-20 decade. There are numerous problems with this estimate. First, the ADB as an infrastructure bank has a vested interest in presenting the largest possible demand for its services. So its claims deserve to be treated with some skepticism. Second, the estimate includes China, which accounts for more than a third of developing Asia's population and two-thirds of its GDP. A reckoning of Asian infrastructure needs *outside* China should probably start by lopping off half of the ADB's topline number. A more realistic but still potentially exaggerated estimate comes from CDB, whose database of potential infrastructure projects in Belt-and-Road countries adds up to US$890bn.

The more basic objection is that how much debt-financed infrastructure a country can usefully deploy depends on its potential growth rate, structure of growth, quality of governance, and ability to service foreign debt—factors hard to assess precisely. History is littered with examples of over-optimistic projections of future needs. The World Bank enthusiastically supported infrastructure investments in poor countries in the 1950s and 60s, only to see much of what it built sink beneath a quagmire of bad governance. The failure of CADF, after seven years of struggle, to deploy even half of its pledged US$5bn in Africa is a cautionary tale.

Some good may come of it

Despite these concerns, it is clear that increased efforts by Chinese lenders under the Belt-and-Road banner will materially increase the available funding for infrastructure in Eurasia, and probably enable the construction of beneficial projects that might not otherwise have been built. And just as we should deflate the claims about untold billions of dollars flowing forth from Beijing, we should not assume that China's international financiers will defy economic reason. Chinese officials are right to point out that Western governments and development banks have long underestimated the importance of infrastructure in poor countries, and that the World Bank and ADB are mired in bureaucratic inefficiency. (The World Bank's 2009 study of its own governance, the Zedillo Report, made many of the same criticisms.) Competition from new lenders benefiting from lessons learned from China's development will on balance be a good thing.

Moreover, evidence does not support the cartoon picture of China pouring money willy-nilly into white-elephant projects to prop up friendly dictators. Research over many years by Deborah Brautigam, a scholar at the School of Advanced International Studies in Washington, DC, shows that China's investments in Africa, while a mixed bag, have generally done more good than harm. And Chinese lenders face intense pressure from skeptics at home to show that their adventures abroad produce returns in hard cash, not just the vague currency of influence. Former CDB chairman Chen Yuan was famous for rejecting unprofitable projects. AIIB boss Jin Liqun recently reassured a Chinese audience he expects to make an annual profit of 6-10% on his loan portfolio—an extraordinarily high target for a development bank. China's ambition to build out Eurasia's infrastructure is an interesting experiment, to be watched closely but not to be feared.