THE AIIB – A 'MIDWIFE' FOR CHINA'S STRUCTURAL REBALANCING

The Asia Infrastructure Investment Bank (AIIB) is only one of China's financial initiatives designed to improve the regional investment landscape. Others include another development bank, the New Development Bank (NDB), and the Twenty-first Century Silk Road project (also known as the One-Belt One-Road, OBOR) announced in October 2013 and backed by the creation of the USD 40 billion Silk Road Fund by Beijing. Such China-led initiatives target infrastructure investment and should foster economic integration with countries across Central Asia, India, South Asia, the BRIC (Brazil, Russia, India, China) economies and Europe via land and sea routes.

Strategically, Beijing sees the AIIB (and the NDB) as multilateral tools to support its policy banks in financing overseas investment and encouraging Chinese companies to 'go out' (or globalise). It also wants to cement its position at the centre of a new economic order with all roads leading to Beijing.

Economically, the 'go-out' policy should help revive China's investment efficiency by providing new opportunities overseas. China's investment-led growth model is unsustainable, with declining marginal returns on investment since 2000. The gradual rebalancing away from investment has left many sectors with excess capacity, notably steel, cement, solar energy and construction. Promoting infrastructure development abroad helps China export this excess capacity, while boosting the market share of its companies overseas.

Meanwhile, Beijing wants to globalise the renminbi. To do so, it needs to let the currency flow abroad. This can be done by becoming a net importer of goods and services (i.e. worsening the current account balance), by becoming a large exporter of capital (i.e. buying foreign assets, expanding Chinese lending overseas, etc.) or by replicating the post-WWII US strategy of creating the Marshall Plan, the World Bank, the IMF and the like, or a combination of these three moves.

Clearly, the AIIB, NDB and OBOR are geared towards the third way of internationalising the renminbi. This implies an acceleration trend of Chinese capital outflows in the form of foreign direct investment in the coming years. Financing infrastructure projects could be a more attractive alternative to keeping China's foreign exchange reserves in low-yielding US financial assets.

We would not view the AIIB-facilitated infrastructure investment drive as a way for China to export its excess investment and, hence, revive the investment-led growth model. Rather, investment-led growth can only transition to very gradual consumption-led growth to minimise the shock to the economy.

This is because the marginal propensity to consume (defined as the change in private consumption per unit change in income) is less than 1, meaning that a one-yuan increase in income will only result in a less than one yuan increase in consumption. But a one-yuan cut in investment will reduce GDP by a full yuan (or more, if the knock-on effect of investment in one sector on other sectors is considered). Thus, a one-for-one rebalancing from investment to consumption is inherently negative for growth.

This is an especially acute problem for China because its marginal propensity to consume (MPC) is significantly lower than that of many other countries. According to our research, on average, China's MPC is only about 0.34, while in many other countries, it is 0.6 or higher.

In other words, if the government were to push for a fast rebalancing (as some observers argue it should) by cutting investment, say by one yuan, and offsetting that reduction by giving one yuan back to the people, GDP would fall by one yuan (or more depending on the knock-on effect), while private consumption would only rise by 34 cents, resulting in a net 66 cent contraction in income.

Hence, the medium-term measures should be to cut investment gradually, or even to keep the investment-to-GDP ratio stable. At the same time, the government should encourage private consumption growth by boosting the marginal propensity to consume through structural reforms such as financial liberalisation (to allow private consumption to be funded by personal borrowing), improving the social safety net (to strengthen consumer confidence) and income growth and redistribution.

The AIIB has the potential to facilitate this expenditure-switching by boosting infrastructure investment to minimise the negative income shock resulting from China's weak marginal propensity to consume. It should be seen as a medium-term step for facilitating China's economic transformation. At the same time, it can improve the economic outlook of Asia by boosting regional investment. n

This material has been prepared by HFT Investment Management (HK) Limited and BNP Paribas Investment Partners Asia Limited* and is issued by BNP Paribas Investment Partners Singapore Limited ("BNPP IPS")** and BNP Paribas Investment Partners Asia Limited, members of BNP Paribas Investment Partners (BNPP IP)***. The content has not been reviewed by the Monetary Authority of Singapore ("MAS") or the Hong Kong Securities and Futures Commission.

This material is produced for information purposes only and does not constitute:

an offer to buy nor a solicitation to sell, nor shall it form the basis of or be relied upon in connection with any contract or commitment whatsoever; or
any investment advice.

Opinions included in this material constitute the judgment of HFT Investment Management (HK) Limited and BNP Paribas Investment Partners Asia Limited or its relevant affiliate(s) at the time specified and may be subject to change without notice. BNP Paribas Investment Partners Singapore Limited and BNP Paribas Investment Partners Asia Limited are not obliged to update or alter the information or opinions contained within this material. Such opinions are not to be relied upon as authoritative or taken in substitution for the exercise of judgment by any recipient and are not intended to provide the sole basis of evaluation of any strategy or instrument discussed herein. The contents of this material are based upon sources of information believed to be reliable, but no warranty or declaration, either explicit or implicit, is given as to their accuracy or completeness. Investors should consult their own legal and tax advisors in respect of legal, accounting, domicile and tax advice prior to investing in the Financial Instrument(s) in order to make an independent determination of the suitability and consequences of an investment therein, if permitted. Please note that different types of investments, if contained within this material, involve varying degrees of risk and there can be no assurance that any specific investment may either be suitable, appropriate or profitable for a client or prospective client's investment portfolio.

Investments involve risks. Investments in emerging markets involve above-average risk. Given the economic and market risks, there can be no assurance that the Financial Instrument(s) will achieve its/their investment objectives. Returns may be affected by, amongst other things, investment strategies or objectives of the Financial Instrument(s) and material market and economic conditions, including interest rates, market terms and general market conditions. The different strategies applied to the Financial Instrument(s) may have a significant effect on the results portrayed in this material. Past performance is not a guide to future performance and the value of the investments in Financial Instrument(s) may go down as well as up. Investors may not get back the amount they originally invested.

Any reference to past performance of any market or instrument should not be taken as an indication of future performance. Neither BNP Paribas Investment Partners Singapore Limited, BNP Paribas Investment Partners Asia Limited nor any BNP Paribas Group company accepts any liability whatsoever for any loss arising, whether direct or indirect, from the use of any part of such information. A BNP Paribas Group company may, to the extent permitted by law, have acted upon or used the information contained herein, or where relevant the research or analysis on which it was based, before its publication. This material is for the use of the intended recipients only and may not be delivered or transmitted to any other person without the prior written consent of BNP Paribas Investment Partners Singapore Limited and BNP Paribas Investment Partners Asia Limited. Furthermore, any translation, adaptation or total or partial reproduction of this document, by any process whatsoever, in any country whatsoever, is prohibited unless BNP Paribas Investment Partners Singapore Limited and BNP Paribas Investment Partners Asia Limited has given its prior written consent.

* BNP Paribas Investment Partners Asia Limited, 30/F Three Exchange Square, 8 Connaught Place, Central, Hong Kong.
** BNP Paribas Investment Partners Singapore Limited, 10 Collyer Quay, #15-01 Ocean Financial Centre, Singapore 049315.
*** "BNP Paribas Investment Partners" is the global brand name of the BNP Paribas group's asset management services. The individual asset management entities within BNP Paribas Investment Partners if specified herein, are specified for information only and do not necessarily carry on business in your juri