

China's New Development Bank and Infrastructure-led Growth

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Summary

In view of China's recent launch of several new development banks (AIIB, OBOR, NDB) with a central focus on infrastructure, this NUPI Brief takes a look at how China's infrastructure projects have fared both at home and abroad in the past. It asks the question: Does economic growth, boosted by infrastructure investment, necessarily benefit development? Admitting that infrastructure has played a crucial role in China's development, as well as contributed to the changes in other developing countries, this brief cautions against several potential economic risks. To be more specific, three issues are highlighted: first, low usage and low profitability; second, debt and broken contracts; third, favouritism towards state-owned companies.

China has been the centre of attention in the world of development cooperation for recently launching or sponsoring the launch of several new development banks and funds, and infrastructure is the biggest brand under all of them. These include the US\$100bn Asian Infrastructure Investment Bank (AIIB), the US\$50bn New Development Bank (NDB, to increase to \$100bn) of the BRICS countries, and the US\$40bn Silk Road Fund (SRF) under the grand Silk Road Economic Belt and 21st-century Maritime Silk Road (or 'Belt and Road') Initiative. Much media and scholarly discussions have primarily focused on whether these new institutions challenge the dominance of the West in development assistance and global economic governance. Less attention has been paid on how they work on the ground – the initiatives are all quite new after all. The SRF was launched in December 2014, (following the announcements of the Belt and Road Initiative in late 2013), the NDB in July 2015, and the AIIB opened the door for business in January 2016. Only the SRF has started to fund a 1.65-billion-dollar Karot hydropower project in Pakistan, and the AIIB has just revealed its first project, also in Pakistan.¹

While we wait and see how China's new international development initiatives pan out on the global political and economic maps, it helps to have a look at how China's infrastructure projects have fared both at home and abroad in the past. Does economic growth, boosted by infrastructure investment, necessarily benefit development?

1 Reuters, 'China's AIIB to co-finance first project with ADB in Pakistan', 3 May 2016.

Infrastructure has been a significant component of the PRC's aid and investment in other developing countries, notably in Africa and Latin America. It has often, but not always, been bundled with natural resources. They have mostly served the roles of 'diplomatic gifts', item of barter trade for natural resources, and facilitator of industrial zones or commodities trade. The current wave of development cooperation initiatives from China, however, has infrastructure as the central component. Plus, the initiatives are already having a significant impact on the allocation of projects funded by China. A recent report by Grisons Peak demonstrates that most of Chinese policy banks' loans of over one billion USD in 2013-2015 have been given to projects along the planned Belt and Road routes. The share of each continent in allocation of such loans has seen a sharp decrease in Africa, with a significant increase in Asia and moderate rise in Europe. Moreover, India and Vietnam, two countries that are not strategic friends with China, are amongst the top twenty recipient countries of Chinese policy banks loans during 2013-15.² This underlines the pragmatic nature of China's recent overseas development projects – economic interests are crucial to the funding decisions.

This policy brief discusses the economic impacts of China's past infrastructure projects to caution against several potential risks. To be more specific, three issues are highlighted: first, low usage and low profitability; second, debt and broken contracts; third, favouritism towards state-owned companies.

Before we do that, two caveats need to be stated. First, social and environmental impacts are not included in this policy brief, despite their importance, because of limited scope and much coverage in existing studies. There are numerous reports about poor labour conditions, forced or poorly compensated displacement, and environmental problems of Chinese projects. The studies in this category often fail to take into consideration the difficulty within China to combat pollution and irregular labour practices. They also tend to ignore the fact that many of such behaviours are conducted by companies without the oversight of the Chinese government. Being

2 'Chinese Policy Bank Loans and the Rapid Buildout of the 21st Century Maritime Routes (2013-2015)', Grisons Peak Special Feature, March 2016, available http://www.chinainvestmentresearch.org/wp-content/uploads/2016/03/Article_Chinese-Policy-Bank-Loans_2013-2015.pdf.

aware of its image, Beijing has consistently urged Chinese companies to comply with local laws when they 'go out'. The question then is whether the host country has complete regulations; if not, whether Chinese companies should instead adopt international standards. With regards to the new development banks, the Silk Road Fund is wholly owned by China, and many projects under the Road and Belt Initiative will be funded by Chinese policy banks. The Chinese actors will thus be decisive on their labour and environmental records. The NDB and AIIB, on the other hand, are multilateral banks, and China has been trying to demonstrate that they adopt international standards in labour and environment safeguards.

Second, infrastructure has played a crucial role in China's development, as well as contributed to the changes in other developing countries. At home, infrastructure development has facilitated industrialisation and trade, and provided connectivity, energy and employment. Many foreign companies still invest and outsource production to China despite the higher wages there compared with some other developing economies, because China has a better infrastructure network. Chinese engineers and construction manufacturers have gained knowledge and experience, particularly under tough working conditions – a competitive edge of Chinese construction companies in bidding for projects in developing countries. At the onset of the recent global financial crisis, Beijing swiftly rolled out a Keynesian-style stimulus package in November 2008 that had a major component of infrastructure. Despite the side effects, it did help China stabilise growth and create jobs.³

Abroad, infrastructure is regarded by many African countries as the single most important contribution that China has made to their development, despite all the controversies, and this contribution is where China differs from colonisers and traditional donors.⁴ African countries believe it was thanks to Chinese investment, particularly in infrastructure, that the continent has changed drastically in the past decade. Roads, bridges and railways, telecommunications, water systems and power stations have removed some bottlenecks that resource-rich countries had faced, improved the people's access to public services and world markets, as well as facilitated investors from other countries to come in. Governments and international organisations, including the World Bank, IMF and ADB, have welcomed China's new development banks as a much-needed source of financing to fill in the infrastructure gap: US\$8 trillion by 2020 in Asia according to ADB and one trillion dollars per year worldwide according to the World Bank.

It is with these caveats and the context of rather positive international responses that this policy brief seeks to address three specific economic issues of Chinese overseas infrastructure drive: low usage and low profitability, debt and broken contracts, and favouritism towards state-owned companies.

Low usage and low profitability

China has become the largest infrastructure market in the world, partly as inheritance to the Soviet-style planned economy that cherished heavy industries and partly as a strategy to facilitate urbanisation, reform and opening. Moreover, local governments have in

the past decades been evaluated by local GDP growth as the most important performance indicator. Given that local officials usually rotate every three or five years, they resort to big projects, typically infrastructure and real estate, as the easy and fast ways to stimulate growth. It is also a sector where grey incomes abound for corrupt officials and their cronies, as will be discussed later.

Low usage and redundancy have become prominent problems in China's domestic infrastructure projects in the past decade, exacerbated by the government's response to the global financial crisis and stimuli afterwards. There are numerous examples of 'ghost cities'; the most known one being Ordos in Inner Mongolia.⁵ There is overcapacity in ports, highways, windmills, and small airports. Utilisation rate of Chinese highways was only 12% of the seven major OECD countries, and the average utilisation rate for small airports was only 50% in 2009.⁶ A government-sponsored domestic study of the high-speed railway development finds that because of the high ticket price and limited demand in less developed areas, the ridership on some high-speed rails were lower than expected and some projects have become economically unsustainable. There are even instances of redundant construction; for example, two parallel lines were constructed between Tianjin and Beijing and between Shanghai and Nanjing in two separate bigger projects. Moreover, the high ticket price and expansion of space used for high-speed rails have sometimes led to congestion on normal roads, obstructing passenger and freight transportation.⁷

The similar problems of redundancy and low profitability can be seen in some overseas projects too. In 2011, China helped build a satellite town, Kilamba, outside Luanda, the capital of Angola, in exchange for the latter's oil. The town, however, became a ghost city, because the price was well out of reach of two-thirds of Angolans, mortgages were difficult to obtain, and flats were mainly awarded to civil servants as a 'bonus'. Only after the Angolan government ordered the price to drop and opened the state-backed mortgage to the public in 2013 did more middle-class people move in. In July 2015, there were 80,000 residents according to official news sources, in comparison with the half a million planned for the town.⁸

Low profitability is a natural consequence of low-usage infrastructure. Indeed the financial returns to such capital-intensive public projects are usually expected in the long term, and some projects serve the purpose of public goods instead of earning profits. However, there is an opportunity cost in how the same money could be spent elsewhere and earn more profits or benefit people's lives in a more adequate way. As most of the infrastructure projects would need co-financing from host governments or host country companies, allocating much resources to infrastructure could significantly distort the developmental path of the country in the long term and exacerbate inequality in the short term, as will be discussed later.

5 'Ordos, China: A Modern Ghost Town', *Time*, <http://content.time.com/time/photogallery/0,29307,1975397,00.html>. 'Data Mining Reveals the Extent of China's Ghost Cities', *MIT Technology Review*, 2 Nov. 2015.

6 EU Chamber of Commerce in China, 'Overcapacity in China: Causes, Impacts and Recommendations' (2009), available at <http://www.european-chamber.com.cn/en/overcapacity-in-china>. 'Overcapacity continues to pressure Chinese port operators', *Moody's Report*, Feb. 2015.

7 Min Chen, Hailong Tang and Kun Zhang, 'Some Critical Issues in the Development of Chinese High-Speed Rail: Challenges and Coping Strategies', *Journal of Transportation Technologies* 2014, 4, 164-74.

8 'Angola's China-Built Ghost Town', BBC, 3 July 2012, <http://www.bbc.com/news/world-africa-18646243>. Chloé Buire, 'Views of Suburban Luanda: Banishing the Ghosts from Kilamba', Africa Research Institute, 2 Sep. 2015, <http://www.africaresearchinstitute.org/blog/views-of-suburban-luanda-banishing-the-ghosts-from-kilamba/>.

3 See Yang Jiang (2015) 'Vulgarisation of Keynesianism in China's response to the global financial crisis', *Review of International Political Economy*, 22, 2, p. 360-390.

4 Reuters (2015) 'West still treats Africa as former vassals' – South Africa's Zuma to RT', 10 May, <https://www.rt.com/news/257353-zuma-africa-russia-china-brics/>

Debt and broken contracts

China followed the Keynesian prescription on debt financing to invest in big infrastructure projects at the onset of the global financial crisis. These projects have caused a sharp rise of government debt. From 2008 to 2012, China's total debt to GDP ratio jumped from 125% to 215%. By the middle of 2013, outstanding local government debt stood at Rmb18 trillion, up 80 per cent in just two years.⁹ Default has already happened to some infrastructure projects sponsored by local governments; for example, the Yunnan Highway project in 2011, the Qilu Bank in Shandong Province in 2013, and Shanghai Chaori Solar Energy Science and Technology Company in 2014. Two researchers at the National Development and Research Commission found in 2014 that nearly 40% of Chinese investment projects were either not finished on time or not completed at all.¹⁰ They also found that the incremental capital-output ratio (ICOR) has risen 50%, from 2.6, (for the period of 1979-1996) to 4 (for the period of 1997-2013), which means about 50% more capital is needed to produce an extra unit of output.¹¹ Underlying this declining efficiency of capital usage is massive expansion of infrastructure and real estate investment.

The problem is that infrastructure investment can become addictive. The infrastructure investment in China in recent year has apparently not had much 'spillover' effect in other sectors except generating more over-capacity in traditional sectors like steel, cement, glass etc. To a government that wants to maintain GDP growth, the short-term solution is to pump more money into infrastructure and construction. Although the Xi-Li government recognizes the inefficiency and the enormous local government debt that infrastructure investment has created under the previous government during the global financial crisis, Beijing has approved several 'mini' packages of infrastructure stimulus, justifying them by underlining the selective and high-tech nature. When the economy slowed in 2014, local officials were tasked with propping up growth with more infrastructure investment. However, even such investment stimulus is running out of steam, having less and less effect in a slowing Chinese economy. At the same time, efforts by Beijing to close down local government finance companies, which have built up dangerous levels of debt, stopped in May 2015, when the government allowed them to borrow again.

One risk with local debt financing for infrastructure in China is that most of these loans are guaranteed with land or investment capital is from the revenue of land transfer.¹² Transfer of land usage has been the major source of income for local governments since the fiscal reform in 1994. The transfer of land for infrastructure and real estate development has pushed up the price of fixed assets and created bubbles, which have become the biggest risk in the Chinese economy today.

Most of China's infrastructure projects have so far been guaranteed by natural resources of the host countries. Often it is the future export of natural resources to China, in a form of barter trade. As the slowing Chinese economy needs fewer commodities, global commodities

prices have started to fall. Some countries may not be able to return the debt they owed in infrastructure through commodities export. In countries endowed with fewer natural resources, it is possible for a Chinese financial institution to provide guarantee for a Chinese loan, as China has done in the successful bid for high-speed rail network between Jakarta and Bandung in Indonesia. The continued funding of the project then depends on the health of Chinese financial institutions. It would be interesting to observe whether land financing would be copied to China's overseas infrastructure projects.

Default is also happening to some of China's overseas infrastructure projects. In Sri Lanka, nearly 70% of the infrastructure projects from 2009 to 2015 had reportedly been funded by China and built by Chinese companies, and the country was heading into a debt crisis in 2015. Relations between the two countries were strained when the newly elected Sri Lankan government in 2015 put on hold several Chinese infrastructure projects alleging graft, including a US\$1.4 billion Colombo Port City project inaugurated by Chinese President Xi Jinping. The new finance minister said: "Chinese loans are a big part of our problem. A bulk of the government expenditure goes into servicing them", when he blamed the previous government for being corrupt and urged China to adjust the terms of the loans to make them more viable.¹³ In this regard, debt forgiveness every few years has been a part of China's diplomatic relations with developing countries. However, it is doubtful that China would allow frequent defaults in its future infrastructure projects as its domestic economy slows down and regards the infrastructure export largely as an instrument to export over capacity. As Zimbabwe headed for an economic crisis in 2015, China seconded officials and experts to the Office of the President and government departments in Harare to advise the government there on economic governance to reduce the risk of default and financial leakage in Chinese-invested mega infrastructure projects.¹⁴

Broken contracts are another risk in Chinese invested infrastructure projects. It is quite a common practice among construction companies within China to win project contracts by bidding at very low prices and then demand a higher price after the contract has been signed and the project is under construction, citing unexpected costs from materials, natural conditions and so on. The same practice backfired in the highway project between Warsaw and Berlin, when neither the Polish government nor the Chinese government wished to step in to help the Chinese Railway Construction Company by subsidizing extra costs. The Polish government cancelled the contract, and the Chinese manager in Poland was demoted to a position in China.¹⁵ However, now central and eastern European countries compete to be a port or hub of China's Belt and Road Initiative. Poland is again wooing Chinese investment in other infrastructure projects.

Favouritism towards state-owned companies

An important feature of the new development initiatives would be cooperation between governments, policy banks, and public-private partnership (PPP). The big infrastructure projects usually need gov-

9 Jamil Anderlini, 'China: Overborrowed and Overbuilt', *Financial Times*, 29 January 2015.

10 Minxin Pei, 'Why China keeps throwing trillions in investments down the drain', *Fortune*, 1 Dec. 2014.

11 'OECD Economic Surveys China', March 2015, p.20, <http://www.oecd.org/economy/surveys/China-2015-overview.pdf>.

12 Kun Zuo, 'Critical Issues in the Next Decade of China's Infrastructure Effort', *McKinsey Rethinking Infrastructure: Voices from the Global Infrastructure Initiative*, May 2014.

13 'Let bygones be bygones, Colombo urges Beijing, as Chinese loans take their toll', *South China Morning Post*, 18 Oct. 2015. After China sent special envoys to Colombo for negotiations, the two countries decided in April 2016 to turn the Colombo Port City project from real estate to a financial hub.

14 'Cautious Chinese Handheld Mugabe', *Zimbabwe Independent*, 14 Aug. 2015.

15 'Chinese Builder Loses Showpiece Polish Highway Deal', *The Wall Street Journal*, 14 Jun. 2011.

ernment participation for the huge amount of capital, usage of land and natural resources, and policy coordination. State involvement is sometimes regarded by observers within China and abroad as an advantage of the Chinese model of development, involving swift decision-making processes, the ability to gather various resources and actors, and the ability to invest in long-term projects, amongst others. There is always a risk with government projects globally – corruption, and the construction sector is known as a ‘grey sector’ within China too. This policy brief will not delve into the problem of corruption, except to say that transparency is needed in all the bidding, financing and implementation processes of the projects. Even if all the practices are legal, there is a potential downside to government-led projects too: the bias towards state-owned companies.

In China, SOEs have been monopolies in heavy industries, and state banks prefer them for the implicit or explicit government guarantee. Because of the rotating door between SOE managers and government officials, they naturally share common interests in taking the commanding height of the economy. Railways, roads, and other infrastructural projects in China are widely considered ‘non-competitive sectors’ and given the nickname ‘iron roosters’ (tiegongji) - meaning that they do not give many feathers (profits) away. In the stimulus packages during the financial crisis, most of the investments in infrastructure and public works went to SOEs, leaving SMEs with little opportunity or incentive to invest. This exacerbated the problem of income inequality in China, with the income gap between SOEs and the national average widening significantly. As the government has continued to pump stimulus packages into the economy after the crisis, the SOEs harbour even more over-capacity. Overseas infrastructure projects are a strategic outlet for exporting their overcapacity. The Chinese government is also trying to attract private investment in infrastructure projects and encouraging PPP. As private companies are suspicious of how much benefits there would be in PPP or other joint investments with SOEs, the government is trying to define the respective rights, obligations, risks, and revenues of both public- and private-sector partners. As in domestic projects, China encourages PPP in its overseas infrastructure projects and the distribution of benefits will depend on the actual contracts and negotiation powers of public and private actors.

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Conclusion

China’s infrastructure projects have made tremendous contributions to the development of both China and many other developing countries. Compared with stringent conditionalities on democracy and good governance demanded by traditional donors, China only demands the host country government to respect the ‘One China’ principle. Chinese construction companies are often much cheaper, with experience and skills accumulated over the years and adapted to tough working conditions in developing countries, construction time much shorter, and their offers are often a bundled package with robust and cheap capital. Compared with other investors who demand hefty co-financing or government guarantee before they can start instilling their own share and start construction, Chinese construction companies agree to start construction immediately if host countries agree to repay the cost by exporting natural resources to some other Chinese firms. In this way, Chinese development banks even avoid money lost in the pockets of corrupt host country officials because money only flows between Chinese players. The recent initiatives by China to launch new development banks will undoubtedly continue to contribute to infrastructure construction in both developing and developed countries in similar ways.

There are however risks to the fast expansion of infrastructure investment through China’s new development banks. Given an overwhelmingly positive international response to financing in order to fill in the infrastructure gap, this policy brief argues that a more careful and nuanced perspective on the role of infrastructure in development is needed, based on a rough review of China’s infrastructure projects both at home and abroad. Environmental and labour issues aside, three economic matters will determine whether the ambitious infrastructure projects will be beneficial to local development or even sustainable themselves: the match between infrastructure supply and local demand, the debt and financing terms, and the distribution of benefits to companies and the wider population. Only when adequate decision-making, bidding and project supervision mechanisms are set up can there be a better chance of infrastructure-led growth translating into infrastructure-led development.

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