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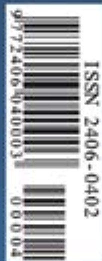

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China's Rise as a Regional and Global Power

The AIIB and the 'One Belt, One Road'

David Dollar

CHINA has been growing extremely rapidly for a long time, but an important shift in its growth pattern occurred at the time of the global financial crisis.

During the six years up to 2007 China's GDP grew at an average rate of 11 percent, with investment equaling 41.5 percent of GDP. The current account surplus was rising in this period, reaching over 10 percent of GDP. In the six years since the global crisis, the external surplus has fallen sharply into the range of two to three percent of GDP, but the shortfall in demand was made up almost completely by an increase in investment, which has reached more than 50 percent of GDP in recent years.

China's growth has been impressive compared to the rest of the world, but lost in the admiration is the fact that the growth rate has slowed down to around seven percent—down more than four percentage points from the pre-crisis period. Thus, in the recent period China has been using a lot more investment in order to grow significantly more slowly than in the past.

This pattern of growth manifests three problems. First, technological advance, as measured by Total Factor Productivity (TFP) growth, has slowed down. Second, and closely related, the marginal product of capital is dropping (it takes more and more investment to produce less and less growth). The real world indicators of this falling capital productivity are empty apartment buildings, unused airports, and serious excess capacity in important manufacturing sectors. The third manifestation of China's growth pattern is that consumption is very low, especially household consumption, which is at only one-third of GDP.

China's response to this changing growth dynamic is partly external and partly internal. On the external side, it is no coincidence that this period of excess capacity at home is the moment at which China launched expensive new initiatives, such as the Asian Infrastructure Investment Bank (AIIB), the BRICS Bank, and the 'One Belt, One Road' initiative in order to strengthen infrastructure both on the westward land route from China through Central Asia and on the southerly maritime routes from China through Southeast Asia and on to South Asia, Africa, and Europe.

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These initiatives are largely welcomed by China's Asian neighbors and this essay's next section will examine how they can contribute positively to Asian integration. However, the thinking in China that these initiatives can be a major solution to China's excess capacity problems is largely misguided. The contributions that these initiatives together make to China's demand are likely to be too small to be macroeconomically meaningful.

The domestic response to China's over-capacity problem is a set of reforms that emerged from the Third Party Plenum in November 2013. Together, these form a coherent set of measures that would rein in wasteful investment, increase innovation and productivity growth, and enhance consumption. A further section of this essay reviews the key reform measures, as well as progress to date with regard to reform. Success in this area will enable China to continue to grow well for another decade or more.

China's initiatives in Asia are seen in many quarters as a setback for the United States. The U.S. government contributed to this narrative through its efforts to discourage allies from joining the new AIIB. In the end, major American allies, such as the United Kingdom, Australia, and South Korea, did join the Chinese initiative, and Japan is seriously considering becoming a member. However, this is likely to be a temporary diplomatic setback for the United States.

America's own main economic initiative in the Asia-Pacific—namely

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the Trans-Pacific Partnership (TPP) —now seems likely to be completed by the end of 2015. Many major economies in Asia, such as Australia, Singapore, South Korea, and Vietnam want to be part of both Chinese initiatives (the AIIB and the 'One Belt, One Road') and the American effort to reduce trade barriers.

I argue in this essay's third section that these different efforts are in fact complementary. The kind of infrastructure financed by the Chinese initiatives is the "hardware" of trade and investment, necessary but not sufficient to deepen integration. TPP, on the other hand, represents the "software" of integration, reducing trade barriers, opening up services for trade and investment, and harmonizing various regulatory barriers to trade.

There is a risk that the competing initiatives of China and the United States will lead to regional blocs and a disintegration of trade, but it is more likely that Sino-American competition will lead to strengthened institutions and deeper integration throughout Asia-Pacific.

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The Bank, the Belt, and the Road

Some of the impetus for China to launch the new Asian Infrastructure Investment Bank was Beijing's concern that the governance structure of existing International Financial Institutions (IFIs) was evolving too slowly. An important agreement to increase the resources of the IMF, and to raise the voting shares of fast-growing emerging markets, has been stalled in the U.S. Congress, whereas all other nations have already ratified it. There is a certain irony that one of China's frustrations with the American-dominated institutions is that China thinks that they need more resources and is willing to contribute, whereas the different parts of the United States government cannot agree to this expansion.

China's frustration is not just about the size of the IFIs and China's weight within them. In the case of the World Bank, China has argued for years for more focus on infrastructure and growth. Several years ago, former Mexican President Ernesto Zedillo chaired what was called a High-Level Commission on Modernization of World Bank Group Governance.

It is worth looking at its key recommendations, because this was a serious effort by a distinguished international committee that included good representation from major developing countries (e.g., Zhou Xiaochuan from China, Arminio Fraga from Brazil, Montek Ahluwalia from India, and Ernesto Zedillo from Mexico). The Zedillo Report is quite critical of the current World Bank arrangement of a resident board that approves all loans. The resident board represents both a large financial cost to the bank ($70 million per year) and an extra layer of management that slows down project preparation and makes the bank less efficient. Slowness of project preparation is one of the main criticisms of clients concerning the poor performance of the Multilateral Development Banks (MDBs).

The Chinese officials charged with developing the AIIB are looking at the Zedillo Report for good ideas. The AIIB will have a non-resident board that meets periodically both in Beijing and via videoconference. Given its newness, a likely compromise among the countries that have signed up is that its board will approve many of the initial projects and eventually delegate more decisionmaking to management. The Zedillo Report recognizes the importance of environmental and social safeguards, but argues that the World Bank has become so risk-averse that the implementation of these policies imposes an unnecessary burden on borrowing countries. In practice, developing countries have moved away from using the existing MDBs to finance infrastructure, because the institutions are so slow and bureaucratic.

I think that the enthusiastic response of developing countries in Asia to the AIIB concept reflects their sympathy with the idea that a new MDB can have good safeguards and still be quicker and more efficient than existing ones.

Some of the Western commentary on the AIIB expresses a fear that China will use it for narrow political or economic ends. Now that a diverse group of nearly 60 countries have signed up, it would be difficult for China to use the AIIB to finance projects in favored countries over the exclusion of other members.

And the idea that this would help with China's over-capacity problems does not make any sense at all. If the AIIB is very successful, then in five years it might lend $20 billion per year—that is to say, on a scale with

the World Bank's IBRD lending. But just in steel alone, China would need $60 billion per year of extra demand to absorb excess capacity. This figure excludes excess capacity in cement, construction, and heavy machinery; the point is that the bank is, simply put, much too small to make any dent in China's excess capacity problem—even if it were the sole supplier for these projects, which it won't be.

The 'One Belt, One Road' initiative is larger than the AIIB. It started with the idea that nearby countries in Central Asia—spread along the traditional Silk Road—could benefit from more transport infrastructure, some of which China could finance bilaterally. However, the economies of Central Asia are not that large, and the potential for investment is limited. Overland transportation will remain expensive, compared to sea-going shipments. For that reason, China added the idea of a maritime road—that is, the expansion of infrastructure along the sea-going routes from the Chinese coast through Southeast Asia to the Indian Ocean and all the way to Europe. A vast amount of world trade already traverses this route.

Because 'One Belt, One Road' will be implemented bilaterally between China and different partners, it may seem that there is more potential for China to use this initiative to vent some of its surplus. But I still doubt that this will be on a scale that would make a macroeconomic difference for China.

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Among the various developing countries along 'One Belt, One Road' routes, there are some with relatively strong governance—India, Indonesia, and Vietnam, for example—which will be hard for China to push around. Those countries will not want to accept large numbers of Chinese workers or take on large amounts of debt relative to their GDP. On the other hand, there are weak governance countries—Cambodia and Pakistan, for instance. It may be more feasible for China to send some of its surplus production to these countries, but there is a reasonable prospect that in the long run, China will not be paid.

The West has a long history of debt forgiveness to weakly governed states. It would be smart for China to learn from that history.

China's Reform Agenda

Domestic reform is a much more promising road to deal with China's surplus problem, and to rebalance its economy away from such a heavy reliance on investment. The resolution that came out of the Third Plenum in November 2013 sketched out dozens, if not hundreds, of reforms. The ones that are likely to have the greatest effect on rebalancing China's economy fall into four areas: (1) the household registration system (*hukou*); (2) inter-governmental fiscal reform: (3) financial liberalization; and (4) opening up China's service sectors to competition.

Under China's *hukou* system, 62 percent of the population are registered as rural residents and to date it has been extremely difficult for them to formally change this designation. The result of this system has naturally been a lower rural-urban migration than would otherwise be the case.

China has one of the highest urban-rural income divides in the world, at more than 3:1. Many peasant families would like to move to cities if it were permitted. Despite the restrictions, a lot of the young rural population has come to cities as migrant workers. Even counting the migrants, however, China's urbanization rate of 52 percent is low given its level of development. One key aspect of the current system is that while migrants can come as workers, they cannot bring families or truly become citizens of the cities.

Reforming the *hukou* system would affect rebalancing in several ways. Quite a bit of measured productivity growth at the aggregate level comes from the reallocation of labor from low productivity to higher productivity activities (often from farming to urban manufacturing and service employment). Easing up on restrictions on mobility should lead to higher productivity growth, higher incomes for those now registered as rural, and greater government expenditure on services. In his work report to the National People's Congress on March 5th, 2015, Premier Li Keqiang set a target of "granting urban residency to around 100 million rural people who have moved to cities."

One of the reasons that local governments have resisted *hukou* reform is that they worry they will lack sufficient fiscal resources to fund the greater social services for migrant families. China overall has ample fiscal resources, but there is a mismatch in which the central government collects most of the revenue, while local governments bear most of the expenditure responsibilities.

China's Ministry of Finance has announced general plans for fis-

cal reform to support rebalancing. First are measures to bolster local government revenue: this could include a nationwide property tax, which could become a stable source of finance for local governments, and also discourage the hoarding of apartments that is one aspect of excess investment in China.

Second, China is planning to collect more dividends from its state enterprises. If this happens at both the local and the central level, it would reduce some of the bias towards investment and help ensure resources for government services.

Changing the incentives of local officials to align with rebalancing is a key institutional reform.

A third aspect of fiscal reform would be allowing municipalities to issue bonds to fund their infrastructure projects, rather than relying on shorter term bank loans.

The final aspect of fiscal reform may be the hardest: local officials are generally rewarded on their ability to provide investment and growth. While the system has been successful at that, it has been less successful at meeting other objectives, such as clean air, food safety, and quality education and health services. Changing the incentives of local officials to align with rebalancing is a key institutional reform.

China's repressed financial system is a third area of reform. Real interest rates that are close to zero amount to both a tax on household savers and a subsidy to investment by firms and local governments able to borrow from the banking system. Almost everywhere in the world has had zero real interest rates in recent years, but China is unusual in that such rates go back more than a decade. The government has taken some initial steps to raise deposit and lending rates, as well as to allow a shadow banking system to develop with better returns to savers and higher-rate loans to riskier clients.

The problem with the current arrangement is that most shadow-banking wealth products are marketed by commercial banks and treated as low-risk by households. Total shadow banking lending has grown at an explosive rate in recent years and, not surprisingly, some of the funded investments are starting to go bad. The first corporate bond default occurred earlier this year, and that result should help ease the moral hazard that has built up in the system. The announcement of the formal introduction of deposit insurance this year is another important step in the separation of a cautious commercial banking sector from a risky shadow banking sector. Central Bank Governor Zhou Xiaochuan recently announced that interest rate liberalization would be completed within one to two years.

Recent moves to liberalize the bond and stock markets, so that private firms can more easily go to the capital markets, are also in the right direction, as are moves to increase the flexibility of the exchange rate.

The IMF assesses that China's exchange rate has gone from "substantial undervaluation" to "fairly valued" in recent years, so it should not be too difficult for the authorities to reduce their intervention and allow a more market-determined rate. Finally, opening up the capital account should be the last step in this process of reform.

A final area of reform is to open up China's service sectors to competition from private firms and the international market. The modern service sectors are the domain in which state-owned enterprises continue to be dominant: financial services, telecom, media, and logistics—to name a few.

The rebalancing from investment towards consumption means that, on the production side, industry will grow less rapidly than in the past, while the service sectors expand. China will need more productivity growth in the service sectors, which is hard to achieve in a protected environment.

Successful rebalancing will create both challenges and opportunities for other developing countries. Compared to a business-as-usual scenario, rebalancing is likely to lead to more growth slowdown in the immediate future, as wasteful investment is reined in. Over time, the rebalancing scenario is likely to lead to a modestly faster growth rate for China, because it will alleviate the diminishing returns that are the problem with the old growth model. Most importantly, the composition of China's growth will be different under rebalancing—with less investment, more productivity growth, and more consumption.

For other developing countries, China's rebalancing means that its appetite for minerals and energy will diminish. China's investment has been an important driver of high metals prices for the last decade. Each surge in Chinese investment has driven metals prices higher, with a short lag.

Reining-in investment in China is already leading to softer commodity prices. The World Economic Outlook base case assumes moderate rebalancing in China and projects moderate declines (three to four percent

per annum) in energy and materials prices. While it is notoriously difficult to predict commodity prices, more aggressive rebalancing in China is likely to have sharper price effects. The fact that U.S. dollar interest rates are going up (QE tapering) at the same time that commodity prices are moderating—owing to China's slowing—will create problems for developing countries that are commodity exporters, especially ones that have borrowed imprudently.

While China's appetite for commodities is likely to moderate, rebalancing should lead to a rise in its demand for manufactures and services from other developing countries. In recent years, China's wages have been rising at faster than 10 percent per annum—far higher than elsewhere in Asia, where low single digits have been the norm. Add in the real effective appreciation of China's exchange rate, and the result is China becoming a high-wage producer among Asian developing countries.

Hence, it is losing its comparative advantage in labor-intensive activities such as garments, footwear, and electronic assembly. There is now an opportunity for lower-wage developing countries to step in and take some market share from China, either by exporting directly to final markets in the United States and Europe, or by exporting to China as part of a supply chain.

Since China still has a large surplus and is moving up the value chain, this relinquishing of market share in labor-intensive activities is a healthy development—one that mirrors what occurred earlier in economies like South Korea's and Taiwan's. This transformation is already taking place; it should be a powerful incentive for nearby developing countries to improve their investment climates and maintain sound macroeconomic policies, so that they gain maximum benefit.

Compared to OECD countries, Chinese outward investment is more targeted towards developing countries.

On the services side, Asian developing countries are dramatically increasing their export of tourist services to China. Last year 100 million Chinese tourists traveled abroad.

In a successful rebalancing scenario, China's external surplus is not likely to grow as a share of its GDP, but it is still projected to remain around three percent of a rapidly growing GDP. At the moment, the counterpart to China's current account surplus is primarily hot money outflow. But one could easily imagine a scenario several years down the road in which China has a current account surplus whose counterpart is net outflow of FDI.

China is rapidly emerging as a major source of FDI. Initially much of its investment was in the energy and mineral sectors, where it is a large importer. But the recent trend is for Chinese outward investment to expand in different directions—both sectorally and geographically. Some of the connection to Chinese supply chains will certainly come via outward investment by Chinese manufacturers. Compared to OECD countries, Chinese outward investment is more targeted towards developing countries.

China's rebalancing creates challenges for other developing countries, but also major opportunities. A world without Chinese rebalancing, on the other hand, is likely to be more volatile. In the short run, commodity prices would likely stay high as China's investment continues apace. But most commentators think it is unsustainable to invest 50 percent of GDP: the diminished returns already evident become more and more acute. The commercial part of China's investment has already declined in response to poor returns. Government-backed investment faces the problem that the government's overall debt-to-GDP ratio—though not yet alarming—has been rising rapidly.

The downside scenario is that investment drops sharply in China and the growth rate also slows sharply. Commodity prices would fall more steeply than in a rebalancing scenario.

This is also a scenario in which a market-driven Chinese exchange rate might depreciate: if investment drops sharply without a commensurate rise in consumption, then the tendency would be for the exchange rate to depreciate and the trade surplus to widen. China would then hang on to its labor-intensive manufacturing exports, rather than opening this space up for other countries.

China's successful rebalancing presents a much more attractive scenario for the developing world.

Competition & Cooperation

China's recent economic initiatives appear to be a diplomatic victory for Beijing and a diplomatic setback for Washington. Certainly, the United States handled badly the emergence of the AIIB. The United States made a mild effort to dissuade some allies from joining, and was then caught flat-footed when European and Asian allies chose to join.

The United States should be pleased that China is shouldering some global responsibility. With nearly 60 countries joining the AIIB, it is likely to have governance and standards similar to existing MDBs, and may well be able to improve on their efficiency through competition. Rather than a challenge to the American-led system, the AIIB is likely to be a useful complement to the existing system.

More generally, the AIIB episode reveals clearly that Asian and European countries do not want to choose between China and the United States, and nor is there any reason why they should have to. The United States made a mistake in its handling of the AIIB, but we should not exaggerate the importance of this incident.

America now looks well-positioned to complete TPP negotiations. The AIIB will be funding infrastructure that can be thought of as the "hardware" of integration. Equally—if not more—important is the "software," that is, the rules and regulations that govern international trade and investment. TPP aims to expand trade into new areas, such as services, whilst laying the foundation for twenty-first-century trade.

Notice that countries such as Australia, New Zealand, Singapore, South Korea, Malaysia, and Vietnam do not hesitate to participate in both Chinese and American initiatives. This is clearly the smart strategy. For Vietnam, for instance, a turn to the AIIB should improve infrastructure, whereas using the TPP framework ought to enable Hanoi to integrate with the vast and innovative U.S. economy.

There is a risk that these competing initiatives will result in the development of trade blocs, but I think it is more likely that the end result will be cooperation. China would benefit enormously from joining the TPP, because it is still extremely closed in many sectors. The United States would benefit from joining the AIIB because it is an important new institution in the fastest growing region of the world economy.