FROM THE FOUNDER

Is China's New AIIB A Clever Ploy?

When the Chinese recently announced the new Asian Infrastructure Investment Bank, or AIIB, the immediate international response was to blame this new development on Washington's failure to grant China greater presence at the International Monetary Fund. There is a lot of truth to this charge. In his cover article, William Overholt brilliantly identifies the failings of both the Bush and Obama administrations in effectively developing with China a joint economic agenda.

There is, however, a counterintuitive view of China's intentions, a view out of the mainstream of global thinking, that is worth examining. After all, those who correctly worried about the global banking system's highly leveraged toxic paper assets back in 2007 were also out of the mainstream.

The counterintuitive view holds that the AIIB may be less a brilliant move on the global chessboard and more a defensive ploy, or even desperate effort. The Chinese economy, the argument goes, is in a precarious position. Most Chinese manufacturing industries have experienced huge growth in oversupply capacity. In the last dozen or so years, China has experienced a domestic investment explosion equivalent in terms of urban infrastructure, residential, and commercial real estate to the building of 320 Manhattans. Yet the economy has still weakened, which is why the Beijing leadership took the unexpected step recently of devaluing its currency.

Today, half of China's debt may now be unserviceable. Several years ago, China's debt could still be financed by domestic savings. Not anymore. China's private sector borrowing in part to finance such investment has skyrocketed to between \$2–\$3 trillion. Because a lot of that debt is dollar-denominated, it is easy to see why IMF head Christine Lagarde is so nervous about the Federal Reserve raising short-term interest rates. The Fed is the central bank to the world. And a stronger dollar as a result of Fed tightenings, combined with Beijing's efforts to weaken the yuan, could risk some form of default, or disguised default, of dollar-denominated debt.

The AIIB is an attempt to resolve China's huge oversupply capacity problem. In cement, steel, and other elements of infrastructure improvement and expansion, China may be sitting on half the world's supplies at a time when the global economy has weakened and China's trade in both dollar and volume terms is shrinking. Such mind-boggling excess capacity, critics charge, is far larger than China can use even under the rosiest of future GDP growth scenarios. Therefore, the only possible place in the world where such supply capacity can be deployed is elsewhere in Asia with a dramatic increase in infrastructure spending. Thus, the need for the AIIB.

But here's the problem. Very few Asian economies can afford the price of absorbing China's excess capacity. Pakistan, for example, has big infrastructure needs but a tiny cash flow. So the idea behind the AIIB, skeptics

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220 I Street, N.E., Suite 200
Washington, D.C. 20002
Phone: 202-861-0791 • Fax: 202-861-0790
www.international-economy.com
editor@international-economy.com

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suggest, is not that China will plop down a trillion dollars of its savings surpluses to lend to developing world economies which are now quickly weakening. It is more an effort to unload vast amounts of steel, cement, and other commodities at a time of swiftly increasing disinflationary pressure. China will even graciously offer "troops of Chinese construction labor" in a one-stop shopping offer to implement the program's expansion. Beijing, of course, will decide on all issues relating to policy and conditionality.

But how to finance this operation? To do the job, the skeptics argue, the success of the AIIB and China's other regional development efforts will depend on China's ability, with the help of the non-U.S. global banking sector, to sell the AIIB and other China-tied development bonds to the world. Success, therefore, comes down to credibility, the credibility to leverage the seed capital China and others initially invest.

But the recent stock market turmoil and clumsy efforts by Chinese officials at stock market price keeping operations, or PKO, not to mention a general lack of financial transparency, is hardly reassuring. True, China may indeed put up funding here and there, but to have a major impact, the rest of the world would need to buy a lot of debt with China as the intermediary.

That is said to be one reason why, in the midst of the Greek crisis several months ago, German Chancellor Angela Merkel flew off to Tokyo. In her private meetings with Prime Minister Abe, she is said to have urged the Japanese leader to support the AIIB party. Her appeal made sense. Germany has become highly dependent upon exports to an economically successful China. But to Merkel's frustration, Abe said no.

The AIIB project, critics add, has come about at a particularly awkward time. As analyst Tadashi Nakamae points out, on an annualized basis producer prices are dropping by roughly 5 percent while wages are increasing by 10 percent. It is, therefore, theoretically speaking, extraordinarily difficult if not impossible for most large Chinese companies to earn a profit. That is why authorities had no choice over the past year but to implement policies to drive up prices on the stock market. The problem: only 15 percent of Chinese families own stocks, so the stimulative effect has been limited.

True, China has large foreign exchange reserves, the ultimate financial shock absorber. Yet the $4 trillion figure thrown around as the level of those reserves may actually be a lot lower. One reason is that thousands of elite Chinese families are said to have been involved in a vast corruption conspiracy. Some analysts argue that a surprisingly large amount of China's reserves may have been pilfered and moved offshore.

To be sure, because of its size, China will always be a major global economic power. The suggestion here is merely that the Chinese manufacturing overcapacity problem is very real. So is the worldwide collapse in commodity prices which seems to be sending the clear message that global demand is quickly declining. At the same time, China's service economy continues to grow only modestly. Unless services boom, the skeptics charge, Western economic leaders should view the AIIB less as some ingenious Chinese global geopolitical chess move and more as a means of compensating for an economic system that continues to produce and stockpile even when market signals indicate there are no buyers.

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The West is undergoing a crisis of confidence. A pessimism has set in. Peter Thiel, the financier of Facebook, argues that this is all to be expected: "Every culture has a myth of decline from some golden age." What the critics of the AIIB are saying is that in the midst of today's pessimism, the West should not look to China and its new infrastructure investment bank with rose-colored glasses. After all, how much does anyone really know about the riddle wrapped in a paradox we call China?

—DAVID M. SMICK
Founder and editor, TIE, *and author of* The World Is Curved: Hidden Dangers to the Global Economy