China’s One Belt One Road Strategy: The New Financial Institutions and India’s Options

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Working Paper No. 2015-155

September 2015

National Institute of Public Finance and Policy
New Delhi
http://www.nipfp.org.in
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Abstract

The revival of ancient Silk Road strategy into the One Belt One Road (OBOR) Strategy or the new Silk Road project signals China's ambitious approach to global issues and challenges. Its outward-oriented strategy attempts to encourage new trade and connectivity throughout Asia with road and maritime links to Africa, the Middle East and on towards Europe. The new financial institutions linked to the OBOR strategy - the US $100 billion Asian Infrastructure Investment Bank (AIIB) and the US $40 billion New Silk Road Fund (NSRF) have been set up. These together with the US $50 billion New Development Bank (NDB) and the US $100 billion Contingent Reserve Arrangement (CRA) represent Chinese backed new financial institutions that are not part of the existing Western dominated financial architecture. They will adhere to the Paris declaration but will not abide by the conditionality driven DAC framework. They are designed to help address issues of infrastructure underfunding, to create new pathways to sustainable development, south-south cooperation and mutually compatible solutions to development problems.

The Yuan’s sudden devaluation, coming on top of a sharp correction in China’s stock markets and a slowing economy are an indication that the old model of Chinese growth has reached its peak. China must restructure its economy from an investment led model to a consumption led model. This is the path that Japan and South Korea followed earlier. But with large State Enterprises and rising debt whether China can emulate them will not be easy. China’s OBOR strategy represents an option to investing abroad and utilising some of this excess capacity.

India and China have a competitive yet cooperative relationship. India has not signed on to the OBOR strategy as it has concerns over some aspects of it – especially the China Pakistan Economic Corridor and the Maritime Silk Road and has proposed its own “Spice Route “ or SAGAR project with India at the centre of Indian Ocean relations. .. Nevertheless India has joined the new financial institutions the NDB, and the AIIB (as its second largest shareholder after China). These new banks are a potential source of long term infrastructure finance for India, however small in magnitude. China and India have growing but yet somewhat unbalanced economic linkages – with a large trade deficit in favour of China. This paper attempts to discuss India’s options to collaborate with China at the event of the formation of new financial institutions and how should India engage with China’s new Silk Road strategy.

KEYWORDS: New Silk Road, New Development Bank, AIIB, Spice Route

JEL Classification Codes: F, H, O

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1. Introduction

China's "One Belt One Road" policy or the New Silk Road strategy is the centre-piece of the Xi Jinping administration. The Silk Road Economic Belt was first laid out first in President Jinping's speech in September 2013 in Kazakhstan. It is revival of the old Silk Road connecting China through Central Asia to the Middle East and Europe. A month later in October 2013 in Indonesia he announced the second part of the initiative - the Maritime Silk Road (MSR) or the 21st century Maritime Silk Route Economic Belt. He also announced new institutions to finance this strategy establishment of the US $100 billion Asian Infrastructure and Investment Bank (AIIB) and the US $40 billion New Silk Road Fund (NSRF).

The OBOR policy was initially meant to be a framework for greater cooperation between Central Asia and China's western provinces in order to ensure more balanced development within China. As China’s western provinces were lagging behind the eastern coastal provinces the new Silk Road strategy was a way to increase trade and cooperation from China to its western borders. The policy has however, evolved into a broader strategy for China's engagement with the world. The new Silk Road proposes to link China to Europe with trade and transport corridors across Central Asia and Russia. The Maritime Silk Road includes maritime links through the Straits of Malacca to the Indian Ocean, Middle East and Africa. This is a revival of China's maritime links to the Indian Ocean and Africa in the 1500's before China turned inward. But it goes well beyond the idea of the ancient Silk Road. The China Pakistan Economic Corridor (CPEC) and the Bangladesh, China, India, Myanmar (BCIM) corridor are also included in the broader Silk Road idea. In scale and scope it is much larger than the traditional Silk Road concept.

Image 1: The Ancient Silk Roads (Land-Based and Maritime)

China has for the last three decades tried to attract foreign investment and technology to learn from the west. With the new Silk strategy, China intends to export its expertise like infrastructure, finance and trade to new markets and more confidently project its economic and technical achievements and its ability to create new institutions.

It is ironic that this new Silk Road strategy is being pushed by China as it takes over the G20 presidency from Turkey as the old Silk Road was a link between Turkey and China through Central Asia. China's new Silk Road strategy should not be confused with the new Silk Road Strategy that the
US tried to initiate in 2012, with some support from Turkey and the EU - whose main goal was to create greater links between Afghanistan and Central Asia and within Central Asia. China and Russia did not look too positively on this US backed strategy.

Image 2: The New Silk Road

China is supporting and creating new organizations to fund its new policy - the Asia Infrastructure and Investment Bank AIIB ($100 billion but could go higher), and New Silk Road Fund ($40 billion). China has also helped create the New Development Bank or the BRICS Bank ($ 50 billion- eventually increase to $100 billion) and the Contingent Reserve Arrangement ($100 billion). The NDB is not directly linked to the OBOR strategy but will fund infrastructure related projects across the world and work closely with the AIIB. It has also proposed the creation of a Shanghai Cooperation Development Bank. These new institutions and funding mechanisms are partly a response to the slow reform at the IFI’s, and partly also a channel for China to utilize its vast reserves. After some initial reluctance and opposition several European countries - including the UK and France, Germany, Italy, Spain, Switzerland, Australia, Korea and Russia have decided to become members of the AIIB. Brazil has also decided to join the AIIB as a founding member and this will encourage other Latin American countries to join as well.

These are important developments as China will be able to recycle some of its huge surpluses for infrastructure and investment by creating new mechanisms. This is in contrast to the oil rich countries which relied largely on existing western institutions to recycle their vast surpluses. Nevertheless, the existing IFI’s - IMF, World Bank and the ADB – have committed to cooperate with the new Chinese backed financial institutions. To kick-start the ambitious "One Belt, One Road" project the People’s Bank of China has also recapitalized the China Development Bank (CDB), the China Exim Bank, and the Agricultural Development Bank of China (ADBC) with US $62 billion.

2 See” What are the prospects for the new Chinese-led Silk Road and Asian Infrastructure Investment Bank?

Mario Esteban and Miguel Otero-Iglesias. ARI 23/2015 - 17/4/2015
China’s “One Belt One Road” policy focuses on connectivity in many dimensions. It includes trade, infrastructure and telecommunications connectivity called the – “Information Silk Road”. China hopes to sign 60 free trade agreements with countries along the new Silk Road. Of these China currently has 12 free trade agreements in place. But the policy goes much broader in also talking about people to people connectivity, cultural exchange and learning from each other's development experience. It also talks about peaceful development as a way of assuaging any fears that China is emerging as a global hegemon or that wants to oppose others.

In his 29 March 2015 speech at the Boao Forum for Asia (BFA) annual conference, President Xi Jinping observed that “the Chinese economy is deeply integrated with the global economy and forms an important driving force of the economy of Asia and even the world at large. [...] China's investment opportunities are expanding. Investment opportunities in infrastructure connectivity as well as in new technologies, new products, new business patterns, and new business models are constantly springing up. [...] China's foreign cooperation opportunities are expanding. We support the multilateral trading system, devote ourselves to the Doha Round negotiations, advocate the Asia-Pacific free trade zone, promote negotiations on regional comprehensive economic partnership, advocate the construction of the AIIB, boost economic and financial cooperation in an all-round manner, and work as an active promoter of economic globalization and regional integration”.

Russia may view China's push into Central Asia as a push into its sphere of influence. It has opposed the creation of the Shanghai Cooperation Development Bank and has instead asked China to become a member of the existing Eurasian Development Bank. The USA and Japan have not been so positive on Chinese backed financial institutions and mechanisms on the ground that they are concerned with -their governance and environmental standards. The USA actively lobbied with its Western allies against joining the AIIB but has since relented and promised cooperation with it. Japan so far remains opposed to the AIIB. Thailand and Philippines which were listed as Prospective founding members have so far not signed on to the AIIB to signal their concerns on China's South China Sea claims.

China has stated that its One Belt One Road strategy is not in opposition to the existing regional and other organizations. It intends to enhance the role of multilateral cooperation mechanisms, and make full use of existing mechanisms such as the Shanghai Cooperation Organization (SCO), ASEAN Plus China (10+1), Asia-Pacific Economic Cooperation (APEC), Asia-Europe Meeting (ASEM), Asia Cooperation Dialogue (ACD), Conference on Interaction and Confidence-Building Measures in Asia (CICA), China-Arab States Cooperation Forum (CASC), China-Gulf Cooperation Council Strategic Dialogue, Greater Mekong Sub-region (GMS) Economic Cooperation, and Central Asia Regional Economic Cooperation (CAREC) to strengthen communication with relevant countries, and attract more countries and regions to participate in the Belt and Road Initiative.

It seeks cooperation from the Russia backed Eurasian Union, Organization for Islamic States (OIC), the South Asian Regional Cooperation body called SAARC and the EU. But questions still remain on the scope and range of the strategy as it unfolds. How China envisages its cooperation with Latin America and the Caribbean and Africa or the Pacific as part of its new Silk Road strategy also remains to be fully clarified? So far Latin America has been excluded from OBOR although China, nevertheless, plans extensive and deeper engagement with Latin America and the Caribbean.

Changes in political climate in individual countries have created roadblocks to China’s
strategy. In Myanmar concerns on environmental issues and China’s overweening presence has led to a decision to stop the construction of the Myitsone Dam. In Sri Lanka a change in government has stalled the ambitious Hambantota port project and other Chinese investments. Philippines and Thailand have so far not joined the AIIB because of concerns over Chinese actions in the South China Sea. So far, Africa has not been able to positively assess China’s engagement.

There has been a proposal to expand the reach of the One Belt, One Road policy into Africa by calling it the “One belt-One Road-One Continent” strategy. China has an ongoing China-Africa strategy so the inclusion of Africa into the One Belt One Road strategy could provide more funding for Africa for infrastructure development but will not address by itself many of the challenges that have come up in the implementation of the existing China Africa strategy.

Latin America is largely absent from official Chinese discussions of the New Silk Road. When President Xi visited the region in July 2014, he made no mention of the New Silk Road during any public event, even though he spoke repeatedly about the initiative during his visits to Europe and South Asia at other times last year. During the first ministerial meeting of China and Forum Community of American and (CELAC) Latin Caribbean States this January, similarly there was no mention of “one belt, one road”. According to the state-run Xinhua News the New Silk Road map released by Agency in May 2014, does not extend to Latin America but China has announced a US $100 fund for new projects in Latin America.

Trade facilitation marks an important part of the Chinese ‘One belt One road’ strategy. The idea is not just to build infrastructure but to ensure that trade facilitation- faster customs, warehousing, marketing and trade credits can enhance exchange of goods, services so that there is mutual benefits to China and to the countries and the communities along the trade routes - currency trading will also be encouraged and currency swap arrangements will be put in place.

### Box 1. Proposed Projects in Africa under New Silk Road

The infrastructural projects to be undertaken in Africa under the “Belt and Road” framework include the development of deep-water ports in coastal cities including Bizerte, Tunisia; Dakar, Senegal; Dar es Salaam, Tanzania; Djibouti, Djibouti; Libreville, Gabon; Maputo, Mozambique; and Tema, Ghana. These will be key sites of the transcontinental exchange of manufactured goods and commodities between Asian and African economies along the Maritime Silk Road. These ports are also likely to be developed as industrial hubs, following the model of China’s development of the new Cameroonian deep-water port of Kribi. In Kenya, China is constructing a railway connecting the capital city Nairobi with the port city of Mombasa. This will eventually be expanded into a regional rail corridor connecting Kenya—one of the African gateways to the Maritime Silk Road—with Uganda, Burundi, and South Sudan.

China and many emerging countries now have assistance programs but view these more as mutual arrangements and do not use the word “aid” in their dealing with less developed countries and prefer to define their interactions with others as technical and economic cooperation. They do believe in the importance of governance but do not believe that aid conditionality can be used to create better governance. Better governance in their view cannot be imposed from outside. They also do not officially adhere to the DAC aid principles.
China’s OBOR strategy is also seen by some as a response to the Asia “pivot” of the Obama administration and more specifically to challenge the Trans Pacific Partnership (TPP). The TPP is a proposed trade agreement between several Pacific Rim countries concerning a variety of matters of economic policy. Among other things, the TPP seeks to lower trade barriers such as tariffs, establish a common framework for intellectual property, enforce standards for labour law and environmental law, and establish an investor state dispute settlement mechanism. The goal of the agreement is to "enhance trade and investment among the TPP partner countries, to promote innovation, economic growth and development, and to support the creation and retention of jobs.

Historically, the TPP is an expansion of the Trans-Pacific Strategic Economic Partnership Agreement (TPSEP or P4) which was signed by Brunei, Chile, Singapore, and New Zealand in 2006. Beginning in 2008, additional countries joined for a broader agreement: Australia, Canada, Japan, Malaysia, Mexico, Peru, the United States, and Vietnam, bringing the total number of participating countries to twelve. How the TPP and China's OBOR strategy interact with each other remains to be seen with some suggesting that China should be brought into the TPP if it were to meet the exacting requirements proposed under the treaty.

Some have suggested that the OBOR strategy reflects China’s internal structural problems and political dynamics. China’s growth is slowing down and it is rebalancing from an investment-driven growth model – under which China now has huge surplus capacity in several basic industries such as steel, sheet glass, aluminium, cement, copper wiring and transport and construction equipment to name a few. China’s OBOR strategy is seen as a way of utilizing some of this excess capacity as it attempts to rebalance, even though it is unlikely that the OBOR strategy alone can take care of all of the existing excess capacity. Others see it as an attempt to shift economic activity from the East to China’s western provinces and a way to help manage restive populations on China’s eastern wing.

The Vision document for China’s OBOR strategy lays out the role for various regions inside China. The pace and impact of with which China can execute the new strategy will depend on its own development as well as on many political factors in the areas covered under the OBOR policy. There is a growing debate on whether the Chinese financial markets are headed for a crash. Some argue that with sufficient structural reforms China will be able to achieve rebalancing and a gradual slowdown. Others see China’s efforts to stimulate its economy ending in a debt crisis. Clearly if China has to deal with internal financial issues its ability to project outwards will also be affected. To the extent that demand for Chinese companies for projects outside China through the OBOR strategy will relieve debt distress can only help.

The ability to execute projects in areas of growing turmoil should also not be underestimated.

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Growing turbulence in the Middle East – vital to any New Silk Road strategy could become a constraining factor. Central Asia also poses challenges.

Kazakhstan’s – sometimes referred to as the Buckle in the Silk Road Belt\textsuperscript{7} - cooperation is vital, as this huge country with its enormous resources tries to balance Chinese demands with Russian interests. The CPEC projects are also fraught with execution problems on the ground. And there remain huge concerns over China’s maritime ambitions in the South China Sea and beyond. Project execution risks are another factor with problems arising from Chinese company’s labour practices and lower environmental standards raising opposition from local civil society.

2. The new financial institutions: rationale and need

There are four strong reasons put forward for the new financial institutions:

- Infrastructure Funding Needs
- New Sustainable Development Pathways
- South-South Exchange
- Slow Reform in the Global Financial Architecture

2.1 Infrastructure Finance Needs

The first strong reason for the new financial institutions and instruments is lack of sufficient financing for Infrastructure Investment.\textsuperscript{8} There are numerous studies which have identified infrastructural needs in Asia and more broadly in the developing world. In Asia alone, the overall need for national infrastructure investment is estimated to be about US$8.22 trillion for the period between 2010 and 2020 according to the Asian Development Bank. More broadly across the developing world infrastructure investment needs are huge According to UNCTAD (2015) developing countries need $1.6-2.5 trillion annually between 2015 and 2030. The infrastructure investment gap is also huge at up to $1.6 trillion. The public sector alone cannot finance such huge investment needs and private sector participation in key Sustainable Development Goals SDG sectors in developing countries must be attained to meet the challenge.

There is extensive empirical evidence that infrastructure development can increase economic growth and reduce levels of inequality (Mwase and Yang, 2012; Straub, 2008). As countries develop through various stages from low income to middle income and industrial economic stages, their infrastructure needs grow rapidly. Furthermore, there is strong evidence that a lack of infrastructure is a barrier to growth, so the relationship between infrastructure and levels of development is parallel. More development increases demand for infrastructure and expansion of infrastructure generates more development. A major feature of development will be huge shifts in population to urban areas.

\textsuperscript{7} See Daniel Runde (2015) “Kazakhstan : The Buckle in One Road One Belt”, Forbes , June 29

\textsuperscript{8} This section draws from Stephany Griffith-Jones (2015)
With around two billion people projected to be moving into urban centres in emerging and developing countries in the next three decades, there is a great need for major investments in urban infrastructure.

As regards inclusion, infrastructure is crucial for increasing access to basic services for the poor. Infrastructure shortages are very large, as almost 1.5 billion people have no access to electricity, almost a billion people do not have access to clean drinking water and nearly 2.5 billion lack access to sanitation. Helping provide these basic needs is a pre-condition for a more inclusive pattern of growth.

To meet these objectives, Bhattacharya and Romani (2013) have estimated the annual need for infrastructure investment. They project broadly that investment spending in infrastructure (excluding operation and maintenance) in emerging and developing countries will need to increase from approximately US$0.8–0.9 trillion per year currently, to approximately US$1.8–2.3 trillion per year by 2020. These would represent a quantum jump in the share of infrastructure investment in GDP from around 3-4% of GDP to 6-8% of GDP. In amounts the largest needs are in Asia although as a share of GDP the largest requirements are in Africa. The largest share of infrastructure financing would be for energy – particularly for the electricity sector followed by transport, telecommunications and water.

The existing IFI’s have not provided enough funds for infrastructure – surprising as they were initially set up for reconstruction and infrastructure. Of the total financing on infrastructure investment of roughly $0.8-0.9 trillion over 50 % comes from national budgets, almost 20% comes from national development banks, 25% comes from the private sector and only 3-4% comes from the existing MDB’s and 1-2% comes from south-south flows. The bulk of future financing for infrastructure financing will continue to come from domestic sources and from private financing if the policy and regulatory hurdles preventing private capital – from banks, insurance companies and pension funds and from sovereign wealth funds- from financing infrastructure can be tackled.

Surprisingly, the existing Multilateral Development Banks (MDB’s) provide scarce funding for infrastructure finance. The IBRD was setup primarily to provide infrastructure finance but then shifted a substantial part of its funding to other priorities. One of the major criticisms of the Poverty Reduction Strategies (PRSP’s)\(^9\) - the main instrument for providing the framework for aid to support economic development and poverty reduction has been its excessive focus on the social sectors at the expense of the infrastructure sector. In Africa more than three fourths of the funding has been on the social sectors at the expense of the infrastructure funding and has hurt growth. In contrast in Asia the balance between social and infrastructure sectors has been better and has helped spur growth.

The MDB’s not only can provide finance for infrastructure but can also be a vital instrument for drawing in private capital according to Bhattacharya, Oppenheim and Stern ( 2015). This they can do by co-financing, policy and regulatory risk guarantees using new and innovative financial instruments. It is hoped that the new financial institutions will have greater flexibility in developing

such instruments as they are not so tied down to existing processes and rules for financing. China’s OBOR policy will require at least $20 trillion in new financing.

2.2 Sustainable Development Pathways

Developing countries needed to grow in order to improve living standards and eradicate poverty and it is crucial for development that environmental sustainability and climate resilience is guaranteed, and this requires new infrastructure. This implies reducing the environmental impacts of existing infrastructure, adapting it to a changing climate, and designing new infrastructure creatively to promote environmentally sustainable lifestyles, as well as a broader model of development. Investment in infrastructure, which enables the use of renewable energy, is an important initiative to promote development that is environmentally sustainable.

Unlike the developed countries of today, Asia-Pacific does not have the option to ‘grow now and clean up later’ in view of the already accumulated huge amount of greenhouse gases in the atmosphere. The region can further accelerate the accumulation because of its large size and rapid economic growth in recent decades. Although per capita emissions in developing Asia-Pacific remain low, total emissions are on the rise, stemming from diverse circumstances in the region and the continued need for bridging inequalities and improving living conditions. The share of Asia-Pacific developing countries in global greenhouse gas emissions increased from 23 per cent in 1990 to about 32 per cent in 2005, only 4 percentage points lower than that of high-income OECD countries in 2005. The share is expected to increase rapidly in view of the high economic growth, continued urbanization, changing life styles, and the consequent higher demand for energy in future.

Between 2005 and 2030, compared with an estimated average world increase in energy demand of 1.5 per cent, the rate in Asia and the Pacific is expected to be 2.4 per cent per year. Against this backdrop, the region has to follow a different growth path using energy-efficient technologies, cleaner sources of energy, and reducing carbon intensity of output more rapidly in years to come. It must do this not only because our shared planet is becoming unsustainable but also because Asia-Pacific itself will continue to be adversely affected by climate change.

The Asia-Pacific was disproportionately hit in terms of natural disasters: 45 per cent of the world’s natural disasters occurred in the region in the last three decades. The region was also disproportionately hit in terms of economic losses — though it accounted for 25 per cent of the world’s GDP, it suffered from 42 per cent of the total economic losses from disasters. If emissions cross borders, so do some of the most affected natural systems, such as glaciers, coral reefs and mangroves. Some of them act as natural buffers to the impacts of climate change, but at the same time are increasingly at risk of deterioration and destruction.

But there is a growing realization in the developing world that they cannot develop along the same energy intensive path that was followed by the developed world a century ago. More sustainable development path is needed and funding for new technologies that are less energy intensive with greater emphasis on renewable energy must be followed. China is the world's largest

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emitter of CO$_2$, but has also made huge strides in the technology of renewable energy, especially wind and solar energy. This has also allowed it to provide off grid energy access to remote areas. Similarly India is investing significantly in renewable energy technology—especially in solar technology.

There is no available road map for the less energy intensive sustainable model of development that the emerging economies must adopt. The new financial institutions must help pioneer these approaches, while at the same time ensuring inclusive growth to help address poverty. Ensuring access to electricity, housing, water and sanitation remain major objectives which the new financial institutions must also keep as major goals. The UNDP has estimated that if the developing world followed the energy intensive development model of the USA and Canada the world would need 9 planets to survive.$^{11}$ So China, India and other emerging economies must follow a less energy intensive development model with a lighter carbon footprint.

2.3 South-South Exchange

Greater south-south exchange must also be a hallmark of the new financial institutions. Many existing MDB’s encourage south-south exchange but it remains a small part of their overall approach and a side show. The new financial institutions must make south-south exchange a central feature of their operational methods. The more recent experience of successful development of many fast growing emerging economies may hold more relevance for the low income developing countries. In the escalator of development those that developed rapidly in the current global economic context is more relevant than those that developed a long time ago. It is necessary to build knowledge platforms that harness these ideas and solutions that are more relevant, more affordable from those that have developed recently, process them to see what can be transportable to others, and make them available in a global solution exchange.

It is by now well recognized that the North-South Aid model built around top down conditionality has not worked as well as was hoped. Some have called it “dead aid” (Moyo, 2012). While this is perhaps too sweeping an indictment of the old North-South aid model it is true is that a new paradigm of development is emerging. A new south-south cooperation model built not just on an emotional solidarity of the Old South around anti-colonialism but instead on a genuine mutually beneficial partnership. This new South is emerging and is shaking the old North-South model built around a now debunked “Washington Consensus”. But the world does not wish to see the Washington Consensus replaced by a Beijing Consensus or a Delhi Consensus or a Brasilia Consensus. Instead, what is needed is a new South built on a global solution exchange—of ideas and experiences.

What is new about the new South? It recognizes that one size does not fit all and today’s development solutions can be found in many parts of the world.

Those that have developed the fastest are not those that followed the “Washington Consensus” but those that were able to take ownership of their development challenges and find solutions internally or borrow ideas from elsewhere but with suitable adaptations to local conditions.

The new South is also built around the idea that solutions to today's development challenges are more likely to be found among those that have developed recently than those that went through their development phase over a century ago. In the “escalator of development” more relevant ideas and experiences for finding solutions to poverty, hunger and disease will come from those that developed a decade or so ago than those that developed a century ago. Many new technologies have also emerged, in telecommunications, energy and IT that allow today’s developing countries to leapfrog from the 19th to the 21st century without having to go through the development path that others followed in the 20th century. It is these possibilities to leapfrog that now define the new South.

Development solutions in the new South are much more affordable, capital intensive and serve the needs of lower-income consumers. Whether it’s in pharmaceuticals, transportation, agricultural technology, energy, the transmission of appropriate and more affordable solutions makes the new south to south cooperation key to developments in the 21st century. We are already seeing these in the way in which China, India, Brazil and South Africa are helping transfer new technologies to many parts of the South. But what is exciting is that the new South is not a one way transfer. It can go in either direction. For example in mobile banking Africa has a lot to teach the others as well. The new South is also helping break the old North-South monopolies. In telecommunications for example the old monopolistic pricing structure kept telecommunications costs at almost 9 cents per minute, exorbitantly high for much of Africa, the Pacific and parts of Asia. These costs have crashed as new South-based companies have entered the market with a business model that is based on supplying a very large number of users at low costs per unit.

Many new solutions such as micro-finance, conditional cash transfer schemes, and social business models are being pioneered in the new South and are being adopted in the North with remarkable success. It's no longer a one way flow of ideas and money from North to South but a global solution exchange with ideas and solutions flowing in both directions.

2.4 Reform in the International Financial Institutions (IFI's):

The International Financial Institutions (IFIs) such as the Bretton Woods were built around an anachronistic. North-South model of conditionality with a governance structure built on the principle that money matters. But with the North, still rich but now tired and debt laden, new ideas, entrepreneurship, paradigms will come from the new South and will be the defining movers of the 21st century. In this new world, ideas will matter more than money and solutions and these will move across the new South; not just from the North to the South. It is in the interests of the old North to support these developments and not see them as a competition because a dynamic new South will enhance global prosperity and benefit the North as well. A new development paradigm is emerging in the New South in which a Hand-Shake will replace a Hand-Out.

Heavy and excessive conditionality based on a one size fits all approach has also been a major criticism of the existing IFIs. Such an approach which emerged out of a so called “Washington Consensus” has come under considerable criticism especially in Africa. A key feature of this was dismantling state support to agriculture and industry, accompanied by premature trade liberalization which led to “de-industrialization”. IFI’s have also come under criticism for the way the East Asian economic crisis was handled when excessive fiscal tightening exacerbated the severity of the crisis. Premature capital account opening was also a central feature of IMF advice – leaving emerging economies vulnerable to sudden reversals in capital flows and making macro-economic management
more difficult. The IFI’s have begun to change some of their dogmatic thinking and now have more flexibility in their approaches - a process which will be accelerated hopefully with competition from the new financial institutions.

Unlike at the UN, the voting power at IFI’s is based on economic size. The richer developed economies were able to call the shots at these institutions. The World Bank President comes from the USA, the IMF is always headed by a European and Japan gets the Presidency of the Asian Development Bank. But voting shares in the existing financial institutions have also not changed sufficiently with the changes in the global economic power. European economies still hold more than 40 percent of the votes while Europe’s share in the global economy has shrunk to around 25%. China and other emerging economies have not seen an increase in their voting power commensurate with their global economic power. An agreement to reform the IFI’s had been reached in principle but its progress has been very slow.

The Zedillo report that was set up to look into reforms at the World Bank made some important suggestions which were not adopted by the Bank but could be looked at in setting up the new financial institutions. The report was quite critical of the current World Bank arrangement of a resident board that approves all loans. The resident board is both a large financial cost to the bank (US$70 million per year) and an extra layer of management that slows down project preparation – as there is heavy emphasis on project preparation documents that satisfy the Board’s one size fits all requirements 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.

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 multilateral development banks to finance infrastructure because of slow bureaucratic procedures. The enthusiastic response of developing countries in Asia to the AIIB concept reflects their sympathy with the idea that a bank can have good safeguards and still be quicker and more efficient than the existing banks. Not having a resident board will help speed decision making and project preparation – with greater emphasis on implementation.

Important recommendations in the Zedillo report were –

a) Reduce the size of the Board to 20 chairs by consolidation of European seats, creating elected-only chairs and distributing board membership more evenly across constituencies, b) Have a 50/50 voting structure for the Bank between developed and developing countries and a significant increase in the basic shares and hence votes. It sets a clear goal for rebalancing of the ownership of the institution and c) Eliminate the U.S. veto. It also recommended changing leadership selection by eliminating the U.S. prerogative in the World Bank, and the European prerogative in the IMF. While this principle appears to have been adopted at a G-20 summit it remains to be implemented in practice.

3. The New Financial Institutions

The frustration of the emerging economies with the existing financial architecture signalled the idea of BRICS Bank which has now culminated into the creation of the New Development Bank
In addition to the NDB, which would provide long term finance the BRICS countries also agreed to set up a US $ 100 billion Contingent Reserve Agreement (CRA) outside an IMF framework to provide short-term liquidity support. The Asian Infrastructure Investment Bank (AIIB) and the Silk Road Fund are also new mechanisms to channel funds for development outside the existing IFI framework. While the IMF and the World Bank have indicated that they intend to cooperate with the new institutions, the new institutions are not setup to be part of the existing IFI framework. It is likely that China and other emerging countries will fund new mechanisms and further expand the new institutions that have been created as future needs develop.

3.1 The New Development Bank (NDB)

The NDB is not directly linked to the OBOR policy. The NDB is a multilateral development bank operated by the BRICS states (Brazil, Russia, India, China and South Africa) as an alternative to the existing US-dominated World Bank and International Monetary Fund. The bank is set up to foster greater financial and development cooperation among the five emerging markets. Together, the four original BRIC countries comprise in 2014 more than 3 billion people or 41.4 percent of the world’s population, cover more than a quarter of the world’s land area over three continents, and account for more than 25 percent of global GDP. The bank will be headquartered in Shanghai, China. Unlike the World Bank, which assigns votes based on capital share, in the New Development Bank each participant country will be assigned one vote and none of the countries will have veto power.

The New Development Bank was agreed to by BRICS leaders at the BRICS summit held in Durban, South Africa on 27 March 2013. On 15 July 2014, at the 6th BRICS summit held in Fortaleza, Brazil, the group of emerging economies signed the long-anticipated document to create the US $100 billion BRICS Development Bank and a reserve currency pool worth over another US $100 billion. Both will counter the influence of Western-based lending institutions and the dollar. Documents on cooperation between BRICS export credit agencies and an agreement of cooperation on innovation were also signed.

Shanghai was selected as the headquarters and an African regional center will be set up in Johannesburg. The first president will be from India the inaugural Chairman of the Board of directors will come from Brazil and the inaugural chairman of the Board of Governors will be Russian.

The Bank was formally launched in Shanghai on July 20, 2015. At the launch ceremony Chinese Finance Minister said “This bank will place greater emphasis on the needs of developing countries, have greater respect for developing countries’ national situation, and more fully embody the values of developing countries.

Development is a dynamic process. There’s really no such thing as so-called ‘best practices’. The new President of the Bank pledged to move the bank “from best practices to next practices”, adding that traditional development lending was often “too rigid, inflexible, and slow”.

3.1.1 Development capital

The bank’s primary focus of lending will be infrastructure projects with authorized lending of up to $34 billion annually. South Africa will be the African Headquarters of the Bank named the "New Development Bank Africa Regional Centre". The bank will have starting capital of $50 billion, which can be increased to $100 billion over time. Brazil, Russia, India, China and South Africa will initially
contribute $10 billion each to bring the total to $50 billion. Each member cannot increase its share of capital without all other 4 members agreeing. The bank will allow new members to join but the BRICS capital share cannot fall below 55%.

The New Development Bank intends to make its first loan in Chinese currency by April 2016. The founding members can also be borrowers. New members will be sought and hopefully inducted by end 2015. The Bank will also make loans in local currency. The New Development Bank by itself is not large enough to meet the unmet financing needs for the developing world – so it must leverage its capital. How much capital it will be able to leverage will depend on how it partners with other sources of funding – private capital, local financing and other international financial institutions. If the Bank is able to leverage in other lenders into its projects it could be a catalytic agent in increasing infrastructure investment – which in turn could help crowd in private investment.

The projected steady state lending by the NDB is expected to be $34 billion annually. This is based on a capital base of $100 billion of which $20 billion is paid in capital, based on which the total stock of loans could reach $350 billion in twenty years. If the NDB is able to co-finance its projects up to 50% then the size of combined lending could reach $68 billion annually which is about the size of lending of the European Investment Bank and much larger than that of the World Bank.

The ability of the NDB to raise resources at a low cost will depend on its credit rating and how it evolves over time. But if the market perceives that some of the founding members will backstop the institution then that country’s credit rating could become the default rating of the bank. At the World Bank, which is perceived as a US dominated institution its credit rating has been AAA even though many of its members do not have AAA ratings. The World Bank retained its AAA rating even when the US lost its AAA credit rating temporarily.

The ratings for the 5 founding members are as follows for three major rating agencies: Standard & Poor’s and Moody’s are as follows:

<table>
<thead>
<tr>
<th></th>
<th>Standard 7 Poor’s</th>
<th>Moody’s</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Brazil</strong></td>
<td>BB+ Negative (on 14.9.15)</td>
<td>Baa2 Stable (on 5.8.11)</td>
</tr>
<tr>
<td><strong>China</strong></td>
<td>AA- Stable (on 20.2.12)</td>
<td>Aa3 Stable (on 5.8.11)</td>
</tr>
<tr>
<td><strong>India</strong></td>
<td>BBB- Positive (on 8.4.15)</td>
<td>Baa3 Positive (on 5.8.11)</td>
</tr>
<tr>
<td><strong>Russia</strong></td>
<td>BB+ Negative (on 26.1.15)</td>
<td>Ba1 Negative (on 20.2.15)</td>
</tr>
<tr>
<td><strong>S. Africa</strong></td>
<td>BBB- Stable (on 13.5.14)</td>
<td>Baa2 Stable (on 6.11.14)</td>
</tr>
</tbody>
</table>

The credit rating of the Bank would probably initially be determined by the credit ratings of the five founding members. But based on its performance it could have a much better rating than its members. The performance of its portfolio will also determine the future path of its credit rating. The CAF – the Development Bank for Latin America which lends more money for infrastructure than the World Bank or the Inter-American Development Bank in Latin America has credit rating of Aa3 from Moody’s and a rating of AA- from Standard & Poor’s. These ratings are higher than the individual ratings of most of its individual members.
Similarly the European Investment Bank which lends more money for infrastructure than the World Bank has a better credit rating than many of its members and has retained its credit rating despite the ratings of its founding members going down after the Global Financial Crisis. How it invests profits from the first round of lending will also help determine its future ability to make loans and its credit rating. The NDB will also be looking for new members – potential members mentioned are Turkey, Mexico, Indonesia and other large G-20 emerging economies. New members from the developed world could also be considered although given its founding philosophy membership from emerging economies may be its first preference.

The NDB can lend funds to the founding members but is also expected to focus its lending to LICs. As it is not a regional bank it can lend for projects anywhere across the developing world including in Latin America and the Caribbean, unlike the AIIB which will lend largely for projects in the broader Asian region. The New Silk Road Fund has greater flexibility as it can ostensibly be used for any project that promotes the new Silk Road idea.

3.2 Contingent Reserve Arrangement (CRA)

The CRA is a framework for the provision of support through liquidity and precautionary instruments in response to actual or potential short-term balance of payments pressures. It will provide financing similar to the IMF but not under an IMF agreement.

The objective of this reserve is to provide protection against global liquidity pressures. This includes situations where members' national currencies are being adversely affected by global financial pressures. For example the CRA could also provide assistance to other countries suffering from the economic volatility in the wake of the United States' exit from its expansionary monetary policy, as was the case in 2013 when the Fed announcement of “tapering” led to sharp volatility in emerging economy currency markets.

This CRA will consist of $10 billion of "paid-in capital" ($2 billion from each member to be provided over seven years) and an additional $40 billion to be "paid upon request". Out of the total initial capital of $100 billion, China will contribute $41 billion, Brazil, Russia and India would give $18 billion each, and South Africa would contribute $5 billion. It is scheduled to start lending in 2016.

The interesting feature of this facility is that its lending will not be tied to an IMF program. In this regard it is different from the Chiang Mai Initiative (CMI) and similar to the much smaller Fondo Latin Americano de Reserva (FLAR). The CMI is an initiative of Asian countries – so it remains regional and takes the form of a currency swap. But only the first 30% (expected to go up to 40% by 2016) of a member’s quota can be accessed without an IMF program. In the case of the FLAR IMF program linkage is not required. The CRA is not linked to an IMF program and attempts to break that link to existing institutions quite deliberately. Its size, of course, remains small but it could come in good use to stabilize currencies when the problem emanate externally and not internally. A good example would be the sudden currency turmoil that took place in 2013 when the Fed announced its intent to taper the Quantitative Easing program that it had been running after the Global Financial Crisis in 2008.

The CRA becomes the first direct competition to the IMF, but for it to be meaningful will require a much larger size. Given the size of portfolio flows a US $100 billion facility will not be large
enough. But an important step has been taken to change the global architecture of financing and it remains to be seen how it will be used and developed.

3.3 Asian Infrastructure Investment Bank (AIIB)

The Asian Infrastructure Investment Bank (AIIB) is an international financial institution which is focused on supporting infrastructure construction. The bank was initiated by the government of China and supported by 56 other countries from Europe, Oceania, Africa and South America as members. AIIB is regarded by some as a rival to the IMF, the World Bank and the Asian Development Bank (ADB), which are regarded as dominated by developed countries like the United States. The United Nations has addressed the launch of AIIB as "scaling up financing for sustainable development" for the concern of Global Economic Governance.

The bank was proposed by China in 2014 and at a ceremony in Beijing in October 2014. The Articles of Agreement (AOA) were finalized and open for signature by PFM s from June 2015. The AOA is expected to enter into force and AIIB to be fully established by the end of 2015. As of 15 August 2015 there are 57 PFMs.

The Asian Infrastructure Investment Bank can be construed as a natural inter-national extension of the infrastructure-driven economic development framework that has sustained the rapid economic growth of China since the adoption of the Chinese economic reforms in the 1980’s. It stems from the notion that long-term economic growth can only be achieved through massive, systematic, and broad-based investments in infrastructure assets.

3.3.1 Shareholding Structure

The final shareholding structure of the Bank is still unfolding. The following table are amounts for 30 largest countries by notional shareholding at the Asian Infrastructure Investment Bank. The voting shares are based on the size of each member country's economy (GDP PPP) (and whether they're an Asian or Non-Asian Member) and not contribution to the Bank's authorized capital. China's shareholding is 30.34 per cent and it has retained 26.06 per cent of the voting rights for certain key decisions. The Philippines and Thailand have not yet signed on to the Bank so the shares could change as new members join.

Table 2. Potential Shareholding at the Asian Infrastructure Investment Bank

<table>
<thead>
<tr>
<th>Rank</th>
<th>Country</th>
<th>Number of Shareholding Voting Rights</th>
<th>Shares</th>
<th>(% of Total)</th>
<th>(% of Total)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>China</td>
<td>297,804</td>
<td>30.34</td>
<td>26.06</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>European Union</td>
<td>190,698</td>
<td>19.43</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>India</td>
<td>83,673</td>
<td>8.52</td>
<td>7.50</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>Russia</td>
<td>65,362</td>
<td>6.66</td>
<td>5.93</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>Germany</td>
<td>44,842</td>
<td>4.57</td>
<td>4.15</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Country</td>
<td>Shares</td>
<td>Price 1</td>
<td>Price 2</td>
<td></td>
</tr>
<tr>
<td>----</td>
<td>-------------------------</td>
<td>--------</td>
<td>---------</td>
<td>---------</td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>South Korea</td>
<td>37,388</td>
<td>3.81</td>
<td>3.50</td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>Australia</td>
<td>36,912</td>
<td>3.76</td>
<td>3.46</td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>France</td>
<td>33,756</td>
<td>3.44</td>
<td>3.19</td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>Indonesia</td>
<td>33,607</td>
<td>3.42</td>
<td>3.17</td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>Brazil</td>
<td>31,810</td>
<td>3.24</td>
<td>3.02</td>
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</tr>
<tr>
<td>11</td>
<td>United Kingdom</td>
<td>30,547</td>
<td>3.11</td>
<td>2.91</td>
<td></td>
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<tr>
<td>12</td>
<td>Turkey</td>
<td>26,099</td>
<td>2.66</td>
<td>2.52</td>
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<tr>
<td>13</td>
<td>Italy</td>
<td>25,718</td>
<td>2.62</td>
<td>2.49</td>
<td></td>
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<tr>
<td>14</td>
<td>Saudi Arabia</td>
<td>25,446</td>
<td>2.59</td>
<td>2.47</td>
<td></td>
</tr>
<tr>
<td>15</td>
<td>Spain</td>
<td>17,615</td>
<td>1.79</td>
<td>1.79</td>
<td></td>
</tr>
<tr>
<td>16</td>
<td>Iran</td>
<td>15,808</td>
<td>1.61</td>
<td>1.63</td>
<td></td>
</tr>
<tr>
<td>17</td>
<td>Thailand</td>
<td>14,275</td>
<td>1.45</td>
<td>1.50</td>
<td></td>
</tr>
<tr>
<td>18</td>
<td>United Arab Emirates</td>
<td>11,857</td>
<td>1.21</td>
<td>1.29</td>
<td></td>
</tr>
<tr>
<td>19</td>
<td>Pakistan</td>
<td>10,341</td>
<td>1.05</td>
<td>1.16</td>
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</tr>
<tr>
<td>20</td>
<td>Netherlands</td>
<td>10,313</td>
<td>1.05</td>
<td>1.16</td>
<td></td>
</tr>
<tr>
<td>21</td>
<td>Philippines</td>
<td>9,791</td>
<td>1.00</td>
<td>1.11</td>
<td></td>
</tr>
<tr>
<td>22</td>
<td>Poland</td>
<td>8,318</td>
<td>0.85</td>
<td></td>
<td></td>
</tr>
<tr>
<td>23</td>
<td>Israel</td>
<td>7,499</td>
<td>0.76</td>
<td></td>
<td></td>
</tr>
<tr>
<td>24</td>
<td>Kazakhstan</td>
<td>7,293</td>
<td>0.74</td>
<td></td>
<td></td>
</tr>
<tr>
<td>25</td>
<td>Switzerland</td>
<td>7,064</td>
<td>0.72</td>
<td></td>
<td></td>
</tr>
<tr>
<td>26</td>
<td>Vietnam</td>
<td>6,633</td>
<td>0.68</td>
<td></td>
<td></td>
</tr>
<tr>
<td>27</td>
<td>Bangladesh</td>
<td>6,605</td>
<td>0.67</td>
<td></td>
<td></td>
</tr>
<tr>
<td>28</td>
<td>Egypt</td>
<td>6,505</td>
<td>0.66</td>
<td></td>
<td></td>
</tr>
<tr>
<td>29</td>
<td>Sweden</td>
<td>6,300</td>
<td>0.64</td>
<td></td>
<td></td>
</tr>
<tr>
<td>30</td>
<td>Qatar</td>
<td>6,044</td>
<td>0.62</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>South Africa</td>
<td>5,905</td>
<td>0.60</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Remaining Countries</td>
<td>50,384</td>
<td>5.13</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Unallocated Shares</td>
<td>18,486</td>
<td>–</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Grand Total</td>
<td>1,000,000</td>
<td>100.00</td>
<td>100.00</td>
<td></td>
</tr>
</tbody>
</table>
3.3.2 Management structure

The bank's governance structure is composed of the Board of Governors as the top-level and highest decision-making body, the board of directors as the middle-level, and the Management Team which is at the bottom of decision-making pyramidal structure.

In principle, the AIIB could be viewed as the Asian equivalent of the European Investment Bank (EIB) which was set up under the Treaty of Rome. If Europe can have a European Bank for Reconstruction and Development (EBRD) headquartered in London and an EIB headquartered in Luxembourg, Latin America can have the Inter-American Development Bank (IADB) and the CAF why cannot Asia have an Asian Development Bank (ADB) and the AIIB. Despite the fact that over 20 non-Asian countries, including key European countries - became its members, with China’s dominant share and its headquarters in Beijing, with a Chinese President, the AIIB is really China’s vehicle to challenge the dominance of the Western financial establishment.

One of the reasons cited by the USA and Japan against joining the AIIB is a concern over its governance and whether it will meet satisfactory environmental and social standards. Whether AIIB can meet global environmental and social standards in its lending operations remains to be seen. One of the criticisms of the existing MDB's is that they have become so risk averse of any lending for large infrastructure projects because of concerns that the international NGO community will raise protests to these projects. On balance they have reduced lending for infrastructure and shifted funds to social-sector lending where such difficult choices do not have to be made. The large voting share (26.6%) of China in the AIIB, its location in Beijing and the fact that the first President is likely to be a Chinese leaves China open to the same criticism as the US faces in its dominance at the World Bank. It remains to be seen how China exercises this dominance and whether it will help set a different trend in global financial architecture or whether it will become yet another multilateral bank with a dominant shareholder.

Its operating procedures, types of loans and management structure are still under preparation. One area it is expected to improve upon compared to the existing MDB's is the speed and cost of loan preparation. The current procedures at the MDB's, laborious clearance processes have made borrowing from the existing MDB's very time consuming and costly. One of the clearest wins that can come from the AIIB would be the speed of loan preparation.

The AIIB cites sustainable development as one of its main objectives – and it can show a path to infrastructure investment which on balance marries environmental protection with development. For many developing countries where there are large gaps in infrastructural investment how the AIIB show the way forward on this issue is even more critical. China’s own development experience so far has been mixed – it has developed fast but at a very environmental cost. It is now shifting greater attention to environmental concerns – but its past experience has not been exemplary. If the AIIB weakens its environmental or social standards it will come in for criticism – but if it can show a good way forward it could trigger simplified approaches at the existing MDB's.

3.4 New Silk Road Fund (NSRF)

China has also established a new Silk Road Fund to explicitly support the project. The fund’s initial $10 billion financing is from China’s foreign exchange reserves—which contributed the majority of the initial funds—the China Development Bank, China Investment Corporation, and the Export-Import Bank of China. The Chinese government will tap its foreign currency reserves for about
65 percent of the Silk Road Fund. China Investment Corp. and the Export-Import Bank of China will chip in 15 percent each, and China Development Bank Capital Co. will invest 5 percent. The upcoming second and third phases will involve domestic and foreign investors. While based in Beijing and currently supported by a majority of Chinese investors, the Silk Road Fund is not state-owned and will eventually hopefully be dominated by currencies other than the Chinese yuan.

The fund operates much as a private equity venture, but with a smaller group of investors committed for longer terms. It is comparable to institutions such as the World Bank’s International Finance Corporation in mission and scale, but it is financed by a small number of investors rather than by public funds. The private equity venture-type structure of the fund should help avoid riskier politically-driven deals that are not always in the best economic interests. The structure will hopefully depoliticize the fund, allowing its managers to seek lower-risk investments.

China’s Silk Road Fund announced its 1st project for investment in the Belt and Road initiative during Chinese President Xi Jinping’s state visit to Pakistan, marking a milestone of the all-weather strategic partnership of cooperation between the two countries. The investment into the US$1.65 billion Karot hydropower project in Pakistan, along with other hydropower projects in the region, will help the South Asian country upgrade power supply and improve its economic performance.

The project is a priority within the broader China-Pakistan Economic Corridor (CPEC) initiative, a flagship program of China’s Belt and Road initiative. The CPEC is a planned network of roads, railways and energy projects linking southwest Pakistan’s deep-water Gwadar Port with northwest China’s Xinjiang Uygur Autonomous Region. With the CPEC at the center, China and Pakistan could achieve a win-win result and common development, and bring benefit to their people. For China, it would shorten the route for its energy imports. For Pakistan, a “1+4” cooperation structure with the CPEC at the center and the Gwadar Port, transport infrastructure, energy and industrial cooperation being the four key areas, will boom the country’s economy and improve people’s livelihood.

Owing to the corridor’s geographical position where the Belt and Road meet, the CPEC is expected to combine South Asia, Central Asia, Middle East and China together, and benefit directly about 3 billion people in the region. Based on this, it could function as a bridge in advancing the Belt and Road initiative after being well developed and successfully operated. The CPEC project has risks as the infrastructure passes through areas with huge disputes.

A gold sector fund involving countries along the ancient Silk Road has been set up in northwest China's Xi'an City. The fund, led by Shanghai Gold Exchange (SGE), is expected to raise an estimated 100 billion yuan (16.1 billion U.S. Dollars) in three phases. China is the world's largest gold producer, and also a major importer and consumer of gold. Among the 65 countries along the routes of the Silk Road Economic Belt and the 21st-Century Maritime Silk Road, there are numerous Asian countries identified as important reserve bases and consumers of gold. About 60 countries have invested in the fund, which will in turn facilitate gold purchase for the central banks of member states to increase their holdings of the precious metal, according to the SGE.

The Silk Road Fund is also looking to invest in companies that will boost transportation globally. It recently signed an equity investment agreement with ChemChina to hold a 25% stake in CNRC International Holding (HK) Limited (“CNRC HK”). CNRC HK was established to acquire, through its affiliates, the Pirelli ordinary shares owned by Camfin and thereafter to launch the
Mandatory Tender Offer for Pirelli ordinary shares and the Voluntary Tender Offer for Pirelli savings shares. The signing of the agreements indicates that ChemChina, Silk Road Fund, Pirelli management and other partners will join forces in the long term industrial investment in Pirelli as they are all committed to working together to build a market leader in the global tire industry.

3.5 Some Issues for the New Institutions

With these three additional sources of multilateral financing outside the existing IFI framework several issues arise. China and the other BRICs countries have accepted the Paris Declaration and the Accra Agenda for Action but they have not agreed to be considered donor countries and sign on to the DAC framework. Just to recap the Paris Declaration and the Accra Agenda for Action:

3.5.1 The Paris Declaration on Aid Effectiveness

The Paris Declaration (2005) is a practical, action-oriented roadmap to improve the quality of aid and its impact on development. It gives a series of specific implementation measures and ensures that donors and recipients hold each other accountable for their commitments. The Paris Declaration outlines the following five fundamental principles for making aid more effective:

- **Ownership:** *Developing countries set their own strategies for poverty reduction, improve their institutions and tackle corruption.*
- **Alignment:** *Donor countries align behind these objectives and use local systems.*
- **Harmonisation:** *Donor countries coordinate, simplify procedures and share information to avoid duplication.*
- **Results:** *Developing countries and donors shift focus to development results and results get measured.*
- **Mutual accountability:** *Donors and partners are accountable for development results.*

3.5.2 The Accra Agenda for Action

Designed to strengthen and deepen implementation of the Paris Declaration, the Accra Agenda for Action (AAA) takes stock of progress and sets the agenda for accelerated advancement towards the Paris targets. It proposes the following four main areas for improvement:

- **Ownership:** *Countries have more say over their development processes through wider participation in development policy formulation, stronger leadership on aid co-ordination and more use of country systems for aid delivery.*
- **Inclusive partnerships:** *All partners - including donors in the OECD Development Assistance Committee and developing countries, as well as other donors, foundations and civil society - participate fully.*
- **Delivering results:** *Aid is focused on real and measurable impact on development.*
- **Capacity development - to build the ability of countries to manage their own future - also lies at the heart of the AAA.*

In principle, China and the BRICS countries and the new financial institutions they are creating support the Paris Declaration and the Accra Agenda for Action. But they are unlikely to sign
on to the DAC framework as one of the reasons cited for establishing the new institutions is their unhappiness with existing financial aid architecture. They also hope to show the way forward in new ways of economic cooperation, which improve upon the existing aid mechanisms. If successful such approaches may incentivize and speed reforms in existing international financial institutions. Mwase and Yang (2014) have looked into how the BRICS countries differ in their philosophy of assistance and is likely to affect how the new financial instruments and institutions will shape their financing.

They assess that development financing provided by China and other BRICS so far has helped LICs alleviate some key bottlenecks to domestic economic activity and boost exports but it has also posed a number of challenges. The concentration of BRIC financing in infrastructure could have large positive growth effects by addressing infrastructure deficits in LICs, raising productivity by reducing business costs for tradables and non-tradables sectors alike, and supporting expansion in trade and investment. However, concerns have been raised about the impact on debt sustainability, subsidized export credits received by some BRICS firms (Brautigam, 2010), and labour practices. These concerns highlight the need to ensure that development financing is used to promote sustainable and inclusive growth.

Though there are some differences across BRICs, the philosophies of most BRICS for development financing differ from traditional donors in three main ways: BRICS provide financial assistance based on the principle of ‘mutual benefits’ in the spirit of South-South cooperation, while traditional donors emphasize the role of aid in poverty reduction. Second, BRICS, particularly China, view policy conditionality as interfering with recipients’ sovereignty and tend to provide noncash financing as a means to circumvent corruption, whilst traditional donors view policy conditionality as a means to ensure efficient use of aid. Third, different emphasis is placed on how to ensure debt sustainability, with some BRICS giving a greater weight to micro sustainability and growth while traditional donors paying more attention to long-run macro sustainability. This difference is, however, narrowing with BRICS increasingly appreciating the importance of overall debt sustainability and traditional donors the need for investing in physical capital and seeing results.

The importance of governance for safeguarding growth performance is particularly important for natural resource exporters, where often governance challenges are the greatest (Collier, 2011). The initiative provides a framework that both recipient countries and donors can use to foster greater transparency and accountability in awarding natural resource (and other) concessions.

The public investment scale-up associated with BRICS development financing has benefited LICs by alleviating key infrastructure bottlenecks, boosting export competitiveness and making goods and services more affordable to consumers. Continued engagement with BRICS holds the potential to raise LICs’ economic growth and reduce poverty in the long run. However, concerns have been raised over debt sustainability, pace of employment creation, labour practices, and competition with local firms. While none of these concerns is uniquely related to BRIC financing and has been debated in the past in relation to financing from other sources, they underscore the importance of managing the broader repercussions of the LIC-BRIC engagement.

As with other sources of financing, to maximize the benefits of LIC-BRIC cooperation, LICs will need to ensure high returns for BRIC-financed projects through sound public investment management. LICs and BRICS can work together to improve the transparency of project financing. This, together with a sound debt management strategy, would help minimize the debt-distress risks of increased borrowing. It would also be beneficial to all parties to deepen linkages between the BRIC-
financed projects and the rest of the economy and encourage the employment of local workers. It is expected that the new financial institutions will be able to operate with more professional standards and transparency than the existing bilateral cooperation programs.

While there is huge debate over China's presence in Africa – it is one player– albeit a large player among many as shown by the Economist (see Figure 1). China's trade with Africa is the largest in the world but this year India's trade with Africa will rise to almost $100 billion and is increasing faster than China's. In FDI western nations have far larger amounts invested in Africa compared to China.

**Figure 1: The Scramble in Africa**

![The Scramble in Africa](image)

*Source: The Economist*

China has increasingly become conscious of its image in Africa and concerns that have been raised over environmental and social safeguards as well as labour issues. Cases of human rights abuses have arisen from Chinese-African co-operation. African workers have protested against ill-treatment and poor pay by Chinese companies, as well as the influx of Chinese workers who took away local jobs. In July 2010, hundreds of African workers at a Chinese-owned Zambian mine rioted over low wages.

In an IMF working paper Drummond and Liu (2013) examine some of the costs and benefits of China’s engagement with Sub Saharan Africa. Many existing studies focus on whether China’s larger involvement in Africa benefits or hurts the region overall. While some scholars and African policymakers have claimed that more trade between China and SSA has benefited the region (Chaponnière, 2009; Ajakaiye and others, 2009; Renard, 2011), others have warned about losses
owing to greater exposure to commodity price fluctuations and reduced demand for African production because of competition from China (Ademola, Bankole, and Adewuyi, 2009).

Among the studies that attempt to quantify China’s impact on the global economy, Ahuja and Nabar (2012) argue that a 1 percentage point slowdown in investment in China is associated with a reduction of global growth of just under 0.1 of a percentage point. Arora and Vamvakidis (2010) find positive spillover impact of China’s growth on the world and this impact has increased in the recent decades: a 1 percentage point increase in China’s growth is associated with an average 0.5 percentage point increase in the growth of other countries. In Africa, Ademola, Bankole, and Adewuyi (2009) analyzed trade patterns between China and Africa both at the aggregate Africa and at the national level. They conclude that African countries that gain from trade with China are oil exporters; ore and metal exporters; cotton exporters; and log timber exporters.

Although the total trade volume between China and Africa has grown rapidly, the speed of such growth has slowed down — from 19.3 percent in 2012 to 5.9 percent in 2013. Such a rate is also lower than the growth of China's overall foreign trade: 7.6 percent in the same year. While the broad context is the slowdown of China's economic growth and of its foreign trade, exports by Africa suffer in particular because China's demand for raw materials has declined.

China ran a small deficit of $24.6 billion in its trade with Africa, while its exports are still largely dominated by finished products including machineries, electronics, automobiles, textiles, etc. Meanwhile, despite the reiterated efforts that China would reduce the percentage of natural resources imports in Sino-African trade, natural resources remain dominant. In total, China's crude oil imports from Africa made up 23 percent of China's global imports in 2013, making Africa the largest exporter of crude oil for China.

The new Chinese backed financial institutions will need to be even more conscious of these concerns and ensure that they meet the best international standards and are yet able to operate with greater speed and at lower costs. It is interesting that the types of financing that will become available from the three new institutions will cover several options. The CRA ($100 b) is an IMF like funding arrangement to help provide short term liquidity. The New Silk Road Fund ($ 40 b) is designed more like the IFC - the private sector arm of the World Bank Group and will invest equity and provide loans to commercial projects and encourage trade and business development. The AIIB and the New Development Bank will provide long-term finance primarily for infrastructure. How well these institutions will partner with other lenders and with national institutions and associations will determine their capacity to leverage their initial funding.

One of the issues with infrastructure financing is that it usually requires long term financing as well as risk mitigation techniques to draw in private financing. The new financial institutions must find innovative way to structure their financial support to suit country and project needs. Just having standard approaches to very different situations and project needs will be required. Modern financing instruments that suit the diverse range of project needs such as equity participation, insurance and credit enhancement, loan guarantees, debt instruments, first-loss equity, challenge funds, and grants and facilitate risk management, as well as project preparation support. Sovereign wealth funds which are using existing international financial institutions must be attracted through more innovative approaches to enhance credit.

Public private partnerships (PPPs) have had mixed success in the developing world. Getting
the right amount of risk sharing is not easy – and in many cases with weak governance arrangements – much of the risk is taken up by government and in some cases too little. In the former case the return to private finance is excessive and in the case of the latter has led to stalled projects and large non-performing assets which has clouded the climate for fresh investment. Getting the balance between execution risk and macro risk around the project which is outside the control of individual investors is vital. New and innovative approaches, better understanding of the nature of risk are needed.

One of the ways to reduce the costs of operations of the NDB and the AIIB is not to have such a large field presence but instead to rely on the field presence of potential partners, local institutions and agencies involved in project preparation. The EIB, for example lends far more than the World Bank or the ADB but with much lower staff and administrative costs. Its gearing ratio, the ratio of lending to its administrative budget is the lowest among the multilateral development banks. It relies heavily on co-financing with others and also uses partnership with national development banks to prepare and monitor its projects.

Rigorous evaluation must be a central feature of the new financial institutions. The existing multilateral development banks have an elaborate evaluation system but it is not very effective because it is not directly linked into a learning process. The time it takes to assess problems is too long and there is no well-functioning in-built learning process from mistakes and lessons learnt. The transmittal of information about what is working well across countries also leaves much improvement. As a result these institutions also do not function to promote greater south-south exchange as a central part of their operations. Instead money is wasted in creating knowledge hubs and knowledge processes as if that were something alien to lending procedures. The new financial institutions must build learning directly into their operational procedures and incentive systems for project managers and staff.

4. INDIA’S OPTIONS WITH THE NEW SILK ROAD

There are conflicting views in India on whether China’s OBOR strategy represents a threat or an opportunity. Some view it as a strategy which China will use to encircle India. Some consider it as a great opportunity to attract the much-needed infrastructure finance into India to fill its infrastructure growth and boost growth and employment. And some regard it as a fait accompli in which India must engage to derive as much benefits from it as possible. What is emerging is a competitive yet cooperative approach from both China and India, in the Indian Ocean and in the South China Sea and parts of East Asia.

India has not signed onto the OBOR strategy and has concerns especially with the MSR, whereas China has expressed opposition to Indian interference in the South China Sea. India was upset about the Chinese President’s recent commitment to invest $47 billion in rail, road infrastructure and a virtual trade corridor connecting West China to the strategic Gwadar port in Pakistan. This will enable China to carry oil and gas from Iran and Arab countries via Gwadar port which was also built by China. India’s objection is that the trade corridor and rail-road link goes through Pak occupied Kashmir. Nevertheless, India has signed onto becoming a founding member of the AIIB and the NDB.

At the same time India has begun its own long overdue initiatives in the Indian Ocean to counter the Chinese and ensure that China does not start to dominate the Indian Ocean – through its
“String of Pearls”. India’s maritime initiative on the Indian Ocean has been variously presented as “Project Mausam”, “Spice Route”, “Cotton Route” “Sagar Mala” and the Blue Revolution (from the Ashoka Chakra on the Indian flag) and SAGAR—Security and Growth for All in the Region. The initiative envisions India as the center of the “Indian Ocean world,” which stretches from Africa in the west to Southeast Asia in the east. Like China’s Maritime Silk Road, Project Mausam would boost regional commercial and cultural linkages – but where the MSR would have all roads leading back to China, Project Mausam seeks to return India to its role as the center of Indian Ocean trade. The project has three-dimensional approach: first, to deepen cultural bonding, second, to ensure maritime security and third, to broaden economic connectivity with nations of the Indo-Pacific Region.

Image 3: The Silk and Spice Routes

China has tried hard to get India to find ways to bring the MSR and India’s Mausam (Spice Route) projects together. On the surface, the two projects do have much in common – both seek to expand regional integration, especially when it comes to trade and commerce. But on a deeper level, both the MSR and Project Mausam are about expanding influence – culturally, economically, and even strategically. India devised Project Mausam to counter perceptions that China was becoming the major Indian Ocean power. The Indian Ocean carries one half of world’s container shipments, one-third of the bulk cargo traffic and two-thirds of the oil shipments, though three-fourths of this traffic goes to other regions of the world and is just trans-shipped through the Indian Ocean.

China’s MSR is all about trade and infrastructural investment and China has been willing to put considerable resources behind the MSR. It has helped build the ports of Gwadar (in Pakistan), Hambantota (in Sri Lanka), Chittagong (in Bangladesh) and Sittwe (in Myanmar). In addition China has offered $500 million in soft loans for infrastructure and housing projects to the Maldives, and

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12 In 1999, for instance, China leased Marao Island in Maldives for “maritime traffic management” purposes. The fear in New Delhi was that Beijing would turn maritime traffic management facilities into surveillance posts and berths for container vessels into havens for vessels of war. The concern was not misplaced. There are persistent reports that China will upgrade Marao, now used to monitor Indian and U.S. warship movements, into a submarine base, some predicting that will happen “in the near future.” And in both September and October 2014 the Sri Lankan government allowed a Chinese submarine and its tender to dock at the Chinese-funded Colombo International Container Terminal. In addition to Marao and Colombo, China is constructing facilities in Payra in Bangladesh, Gwadar in Pakistan, and Kyaukpyu in Burma. There is a Chinese-funded port with obvious military applications in Seychelles, and soon there will be what looks like a military base in Obock in Djibouti. Namibia’s Walvis Bay, in the South Atlantic near the Cape of Good Hope, anchors the western end of
over $700 million to Mauritius for expansion of its airport and special economic zone. Additionally, in Sudan, China has invested over $10 billion in infrastructure projects, including a railway line between Khartoum and the crucial Port Sudan on the Red Sea, and is financing and building a $10 billion port at Bagamoy in Tanzania.

China has had success in other cases tying its MSR to another country’s own development goals, most notably Indonesia’s ‘maritime fulcrum’ policy. But when it comes to India, China faces deeper distrust given China’s border dispute with India and its support to Pakistan. China’s military-strategic intent behind the MSR cannot be discounted. The unprecedented docking of a PLA Navy submarine at Colombo port in September 2014 is a bellwether for future developments in the Indian Ocean. China is likely to seek naval access to the maritime infrastructure that it is helping to create, thereby increasing its strategic presence in India’s backyard. The PLA Navy could seek replenishment facilities in Chittagong, Colombo, Gwadar, Hambantota, and so on.

With the exception of China’s extensive economic relationship with Pakistan, China’s growing influence in South Asia is a relatively recent phenomenon. The China-Pakistan axis stands as a special and separate case, one that reflects a unique strategic logic unparalleled with other South Asia countries. China’s most recent economic commitment to Pakistan—a declared package of $46 billion in infrastructure development and assistance—thus represents an intensification of, but not a strategic change in, a longstanding relationship going back five decades. Their current two-way trade volume surpasses $16 billion.

In the past decade, China has emerged as a top exporter of goods to the region, including to India, breaking into South Asian markets with its export-led growth strategy. Bangladesh provides the starkest example of this trend. Around 2005, China overtook India as Bangladesh’s top trading partner. China displaced many Indian goods in Bangladesh, offering cheaper Chinese products (especially cotton and other fabrics central to the garment industry) without the visa, transport, and customs challenges that had limited trade between India and Bangladesh. The 2015 Land Boundary Agreement between India and Bangladesh, however, positions both countries to address border issues affecting trade in the near future.

China’s trade with Sri Lanka still lags behind India’s, but the gaps are narrowing. Sri Lanka is among India’s top trading partners in South Asia, and India is Sri Lanka’s largest trade partner. Since 2005, however, Chinese exports to Sri Lanka have quadrupled to about $4 billion, coming closer to Indian levels. China and Sri Lanka are also negotiating an FTA to further boost trade and provide better access for Sri Lankan goods in Chinese markets; the current trade balance overwhelmingly favours China.

Labour migration reflects economic and cultural linkages among South Asian countries. Here, India is linked much more deeply than China across South Asia. The remittances resulting from such migration represent substantial economic ties. Around five million South Asian migrant workers in India sent more than $7.5 billion in remittances back to their home countries in 2014, while just twenty thousand workers in China sent $107 million (including to India), according to the World Bank. In the case of Bangladesh, remittances from India inject the Bangladeshi economy with more than $4 billion

Beijing’s Indian Ocean facilities.
nearly eight times the value of the $557 million in Bangladeshi goods imported by India in 2014, making remittances a vital economic component of the relationship.

**Figure 2: Remittances in South Asia from China and India**

<table>
<thead>
<tr>
<th>REMITTANCE-RECEIVING COUNTRY</th>
<th>Afghanistan</th>
<th>Bangladesh</th>
<th>Bhutan</th>
<th>India</th>
<th>Maldives</th>
<th>Nepal</th>
<th>Pakistan</th>
<th>Sri Lanka</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>FROM INDIA</td>
<td>1</td>
<td>4,163</td>
<td>1</td>
<td>-</td>
<td>0</td>
<td>832</td>
<td>2,061</td>
<td>488</td>
<td>7,548</td>
</tr>
<tr>
<td>FROM CHINA</td>
<td>0</td>
<td>10</td>
<td>0</td>
<td>57</td>
<td>-</td>
<td>4</td>
<td>16</td>
<td>20</td>
<td>107</td>
</tr>
</tbody>
</table>

Credit: Ashlyn Anderson, Julia Ro

Much of the recent attention to China’s growing footprint in South Asia focuses on its development assistance and government investment programs, particularly for large infrastructure projects. This component of economic interaction is also the one for which apples-to-apples data is hardest to find. Overseas development assistance, as defined by the OECD, requires a “grant element of at least 25 per cent” meanwhile, the debt-servicing conditions on Chinese loans often fall outside of OECD standards. According to Beijing’s 2014 foreign aid white paper, concessional loans represent more than half of China’s aid.

Projects funded by Chinese concessional loans must also be awarded to Chinese companies and source Chinese goods, linking Chinese aid to its government investment activities. Lack of transparency also hinders comparison: while India releases its figures publicly, China provides only outlines. The data suggests some general trends, but problems in the classification of Chinese development assistance for well-known infrastructure projects in South Asia further complicate the picture.

Sri Lanka has seen a sudden rise of Chinese influence in South Asia. The increase in Chinese development assistance to Sri Lanka—mostly in the form of concessional loans—began in 2009 after the Sri Lankan civil war and then spiked dramatically in 2011. Chinese support for a port, airport, and cricket stadium in Hambantota, the hometown of the former Sri Lankan president, revealed an increasingly close relationship between the two countries.

The upgrade of the China–Sri Lanka relationship to a “strategic cooperative partnership” in 2013 demonstrated the geopolitical influence of China’s generous support to Sri Lanka. Detailed loan disbursements available from the Sri Lankan government show a dramatic gap between Indian and Chinese contributions. Between 2012 and 2015, China disbursed almost $2.5 billion, of which more than 75 percent came from the Export-Import Bank of China. During the same period, India extended $660 million in lines of credit.

Sri Lanka also features prominently in China’s Maritime Silk Road project. Beijing’s focus on deep seaport development played on New Delhi’s fears of a Chinese “string of pearls” encircling
India. The Colombo port of call of two Chinese submarines in late 2014 and reports that Sri Lanka granted Chinese state-owned enterprises operating rights at the Hambantota port exacerbated Indian concerns. But upon taking office, Sri Lanka’s new president, Maithripala Siresena, suspended several Chinese projects, including the $1.4 billion Colombo port city due to the opacity of financing terms.

**Figure 3: China’s Rising Investment in South Asia**

Source: Anderson and Ayres (2015)

While China is acting across the Indian Ocean region, India is working with nations surrounding the South China Sea and restricting its activities to the water-body. The most visible Indian presence is off the shore of Vietnam. India started looking for hydrocarbons in Vietnamese waters in 1988, and since then there have been a series of deals, including those signed in 1992, 2006, 2011, and 2014. India has also asserted the “right to free navigation through the South China Sea “as almost one quarter of India’s trade passes through those waters. India has also signalled greater involvement in East Asia – with an Act East rather than just a Look East policy. Landlocked Mongolia has declared India its “third neighbour” in addition to its two giant neighbours China and Russia.

**Image 4: The String of Pearls**

One view is that China’s “string of pearls” is not directed at India but is China’s response to reduce its vulnerability on oil and trade shipments through the Straits of Malacca. If China’s oil supplies are threatened through the Straits of Malacca it needs alternative options, with access to the
Indian Ocean and the Gulf. India also needs to overcome infrastructure-related constraints to enhance connectivity for its overseas trade, which contributes substantially to the national economy. The MSR could be an effective maritime supplement to the land-based Bangladesh-China-India-Myanmar (BCIM) Economic Corridor under active consideration by New Delhi. It could be dovetailed with India’s own ‘Sagarmala’ project, and thereby contribute to the nation’s efforts to enhance sea-trade connectivity, while also progressively leading to ‘port-led development’ of the hinterland, and the SEZs.

China and India must cooperate rather than compete if an Asian century is to be realized. According to Angus Maddison (2007) India and China 200 years were almost 50% of the global economy. But by 1950 their share of the global economy had dropped to only around 15%. Since 1980’s both economies saw a step increase in their growth rates – more so in the case of China which saw almost 3 decades of spectacular growth rates. India also shed its slow growing so called “Hindu” growth rate and began to grow much faster. If both China and India could continue to grow rapidly they are projected to become more than 50% of the world economy by 2030 – roughly where they were 250 years ago. China and India have much to gain if they cooperate and much to lose if they compete in a manner that pulls each other down.

Greater trade and investment will provide more incentives to cooperate rather than compete with each other. But trade between the two Asian giants is increasing but still remains quite small. India’s trade with China in 2000-01 was $2 billion, and it became $65.86 billion in 2013-14, with the potential to top $100 billion in 2015. This should mean tremendous opportunities for traders and
investors in both countries. But India’s trade deficit with China has increased from $1 billion in 2001-02 to $36.22 billion in 2013-14, and is expected to grow further to $48.43 billion in 2014-15 (see Figure 4). Some of China’s biggest exports to India are telecommunications equipment, computer hardware, industrial machinery and other manufactured goods. India sends back mostly raw materials such as cotton yarn, copper, petroleum products and iron ore.

It is interesting as shown by Kala, Zhong and Mandhana (2015) using data from UNCTAD that India is following a path of growth, investment and even exports very similar to China’s with a lag of 13 years as India began its liberalization 13 years after China (see Figure 5). But whether India will be able to track China’s impressive 30 year record will depend on India’s ability to carry out second generation reforms which have so far proven elusive.

Given China’s huge trade imbalance with India one obvious solution would be to have Chinese companies invest and manufacture in India. India’s emergence as an investment hub can be seen as average net inflow increased to $13.6 billion during 2006-2011, up from an average net inflow of $3.8 billion during 2001-2005. The average net inflow could rise to $22 billion by the end of 2015. This reflects rising demand and fresh business friendly initiatives by new government. While Chinese companies have been great at peddling their products in India, they have been surprisingly reluctant to invest here. China has invested less in India than even Poland, Malaysia or Canada has.

**Figure 5: India Follows China 13 years later**

![Closing the Gap](image)

Source: Kala, Zhong and Mandhana (2015)

However, according to data from United Nations Conference on Trade and Development, China was the third biggest source of foreign direct investment last year, having invested more than $100 billion in other countries. In the seven years to 2012, it invested more than $25 billion in the 10 members of the Association of Southeast Asian Nations alone.

There is a strong call in India to increase tariffs on Chinese manufactures to manage the trade imbalance and to encourage Chinese companies to invest in India, as wages have risen in
China and the Chinese Yuan has appreciated considerably.\textsuperscript{13} But with weak infrastructure, and the huge costs of doing business as well as an overvalued exchange rate India remains uncompetitive.

One wild card in the China India relationship is the TPP. If India were to join the TPP it would strengthen its hands with respect to China.\textsuperscript{14} But as Devashish Mitra (2015) writes it is important to understand that there are many channels through which the TPP can affect India. First, we can expect some trade diversion and significant foreign investment diversion. A large proportion of India’s exports belong to services. With the anticipated reduction in barriers to trade in services among TPP members, there is the possibility that some of India’s services exports to those countries will be replaced by services trade within the TPP. In the case of goods trade, there should not be much of an impact as the large economies within the TPP already have very low tariffs on imports from all WTO member countries.

\textbf{Figure 6: FDI into India by China and Others}

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{figure6.png}
\caption{FDI into India by China and Others}
\end{figure}

\textit{Source: Kala, Zhong and Mandhana (2015)}

A key component of ‘Make in India’ scheme of Prime Minister Modi is attraction of foreign investment. If the US manages to bring TPP nations closer to its own IPR regime and make them commit to an agreement preventing expropriation, it will make it difficult for India to attract foreign investment, especially given its history of retrospective taxation. In other words, some TPP nations will then become more attractive destinations for foreign investment flows.

\textsuperscript{13}India increased duty on steel imports by 20% on Sep 13, 2015 in response to reported Chinese dumping.

\textsuperscript{14}This section draws on Mitra (2015)
While the US and India has started negotiating a bilateral investment treaty (BIT), this negotiation is going to be slow. This is because there is vast divergence between the two countries’ model BITs, especially on issues of IPR and market access commitments. Thus, significant foreign investment diversion, including a deceleration in foreign investment flows to India, is a possible consequence of the TPP. In addition, the TPP reduces India’s bargaining power in its BIT negotiations with the US, as it expands the set of options available to the latter.

The TPP will also provide a template for any future agreements with the US. So, if India has to successfully arrive at any economic agreement with the US in the future, the labour, environmental and IPR standards in the TPP will become the minimum requirements of such an agreement. This, through spill-over effects, will also be true of agreements with other countries. For example, the Regional Comprehensive Economic Partnership (RCEP) is a proposed agreement between ASEAN nations and six other countries, including India. There is a large overlap in the memberships of the TPP and the RCEP, so that if the TPP is the first of the two to be put in place, the TPP standards will get into the RCEP through the common member countries. This is a possibility, even though the RCEP is being envisioned as a more flexible trade agreement that does away with a one-size-fits-all approach.

One positive for India from the TPP would be the active role played by the US in the region that will, to a certain extent, neutralize China’s power in the neighbourhood. Some of the potential signatories to the TPP, such as Vietnam, South Korea and Japan, are also hoping for such an outcome.

India is trying to increase its infrastructure investment but faces serious fiscal constraints. India invests some 5% of GDP in infrastructure investment compared to 17% of GDP in China. Even to raise India’s infrastructure spending to 8% of GDP will be a herculean task. The India Infrastructure Finance Company estimated that India needed $1 trillion – of which $750 billion in debt- to finance its infrastructure deficit in the period 2012-2017. The debt required is more than twice the size of Singapore's economy, and five times the existing 9.2 trillion rupees ($144 billion) of bank loans to Indian infrastructure projects.

The new financial institutions offer one new source of finance for India. India has become a founding member of both the New Development Bank – where the first President is an Indian, and the AIIB – where it is the second largest shareholder. It remains to be seen how much financing India itself will receive from these new institutions – whose main focus is infrastructure financing. Given the current size of the AIIB and the NDB India can expect to get at best no more than $1 billion annually from these two institutions. This is a very small amount compared to India’s vast infrastructure needs but is nevertheless welcome long term funding provided it comes on the right terms and conditions. As a founding member of these two financial institutions India hope to ensure acceptable terms for this financing.

The sudden devaluation of the Yuan – ostensibly towards a more market oriented exchange rate – is considered by some as a strong indication that the restructuring of the Chinese economy from an investment driven towards a consumption-led economy is not proceeding as smoothly as was anticipated. Investment and private savings – especially corporate savings remain too high. The official reason given for the devaluation is that it is designed to make the Yuan more market
determined – a requirement of the IMF to include the Yuan in the SDR and help internationalization of the Chinese currency. But some analysts\textsuperscript{15} also see it as a convenient reason to make Chinese exports more competitive. The IMF has deferred the decision to include the Yuan in the SDR until 2016.

**Figure 7: Will China Follow Japan and South Korea?**

![Graph showing Real GDP growth (%)](image)

**Figure 8: Rebalancing Remains a Big Challenge for China**

![Graph showing Real GDP per capita: 2005 US$ (thousands)](image)


But given India’s already high trade deficit with China it will increase the clamour for higher import tariffs on Chinese products. India’s Rupee which was already overvalued will need to devalue

much faster to maintain competitiveness and avoid an even larger trade deficit with China in the future. The Rupee has devalued more than the Yuan – but in real terms over the last few years the rupee has appreciated against the Yuan. While there are many reasons why India cannot compete with China, these can only be fixed over a period of time. In the meantime the rupee should not appreciate against the Yuan to make India’s competitiveness even worse. It will also make more difficult India’s ‘Make in India’ campaign. India must also find ways to attract more Chinese capital to invest in India.

China’s ambition to become an industrial country in the near future is a major goal of the Xi Jinping administration. China is following a trajectory laid down earlier by Japan and South Korea (Figure 8) as well as Taiwan. Whether China will be able to manage this transition remains an open question. China’s weakness remains its financial sector and its over-reliance on state enterprises. China has so far considered this a source of strength. In fact some have argued that China’s successful state enterprise led growth model has emerged as a rival to western capitalist models of growth. Japan and South Korea also were built on export led models with strong state support for their economy – but it was largely private conglomerates that led the way. China has followed so far the same export led model but state owned enterprises have remained a large component of the economy. This model has made the badly needed rebalancing difficult because corporate savings have remained high and are re-invested by corporations rather than being paid back as dividends. Ultimately it’s also political as the Chinese communist party must loosen control over levers of the economy which would reduce its ability to steer the economy. The OBOR strategy is seen by some as a way to invest some of the surplus capital in SOE’s abroad by building infrastructure and exporting this surplus through the new financial institutions and directly in bilateral projects. It’s a huge and ambitious gamble that will be played out across the new Silk Road with many pitfalls and challenges. But Napoleon was right in his assessment “China is on the move and one way or another will shake the world.” India must learn to actively cooperate and compete with China to ensure its own interests.

5. CONCLUSIONS

China’s OBOR strategy is a bold and new strategy, which is still evolving and being developed as new issues arise. It is not a finite strategy in terms of time and geographic space. While it is built on the idea of revival of the old Silk Road which connected China – through the Eurasian landmass to Europe it has evolved beyond that to a broader way of engagement with countries and with regional and other groups of countries.

It signals a more outward oriented approach from China. It is a signal that China now intends to use its vast surpluses in new ways which could be mutually beneficial to China and to the countries and groups that come into this engagement. With slow growth in the developed world, and with the limits of existing financial institutions it represents a new opportunity for more innovative ways to increase trade, help finance infrastructure deficits and better utilize and channel the world’s savings surplus.

New China-led financial institutions have been established – the New Development Bank (US $50-100 b), the Contingent Reserve Facility (US $ 100b), the Asian Infrastructure and Investment Bank (US $ 100 b) and the New Silk Road Fund (US $ 40 b). These new institutions are beginning operations and their modalities are being worked out.
Given the vast investment needs in the developing world – over $1 trillion per year for infrastructure alone, the size of the new institutions – some $290-$340 billion adding up the three announced so far remains quite small – but if the mechanisms can be leveraged and gradually built up in size could play a significant role in the international financial architecture and eventually help reform it as well.

It is an opportunity also for China and the other BRICS countries to show how they can become responsible stakeholders in helping address global challenges and help lift more and more people out of poverty in a sustainable manner. It is a signal that the new South will not wait for solutions from the developed world but will strike out on their own to help each other.¹⁶

But there remain pitfalls and potential problems – Russia’s concerns on Chinese growing influence in Central Asia, the South China Sea dispute, the future course of the Trans Pacific Partnership, the Trans-Atlantic Partnership and the Japan-European Union free trade union, India’s concerns on Chinese influence in the Indian Ocean and Africa’s worry over the potential benefits of Chinese investment and trade. The new silk route also traverses areas riddled with ethnic and other disputes.

But there is no doubt that China’s OBOR represents also an opportunity for more trade, investment and job creation in many parts of the world. How well China executes this strategy remains to be seen. Concerns over its environmental and social standards and its labour policies will be closely watched. Even if the full benefits of the new Silk strategy are not as large as has been projected it will be a game changer in the coming years.

India and China are playing a competitive and yet cooperative game on many levels. India has not yet signed on to the OBOR strategy and has concerns on CPEC and MSR. China has not taken kindly to India’s Act East policy especially to its investments in oil exploration in the South China Sea in collaboration with Vietnam. India has countered MSR with its own Spice Route or SAGAR project and is also strengthening its relations with ASEAN, Japan, Mongolia, Iran and countries in Central Asia.

India’s trade with China has grown rapidly but suffers from huge imbalances and is alone responsible for almost half of its trade deficit. India could potentially benefit from greater Chinese investments – as Chinese investments abroad increase by leaps and bounds and India is becoming an attractive FDI destination - especially if they were to help reduce the huge and growing trade imbalance between the two countries. Chinese investment in infrastructure could also help India meet its infrastructure deficit if Chinese companies learnt to operate under Indian conditions. So far Chinese FDI into India remains very small.

India has joined the new financial institutions the NDB, and the AIIB. These new banks are a potential source of long term infrastructure finance for India but given India’s huge infrastructure gap will only be able to provide a very small part of it. They nevertheless represent a very visible and

¹⁶ For a very sceptical view on the AIIB see Pettis (2015)
tangible symbol of cooperation between India and China which can fructify and grow. If China and India cooperate rather than compete they could become almost 50\% of the world’s economy – where they were some 200 years ago. Disputes will only derail them from reaching that goal.
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