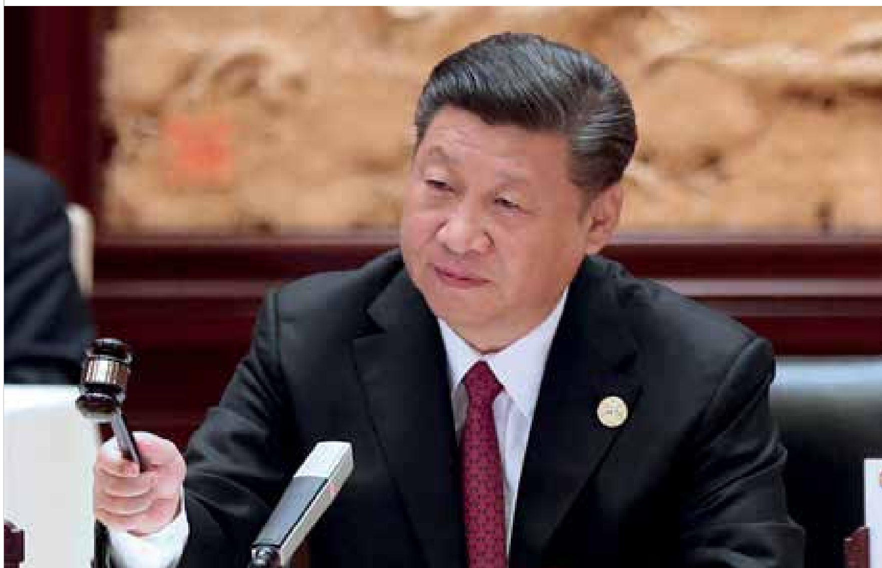
Patient Capital in the Context of the **Belt and Road Initiative (BRI)**

BY JUSTIN YIFU LIN AND YAN WANG

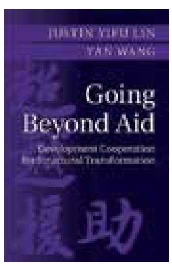


Chinese President Xi Jinping declares opening of the Leaders' Roundtable Summit at the Belt and Road Forum (BRF) Beijing, China, May 2017 © Xinhua/Ma Zhancheng

As the world is carefully watching China's Belt and Road Initiative, many new opportunities continue to spring from the counrty's endeavour. In this article, the authors elaborate on New Structural Economics and "going beyond aid" as an ideal development objective for trade, aid, and investment in relation to developing countries.

Against the backdrop of Brexit and the "Paris-exit" by the Unite States, China-led "Belt and Road Initiative (BRI)" was welcomed by many, as shown by its Forum held in Beijing with 29 heads of state attending and over 100 countries represented. What are the rationales behind the Belt and Road Initiative (BRI)?[1] What is the theoretic foundation of South-South Development Cooperation (SSDC)? How does it differ from Aid? How to finance the BRI and other infrastructure gaps in the developing world?

The idea that the Official Development Assistance (ODA) must be concessional is questionable. Economic development is the main purpose of ODA, yet some of the more effective instruments of facilitating structural transformation, such as equity investment and large non-concessional loans for infrastructure are excluded from the OECD definition of ODA. Our new book, *Going beyond aid: Development Cooperation for Structural Transformation*, published by Cambridge University Press,[2] is an attempt to explore these rationales and provide a theoretic foundation based on New Structural Economics.[3] In our view, we need to "go beyond aid" with a broader concept including trade, aid and investment for development objectives. Differing from the OECD definition, South-South Development Cooperation (SSDC) combines trade, aid and public and private investment, utilises comparative advantages of each countries and their intimate know-how on development, and hence is more effective in overcoming bottlenecks in partner countries. Whereas, the OECD definition of ODA separates aid from trade, delinks aid with private investment and foreign direct investment, and therefore, "comparative advantage", a trade concept, cannot be utilised in official aid.



Going beyond aid: Development Cooperation for Structural Transformation by Justin Yifu Lin and Yan Wang

The New Structural Economics (NSE) starts with the observation that the nature of modern economic development is a process of continuous structural change in technologies and industries, which raises labour productivity, and hard and soft infrastructure, which reduces transaction costs, making possible the continuous increase in per capita income in an economy.[4] According to the NSE, the most effective and sustainable way for a low-income country to develop is to jump-start the process of structural transformation by developing sectors of its *latent comparative advantages*, which the country has low factor costs of production determined by its endowment structure but high transaction costs due to inadequate hard and soft infrastructure. The government can help transform the sectors with latent comparative advantages into the nation's competitive advantages by reducing transaction costs through special economic zones or industrial parks with good infrastructure and an attractive business environment. If a developing country adopts this approach, it can immediately grow dynamically and launch a virtuous circle of job generation, export expansion and poverty reduction, even though overall infrastructure and business environment in the nation may be poor.

The rationales of BRI are related to China's own structural transformation, and are deeply rooted in its thousand-year history of Confucianism, who said, "One who wishes himself to be successful must also help others to be successful; one who wishes to develop himself must also help others to develop."

First, China has proposed to enhance global connectivity by BRI in part because it has demonstrated comparative advantages in building infrastructure, including hydroelectric power stations, highways, ports, railways, and telecomm. China's labour cost for project site foremen is one eighth of those in OECD countries. The vast domestic market and railway network allow China to realise "economy of scale" that other countries can't have: the overall construction cost for high speech rail is only two thirds of those in industrial countries. Based on China's own experience, building infrastructure sooner rather than later could facilitate international trade by lower transaction cost.[5]

Second, China has constructed many industrial parks and special economic zones overseas, in part as it has successful experiences. In addition, China has comparative advantage in 46 out of 97 subsectors, mostly in manufacturing sectors, and is using them to help other developing countries achieve win-win. As labour cost rises in China, its labour-intensive industries are relocating to other lower-wage developing countries, providing millions of job opportunities. This is already happening in Southeast Asia and in East Africa as shown by examples of Huajian Shoemaking Company located in Eastern Industrial Zone of Ethiopia, C&H Garments in Rwanda and China JD Group, a giant apparel firm in Tanzania.[6]

Third, a new concept of "patient capital" can be utilised to finance the BRI and infrastructure gaps. Based on a culture of Confucianism, China and several East Asian economies are ranked high in "long term orientation" index.[7] In our new joint paper we propose a concept of "patient capital" as those capitals to be invested in a "relationship" in which the stakeholder/investor is willing to take a stake in the host country's development, aiming for a win-win.[8] Owners of patient capital are equity-like investors but willing to "sink" money in the real sector or unlisted infrastructure projects for a long time – as long as 10 years and above. And they are willing and better able to take risks. In addition, we find that Net Foreign Asset is positively and significantly associated with Long Term Orientation index. On the other hand, countries with Short Term Orientation and low savings rates would see their Net Foreign Asset positions deteriorating and their foreign debt mounting.

China is a late comer – as it **has just started** to use its comparative advantage in patient capital to help releasing infrastructural bottlenecks to achieve win-win solutions. In terms of cross border M&A, China started to be a net supplier in 2008. In terms of Net FDI (outflows minus inflows), China's Outward Foreign Direct Investment (OFDI) in 2016, stood at $183 billion dollars, second only to the United States, had exceeded the inflows for two consecutive years (UNCTAC 2017). In addition, China also provides significant overseas lending through China EXIM Bank and China Development Bank. In recent years, each bank has been lending about $100 billion overseas.[9]

Patient capital plays an important role in infrastructure financing. Successful countries with future orientation (as in Spence 2008) have seen their infrastructure better financed. Other evidence of rising patient capital can be seen by the rising number of Sovereign Wealth Funds (SWFs) and government-sponsored "Strategic Investment Funds (SIFs)" established by countries like Kazakhstan, Malaysia, Mexico, Morocco, Nigeria, Philippines, Senegal, South Africa and Vietnam.[10] The number of Multilateral Strategic Investment Funds (MSIFs), including those for infrastructure, are rising as well. This trend is in tune with our proposal of establishing a "Global Structural Transformation Fund" in our 2013 paper for the UN Post-2015 agenda.[11] Using recent PrEQin data, it shows that "the median net internal rates of return (IRR)

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for private infrastructure funds across all vintages remains consistent at around 10%" (2015). The best performance can be seen in Temasek, Singapore's SWF: By investing in Asian emerging market economies, its annual shareholder return reached a stellar 15 percent since inception (Temasek Annual Review 2016). The point is that, if the patient capital can be invested in the bottleneck releasing infrastructure, the economic and financial returns could be higher than the "risk-free bond yield".

Currently China's large amount of patient capital has been used at home. Along with the gradual opening of China's capital account, more patient capital is going to be exported as more enterprises and banks "going global". Patient capital often comes with technology, management skills and implementation capacity in infrastructure and manufacturing, the export of which will have strong impact on global connectivity and development. Using NFA as an imperfect measure, "China is likely to emerge in the next few years as the world's largest net creditor",[12] and a proportion of these net foreign assets would be in fact patient capital, suitable for infrastructure, manufacturing and employment generation.

China is shifting from bilateralism to multilateralism showing its willingness to work with partners from the North and the South. The establishment of AIIB, New Development Bank and the Silk Road Fund, provide new momentum in the global development arena. China is trying to learn from partners to overcome its own constraints in governance, labour and environmental standards. And during the two-way learning process, new ideas, new theories and new concepts/definitions are going to emerge – our book being one of them. We are cautiously optimistic that a common ground can be found for partners from the North and the South to work together on multiple win approaches to achieve the goals of sustainable development by 2030.

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