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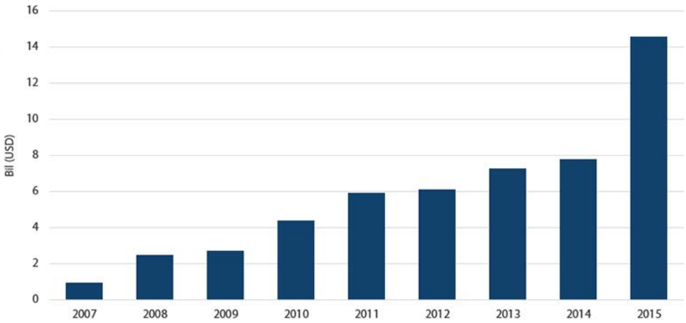
THE RISE OF CHINESE FDI INTO ASEAN

US, Japan and Europe have historically accounted for the bulk of FDI into ASEAN, but this fact is now being challenged by China. In the past two years, ASEAN has seen a significant jump in FDI flows from China. We expect this trend to persist, resulting in the latter having a more extensive influence (both economically and geopolitically) on the region over time. Meanwhile, the rise in Chinese FDI will provide ASEAN with tremendous benefits, mainly in terms of infrastructure development and further opening of its markets.

China's FDI into ASEAN



Source: WIND, 2017

Why is China looking outwards?

From China's point of view, the rise in its domestic labour costs, the slowdown in potential growth and imbalances due to sector overcapacity are some reasons prompting authorities to channel capital overseas for investments. These factors feed nicely into China's ambitious Belt and Road Initiative (BRI), which envisions a Chinese-led investment programme to creates a web of infrastructure to enhance the economic interconnectivity and facilitate development within and outside of Asia. The benefits to Chinese companies will be multi-phased. In the initial stage, large state-owned enterprises will win most of the infrastructure contracts, but as the host countries benefit from the investment over time, their markets will open up to a wider range of goods and services where smaller private Chinese firms can stand to participate.

It is important to note that China is not providing the entire funding of the planned BRI infrastructure projects. On a case by case basis, some of the projects are funded off special purpose vehicles/funds like the Asian Infrastructure Investment Bank and the Silk Road Fund, while some are either partially or in whole financed by Chinese policy banks. Most of the projects involve joint ventures between local companies and Chinese corporates/SOEs. In Thailand, where a deal has been agreed upon for the first part of a High Speed Rail line linking from Bangkok to the border with Laos, it was decided that China will only provide technology and equipment instead of financing. On the other hand, as the Indonesian government pushes its own domestic agenda of increasing infrastructure spending, Chinese banks have been involved in providing loans for these projects.

The increase in long term investment overseas also helps accelerate RMB usage in the form of trade or financial settlement. As commercial activities between China and other regions grow exponentially, the currency will gain wider acceptance over time and help fulfil China's long term goal of internationalising the RMB.

Lastly, viewed from a geopolitical angle, this move promotes China as a rising super power. Over time, rising influence in the region may also help to gain more support (or reduce opposition) for geopolitical issues such as its South China Sea claim.

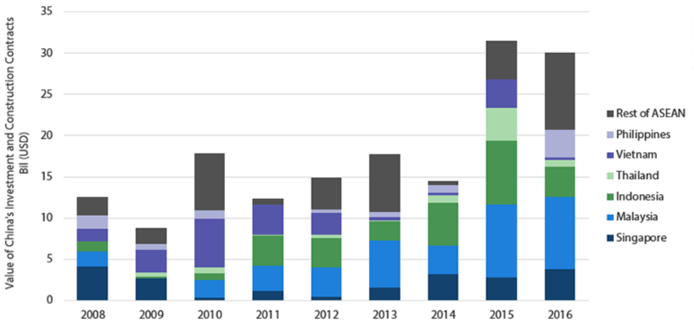
Why into ASEAN?

ASEAN as a whole has a population of more than 600 million, about half of which are under 30 years of age. This large and growing market, together with the availability of low cost labour is an attractive destination for China to relocate labour-intensive industries. Moreover, ASEAN is projected to rank as the fourth largest economy by 2050. Strong economic growth over recent years has helped spread wealth throughout the region, leading to the rise of the middle class. As these consumers migrate towards more developed and opportunity-rich urban areas, the need for huge infrastructure development is emerging. ASEAN governments' commitment to accelerate infrastructure investment provides great growth potential for the region, and is a key reason for encouraging FDI from China. Large parts of ASEAN remain under-built, and savings-rich China aims to play a key role in funding the infrastructure investment gap inherent in the region.

In addition to the economic potential, ASEAN is strategically located, with a major part of the world's shipping traffic traversing the region's waters. For China, having improved connectivity and relationships with countries along major sea routes means a reduction in potential naval blockades that could hinder Chinese exports.

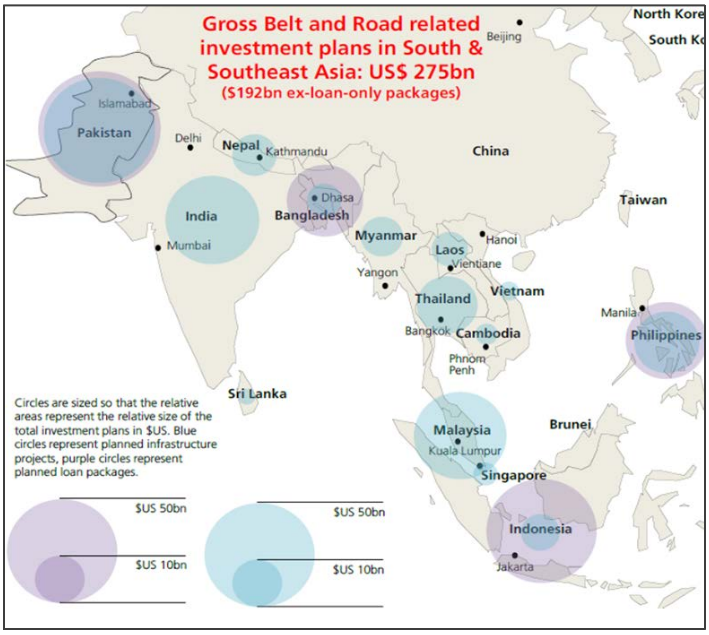
Meanwhile, ASEAN countries have also made good progress on reforms, improving the ease of doing business. Governments have been looking at simplifying the tax system and to, among other things, potentially lower corporate tax rates. Meanwhile, the launch of the ASEAN Economic Community in December 2015 has prompted improved investor perceptions of the region.

Value of China's investment and construction contracts in ASEAN countries



Source: American Enterprise Institute and the Heritage Foundation, ANZ 2017

Gross Belt and Road related investment plans in South & Southeast Asia: US$ 275bn



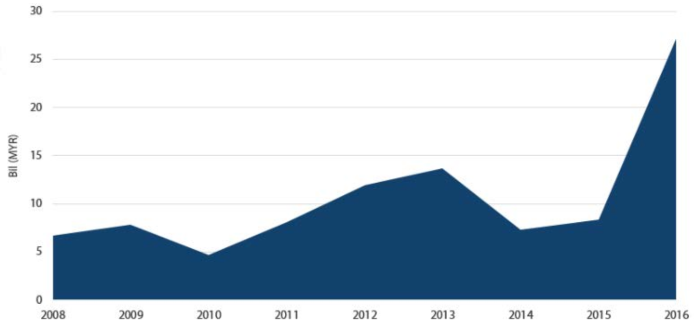
Source: UBS Sep 2017

Major projects in the pipeline

Malaysia

Malaysia has been one of the largest beneficiaries of Chinese FDI. A Memorandum of Understanding (MoU) amounting to USD 33bn was signed between the two countries during Malaysian Prime Minister Najib Razak's visit to China in November 2016. Recent statistics reveal that Chinese FDI now accounts for 6.2% (2016) of total Malaysian FDI inflows, up from just 1% in 2010.

China FDI into Malaysia



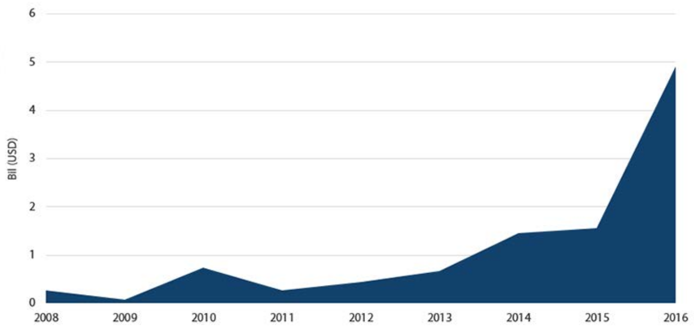
Source: Malaysia Govt Agency, BAML Sep 2017

China now plays an important a role in Malaysia's port development, which in turn enhances China's own sea route connectivity. The Kuantan Port, which faces the South China Sea, is now expanding its New Deep Water Terminal with Guangxi Beibu Gulf International Group, with the aim of doubling existing capacity. The two countries also plan to jointly develop Malaysia's first industrial park near the port. The industrial park project has so far attracted investments totalling MYR 13.4 billion, spanning industries such as energy-saving, environment-friendly technologies, and high-end equipment and advanced materials manufacturing. Chinese companies have signalled willingness to finance a large share of the projects in Malaysia, backed by soft loans from China-headquartered banks. Meanwhile, many Chinese banks have likewise been awarded banking licences to operate in Malaysia.

Indonesia

Indonesia is the region's largest market. In 2015, the Indonesian and Chinese governments signed a USD 5.1 billion high-speed railway contract. The 150km-long railway line will run from Jakarta to Bandung and is scheduled to be completed in 2019, with China providing 40% of the total investment. This engineering, procurement, and construction (EPC) project was awarded in April 2017 to a Chinese consortium led by China Railway Corporation, with China Development Bank providing a USD4.5 billion loan to kick-start the project. China has also committed to help finance the construction of five dams in Indonesia, which will amount to about USD 10 billion. In addition, China has also invested heavily in Indonesian coal power plants, totalling USD 5.8 billion from 2015 to 2016.

China FDI into Indonesia



Source: Indonesia Govt Agency, BAML Sep 2017

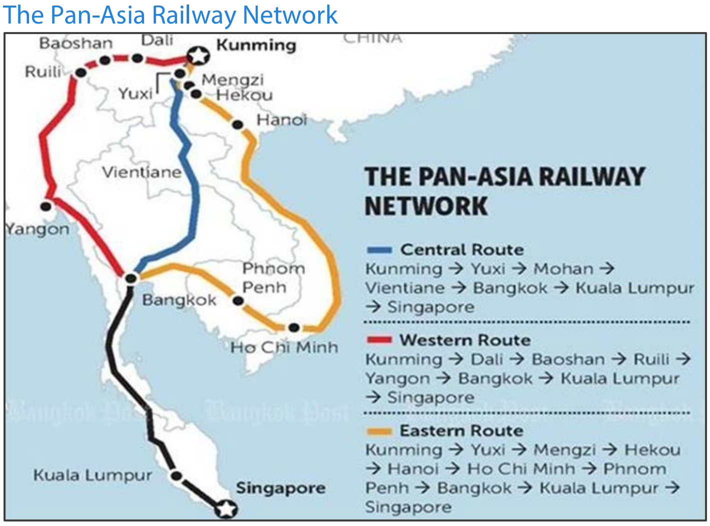
Philippines

Improved relations between the Philippines under the Duterte Administration and China has created enormous investment opportunities for the two countries. Together, they have identified three priority infrastructure projects that will be financed via a USD 9 billion credit facility pledged by the Chinese government during President Duterte's state visit to China last year. These are the Chico River Pump Irrigation Project, the New Centennial Water Source-Kaliwa Dam Project and the North-South Railway Line. Implementing these projects is expected to cost USD 3.4 billion. In addition, China has offered to donate two bridges (the Binondo Intramuros and the Estrella-Pantaleon bridges) to help ease traffic conditions in Metro Manila.

Thailand

China has an ambitious plan to establish a "Pan-Asia Railway Network" consisting of three major railway routes. The objective is to foster rail connections between China and ASEAN countries, with Thailand serving as the hub. This proposed railway network will run across Southern China, Laos, Thailand, Myanmar, Vietnam, Cambodia, Malaysia and Singapore.

The Pan-Asia Railway Network



Source: Bangkok Post 2015

Thailand's military government has approved USD 5.2 billion in funding to build the first stretch of the high-speed railway that will ultimately link Bangkok to southern China. China Development Bank is expected to cover 75% of cost via loans. China is expected to provide expertise and supervision, while Thailand delivers the equipment and materials. This railway project is expected to play a pivotal role in boosting trade, industry and tourism for Thailand, leading to more investment and development opportunities. As it is, China is already the country's largest export and trade partner. The expansion and improvement in Thailand's connectivity to China is expected to lead to a surge in bilateral trade as well as Chinese investment in Thailand.

Vietnam

China has been Vietnam's largest trading partner in the past decade and in 2016, Vietnam surpassed Malaysia to become China's biggest ASEAN trade partner. The two countries have agreed to align the BRI initiative with the "Two Corridors and One Economic Circle" plan, which is set to connect northern Vietnam and southern China. Whereas Vietnam used to purchase electricity from China, policymakers' commitment to macroeconomic reforms has led Vietnam to invite China companies to build power plants in the nation.

The Vinh Tan 1 Power Plant, being constructed by China Southern Power Grid, involves an investment of USD 1.8 billion. Meanwhile, the China-Vietnam (Shenzhen-Haiphong) Economic and Trade Zone is under construction, and upon completion, it is expected to achieve an annual output of about USD 1 billion.

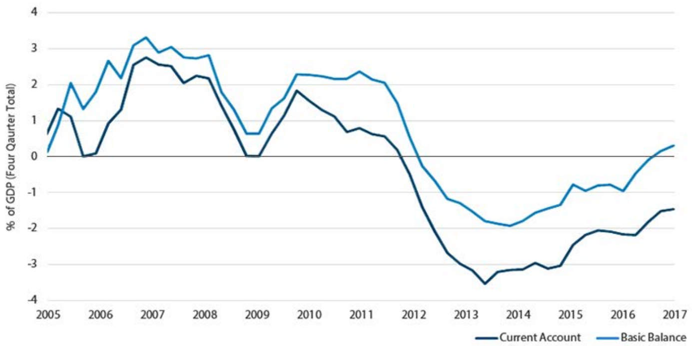
Implications and Conclusion

We do note that it remains unresolved how the resultant risk will be allocated between Chinese banks and other entities providing funding for projects under the BRI. The high implementation risk that Chinese banks and SOEs supporting these projects face, could lead to a jump in contingent sovereign liabilities. Moreover, there remains little transparency with regard to returns on capital in BRI regions. Consequently, the scope for negative impacts on Chinese banks is something that we should be watchful of.

That said, China's long term investment commitment towards ASEAN is expected to reap tremendous economic benefits for the recipient countries. The region's connectivity to the rest of the world will be vastly improved, on the back of planned major infrastructure projects. This, together with the expansion of Chinese companies' regional footprint in ASEAN will create enormous employment opportunities for the latter, and drive investment and regional GDP. More importantly, ASEAN countries will have access to much needed financing and expertise which was previously unavailable. The success of China's BRI would allow ASEAN's developing countries to be less dependent on developed nations, improving ASEAN's economic clout.

We are fundamentally positive on ASEAN currencies on a long term view, as we believe that the improved flow of sticky FDI into ASEAN will provide an important structural support to regional currencies, helping cushion hot money outflows in the event of risk aversion in markets. Indeed, we note that ASEAN currencies are exhibiting less volatility now compared to the past. The Indonesia Rupiah is a case in point, with marked improvement seen in their basic balance and currency volatility.

Indonesia Basic Balance improves



Source: Haver, ANZ Research

Nonetheless, as China becomes more economically integrated into ASEAN, concentration risk to these markets will be increased, given that ASEAN is already heavily exposed to China via trade and tourism flows.

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