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Topics Current situation of AIIB and Japan's involvement

Despite the concerns expressed at its inception, the Asian Infrastructure Investment Bank (AIIB) has been operating steadily without any signs of undue Chinese influence. To increase its presence and expand business opportunities in Asia, it may be necessary for Japan to examine the possibility of seeking AIIB membership.

■ Rising expectations for AIIB

Expectations are heightening toward the AIIB as a procurement route to meet the huge capital requirement to construct infra structure. For example, in the Annual Meeting of the AIIB held at the end of June 2018, Narendra Modi, Prime Minister of India, said, "The AIIB should increase its lending to US$40 billion by 2020 and US$100 billion by 2025 to cope with sharply increasing demand for funds to build infrastructure in Asia."

Looking at the number of countries and regions joining the AIIB, many countries, not only in Asia but also in Africa, South America, Oceania, and other regions, have become members of the AIIB one after another since 2017. Strong expectations by each country toward the AIIB are illustrated by the fact that the number of AIIB members exceeded the number of the Asia Development Bank (ADB) members around one year after the commencement of operations.

＜AIIB Membership (As of June 2018)＞

Approved Membership Date	Major Countries, Region, and Number of Countries
2015 (Year)	China and so on, 57 Countries (Founding Member)
March 2017	13 Countries and Regions Including Hong Kong and Canada
May 2017	7 Countries Including Bahrain
June 2017	3 Countries Including Argentina
December 2017	4 Countries Including Belarus
May 2018	Papua New Guinea, Kenya
June 2018	Lebanon

Source: Website of the AIIB
Note: Year 2015 describe the country that signed the establishment agreement by the end of 2015.

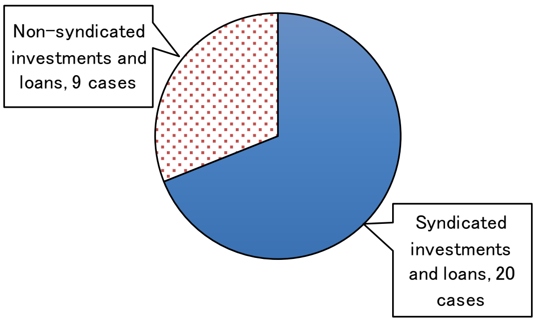
Meanwhile, Japan kept its distance from the AIIB, since it feared that the bank would be arbitrarily used to realize China's Belt and Road Initiative. However, there are signs that economic cooperation is likely to deepen against the backdrop of a recent improvement in relations between Japan and China. For example, discussions began on how Japanese and Chinese companies will cooperate in third countries under the belt-and-road plan. Under such circumstances, we would like to sum up the current state of the AIIB, which was established at the initiative of China.

■ AIIB has maintained a cautious attitude in business operations

We can point out the following two characteristics of the AIIB's investments and loans from projects approved by the end of June 2018.

First, the AIIB has taken a careful attitude towa rd investments and loans. The AIIB approved 29 investment and loan projects over the two years from June 2016 when it approved the first project. The total amount of these projects was around US$5.6 billion. Compared to the ADB, whose annual loan and assistance amounts to around US$ 30.0 billion, the amount of the AIIB's investments and loans remained at a low level. This was attributable to inadequate preparation of its system, including a lack of know-how. However, we believe that the AIIB is still cautious about expanding its operations, even after there has been an improvement in the situation.

＜Syndicated Investments and Loans with Multilateral Development Banks＞



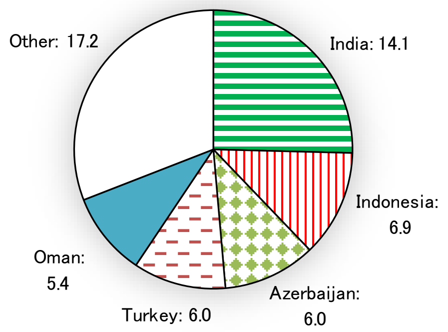
Source: Website of the AIIB
Note: Investments and loans specified as joint projects with MDBs are defined as syndicated investments and loans.

Among the 29 projects, there are few loans and investments independently arranged by the AIIB. In many projects, the AIIB chose to organize syndicated loans with other Multilateral Development Banks (MDBs), such as the ADB, the World Bank (including other organizations in the Group), and the European Bank for Reconstruction and Development and in general kept its loan amount not exceeding that of other MDBs.

We consider this reflects both the AIIB's decision to give priority to the accumulation of know-how on project loans and their risk avoidance tendency, such as wanting to avoid loan losses as much as possible.

Second, the AIIB places emphasis on investments and loans to India. The number of loans and investments provided to projects in India totals seven, while that for other countries ranges from one to four. India is the largest recipient of the AIIB's loans and investments. In terms of value, India received US$1.41 billion, accounting for one-fourth of the AIIB's total loans and investments. India initially showed a strong aversion to China's belt and road plan. These facts indicate that the AIIB has provided loans by objectively evaluating projects and the borrowers' ability to meet debt payments, regardless of whether or not borrowers cooperate with China. The released documents also show that the bank has considered the environmental impact of projects when granting its approval.

＜Destination of AIIB's Loans and Investments (by country, US$100 million)＞



Source: Website of the AIIB
Note: Projects approved by the end of June 2018

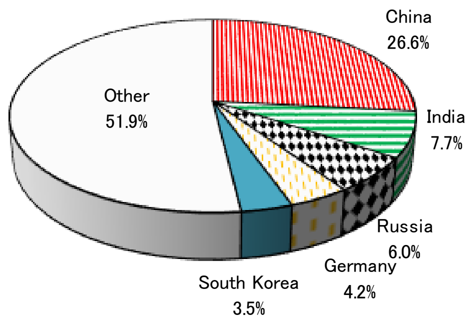
Looking at the organizational structure of the AIIB, we found that China does not monopolize important positions. Although Mr. Jin Liqun, President, is a former executive official of the Chinese government, five vice Presidents are experts or persons with business experience who hail from countries other than China. Furthermore, the AIIB has been also been trying to sweep away concerns that the bank is an organization primarily to promote the China's belt-and-road initiative by emphasizing that the AIIB is strictly an international organization, though it contributes to the improvement of infrastructure in Asia. The AIIB has strengthened cooperation with other MDBs by concluding memoranda on the implementation of and cooperation for syndicated loans. These have apparently helped allay initial concerns about the AIIB.

As a result, the AIIB has achieved a high objective evaluation. It had been pointed out at its inception that the AIIB could not meet the huge financi al requirement to build infrastructure since the bank would not receive a credit rating from international credit-rating agencies. However, the bank has obtained the highest credit rating from each of the three major rating agencies in 2017 or later. This has enabled the AIIB to raise funds on the global financial market.

■ China has taken a wait-and-see attitude toward the AIIB's activities

China has maintained a wait-and-see posture toward the AIIB's careful lending stance without exercising its influence forcibly. The Xi Jinping administration, which enters its second term, has set its national strategy under which China aims to become the global leader in place of the United States. To that end, Xi Jinping has shifted priority to international cooperation in its diplomatic activity to bolster support from various countries. It appears that the Chinese government considers that excessive intervention in the AIIB would result in a decline in their credibility in the international community. Thus, we think that China is most likely to give tacit approval to the AIIB's careful lending stance and moves to strengthen relationships with other MDBs.

＜AIIB 5 Largest Members in terms of Voting Rights ＞



Source: Website of the AIIB
Note: As of July 12, 2018

Under such circumstances, we believe that it may be necessary for Japan to examine seeking AIIB membership from the standpoint of supporting the steady business operations of the AIIB. Major decisions require consent from holders of at least 75% of the voting shares in the AIIB. Only China has veto power in the AIIB. So far, China has not taken any unilateral self-serving action regarding the operations of the AIIB. However, we think that it makes sense for Japan to nullify China's veto power by joining the AIIB, considering risk in the future.

Furthermore, we believe that becoming an AIIB member will help Japan to increase its presence in Asia. As it is expected that business opportunities will expand, Japanese enterprises will also enjoy benefits. Taking into account the fact that the major concerns about the AIIB at its inception have been wiped away, we consider Japan should examine the possibility of seeking AIIB membership after reassessing the AIIB's position and roles.

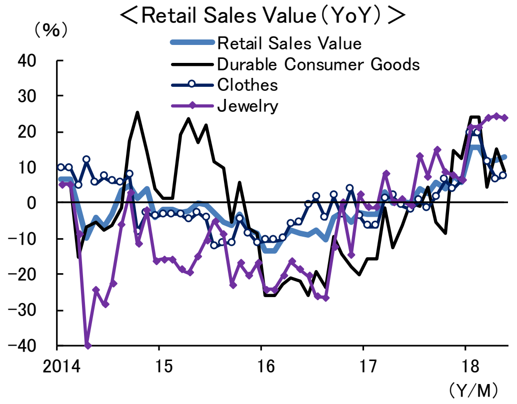
(Junya Sano)

Hong Kong Economic expansion continuing

■ Internal and external demand have remained strong

The Hong Kong economy has expanded briskly, supported by internal and external demand. Private consumption has been serving as an engine for internal demand. In 2018, sales of a wide range of goods have greatly exceeded those in 2017. Retail sales as a whole have been growing by more than 10% from the previous year. It can be pointed out that robust consumption is attributable to improvement in the employment and income environment and an asset rise effect. The supply and demand for labor has become tight due to an increase in inbound tourists from overseas and active personnel recruitment by enterprises. Consequently, the unemployment rate has declined to the 2% range. Real wages have been growing steadily against the backdrop of the improvement of employment and low inflation. Furthermore, asset values have greatly risen from their bottom in early 2016. For example, housing prices soared around 40% and stock prices jumped around 50%.

＜Retail Sales Value (YoY)＞



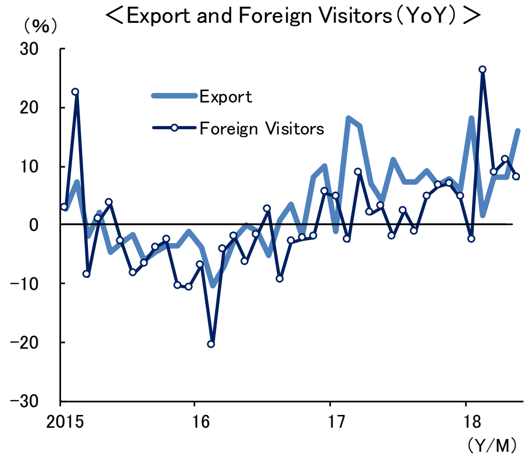
Source: Census and Statistics Department
Note: The January and February data were averaged to adjust for the impact of the Lunar New Year.

Meanwhile, looking at external demand, in addition to the increase in the exports of goods amid the expansion of global economy, the recovery in the number of visitors from overseas has pushed up the exports of services.

The Hong Kong economy is expected to continue growing steadily in the future.

Especially, in the latter half of 2018, two huge infrastructure projects, the Hong Kong-Zhuhai-Macau Bridge that connects Hong Kong, Macau, and Zhuhai, Guangdong province, and the Guangzhou-Shenzhen-Hong Kong Express Rail Link that connects Guangzhou, Shenzhen, and Hong Kong, are scheduled to be completed one after another. The completion of the bridge and railway line is likely to contribute to a rise in the number of visitors from mainland China.

＜Export and Foreign Visitors (YoY)＞



Source: Census and Statistics Department, Tourism Board

Moreover, the Chinese government seems to be helping strengthen the position of Hong Kong as a regional finance and distribution hub as part of its prioritized policy, "Big Bay Area concept," under which it will construct one major economic zone through enhancing economic cooperation among Guangdong province, Hong Kong, and Macau. Combined with the completion of the infrastructure projects mentioned above, the move is expected to invigorate related businesses. In addition, the FTA between Hong Kong and ASEAN will come into effect in January 2019. The agreement is likely to boost exports.

■ Adjustment of asset prices caused by interest-rate hikes and rising pressure for protectionism are considered to be risk factors for the Hong Kong economy

Although the Hong Kong economy is strong as mentioned above, we need to pay attention to the following two risks.

The first risk is the adjustment of asset prices caused by interest-rate hikes. Since Hong Kong adopts a dollar-peg system, it takes the same financial policies as the United States. The Hong Kong Monetary Authority is likely to raise its official interest rate following the FRB's interest rate hike in the future. As asset prices have been soaring, a further rate hike may involve the risk of triggering the adjustment of asset prices.

The second risk is rising pressure for protectionism. Merchandise trade and distribution account for more than 20% of Hong Kong's GDP. If global trade shrinks, there is a strong possibility that Hong Kong will suffer greater damage than other countries.

(Michinori Naruse)

Philippines *Raised interest rates to curb inflation*

■ Inflation rate stood at 5.2% in June 2018

Philippines' inflation rate has soared in 2018. In June 2018, consumer price index increased by 5.2% from the previous year, exceeding the upper limit of the central bank's inflation target (4.0%) and reaching historical high levels under the current statistical standards.

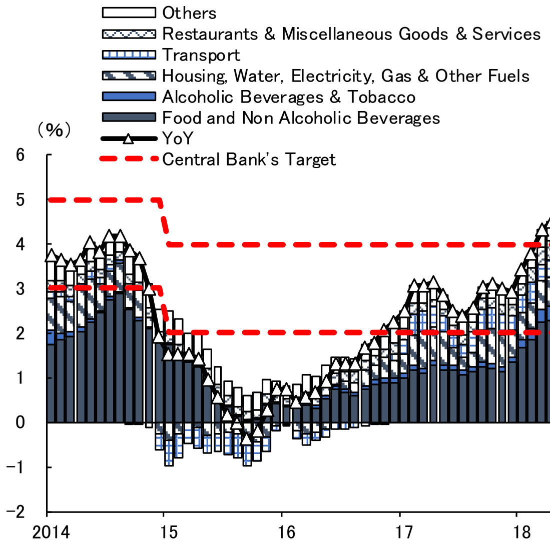
The following three factors can be raised as possible causes for the higher inflation.

The first is the implementation of the Tax Reform for Acceleration and Inclusion (TRAIN), which came into effect in January 2018. Under TRAIN, the government reduces personal income tax for low income citizens, while it increases excise taxes on cigarettes and fuels including gasoline. Furthermore, the government introduced a new tax on drinks using sugar and other sweeteners. Consequently, the prices of food stuffs and cigarettes and transportation charges increased.

The second is the depreciation of Philippine peso. The peso-US dollar rate has continued declining since the middle of 2015, when expectations for interest rate hikes by the FRB increased. In 2018, the depreciation of the peso against the US dollar gained momentum, since the acceleration of interest rate hikes by the FRB moved a step closer to reality against the backdrop of a robust economy. Philippines depends heavily on imports of food including rice in addition to intermediate goods and capital goods. Consequently, the country's economic structure is vulnerable to imported inflation caused by currency depreciation.

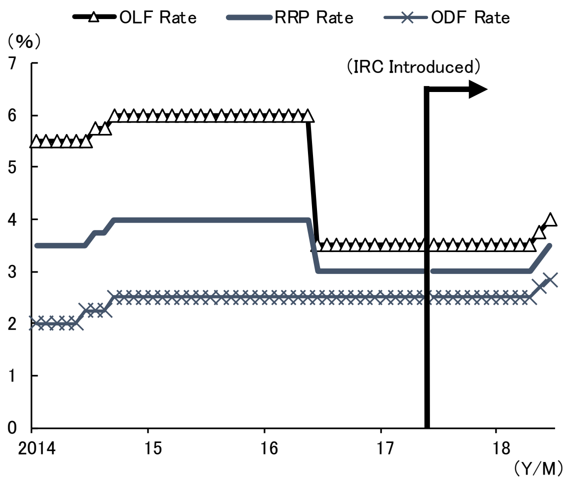
The third is an overheated domestic economy. The Duterte Administration launched an eight-trillion peso infrastructure plan that runs for six years from 2016 to 2022, and implemented measures successively. The plan has contributed to the improvement in the domestic employment and income environment. Actually, the unemployment rate continues declining and consumer sentiment remains strong.

＜Consumer Price Index（YoY）＞



Source : PSA, BSP

＜Policy Rate＞



Source : BSP, PSA

■ The Central Bank raised the interest rate for the first time in four years

Under such circumstances, Bangko Sentral ng Pilipinas successively increased interest rates after its policy meeting held in May and June 2018. The central bank implemented an interest-rate hike for the first time in four years since July 2014. Taking a look at the future, we forecast that the impact of TRAIN will continue till the end of 2018. However, the inflation rate is expected to converge toward the central bank's target range from around the fall of 2018 since the two-times rate hike helped reduce pressure on the depreciation of the peso and restrain overheated personal consumption. Therefore, we do not expect that the Philippines Central Bank will be forced to continue sharp interest rate hikes in the latter half of 2018.

(Yuta Tsukada)

China Changes policy and places emphasis on economic growth

■ Growth rate reached 6.7% in the April to June quarter of 2018

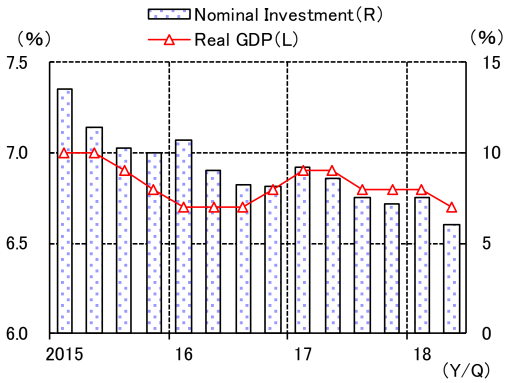
China's real GDP in the April to June quarter grew 6.7%, compared to the same period in the previous year, maintaining high growth that exceeds the government's target (around 6.5%), although it fell 0.1 percentage point from the January to March quarter.

Looking at the contribution of individual demand items, investment lost momentum. Investment in fixed assets (excluding rural households) increased 6.0% from the previous year, sharply falling below the January to March quarter (7.5% growth). The main probable cause is a slowdown in infrastructure investment caused by tighter regulations on public-private partnerships (PPP) that aimed to restrain the expansion of local governments' debt obligations.

Personal consumption continued steady expansion, up around 9.0% from the previous year, supported by the acceleration of nominal retail sales. Online sales drove the expansion of retail sales against the backdrop of the improvement in the employment and income environment.

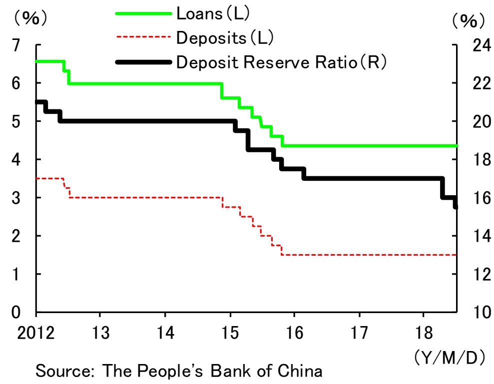
There was no significant change in external demand. Exports grew 11.2% in June 2018 from the previous year, achieving growth of more than 10% three months in a row, although the growth rate decreased from May 2018. Imports also maintained a high growth rate, supported by strong domestic demand.

＜Real GDP, Fixed-asset Investment (Y o Y)＞



Source: National Bureau of Statistics
Note: Investment figures are year-to-date excluding rural households.

＜Base Interest Rate (1 Year), Deposit Reserve Ratio＞



Source: The People's Bank of China
Note: Deposit Reserve Ratio are major commercial bank figures.

■ Upgrading measures to stimulate domestic demand

Taking a look at the economy in the latter half of 2018, one of the biggest concerns is the development of trade friction, mainly with the United States. There is a slight chance that exports will continue expanding robustly, since exports are expected to decrease in reaction to a last-minute rise in shipments before the implementation of additional tariffs on Chinese products by the US government. Furthermore, there is a possibility that both the US and Chinese governments may retaliate against each other by imposing additional tariffs if their trade negotiations come to a deadlock.

Considering these circumstances, the Chinese government has apparently changed its stance and decided to support economic growth by strengthening measures to boost domestic demand.

For example, the China's central bank cut its deposit reserve ratio (DRR) in July 5, 2018 and requested large financial institutions to use the DRR cut funds to promote "debt-equity swaps." They seem to aim not only to expand loans to small and medium-sized enterprises but also to stimulate the motivation of the entire corporate sector to invest by taking measures to reduce debt burdens.

Furthermore, the Chinese government released its directive that summarizes the policy initiatives of the central government ministries to expand imports in July 2, 2018. Solving the trade imbalances is the main purpose of the directive, but responding to brisk consumer demand is also indicated as one of their purposes. As mentioned above, the Chinese government has used a carrot-and-stick tactic in the negotiations with the United States. It is expected that China will take additional measures to promote imports, such as a reduction of import tariffs, with the aim to also stimulate domestic demand.

In the latter half of 2018, the Chinese economy is likely to gradually decelerate, supported by measures to expand consumption and domestic demand, while external demand will slow down. A series of measures to support economic growth implemented by the central government may discourage local governments and enterprises from tackling structural reform. Therefore, it should be noted that whether China as a whole can strike a balance between the stabilization of economic growth and structural reform remains a question.

(Junya Sano)