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ZURICH

Redesign needed for China's Belt & Road

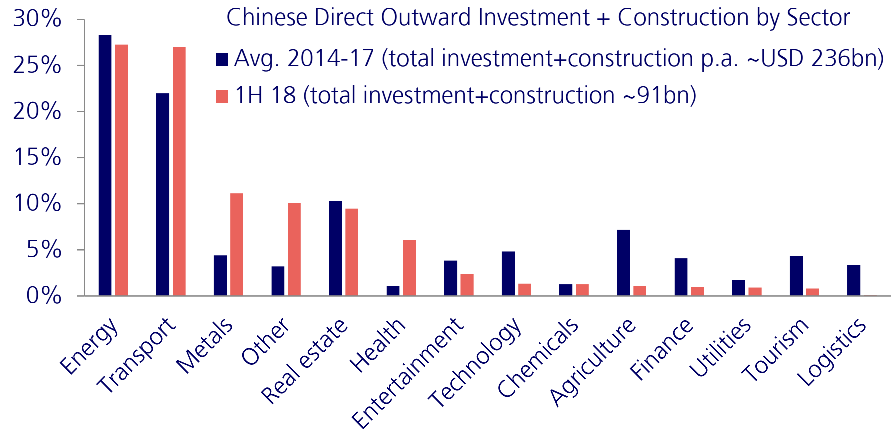
The ambiguous response to China's ambitious global investment

China's 'Belt and Road' initiative has attracted a lot of attention since it was introduced five years ago. The next few years will bring an acceleration in trade and investment, benefitting mainly developing but also developed countries, and foremost China itself. Critical voices have started to become louder, and we believe it is in China's own interest to listen and to adjust course.

Source: Xinhua

China's Belt & Road Initiative (B&R) is celebrating its fifth birthday. President Xi introduced the 'One Belt, One Road' concept in a speech in Kazakhstan in September 2013. Synonyms are 'OBOR', 'BRI', the 'New Silk Road' or 'Yi Dai Yi Lu' in Mandarin-Chinese. The B&R concept is split into two major tracks and six economic corridors. The Eurasian land bridge as well as the Maritime Silk Road connect China with Central Asia, Southeast and South Asia, Africa and Europe and spans over 69 countries containing 63% of the world's population, 34% of global merchandise trade and 31% of world GDP. Several countries not on the route have officially joined the B&R initiative, which brings the total to 84 member countries, according to the official portal. The McKinsey Global Institute projects that the B&R region could cover 80% of global GDP by 2050, with spending of USD 900bn, seven times larger than WWII Marshall Plan spending in today's terms. China intends to export its growth model to the developing world, which would shift another three billion people into the middle class, and is targeting the development of local and regional infrastructure projects. Infrastructure has been the bottleneck for many developing countries to move towards their next development stage. By making use of China's extensive expertise in building roads, railways, airports, harbours and telecommunication as well as water and power supply, the principle idea is that these countries can be integrated into the global value chain, enabling what economists call an economic 'pareto optimum', or a 'win-win' situation, benefitting both China and the targeted countries or regions, with positive feedback loops via expanding regional trade.

Figure 1: China wants to ensure long-term access to commodities

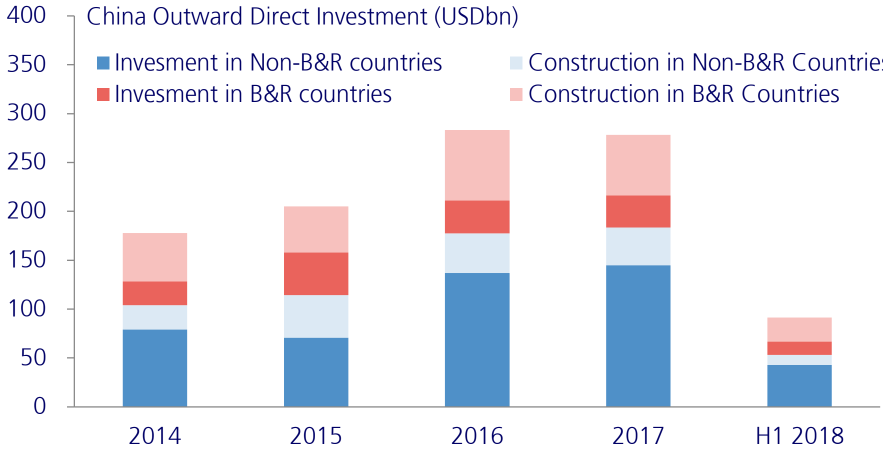


Source: American Enterprise Institute & the Heritage Foundation

There are multiple benefits for China in promoting the B&R initiative

China is not devoting such a significant amount of expertise to the B&R project purely from an official development aid perspective, there is clearly a strong self-interest as well. The project will add momentum to the development of China's northern and western regions that still lag in comparison to the wealth created in China's eastern coastal regions. It may also relocate its low-cost manufacturing capacities to developing countries, while upgrading its high-value added production facilities, in line with the 'Made in China 2025' strategy.

Figure 2: China builds in B&R countries but invests in Non-B&R



Source: American Enterprise Institute & the Heritage Foundation

More importantly, China wants to ensure long-term access to commodities (figure 1) and strengthen global diplomatic ties to manifest its geopolitical aspirations, particularly versus competitors like the US, Japan and India. While the US is engaged in trade disputes, China can put itself into the position of a champion of global trade, a role that President Xi reiterated during his speech at the Davos Forum in early 2017. China will also be able to strengthen its military power, as three out of the eleven harbours it is operating along the Maritime Silk Road, namely the ports of Gwadar in Pakistan, Hambantota in Sri Lanka and the port of Djibouti, can be used both for commercial and military purposes.

Furthermore, China has recognised that it needs to cut excess capacity domestically to fulfil its deleveraging needs, particularly where China's state owned enterprises are concerned (see our Topical Thoughts paper on China's SOE reform). It is therefore helpful if it can export parts of its excess industrial capacity to other countries on the New Silk Road, particularly in the construction and steel industries, but also in the solar business. Many of the B&R contracts with local governments in the B&R countries require the involvement of Chinese construction and engineering firms, which again mainly employ and benefit Chinese workers. China has also realised that the B&R initiative is a clever way to deploy its excess savings and FX reserves, and that it may benefit the expansion of the RMB as a transaction and reserve currency. This should also support Hong Kong as a financial centre, as the city has become a hub for various B&R projects via its 'Infrastructure Financing Facilitation Office'. Singapore should also benefit as a hub for raising funds for projects in South and Southeast Asia.

B&R project sizes will expand significantly from their current status

Despite quick expansion during the last five years, many B&R projects are still in their early stages and have room to expand significantly. Based on NAB and EIU data, only 1% are in the operational stage, 17% are signed or in the procurement/pre-construction stage, while 47% are in a planning stage. The remaining 35% are still in either the feasibility study, tendering, awarded or design phase. For example, the four projects in Pakistan (railway, motorway, coal power plant, and hydro) so far add up to a value of about 6% of Pakistan's GDP, while the proposed investments add up to a total of 20% once in full operation, according to calculations by Nomura.

B&R countries are the main beneficiaries of construction funds, while non-B&R countries are major investment recipients

Even if the B&R initiative is making headlines, China has actually diversified its spending outside of the B&R regions. Using transaction data from the American Enterprise Institute and the Heritage Foundation, we find that non-B&R countries benefit to a larger extent from Chinese outward investments, combining a share of about 75% in the last 4½ years, vs. 25% for B&R countries (figure 2). The US, Switzerland, the UK, Australia, Germany and Brazil rank as the largest recipients. Large and lumpy M&A transactions, such as the 2017 Syngenta deal with Switzerland, have an impact on these data. In contrast, B&R countries have received roughly 60% of Chinese construction funding. Pakistan, Bangladesh, Egypt, Malaysia and Indonesia dominate in terms of total construction spending.

The Silk Road Fund and the AIIB are major B&R financing vehicles

Three supra sovereign financing institutions were established by China, or on China's initiative. Set up in 2014, the 'Silk Road Fund' provides investment and financing for trade and economic cooperation specifically for B&R projects. It is directly financed by China's SAFE, the China Investment Corporation, the Export-Import Bank of China and China Development Bank. The 'AIIB', the multilateral Asian Infrastructure Investment Bank, headquartered in Beijing, was founded by 77 member countries in 2014 and now has 87 members. AIIB started its financing operations in 2016 and has within less than three years already approved 25 projects in a dozen countries with a total financing volume of over USD 4bn, with a target to reach USD 40bn by 2020 and 100bn by 2025. The AIIB projects Asia's infrastructure investment needs to rise to USD 2tn per year by 2030, or roughly triple what it has been in the past. Many of its initial projects have been prepared in collaboration with other multilateral development banks including the World Bank and the Asian Development Bank (ADB).

Meanwhile, China's policy banks are also providing low-cost, long-term funding for B&R projects and are key suppliers of funds to the Silk Road Fund. Other major suppliers of funds for Asian and African infrastructure investments are the Japanese policy-based financial institutions JICA and JBIC in co-financing deals with the Japan dominated ADB and major Japanese commercial banks, but also with a major commercial bank in Singapore, for example. Despite some cooperation, there is also competition with the China dominated AIIB, where Japan refused China's invitation to become a founding member.

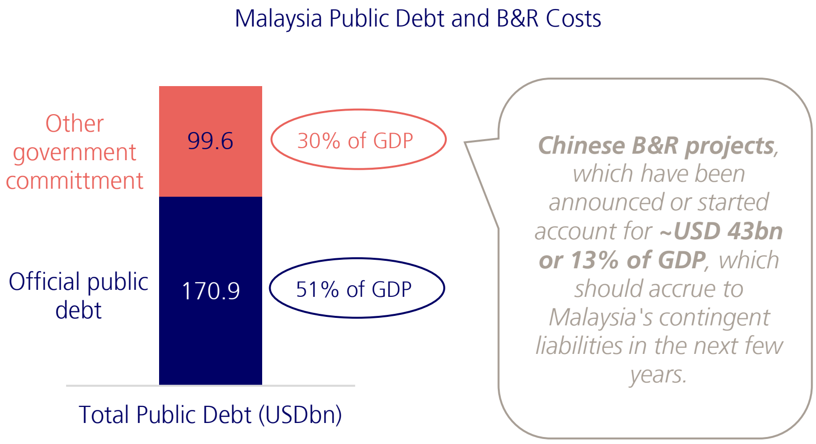
Some developing countries have run into a debt trap due to Chinese financing

In addition to lending on concessional terms by multilateral public lenders, many B&R projects are financed by direct Chinese lending, often in a combination of concessional and commercial terms. Particularly some poorer developing countries with autocratic governments are open to Chinese lending, which is less prone to be conditional on the improvement of human rights issues, for example, differing from many European public lenders. Instead, China-friendly autocratic governments are more open to accepting Chinese terms, for example ensuring that only Chinese contractors and workers are involved in infrastructure projects, which also often coincides with the tendency for borrowing countries to be at risk of running into a debt trap.

A recent study by Citigroup reveals that the degree to which China is involved in debt problems varies. Pakistan is China's biggest B&R commitment, with the 'China Pakistan Economic Corridor' (CPEC) comprised of projects worth USD 62bn. Although infrastructure projects are mainly financed on concessional terms, the majority of CPEC projects are undertaken in the energy sector and are financed on commercial terms by Chinese financial institutions. Without going into details, it is likely that power distribution companies will suffer and increase the government's contingent liabilities. Now that Pakistan is about to enter an IMF stabilisation programme, austerity measures need to be undertaken that might reveal problems with many deals that have mainly favoured Chinese interests.

Another showcase is Djibouti, a tiny country with strategic importance as it is a gateway to the Suez Canal. Djibouti's external public debt doubled between 2014 and 2017 to nearly 100% of GDP, of which a majority is related to Chinese loans. Indeed, China accounts for 97% of bilateral loans. Major loans have been provided for a deep seaport that can also be used for military purposes, and for the Addis-Ababa-Djibouti Railway, which is operated by China and mainly benefits Chinese contractors. Grace periods will end within the next five years, after which potential repayment issues need to be monitored carefully.

Figure 3: Chinese B&R lending will weigh on Malaysian debt



Source: HSBC; Note: end-2017 debt, B&R costs span several years

In Sri Lanka, China Merchant Holdings managed to make a deal with the previous president securing a 70% stake in a 99-year lease for the Hambantota Port, which can also be used for military purposes. However, China only accounts for less than 12% of the country's public debt and cannot solely be made responsible for Sri Lanka's debt problem, as the study shows.

The latest example is Sierra Leone, where the new president cancelled a Chinese USD 400mn loan arranged by his predecessor to build a new international airport. The government believes the project to be uneconomical as its existing international airport is grossly underutilised. This is a blow to China's ambitions to strengthen its footprint in Africa, just one month after the September Forum on China-Africa Cooperation in Beijing.

Malaysia and China are redefining their B&R partnership

The case of Malaysia illustrates the ambiguous economic effects of the B&R initiative on the recipient countries. With an estimated USD 28.5bn of investment and construction funds received from China since 2014, Malaysia stands as the second largest B&R beneficiary behind Pakistan. Part of Malaysia's appeal is its strategic location on the Malacca Straits, one of the main trading routes to China. The "Melaka Gateway", a joint-venture between the Malay company KAJ Development and PowerChina plans to develop a liquid bulk terminal and a maritime industrial park on the Straits of Malacca.

Malaysia's other advantages are its leadership in petroleum exports, and the cultural and linguistic affinity of part of its population with China.

Chinese investment generates certain benefits for Malaysia. The Malaysia-China Kuantan Industrial Park (MKCIP), 49% owned by a Chinese consortium, is expected to boost trading of metals, chemicals, solar cells and other industrial goods between the domestic port of Kuantan and the Chinese port of Qinzhou. It is also likely to create new jobs for the locals.

However, the project also serves the interests of Chinese corporates, while it does not bring any fiscal revenue to Malaysia because of corporate income tax exemptions. The major criticisms about B&R projects relate to their funding structure. For example, the East Coast Rail Link (ECRL) project, recently put on hold, had an estimated total cost of MYR 81bn, and was to be 85% funded by a loan from Exim Bank of China. Considering Malaysia's sizeable liabilities and debt servicing burden, we find prudent the review of B&R projects' costs and benefits by the new Malay government (figure 3).

In our view, China and Malaysia share strong cultural ties and potential economic synergies, but the B&R partnership needs to be redefined. Malaysia can benefit from China's financial and technological assets, on the condition that China is willing to share knowledge and productivity gains by training the local workforce for example. We hope that the current geopolitical dispute between the new Malay government and China will mark the beginning of a new, more equitable partnership.

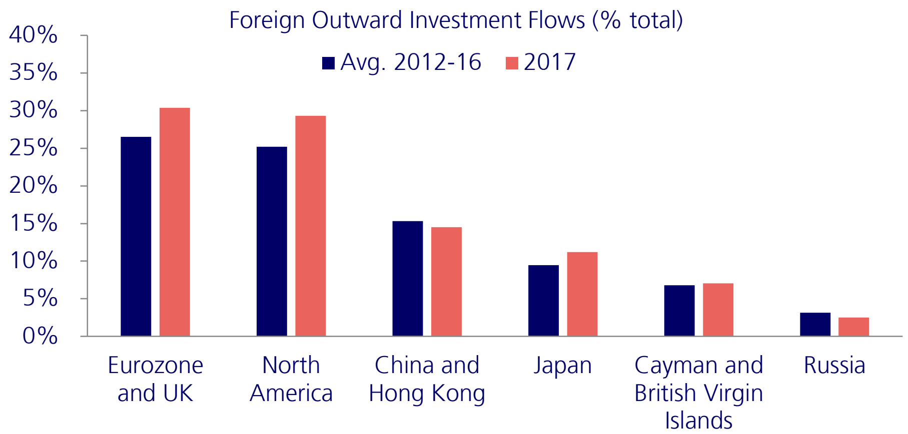
In Germany, Duisburg has developed into a major B&R hub

If you ask Germans what comes to mind when referring to Duisburg, many will say it is a dull, grey city in the centre of the 'Ruhrpott', the industrial area that has seen the best of times, with environmental problems and a high unemployment rate. Duisburg's local soccer team, the MSV Duisburg, has mirrored the downturn having been relegated from the 'Bundesliga' to the third league, and now hovering at the bottom of the second league.

However, not everybody knows that boomtown Duisburg is operating the world's biggest inland port and has become a major hub on China's New Silk Road, being the final destination of products imported from China via the railway link, and a reloading point for goods to be transported to and from other European destinations. E-commerce is hugely beneficial for trade between China and Europe, as goods ordered on one of the dominant Chinese internet portals are transported on the new railway Silk Road to their European customers. Vice versa, goods are also transported from Europe to China via Duisburg, ranging from milk powder to luxury cars. Every week up to 35 trains full of containers, each 600m long, move between Chongqing, dubbed the world's biggest city, and Duisburg, which is more than 60x smaller in terms of inhabitants. The number of containers moved along the rail link rose twentyfold to 20,000 between 2014 and 2016, and the number keeps accelerating. 700 trucks are loading and unloading merchandise goods every day. Transport via railways is still small compared to air transport or shipping, but it is growing rapidly. While shipping takes more than five weeks, transport by rail takes about 12-14 days. This has come down from 19 days, and is expected to be reduced further to only 10 days. Meanwhile, air freight is quicker, but far more expensive.

Huge Chinese business centres have developed around Duisburg and along the railroad track, like in Belarus, for example, and Chinese investors plan to expand further. About 100 Chinese companies have settled down in Duisburg, supported by the China Business Network and public German trade and industry promotion entities, with more to come. However, there are complaints that the benefits are not reciprocal, as Chinese companies benefit much more than German enterprises. For example, tenders for projects are often not public, but will mainly be handled within the Chinese business community, with German and other European companies falling behind. Criticism towards Chinese business practises has increased,

Figure 4: China ranks among the top 3 global investment providers



Source: UNCTAD

despite the euphoria that the B&R initiative has created in Duisburg.

B&R is a double-edged sword

By introducing the Belt and Road initiative, China has labelled its own version of globalisation and has managed, in a few years, to climb to the third rank of global investment providers, just behind Europe and North America (figure 4). A lot of euphoria has accompanied the Belt and Road initiative since it was announced five years ago. Wealth has been created, and both Chinese companies and corporations in the developing world, as well as consumers, have benefitted. But there has also been criticism, which has increased recently, particularly as Chinese business practises have made the 'win-win' deal asymmetric to China's benefit. As US Vice President Pence's recent speech revealed, the US administration has broadened its 'China bashing' to other issues than purely trade.

Other major countries remain sceptical from a more geopolitical perspective. As mentioned, Japan has avoided becoming a member of the AIIB, which it may not value as reciprocal to the ADB, while India is concerned about the 'string of pearls', the deep sea ports in its neighbouring countries Pakistan, Sri Lanka and Myanmar, which are under Chinese control.

Various countries have also become more careful towards Chinese companies taking over both SMEs and even large firms that are operating in strategic businesses or niches, including Germany. As referred to earlier, many B&R tenders are not open to non-Chinese contenders, and in some developing countries violent acts against Chinese workers have occurred. Meanwhile, some emerging countries are at risk of running into a debt trap due to Chinese lending, while autocratic governments are more interested in prestige projects than a professional project evaluation process.

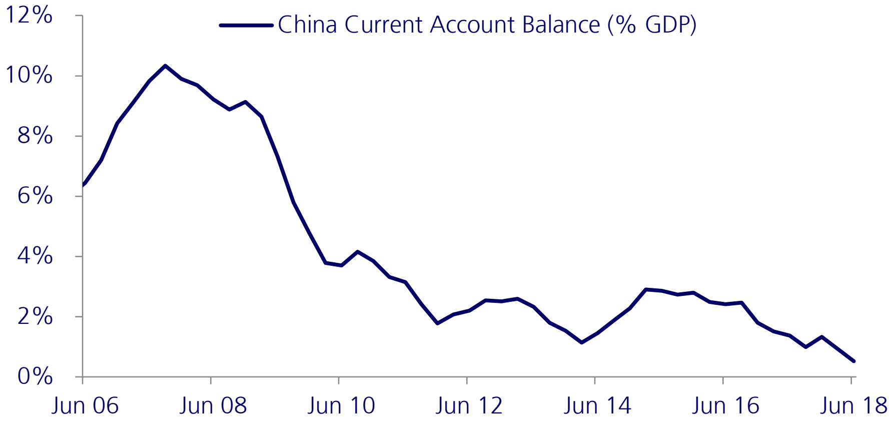
Finally, Chinese investments face some risk if a China-friendly government in a developing country is voted out of office and replaced by a more critical administration, as has happened in Sri Lanka, Malaysia and the Maldives.

China's current account surplus is dwindling

About ten years ago, China's current account surplus stood at 10% of GDP, but has declined significantly since then to only 0.5% of GDP in Q2 this year (figure 5). The service sector deficit has become bigger during the last six years or so, while the income balance has also moved into negative territory, even though this deficit remains rather small. Amid expanding trade disputes with the US, it seems likely that even the goods surplus will shrink. A potential current account deficit would curtail China's ability to provide USD funding and may open the door to promote joint financing with other developed countries.

We believe China would benefit were it to start amending some of its malpractices and put greater focus on multilateral projects with other partners along the New Silk Road 'Belt' and the Maritime Road. More participation of local companies and the broader population will improve China's reputation. Avoiding playing the role of the global bogeyman, who is primarily focussing on its own interests, will pay dividends in the longer term, not only for the countries involved in the B&R initiative, but particularly for China itself.

Figure 5: Dwindling CA surplus curtails China's funding power



Source: Bloomberg

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