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CHINA’S BELT AND ROAD AT FIVE
A Progress Report
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CHINA’S BELT & ROAD AT FIVE
A Progress Report

China’s Belt and Road Initiative (BRI) marked its fifth birthday in September 2018, though there was probably less to celebrate than the Chinese authorities might have wished. Five years after President Xi presented the initiative to the world in a speech in Kazakhstan, the BRI is facing pressures on three fronts. The first is what might be called a ‘dollar constraint’. Since the renminbi is not a fully functioning global currency, the BRI largely requires dollar-denominated financial resources to fulfill its objectives: it is significant that the major financing announcements made to kick-start the BRI in 2014 — recapitalizations of the China Development Bank, China Export-Import Bank, as well as new capital for Silk Road Fund, the AIIB, and the New Development Bank — were all made in dollars. And since China lacks an infinite supply of dollars, it therefore lacks an infinite capacity to meet its goals.

The second is the increasingly loud accusation from recipient countries that the initiative is too little ‘win-win’ and too much ‘China-win’. This summer the Malaysian prime minister Mahathir Mohamad described a “new colonialism” — a phrase that captures the idea that the BRI has led to the accumulation of liabilities on receiving countries’ balance sheets to pay for projects of uncertain value, built mostly by Chinese contractors on opaque terms, allowing China’s regional influence to grow in ways that are out of proportion to the benefits that countries can expect to enjoy. This kind of concern led to Malaysia’s suspension last month of the $20 billion East Coast Rail Link, one of the biggest-ticket projects in the entire BRI. Even Pakistan, whose people and governments routinely express the world’s most amiable view of China, recently cut down the scale and cost of the Karachi-Peshawar railroad project. The IMF’s Managing Director has called for ‘absolute transparency’ in the nature of the liabilities the BRI is creating.

A third source of unease now facing the BRI is the explicit opposition of the United States, made clear in recent speeches by the U.S. Vice President, who has warned recipient countries against what he described as a ‘constricting belt’ and a ‘one-way road’. What started off as an unwelcoming but tolerant U.S. response to the BRI five years ago has now turned into outright hostility.

The BRI should be understood as in the context of a shift in Chinese foreign policy that has become evident in the past few years. The Deng-era concept of tao guang yang hui — ‘hide your light and make the most of your obscurity’ — was replaced in late 2013, shortly after Xi’s Kazakhstan speech, with a more assertive principle: fen fa you wei, or ‘exert yourself and get things done’. The BRI can be seen as an extension of this principle into the economic sphere. As with any new foreign policy strategy, a period of reassessment will follow the initial implementation. In broad terms, Chinese scholars are already debating whether China has been guilty of ‘strategic overstretch’ in recent years. Given some of the constraints that the BRI has faced since its launch, the question can similarly be posed about the initiative itself.

Perhaps what will emerge from this debate is a ‘kinder, gentler’ BRI, one that is more sensitive to the international criticisms described above, and one that more obviously meets China’s objective of becoming a ‘many-to-many’ platform for international cooperation that links countries through the development of infrastructure, trade agreements, a simplification of customs procedures, and cultural exchange. One indication that this might be the case lies in China’s growing interest in co-financing BRI projects with multilateral development banks. Since these banks require open tendering and adherence to strict governance standards, their involvement could create a more multilateral-looking BRI.

Though it might change shape, the BRI is certainly not going away. This Citi GPS report aims to set out its contours and to provide an assessment of where the initiative stands, what the economic effects have been, and some of the policy issues that have been raised by China’s remarkable foray into international economic leadership.
A Five-Year Report Card

Since the launch of BRI in 2013, China investment in BRI countries has been primarily ‘creating’ via construction and greenfield investment while in non-BRI countries it has been ‘acquiring’. Source: AEI

Construction $434bn
Greenfield $138bn
Other $504bn

China’s investment and construction spending globally has increased substantially post-BRI...

<table>
<thead>
<tr>
<th>Year</th>
<th>Pre-BRI</th>
<th>Non-BRI</th>
<th>BRI Countries</th>
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Source: AEI
...but over the past five years China has only accounted for 12% of global cross-border M&A and 9% of announced greenfield projects.

Despite challenges brought by BRI, we believe a shift in strategy will lead to China being a successful and responsible creditor.

Challenges:

- Inefficiencies - BRI recipients tend to have more infrastructure deficiencies and also have weaker institutions prone to corruption.
- Credit and Operational Risk - macro risks and unsustainable debt burdens for borrowing countries resulting in rising credit and operational risk for Chinese banks and state-owned enterprises.
- Opaque Bilateral Agreements - undue advantage to Chinese economic interests that hurt recipient economies.

Strategy Shift:

- More Prudent Lending - adopt more international creditor norms.
- Project Selection and Execution - better governance standards.
- Financing and Implementation - push towards multi-lateralizing projects.
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1. Is BRI ‘One-to-Many’ or ‘Many-to-Many’?

It was September 2013 when Xi Jinping first announced China's Belt and Road Initiative (BRI), which gives us an opportunity to assess its first five years. It is also, coincidentally, the first anniversary of the Chinese Communist Party’s decision, at its 19th Party Congress in October 2017, to incorporate into its constitution a pledge to ‘pursue the Belt and Road Initiative’. What this report aims to do is to identify the achievements of the BRI so far and to discuss a number of the challenges facing the initiative. Implementing the BRI has not been, nor will be, plain sailing for China. Yet it would be extremely unwise to dismiss the initiative or underestimate its importance to China’s leadership.

For all the attention it receives, the BRI can be surprisingly difficult to nail down. Although BRI does have some specific goals in terms of the countries and sectors that are targeted, one of the defining features of BRI is its vagueness. What’s clear is that there are three broad areas of activity. The first, most visible, is ‘hard’ infrastructure, which includes roads, railways, ports, and telecommunications projects. The second is ‘soft’ infrastructure, which includes, for example, investment and trade agreements as well as efforts to smooth customs clearance; but also includes efforts to promote the use of the renminbi (RMB) across the Belt and Road. A third area of activity is the promotion of cultural ties. But the precise scope of the initiative is only vaguely defined, both in time — when really did it start? — and in space — where really does it end??. Although the BRI was formally launched five years ago, Chinese investment in BRI-like projects pre-dates this by a considerable time, and the whole initiative can be seen as an extension of the ‘go out’ strategy that China announced as far back as 1999. And as far as geography is concerned, there is also significant uncertainty. The BRI ‘formally’ includes around 70 countries, and six ‘corridors’, but the investment activity of some of its funds belies the specificity of this list. One of the first investments made by the Silk Road Fund — an organization capitalized with $40 billion in 2014, which as its name suggests is central to financing China’s BRI strategy — was in Pirelli, an Italian tire-manufacturer, which doesn’t on the face of it fit neatly into the BRI’s stated geographical objectives; and it has been given formal approval to invest in the Americas. The hazy geography of the BRI also raises a particular question about Latin America, which is not formally part of the BRI but where China aims to increase its exposure markedly. Indeed, China’s exposure to that region is already significant. For China Development Bank — the principal financier of the BRI — Brazil is already among its five biggest borrowers, along with Russia, Kazakhstan, Indonesia, and Australia.

Two documents flesh out Xi’s vision, and which can be described as the ‘what’ and the ‘why’ of the BRI. The ‘what’ is a policy document released in March 2015 entitled ‘Vision and Actions on Jointly Building Silk Road Economic Belt and 21st-Century Maritime Silk Road’. The central objective is to ‘promote the connectivity of Asian, European and African continents and their adjacent seas, establish and strengthen partnership among the countries along the Belt and Road…and realize diversified, independent, balanced and sustainable development in these countries’.1

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The ‘why’ is a 2016 book by Wang Yiwei, a Professor at Renmin University, called ‘The Belt And Road Initiative: What Will China Offer The World In Its Rise’.

One way of characterizing the BRI can be approached by a comparison with the Marshall Plan. The analogy between BRI and the Marshall Plan, the US’s post-WW2 effort to aid Western Europe, is often made, for two reasons in particular. In the first place, the Marshall Plan made a decisive contribution to renewing transport and infrastructural connectivity across Europe, which facilitated a post-war rise in trade within Europe and helped to raise productivity. This seems to echo China’s ambitions as they are described in the ‘Vision and Actions’ document referred to above. And the Marshall Plan also played a particular role in helping to pull Europe towards the US, not just economically but culturally and philosophically. The idea that China is using BRI as a tool for expanding its own geopolitical influence is often discussed, sometimes as a modern recreation of the ancient Chinese concept of tian xia, 天下, or ‘everything under the heavens’, denoting the broad geographical area divinely appointed to Chinese emperors by principles of order and humane authority. Another ancient concept of Chinese statecraft that might be helpful in understanding China’s behavior is de, 德, or ‘virtue’, which Chinese dynastic rulers emphasized as a means to legitimize their projection of power and their use of force. China wants to be seen as a benign pillar of the global order.

The BRI can be approached as a comparison with the Marshall Plan

Figure 1. Classification of 84 Countries Involved in the Belt and Road Initiative

<table>
<thead>
<tr>
<th>CIS, Caucasus, Central Asia</th>
<th>East Asia, South-East Asia &amp; Pacific</th>
<th>South Asia</th>
<th>Central and South-East Europe</th>
<th>Middle East and North Africa</th>
<th>Americas</th>
<th>Sub-Saharan Africa</th>
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<td>Bhutan</td>
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Source: Citi Research

There are two essential differences between BRI and the Marshall Plan. The first is the respective scale of the two initiatives. The Marshall Plan was focused on 16 countries in Europe, and was backed by the disbursement of just under $13 billion dollars at the time – 43% of which went to just two countries, Britain and France - which represented 5.4% of their aggregate 1947 GDP. $13 billion in 1948 is roughly equivalent to around $200 billion today.

By that standard, the BRI is vastly more ambitious both in terms of the number of countries involved, and in terms of the scale of financing that could be available. Figure 1 gives an impression of the range of countries involved in BRI, but that shouldn’t be considered a closed list: not only is BRI open-ended by design, but it is also difficult to separate, for example, China’s strategy in Latin America from its strategy in the countries more usually considered part of the BRI. In other words, compared to the Marshall Plan, BRI has a vastly larger geographical scope. It is likely to involve considerably larger sums of money. Since there is no single financial plan that defines BRI, there is no dollar amount that can capture its scale, though according to The Economist, ‘Chinese officials seem comfortable with a number in excess of $1 trillion’.4

A further difference between BRI and the Marshall Plan might lie in the way their respective geopolitical contexts should be understood. Professor Wang makes an interesting distinction between a ‘one-to-many’ strategy and a ‘many-to-many’ strategy. He characterizes the Marshall plan as reflecting a ‘U.S. strategic intention to control Europe’,5 and was, in that sense, a ‘one-to-many’ strategy. By contrast, he insists that BRI is a platform of ‘win-win cooperation’, a view which echoes the language that is frequently used in Chinese descriptions of the initiative, where the emphasis is often on the ‘harmonious and inclusive’ nature of an initiative whose aim, according to ‘Vision and Actions’ document, is to promote ‘mutual political trust’. As Wang puts it: ‘China will never seek hegemony, nor will it be a hegemon’.6 This points towards the conclusion that the BRI is — at least in the way it is being presented to the world — a ‘many-to-many’ strategy. It is certainly the case that Chinese scholars make a fair amount of effort to distinguish China’s global ambitions from anything that could be described as ‘hegemony’. In addition to Wang’s characterization of China’s ambitions, it is also worth considering another scholar, Yan Xuetong, who traces the principles of Chinese foreign policy back to the pre-Qin era, before 220 BC. For him, Chinese foreign policy is based on the idea that ‘humane authority has the role of taking the lead in implementing and upholding international norms; whereas hegemony lacks this’.7 And indeed, the vastness of the BRI initiative’s geographical scope, illustrated in Figure 2, might support that conclusion.

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Whether the BRI is best characterized as a ‘one-to-many’ or a ‘many-to-many’ initiative partly depends on the financial resources that China has to devote to it. In the eyes of many observers, the idea that China is entirely selfless in promoting the BRI sounds naïve. Even Wang acknowledges that ‘China is transforming from a participant in to a shaper of globalization’, an idea which implies some form of dominance, if not hegemony. Up until now, that dominance has sprung from the overwhelming role played so far by two Chinese ‘policy’ banks, namely China Development Bank (CDB) and the Export-Import Bank of China (’Exim Bank’). By the end of 2014 — a year in which each of them was awarded with $50 billion of new capital that was allocated from China’s foreign exchange reserves — these two banks had outstanding loans to foreign borrowers of nearly $700 billion, much the same as the total outstanding lending of the World Bank and the five leading regional development banks combined. That kind of financial clout did indeed buy ‘dominance’. This is evident in Figure 3 and Figure 4, which show data from Reconnecting Asia, a project at Washington’s Center for Strategic and International Studies. They suggest that 89% of Chinese-funded projects in Asia use Chinese contractors; while only 29% of projects funded by multilateral development banks in the region have contractors of Chinese origin. If Chinese financial muscle could be endlessly applied in this way, it would be easy to argue that the BRI could become a ‘one-to-many’ initiative, fitted around China’s financial clout and a ‘charmed circle’ of its state-owned construction and engineering firms.

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But as we aim to show, that prowess has serious limits, which could indeed help to ‘multi-lateralize’ the BRI and push it towards something more like a ‘many-to-many’ operating model.

Figure 3. China Funded Projects in BRI Have Overwhelmingly Involved Chinese Contractors, Which Reinforces the ‘One-to-Many’ Paradigm...

Nationality of Contractor in Chinese-funded BRI-projects

- Chinese: 89%
- Local: 8%
- Foreign: 3%

Figure 4. ...While Projects Funded by MDBs Have a More Diverse Distribution of Contractors Due to Open-Sourcing Requirements

Nationality of Contractor in Projects Funded by Multilateral Development Banks

- Chinese: 29%
- Local: 41%
- Foreign: 30%

China might be forced into a ‘many-to-many’ approach to BRI because of what can be described as its ‘dollar constraint’. Imagine if the renminbi were a truly global currency with all the attributes of an internationally accepted means of exchange and store of value. In that world, frankly, China could simply print renminbi and use them to finance projects in the BRI. But that is plainly not what is happening. Of course there are some high-profile projects in the BRI that have used renminbi funding: Malaysia’s East Coast Rail Link is an example.10 Although the financial terms of many BRI projects are not made public, we think it is safe to say that most of the BRI is essentially a dollar-funded initiative. One official from China Development Bank acknowledges that the amount of its international lending to the 115 countries to which it has exposure is ‘very small’. The Silk Road Fund is still struggling to work out how to deploy the RMB100 billion of capital that Xi Jinping offered to it in May 2017. The dollar-dependence of the BRI is partly because contractors seem to prefer to receive dollars rather than renminbi for their work, and partly because of the general lack of fungibility of the renminbi. It is significant that major financing announcements that were made in 2014 when the BRI was first being set up — recapitalizations of China Development Bank, China Exim Bank, as well as new capital for the Silk Road Fund, the Asian Infrastructure Investment Bank (AIIB), the New Development Bank — were all made in dollars.

The BRI’s ‘dollar constraint’ exists because the renminbi has lost momentum establishing itself as an international currency. In the years running up to 2015 there seemed to be growing evidence that the renminbi was on its way to becoming an internationally usable currency. Since then, though, the metrics that many analysts relied on to highlight the renminbi’s international desirability have shown a marked decline in its international relevance.

The cost of the ECRL is 55bn ringgit ($13 billion), of which 85% is funded by a 20-year loan from China’s Exim Bank (with a seven year moratorium on repayments), at a 3.25% interest rate. 60% of the loan is made available in renminbi, to pay the main Chinese contractor, China Communications Construction Company, with the remaining 40% in ringgit.
The currency has a diminishing presence offshore, is used less as a medium in which to denominate debt contracts, and its role as a medium for settling trade contracts has fallen. Figure 5 and Figure 6 illustrate the renminbi’s decline during this period. International bond issuance in renminbi, according to data from Bloomberg, has declined since the end of 2014: from around $25 billion per quarter to less than $8 billion recently. This coincides with a decline in the renminbi’s use as a settlement currency for China’s international trade: having settled almost 30% of China’s trade in late 2015, only 13% of China’s trade is now settled in renminbi. Meanwhile, RMB-denominated deposits in Hong Kong have fallen sharply — a phenomenon which is closely associated with the decline in the amount of Chinese trade that’s settled in renminbi, since the use of renminbi to settle trade was disproportionately a payment of renminbi to settle import bills, and this had had the result of leaving a pool of renminbi in Hong Kong. Now that renminbi is being used less to settle trade, offshore liquidity in renminbi has declined.

A ‘dollar constraint’ on the BRI might become more pressing if China starts to run a current account deficit in the near future. China’s current account surplus has fallen sharply in the past ten years, raising the question of whether it is about to start running deficits: its surplus was a mere 1.3% of GDP in 2017, down from the 10% or so it had reached in 2007. This fall in the current account surplus has coincided with a substantial appreciation of the real exchange rate, but it is clear this relative price change has done little to erode China’s trade surplus, which is larger these days than it was ten years ago (Figure 7). The ‘damage’ done to China’s current account surplus has one dominant source: tourism outflows. As Figure 7 shows, the bulk of the erosion of the current account surplus comes from a growing services deficit, and this decline is overwhelmingly explained by the increasing net outflow of tourism expenditure. In the past five years, the ‘net travel’ deficit explains almost 85% of the entire ‘net services’ deficit of the current account. The situation in 2017 was that the current account surplus of $165 billion was equal to a mere 9% of the import bill. So it would only take a 10% increase in imports, other things equal, to push China’s current account balance into a deficit for the first time since 1993. All this is significant for the BRI for a simple reason: if China needs the rest of the world’s dollars to finance itself, that might mean it is less easy for Beijing to accumulate the dollar resources it needs to finance projects in the BRI.
Another perspective on China’s ‘dollar constraint’ comes from the relative failure of its efforts to denominate its oil and gas imports in renminbi. In crude oil, for example, China has tried to foster the emergence of a petro-yuan in the context of the BRI, and has launched an RMB-denominated crude futures contract. But efforts to promote the renminbi as an oil currency have been stymied by the U.S.’s insuperable leading position as an oil-trading hub, thanks to a large rise in U.S. exports of crude oil, petroleum products and liquefied petroleum gas (LPGs). As the U.S. cements its position as the world’s foremost trading and pricing hub, the dollar will remain the dominant settlement currency by far, not just for oil but for gas too — albeit that China may have some flexibility to establish RMB-settlement for pipeline gas from central Asia.

The newly launched RMB-denominated INE (International Energy Exchange) crude oil contract appears to have a mandate of bolstering RMB-denominated crude pricing, but as Figure 9 shows, it has far to go before it challenges more established benchmarks. Chances are high, however, that re-imposed U.S. sanctions on Iran will lead to Iran’s acceptance of renminbi as a form of settlement to avoid the grip of those sanctions, and Iran appears already to be participating in the INE crude contract, which allows foreign market participants to take positions and to settle them either in U.S. dollars or yuan.

Chinese efforts to denominate other commodity imports in RMB have also been disappointing. The recent opening of the Dalian iron ore contract to foreign participation may eventually enable overseas miners to hedge their production with the world’s most liquid iron ore contract, particularly if liquidity on Dalian can be extended beyond active contracts and more importantly if China convincingly lifts all barriers to currency convertibility. Four Chinese futures contracts were among the world’s most traded contracts in 2016, but their trading volumes relative to other contracts have dropped since then due in part due to Beijing’s crackdown on speculation in futures markets and tightened liquidity conditions. Over the first half of 2018, only the SHFE rebar contract (on the Shanghai Futures Exchange) was among the top ten most traded futures contracts (Figure 10). All in all, it seems that China’s ability to reduce its reliance on the dollar in its effort to strengthen the BRI will be very limited for some time.
All this points to the renminbi’s relative lack of global usefulness, and this is helping to push China to seek more co-financing from others. So, a ‘many-to-many’ approach could be emerging. The important point here is that co-financing would reduce China’s ability to allocate Chinese contractors to Chinese-funded projects. The more dependent China is on co-financers, the more it will be the case that other countries’ contractors will become increasingly involved in BRI projects. That is certainly true if China chooses multilateral development banks, including the AIIB, as its lending partners. These banks are required to follow strict ‘open-content’ rules, which forbid them from preferring contractors from any one country. So the ‘dollar constraint’ means that the BRI could in theory become a more open set of projects. And there is some evidence that this is what is happening. Certainly, Chinese officials have encouraged participation by multilateral institutions like the World Bank, the Asian Development Bank (ADB), the European Bank for Reconstruction and Development (EBRD) and others that lie outside the ‘China-driven’ world of the Beijing-based AIIB and the Shanghai-based New Development Bank. This is particularly important because of some effort that China is making to disassociate the AIIB from having too close a link to the BRI: its largest borrower to date is India. And the Financial Times has reported that co-financing is becoming a more important priority for the Chinese government, which suggests that the BRI may over time adopt more ‘many-to-many’-like characteristics.\textsuperscript{11} To date, the Ministry of Finance of China signed memoranda of understanding on ‘collaboration on matters of common interest under the Belt and Road Initiative’ with the ADB, the AIIB, the EBRD, the European Investment Bank, the New Development Bank and the World Bank Group.\textsuperscript{12}

\textsuperscript{11} See FT, ‘China development banks expand links with foreign lenders’, 16 July 2018, https://www.ft.com/content/e0a2dd52-85b4-11e8-a29d-73e3d454535d.

A many-to-many approach will be particularly welcome internationally, because of signs of increasing discomfort about China’s aims in promoting the initiative. The three most obvious sources of international discomfort about BRI come from recipient countries themselves, from criticisms about the financial consequences of what is sometimes called China’s ‘debt diplomacy’, and most recently from the U.S. administration. The first source of opposition was expressed most clearly by the Malaysian prime minister Mahathir Mohamad when he claimed during the summer of 2018 that China was engaged in a “new colonialism” — a phrase that captures the idea that the BRI has led to the accumulation of debt on receiving countries’ balance sheets to pay for projects of uncertain value, built mostly by Chinese contractors on opaque terms, allowing China’s regional influence to grow in ways that are out of proportion to the benefits that countries can expect to enjoy. As a response to that perception, Mahathir cancelled the East Coast Rail Link (ECRL), with an official project-cost of $13.4 billion, but whose true cost was estimated by the Malaysian finance minister at $20 billion — up from an original cost-estimate in 2009 of closer to $10 billion. Shortly after the election, the Prime Minister claimed that the ECRL could have been developed by a Malaysian company for less than half the value of the contract that had been won by China Communications Construction Company; the cancellation was formally announced in August 2018. That month also saw the cancellation of a $2.5 billion agreement for the construction of gas pipelines.\textsuperscript{13} And finally, the U.S.’ opposition to aspects of the BRI was clearly stated by Vice President Mike Pence in a speech last month to the Hudson Institute, in which he claimed that ‘China uses so-called “debt diplomacy” to expand its influence. Today, that country is offering hundreds of billions of dollars in infrastructure loans to governments from Asia to Africa to Europe to even Latin America. Yet the terms of those loans are opaque at best, and the benefits flow overwhelmingly to Beijing.’\textsuperscript{14} Whether a ‘many-to-many’ approach to BRI actually materializes or not is probably the central question surrounding the future of the initiative.


\textsuperscript{14} See https://www.hudson.org/events/1610-vice-president-mike-pence-s-remarks-on-the-administration-s-policy-towards-china102018.
2. The China-Pakistan Economic Corridor: BRI in Microcosm

The China-Pakistan Economic Corridor (CPEC) is China’s largest commitment by far to a single country within the BRI, and in many ways encapsulates the themes that are evident throughout the initiative. The bilateral relationship between Pakistan and China has always been extremely close. Pakistan was one of the first countries to give diplomatic recognition to the People’s Republic, and played an important role in brokering the U.S.-China dialogue in the early 1970s. Indeed, one can argue that CPEC is a simple acceleration of deepening relationship between the two countries that has been evident for the past 20 years (Figure 11 and Figure 12). Building on a 2006 Free Trade Agreement, the CPEC was formalized in April 2015 with a set of 51 agreements that added up to a financial commitment on China’s part of some $46 billion. A number of additional commitments — to upgrade the Karachi-Lahore railway, for example — have taken China’s headline commitment to over $60 billion. There are a couple of useful ways of putting this number into context. One is to recognize that Pakistan’s nominal GDP is approximately $300 billion: China’s commitment therefore, at 20% of GDP, is extraordinarily large. Another is to understand that since 2008, the flow of foreign direct investment (FDI) to Pakistan from all sources has been a total of $26 billion. So the planned flow of funding from China to Pakistan is on a scale that has potentially transformative effects on the Pakistan economy, on China-Pakistan relations, and on the geopolitical shape of the Asian region. And as if to indicate how central CPEC is to China itself, it is worth noting that initiative was incorporated into China’s 13th Five Year Plan in November 2015.

Figure 11. Pakistan’s Increasing Reliance on China Predates CPEC and Is Part of a Longer-term Trend...

Figure 12. ...Which Has Pushed Pakistan’s Trade Deficit with China Towards 5% GDP and Over a Third of Pakistan’s Total Trade Deficit

The CPEC has four areas of activity, detailed in a Long-Term Plan that was released in December 2017. These are the Gwadar port and a set of projects in energy, transport infrastructure, and industrial cooperation. The Plan sets out timelines for projects stretching out to 2030, but contains rather little detail about the exact nature of many projects or the structure of any proposed financing for them. But the ‘early harvest’ phase of CPEC does seem to emphasize power projects, which will consume something like $34 billion of the total financing that will be made available to Pakistan under CPEC, including coal-fired and renewable power plants, transmission lines, and other infrastructure.
That power projects take up so much space in the strategy is unsurprising in view of Pakistan’s persistent energy shortage, which requires firms to rely on high-cost alternatives: back-up diesel generators, or battery-powered Uninterrupted Power Supply apparatus. One central objective is the construction of a 4,000MW transmission line for power distribution, from south Pakistan to Lahore and to Faisalabad in the north. Away from energy, the main priority within CPEC is transport infrastructure. Following a set of political compromises within Pakistan, the strategy envisages three transport corridors linking the Gwadar in Balochistan to Kashgar in Xinjiang, China: a western route via Quetta to Islamabad; a central route via Khuzdar and up through Dera Ismail Khan; and an eastern route through Karachi, Hyderabad, and up via Lahore.

Figure 13. Highways Network of CPEC

CPEC illustrates in a microcosm six themes that are relevant throughout the BRI. The first is the geopolitical context in which BRI should be understood, and the strategic gains that China has in mind when it chooses where to make financial commitments and on what scale. The second is the role the BRI plays in supporting the development of western China, and the way the BRI as an outward-looking strategy connects to the more inward-looking objective of raising incomes and promoting political stability at home. The third is the possibly transformative scale of the funding involved for Pakistan, which is echoed in a number of other countries. The fourth, which follows from this, is the set of questions that is raised about risks to financial stability in countries on the receiving end of large flows of finance from China and its co-financing partners in the BRI. The fifth is a set of questions about transparency, given the claims that have been frequently made that the terms of funding and the structure of projects in the BRI are characterized by opacity and limited access to information. Finally, CPEC raises questions about the domestic political consequences of BRI in recipient countries, and the way attitudes towards China have been re-shaped by its involvement in the BRI.
The geopolitical context for CPEC is crucial to understanding its importance to China. In geopolitical terms the centerpiece of CPEC is the development of Gwadar — a warm-water, deep-sea port near the Strait of Hormuz. Previously controlled by the Port of Singapore Authority, the port’s leasing rights were transferred in February 2013 to the China Overseas Port Holding Company-Pakistan (COPHC-P), which is entitled to 91 percent of the port’s profits over a 40-year period. In November 2015, COPHC-P also took control of Gwadar’s free trade zone, and the port itself became formally operational in November 2016. In November 2017, Pakistan rejected a request by Beijing to make the renminbi legal tender in the free trade zone. The geopolitical significance of the port is its alleged membership of the ‘string of pearls’, a supposed network of ports that creates a secure Chinese maritime route from the South China Sea through to Myanmar, Bangladesh, Sri Lanka, the Maldives, Pakistan, and through to Africa and the Persian Gulf. The theory of the ‘string of pearls’ puts emphasis on the idea that China could use these ports in the future to project military power.

Figure 14. China-backed Ports

Source: From Chinese Port Investments Research by Dr Sam Beatson, Lecturer at University of Nottingham Business School (UK) and Visiting Professor of University of Hong Kong; Director, Statis Ltd. http://www.sambeatson.com sam.beatson1@nottingham.ac.uk & Jim Coke. China Business Researcher at Kings College London Lau China Institute. Chairman and Founder of Hilmann Reinier brands.

Whether or not the ‘string of pearls’ theory has any validity, India is certainly a critical factor in considering the geopolitical implications of BRI. It is presumably significant that India was the only country invited to China’s Belt and Road Forum in Beijing in May 2017 that didn’t attend. The latent mistrust between China and India, since they were briefly at war in 1962, has arguably been given fuller expression by China’s pursuit of the BRI, not least because the central connecting link between Pakistan and China — Gilgit-Baltistan, which borders China’s Xinjiang Uyghur Autonomous Region (XUAR) — is disputed territory from India’s point of view. That political tension, ironically, could be acting as an accelerator for investment activity in Belt and Road countries. India, for example, is already involved in a 1,360km trilateral highway project with Myanmar and Thailand, and is reportedly aiming to develop similar projects through Cambodia, Laos, and Vietnam. Meanwhile, China is aiming to finish the 720 megawatt Karot power station on the Jhelum River in Punjab, also disputed territory from India’s point of view, which was initiated in December 2016 and looks set to finish nine months ahead of its December 2021 completion date.

CPEC also illustrates the way BRI mobilizes Chinese resources and helps to promote economic and political stability at home. As we discuss in the next section, BRI can be thought about as matching target countries’ excess demand for infrastructure and trade with China’s excess supply of inputs, namely capital inputs in the form of steel, cement and glass, as well as land and labor. In CPEC’s case, mobilizing Chinese labor is a particularly attractive objective for Beijing, because of the possible benefits to its Xinjiang region, a part of China which is home to about a fifth of its oil, almost half of its coal, and a good deal of agriculture, including 70% of China’s tomatoes.\(^{16}\) Political tensions in the region — home to China’s ethnically Turkic, Islam-following Uighur citizens — are often described as resulting from resentment at the growth of the Han population in the region: whereas in 1953 the province was 75% Uighur and 6% Han, by 2010, the Han population had reached 40% compared to a 45% Uighur share. As an effort to combat China’s ‘three evils’ — separatism, extremism, terrorism — BRI could offer some benefits on the assumption that regional poverty is a root cause of those evils.

The transformative scale of funding for CPEC necessarily raises questions about financial stability in Pakistan. China is now Pakistan’s biggest bilateral creditor, overtaking Japan in 2017. But Pakistan’s bilateral debt to China of $7.2 billion in June 2017 must understate Pakistan’s current liabilities to China by some significant amount. Not only has there been some $2.5 billion of additional official lending in fiscal 2018, but also an additional $2.9 billion of loans to Pakistan by Chinese commercial banks, leading to a Pakistan debt stock of at least $12.6 billion, and this figure doesn’t include (1) additional reported commitments in July 2018 and (2) external debt that is not officially guaranteed, which could be at least $3.5 billion.\(^{17}\) All told, Pakistan’s current total debt to China could be approaching $20 billion, and will necessarily increase to the extent that China’s commitments to Pakistan actually get disbursed. These issues are taken up further in Section 5 of this report.

### Figure 15. Pakistan’s Long-Term Government and Government-Guaranteed Debt ($ bn)

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Long Term</th>
<th>Paris Club</th>
<th>China</th>
<th>Other Bilateral</th>
<th>Multilaterals</th>
<th>Commercial</th>
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<tr>
<td>2013</td>
<td>$42.4</td>
<td>$13.5</td>
<td>$4.0</td>
<td>$0.7</td>
<td>$24.2</td>
<td>$0.0</td>
</tr>
<tr>
<td>2014</td>
<td>$44.7</td>
<td>$13.6</td>
<td>$4.5</td>
<td>$0.5</td>
<td>$25.9</td>
<td>$0.2</td>
</tr>
<tr>
<td>2015</td>
<td>$42.3</td>
<td>$11.7</td>
<td>$5.5</td>
<td>$0.5</td>
<td>$24.3</td>
<td>$0.3</td>
</tr>
<tr>
<td>2016</td>
<td>$46.6</td>
<td>$12.7</td>
<td>$6.3</td>
<td>$0.5</td>
<td>$26.4</td>
<td>$0.9</td>
</tr>
<tr>
<td>2017</td>
<td>$52.0</td>
<td>$12.0</td>
<td>$7.2</td>
<td>$0.4</td>
<td>$27.6</td>
<td>$4.8</td>
</tr>
</tbody>
</table>

Source: Citi Research, Note: Year-end is June

Opacity is a characteristic of both CPEC and the BRI more broadly. The vast flow of papers, books, and journalistic analysis of the BRI is heavily hampered by a lack of transparent information. One typical summary comes from the International Crisis Group, whose 2018 report of the CPEC claims that ‘analysis of the economic promise and impact of CPEC — as well as its ability to support a broad set of economic goals and an Islamabad-devised integrated strategy to develop the economy — is hampered by the opacity of its formulation and rollout’.\(^{18}\)

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\(^{16}\) See ‘China’s Eurasian Pivot: The Silk Road Economic Belt’, by Raffaello Pantucci and Sarah Lain, RUSI Whitehall Paper Number 88.


Writing in the Financial Times earlier this year, a Pakistani journalist made a similar claim, saying ‘Pakistan’s government has not made public the details of project agreements with China, which contain information about the financing models. The result has been mounting public discontent and intense criticism in Pakistan — so much so that Chinese ambassadors in the country took to social media to defend the projects.’ That opacity is reflected in the limited amount of information available about the exposures of China Development Bank and China Ex-Im Bank, the two most important bilateral lenders involved in BRI. Loan amounts, loan structure, financing terms, currency, and contractor-specification are unavailable. In part, one can argue that this opacity helps to fuel a political reaction against the BRI – though ironically the closeness of Pakistan’s relationship to China helps to limit this as far as CPEC is concerned.

Perceptions of China have not necessarily been improved in the way that BRI has been implemented. One risk for China in its pursuit of its objectives in the BRI is the risk that more hostile perceptions of China in recipient countries might create political pressures to cancel projects or minimize a country’s engagement with China. On the face of it, this shouldn’t be a risk in Pakistan, which regularly shows up in Pew Research Centre data as having the most favorable view of China in the world (Figure 16). Moreover, that favorable perception of China among the Pakistani population has remained durable in recent years. But even for Pakistan, that hasn’t prevented the emergence of some evidence of ‘rollback’ of China’s ambitions. In November last year, Pakistan cancelled China’s involvement in the $14 billion Diamer-Bhasha dam construction project because strict funding conditions for the project were “not doable and against our interests”, in the words of the Power Development Authority chairman Muzammil Hussain. That decision followed shortly after Nepal called off a $2.5 billion hydropower plant awarded to a Chinese state-owned company, which was also part of the Belt and Road Initiative. For Pakistan, however, liquidity constraints that have required the country to seek an IMF facility are likely to limit its willingness to push China away.

Figure 16. Pakistan is the Country Whose Public Support for China Is the Highest in the World...

Do You Have a ‘Favorable’ View of China?

Source: Pew Research Center, 2015 data (2014 for Bangladesh, Thailand and Egypt); Citi Research

Figure 17. ...And That Has Been Reliably Stable in Recent Years

‘Favorable’ Views of China Over Time

Source: Pew Research Center; Citi Research

19 Adnan Aamir, ‘China’s Belt and Road plans dismay Pakistan’s poorest province’, FT, 16 June 2018, https://www.ft.com/content/c4b78fe0-5399-11e8-84f4-43d65af59d43.
3. Characterizing China’s BRI Investment Strategy: What the Data Tells Us

China’s FDI activity constitutes a portfolio reshuffle rather than an increase in financing to the world. By definition, a country’s net contribution to the global supply of funding is its current account balance. China’s current account surplus peaked in 2008 at $420 billion, or 0.7% of global GDP. In 2017, it had shrunk to $165 billion – 0.2% of global GDP. As a net financier, China’s role has therefore actually decreased, but its asset allocation has changed significantly, away from reserve accumulation, towards more direct investment. In other words, China is increasingly becoming a share-owning investor rather than only a creditor.

China’s footprint in global foreign direct investment has increased markedly since the launch of the BRI. However, although one might be forgiven for thinking otherwise amidst headlines of increased Chinese takeovers, this merely brings Chinese FDI closer to what one would expect based on its weight in the ‘real’ global economy (Figure 18). According to UNCTAD data, China accounted for about 12% of global cross-border mergers and acquisitions and 9% of announced greenfield FDI projects over the last five years (Figure 19). Especially China’s share in the latter has increased noticeably over the last years and we will argue in this section that this is related to the launch of the BRI.

Precise data on Chinese direct investment is hard to come by. A number of Chinese authorities such as the State Administration of Foreign Exchange, the China National Bureau of Statistics and the Ministry of Commerce provide estimates of Chinese overseas direct investment (ODI). The data differ with regards to coverage of sectors, timespan and detail. Moreover, the aggregates, while showing broadly similar trends, provide estimates that at times differ by over $30 billion (Figure 20).

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20 A simple panel regression (using the between effects estimator for 51 countries over the last 17 years) of outward FDI/GDP shares on measures of economic size, financial and trade openness similarly suggests that China’s investment abroad is now more or less in line with global norms.
In this chapter, we therefore rely heavily on data from the American Enterprise Institute’s China Global Investment tracker (CGIT), which differ both in scope and methodology from official ODI statistics. The CGIT records investment commitments and construction contracts over $100 million by Chinese corporates (both state-owned enterprises (SOEs) and private enterprises) since 2005 when the intention is first made public. The CGIT is thus based on corporate sources rather than official data. It does not distinguish by sources of funds; as such, locally raised funding will be counted, whereas in FDI statistics, it would be excluded. Moreover, the CGIT does not account for depreciation and disinvestment. However, the CGIT provides the most detailed insight into Chinese direct investment and construction activity abroad as it lists the details of individual projects. It allows thus for a more transparent analysis compared to official data, which make adjustments and exclusions in sometimes non-transparent ways.21

The CGIT data broadly confirm the rise in Chinese involvement abroad. Chinese investment commitments abroad rose from $10 billion (0.5% of Chinese GDP) in 2005 to almost $180 billion (1.5% of GDP) in 2017 (Figure 20). Similarly, construction contracts awarded to Chinese companies have increased from $10 billion in 2005 to over $100 billion (Figure 21). Construction by Chinese companies is an export rather than FDI, although there can be links, e.g., if Chinese greenfield investment involves construction by a different Chinese company. However, it can represent an important form of involvement, especially if related to crucial infrastructure. And as we argue in this section, it is an important feature of the BRI.

However, since the launch of BRI, China has been more involved in non-BRI countries than BRI ones. Since October 2013, the CGIT has recorded $420 billion worth of investment and construction in BRI countries, versus $655 billion in other countries (Figure 22). However, most BRI members are emerging markets, whereas advanced economies are still largely outside the scope of BRI. As a consequence, companies outside the BRI tend to have much higher market values, as in the case of the $43 billion takeover of Switzerland based agrochemicals producer Syngenta.

A similar argument could be made for greenfield investment and construction in advanced versus emerging economies; the purchasing power of a dollar is higher in the latter than in the former. As a result, Chinese investment and construction in BRI countries since October 2013 amounts to 2.7% of recipient countries’ GDP, but only 1.3% in other markets. Moreover, breaking down the data reveals that Chinese activity in BRI countries differs from that in other markets. Greenfield investment in BRI countries sums up to $72 billion, but only to $66 billion elsewhere (Figure 23). Greenfield investment thus represents almost half of all investment in BRI countries, but only 13% in other markets. The trend is even more pronounced in construction figures; since October 2013, Chinese firms were awarded $268 billion worth of construction contracts in BRI countries versus $166 billion elsewhere.

The BRI appears to be about ‘creating’ rather than acquiring. Greenfield investment and construction in BRI countries since October 2013 sum up to $340 billion, versus $230 billion in non-BRI countries. This represents 80% of total ‘involvement’ (sum of investment and construction) in BRI countries, against 35% elsewhere. Granted, a large share of this newly created value comes from construction contracts, which are exports rather than investment. Moreover, they are usually financed by entities in the host country (see Section 5) and thus do not end in Chinese ownership of the assets after construction is finished. However, Derek Scissors from the American Enterprise Institute reckons that many of these construction projects, largely carried out by state owned enterprises (SOEs), are losing money.22 The implicit subsidy means that, besides as a stimulus program for Chinese construction companies, they could be seen as investment and as part of a larger strategy not solely focused on commercial profits.

The ‘creating vs acquiring’ theme is observable across all sectors. Figure 24 shows the share of involvement in BRI versus non-BRI countries across a range of sectors, while distinguishing between ‘creating’ (greenfield and construction) and acquiring activities.23 We can see that markets outside the scope of BRI dominate Chinese mergers and acquisition (M&A) activity in every sector. On the other hand, ‘creating’ involvement in BRI countries exceeds that carried out elsewhere in nine out of fourteen sectors and captures significant shares in the remaining five.

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23 We define non-greenfield investment as ‘acquiring’.
For perspective, the BRI countries’ market size amounts to less than a third of that of non-BRI countries for which the CGIT records transactions. There are however a few sectors in which the BRI region catches significant shares of M&A transactions as well, such as energy, logistics and utilities.

The greenfield and construction expenditure in the BRI region and the M&A activity elsewhere might be complementary. As we suggested in the introduction to this section, we are witnessing a portfolio reshuffle rather than an increase in Chinese financing to the world. The increased M&A activity in established industries in advanced markets could be seen as balancing a portfolio containing large emerging markets infrastructure projects with uncertain (commercial) profit perspectives. It also makes sense to consider BRI and non-BRI investments jointly with regards to industrial diversification and knowledge acquisition. Chinese takeovers of Western firms broaden the industrial portfolio of China and allow it to acquire new skills and knowledge. The investment in BRI countries complements this by providing the necessary infrastructure to nest these new industries into a more China shaped network of supply chains and destination markets. At the same time, it allows China to deploy its excess capacities in capital goods (and to some degree labor) in a way that mergers and acquisitions do not. This interpretation is supported by the fact that Chinese private firms have been mostly interested in taking over profitable businesses in Europe and the U.S., whereas BRI involvement has largely come from SOEs.

The energy sector has by far been the largest target of Chinese BRI activity

The energy sector accounts for about 40% of both construction and investment (Figure 26); in greenfield investment, its share is around 45%. To some degree, this is a sectoral effect; investment in energy production and distribution requires large investments in capital goods. However, the CGIT data suggests that China’s investment goes beyond this sectoral effect. According to UN Conference and on Trade and Development (UNCTAD) data, the energy sector attracted 22% of global greenfield FDI and 10% of global net cross-border M&A since 2013. ²⁴

²⁴ This is might be an overestimate, since we add up the components “Mining, quarrying and petroleum”, “Coke petroleum products and nuclear fuel” and “Electricity, gas and water”, which is likely to contain investment not related to energy.
The CGIT dataset, although not perfectly comparable, has these numbers at 36% and 18% respectively over the same time. For the BRI region, these shares are even higher at 45% and 33% respectively. This is of course also a function of the industrial structure of these countries; Africa, the Middle East, and Central/Western Asia contain many countries with abundant natural resources. However, it is hard to imagine that they could attract the same amount of investment and construction activity in different sectors — their attractiveness for China is a function of their abundance in resources. However, China’s involvement in energy is not limited to commodity-rich countries and/or to extraction of natural resources. Its investment and construction activity extends to various stages of energy production and also distribution, such as regional or national grids, in both energy exporting and importing markets. The majority of involvement comes in the form of construction contracts, which do not involve Chinese ownership after termination of the project. However, they often involve a suite of services (e.g. maintenance, training, etc.) and even goods (e.g., nuclear fuel) purchases for years to come. In some cases, this might give China significant influence over electricity generation and distribution, and important advantage when constructing global supply chains.

But sectors such as transport, real estate, and logistics have also seen significant Chinese involvement. Other sectors with significant Chinese involvement are transport, real estate, and logistics. Like energy, investment and construction in these sectors are capital intensive and involve skills which China has acquired in abundance in the past two decades of investment led growth. At the same time, building and investing in these sectors lays the foundations for future markets and supply chains; Chinese ownership of real estate firms abroad secures the demand for future demand of construction materials and labor, while enhanced (or in many cases, newly created) logistics and transport networks improve Chinese companies’ prospects for creating new supply chains and links to Western markets. Investments in high-tech/high-skilled labor sectors like health, finance, technology and agriculture on the other hand are rather small by comparison. However, Chinese M&A activity outside the scope of BRI is strong in these sectors, as China is looking to acquire skills and technology.
Instead of a geographic pattern, BRI follows a supply and destination market pattern

The BRI follows a supply and destination market pattern rather than a geographic one. Asia has been the main recipient of BRI related activity (Figure 27, see Figure 28 for definition of regions). Investment and construction in East and West Asia was just under $300 billion. This might not come as a surprise, since it is a frequent finding that FDI, like trade, follows roughly a gravity model pattern. However, the CGIT data on investment and/or construction does not yield any sensible fit with common gravity equations, reflecting the rather directed, statist nature of BRI related investment and construction. This impression is further reinforced by the fact that the Arab countries of the Middle East and North Africa have been a significant market for Chinese investment and construction, despite greater distances and smaller economies. Similarly, rather remote Sub-Saharan Africa has received considerable attention. Relative to market size, the Americas have been a significant target as well, but the small number of countries and projects make it difficult to infer any interpretation. Latin America has however received considerable funding from Chinese policy banks such as the China Development Bank or the Exim Bank of China (see Section 9).

Figure 28. Regional Classification in the CGIT

<table>
<thead>
<tr>
<th>East Asia</th>
<th>West Asia</th>
<th>Arab MENA</th>
<th>Europe</th>
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<tr>
<td>New Zealand</td>
<td>Maldives</td>
<td>Saudi Arabia</td>
<td>Latvia</td>
<td>Hungary</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Papua New Guinea</td>
<td>Nepal</td>
<td>UAE</td>
<td>Macedonia (FYR)</td>
<td>Latvia</td>
<td></td>
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</tr>
<tr>
<td>Philippines</td>
<td>Pakistan</td>
<td>Yemen</td>
<td>Montenegro</td>
<td>Lithuania</td>
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<tr>
<td>Singapore</td>
<td>Russia</td>
<td></td>
<td>Poland</td>
<td>Romania</td>
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<tr>
<td>South Korea</td>
<td>Sri Lanka</td>
<td></td>
<td>Romania</td>
<td>Serbia</td>
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<tr>
<td>Thailand</td>
<td>Turkey</td>
<td></td>
<td>Serbia</td>
<td>Slovenia</td>
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<tr>
<td>Timor-Leste</td>
<td>Turkmenistan</td>
<td></td>
<td>Switzerland</td>
<td>Ukraine</td>
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</tr>
<tr>
<td>Vietnam</td>
<td>Uzbekistan</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Note: Table only contains countries for which the CGIT has an investment or construction entry since the launch of BRI. Senegal has been added to the list by Citi.
Source: AEI, Citi Research

Energy and transport are the dominant sectors globally

Energy and transport are the dominant sectors across the globe, but some regional differences in sectoral patterns exist. They are usually a function of a region’s relative endowment in natural resources, level of development or geographic location such as sea-access or located between China and an important destination market.

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25 Gravity equations model bilateral flows like trade, investment, migration etc. as a function of characteristics like distance, size, and development of both markets historical ties, institutional characteristics etc. See Belgibayeva & Plekhanov (2016) “Does corruption matter for sources of foreign direct investment?” Birbeck Working Papers in Economics and Finance for an example using bilateral FDI flows.
Chinese involvement in East Asia BRI member countries has been just under $160 billion. Just above half of this is made up of investment, making East Asia one of the few regions where the BRI is not mostly about construction. Energy and transport are dominant in the sectoral distribution, but slightly less so than in other regions; investment and construction in these sectors represents 57% of the total, against 65% for the BRI region as a whole. The slightly higher diversification benefits mostly the logistics and real estate sectors. The latter is unsurprisingly more important in the region's more developed countries like South Korea, Singapore and Malaysia, while the former is essentially a result of the takeover of Global Logistics Properties (GLP), Asia's biggest warehouse operator and registered in Singapore, by a Chinese private equity consortium consisting of the Vanke Group, Hopu Investment Management, the Hillhouse Capital Group and the Bank of China. This makes Singapore the largest BRI investment market with over $24 billion, although this number might be misleading, since Singapore as a financial center is the legal domicile for many companies which have their main operations elsewhere.

When construction is added, the country with the most BRI related activity in East Asia is Malaysia, followed by Singapore and Indonesia. Relative to market size however, Laos has been the main BRI destination, with investment and construction since October 2013 at almost $18 billion exceeding the country's $17 billion GDP, followed by Mongolia and Brunei, where Chinese involvement since the launch of BRI stands about a third of current GDP according to CGIT data. The largest investment projects in the region since the launch of BRI are the aforementioned takeover of GLP for over $9 billion, followed by the $6 billion takeover of the Malaysian energy company Edra by the China General Nuclear Power Generation Corporation. Greenfield investments in Brunei's oil and South Korea's property market are listed in the CGIT at over $3 billion each. The largest construction contracts were granted for railway construction in Indonesia ($3 billion) and Thailand ($2.7 billion).
Investment and construction in West Asia by China is around $140 billion

West Asia comes second with a total investment and construction of around $140 billion since the launch of BRI. This equals 2.2% of the region’s 2017 GDP. More than two thirds of China’s involvement in the BRI countries of the region is in construction and both investment and construction are strongly concentrated in energy, which accounts for about half of it, and transport, which makes up another quarter (Figure 31). Russia is the country with the largest investment inflows, about $11 billion, mostly in the energy sector. A bit more than a third of this is greenfield investment. In addition, Chinese companies were awarded construction contracts worth around $13 billion, bringing the total involvement recorded in the CGIT to $24 billion. This grants Russia the second place in the region, ahead of Bangladesh with $21 billion, but with some gap towards Pakistan. The latter has attracted Chinese investment of almost $8 billion and construction contracts awarded to Chinese companies’ amount to $32 billion, mostly within the framework of CPEC. The total involvement is thus almost $40 billion, or 13% of GDP, which makes it the largest BRI market so far. Energy ($27 billion) and ($11 billion) make up 97% of Chinese investment and construction in Pakistan since October 2013. The region’s largest BRI project is also located in in Pakistan: the construction of a $6.5 billion nuclear power project in Karachi.
Relative to market size, Chinese involvement is larger in the Arab Middle East and North African region than in Asia. It amounts to $70 billion, 3.5% of the region's GDP. However, almost 90% of this represents construction contracts awarded to Chinese companies. Sizeable investments are limited to some greenfield in the oil sector in the Emirates and the purchase of a part of ExxonMobil's stake in an oilfield in Iraq. Besides its large construction activities in the energy sector, China has also been awarded significant construction contracts in the real estate sector in the Emirates, Egypt and Saudi Arabia. According to the CGIT, the region's largest BRI activity is a real estate construction deal in Egypt of $3 billion, likely the skyscraper-studded portion of Egypt's proposed new capital.  

Chinese investment and construction in BRI countries outside Asia and Arab Middle East & North Africa (MENA) amount to another $58 billion. Construction accounts for a bit less than two thirds of this. Transport and energy are once again the main target sector, with transport taking the lead (40%) as opposed to Asia and Arab MENA, where energy is dominant. The agriculture and entertainment sectors attracted about 10% of total investment and construction activity each, mainly because of Chinese acquisitions in Israel, the largest BRI market outside Asia and Arab MENA with about $12 billion in investment and construction. The largest BRI entry in the CGIT outside Asia and Arab MENA is also for Israel, the acquisition of Playtika, a game developer, by Giant Network for $4.4 billion. Relative to market size, Chinese involvement in Sub-Saharan Africa and the Americas is larger than in Asia or Arab MENA. However, this is to some degree just a consequence of the small number of countries in these groupings, particularly in the Americas. When lumped together with Israel and BRI countries in Europe, Chinese involvement amounts to 2.1% of recipient countries’ 2017 GDP.
4. Why China Should Care More About Financial Stability of BRI Countries

Infrastructure is often considered a key driver of national development and boosting a country’s growth prospects, especially among lower income economies where under-provision of capital would mean potentially higher returns. Thus, when China made big pronouncements about going into infrastructure investment via its Belt and Road Initiative (BRI) in 2013, this was largely embraced by the international community as a way to galvanize global growth and drive much needed competitive crowding-in of other financing sources for the same purpose.

But financing infrastructure requires predominantly debt financing, not all economies have the same degree of fiscal space and economic slack (which impacts fiscal multipliers), and some types of infrastructure projects cannot generate the economic returns needed to service the debt service obligations unless they are financed at very concessional rates with long grace periods and tenor, assuming these projects are eventually self-financing in the longer run. Moreover, not all creditors are as generous with concessional financing, and given that China is still a developing country, it’s not clear if China should be expected to be as generous. In fact, by some metrics, China already provides relatively higher official aid assistance (% of GDP) relative to its’ per capita income.28 Given the sheer scale of China’s BRI, the risk of large scale infrastructure projects undermining financial stability in borrowing states was bound to become an issue.

Chinese loans are particularly appealing in some low-income and developing economies as they come with “less-politically sensitive” strings attached, such as governance requirements (which can lead to very slow disbursements), policy adjustments (e.g., IMF loans), and human rights. However, they are accompanied by more Chinese-centric conditions, including the importation of Chinese labor, raw materials, and capital goods and the use of Chinese contractors with no open tender. While undue advantage to Chinese economic interests also carries its own political consequences in recipient economies,29 these terms can be concealed in the opacity of bilateral agreements.

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Note: We use 2014 data for all due to lack of updated data in China, and China’s data on ODA is defined differently as it includes both aid and non-concessional financing. Source: OECD, AidData at William & Mary,27 Citi Research

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29 One example is in the case of Indonesia, which Chinese labor importation became an issue during the Jakarta Governor elections. See: Reuters: In Indonesia, labor friction fuel anti-China sentiment.
Thus, in low income economies where institutions are often weak (in fact, 40% of the top 50 BRI-receiving countries are led by “autocratic” governments),30 large scale infrastructure projects can be a recipe for capital inefficiencies, which further undermine the economic viability of a project. Moreover, the softer budget constraints that Chinese loans provide can become an inhibitor to much needed structural reforms, or a version of “aid curse”, as found in a recent study analyzing Chinese development aid in 2000-2014.31

While infrastructure investments done right can be transformatively positive for an economy, recent empirical studies on the economic impact of infrastructure investment in emerging and lower-income countries have been less conclusively positive. The IMF finds the response to output from public investment booms is smaller in emerging market than advanced economies, while some studies find no discernible impact on long term output.32 Weaker output effects means investments would result in rising public debt-to-GDP ratios. Thus, improving investment efficiencies — e.g., via improved project evaluation and procurement standards — is critical in ensuring the (debt) sustainability of these infrastructure projects.

Otherwise, macro risks and unsustainable debt burdens of borrowing countries could result not only in rising credit and operational risk for Chinese banks and SOEs, but more importantly, but also a political backlash against China that would undermine China’s long term geopolitical interests at the heart of BRI. Instead of BRI being seen as promoting “win-win”, it could start looking like “China wins”.

30 We define “autocratic” as those that Freedom House classifies in 2018 as “not free”.
There seems to be a growing backlash against China for its alleged pursuit of “debt-trap diplomacy” heightened by BRI investments. These arguments need to be balanced by two points. First, if structured and chosen right, there are clearly some positive experiences with Chinese infrastructure investments, for example, the $1.6 billion Chinese investment in steel, aluminum, and palm oil processing plants and expansion of the Kuantan port in Malaysia in 2013 (though admittedly, preceded BRI). Second, BRI needs to be assessed more holistically, not only on the infrastructure project itself, but on the spillovers it can generate through private sector FDI. Ethiopia is an example where infrastructure helped catalyze the development of a vibrant industrial/manufacturing sector.

However, there is also the risk of heavily debt-financed BRI projects pushing a borrower country to make economic or political concessions to China. We think countries most prone are (1) those with Chinese friendly governments, and thus, open to receiving a surge in Chinese lending; (2) relatively small (with less bargaining power; doesn’t take a lot to make them heavily indebted while posing manageable risk exposure to Chinese lenders) and (3) have weak institutional safeguards against poor project evaluation. In an analysis by the Center for Global Development, seven of the eight countries it identified as being at significant debt risk from BRI are very small (only Pakistan is an exception), with nominal GDP ranging from $2 billion to $17 billion. Four of these are classified as “not free” in terms assessment of political and civil liberties.

### A Closer Look at Sri Lanka, Djibouti, and Pakistan

The most widely cited illustrative case of China’s “debt-diplomacy” is Sri Lanka, whose Chinese borrowings preceded the launch of the BRI. Former President Mahinda Rajapaksa was in the midst of ending the country’s 25-year civil war when he made a big push for infrastructure (power, road, ports, etc). One major project was the construction of the Hambantota Port in the sleepy and rural southern tip of the country in 2008. Hambantota is also Rajapaksa’s hometown, and thus, we think was also a politically expedient project for a re-election seeking President. In fact, the port was soon followed by the largely China-funded ($190 million out of $209 million) nearby Mattala International Airport, dubbed “the emptiest airport in the world.”

Sri Lanka was already very heavily indebted by the time it took on these projects, and it was apparent to many that the government wouldn’t have deep enough pockets to transform the jungle around Hambantota, which had poor connectivity and dearth of business activity, into a commercially viable port, especially when there was a bustling port in the capital of Colombo just 240km away, ripe for expansion.

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33 The term is attributed to Brahma Chellaney, “China’s Debt-Trap Diplomacy,” Project Syndicate (23 January 2017).
34 See Asia Economics View - Belt and Road Binds ASEAN Closer to China.
Rather than seeking direct equity investors to share the risk in the Hambantota venture, the government stuck by its nationalist/anti-privatization agenda to maintain control but borrow. The Sri Lankan government at the time bore responsibility for these choices — to borrow heavily on a project they themselves chose, but the country didn’t have the resources to economically sustain.38

To argue that China pursued predatory lending at onerous rates in order to deliberately push Sri Lanka into distress and seize assets is also misguided. China’s infrastructure lending is never meant to be purely aid. Instead, the over $1.7 billion Exim Bank of China agreed to lend to Sri Lanka for Hambantota Port development from 2007 to 2016 was lent in both concessional and commercial terms, or what the OECD would classify as other official flows (OOF) versus official development assistance (ODA). We estimate about 79% of the loans were fixed at 2%, with a 20 year tenor and a 6 year grace period, but the rest were at less preferential rates, partly because the initial $307 million loan in 2007 came when the government had already utilized its preferential loan quota from China from other projects — such as the Norochchalai coal power plant — and Sri Lanka was already at heightened credit risk at that time amid an intensified military offensive in the north to end the civil war.39

While China exacerbated the problem, China cannot be predominantly accountable for Sri Lanka’s debt woes, which eventually led the successor government of President Maithripala Sirisena to sell a 70% stake in a 99-year lease in Hambantota Port to China Merchant Holdings (CMH) for $1.12 billion in 2017. The country’s debt woes went well beyond China. On the general government level where data is readily available, China accounted for 9.2% of government external debt in 2017, but this underestimates China’s role as some Chinese lending went to public sector enterprises (PSEs). We estimate that China accounted for about 11.6% of combined government and PSE external debt, down from a peak of close to 14% in 2015 following debt reductions at the Sri Lanka Ports Authority (SLPA). While China-related borrowings certainly rose, it is clear that in a broader context, much of the debt build up went beyond China and was a result of other policies — e.g., low tax rates and narrow tax base — that led to a faster accumulation of government domestic debt and a rise of foreign debt owed to others, notably foreign bondholders.

38 The project idea also reportedly came from the Sri Lankans, and was not solicited by China. See Jonathan Hills. “Game of Loans - How China bought Hambantota”, CSIS Briefs (2 April 2018).
39 See http://www.xinhuanet.com/english/2015-06/04/c_134297249.htm. The initial $307 million for Hambantota Port Phase 1 development signed in October 2007 had a fixed rate of 6.3% (15yr, 4yr grace), and another $51 million loan in September 2012 had an interest rate of Libor +4% (15yr tenor, 4yr grace).
But China’s willingness to lend large sums to a project that Sri Lanka didn’t seem capable of economically sustaining suggests complicity — and that China lending objectives were not necessarily couched on “win-win” economic gains, but instead, lopsidedly geared towards China’s economic and geopolitical self-interest.

What happened in Sri Lanka likely bears a useful lesson — while China managed to secure control over a strategically located port in the Indian Ocean, it came at a cost of significant reputational damage (which was actually cited by the new Malaysian government when it canceled their Chinese-funded projects in 2018). China’s perceived close relations with former President Rajapaksa and governance questions around this probably contributed to Rajapaksa’s surprise election loss in January 2015. With heightened scrutiny, it will likely be difficult for China to use the Hambantota Port for military purposes (the Sri Lankan navy moved their southern headquarters to the port). It still remains unclear how much the China-controlled CMH-SLPA joint venture will need to spend to turn the fortunes of Hambantota Port around. Lastly, even former President Rajapaksa is now looking to capitalize on nationalist sentiment and seek to renegotiate the 99-year lease on Hambantota if his party returns to power in 2020.40

The smaller role of China in Sri Lanka’s debt build-up cannot be applied to the dramatic surge in Djibouti’s external debt in recent years. A tiny state bordering the neighboring land-locked Ethiopia and a gateway to the Suez Canal, Djibouti is heavily dependent on the strategic position of its deep seaport and the presence of foreign military bases (the most in the world, including China and Japan’s only foreign military bases). But with a nominal GDP of a little over $2 billion, it is easy to see how debt can increase dramatically on the back of mega infrastructure projects to which China has played a very disproportionately large role. In a mere three years, Djibouti’s public and publicly-guaranteed debt rose from about 50% of GDP in 2014 to almost 98% of GDP in 2017.41

However, what happened in Sri Lanka likely bears a useful lesson

China has played a large role in debt build-up in Djibouti through mega infrastructure projects

40 P. Saghal, “We will have to change 99-year lease…Rajapaksa”, Sunday Guardian (15 Sep 2018).
41 Government domestic debt of only 1% of GDP, it is state and its public enterprises that are the major sources of macro vulnerability.
In 2016, the IMF noted 77% of public enterprise external debt came from the Exim Bank of China alone, and China had accounted for 90% of the loans contracted from 2014 to 2016. By 2017, *Banque Centrale de Djibouti* noted that 97% of bilateral loans (or ~70% of total public sector external debt; 69% of GDP) came from China.

The IMF had identified Djibouti as being at high risk of debt distress in 2016, and large scale loans to public sector enterprises in recent years, amounting to at least $1.07 billion, were reportedly lent on commercial (i.e., not concessional) terms by Exim Bank of China. Beyond China benefiting from the loan, it also benefited from the use of Chinese contractors, machinery, and labor, and even have operational control, for example, in the case of the Addis-Ababa-Djibouti Railway. However, as these projects are relatively new or still underway, only time will tell whether how the state of Djibouti will handle repayments and how China will respond. The grace periods for two large Chinese loans — $490 million for the Addis-Ababa-Djibouti Railway and $580 million for the Multipurpose Port — end in 2019 and 2023, respectively.

The Addis-Ababa-Djibouti Railway was largely funded by commercial loans, according to Yun Sun’s “China and the East Africa Railways – Beyond full industry chain export” (*Brookings Institution*, 6 July 2017). The IMF Article IV Report in 2016 noted the Exim Bank of China’s loan to build a Multipurpose Port was also lent in commercial/non-concessional terms.

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**Figure 41. Djibouti: External Debt - Central Government & Public Enterprises**

<table>
<thead>
<tr>
<th>Year</th>
<th>Bilateral</th>
<th>Multilateral</th>
</tr>
</thead>
<tbody>
<tr>
<td>2012</td>
<td>48.8%</td>
<td></td>
</tr>
<tr>
<td>2013</td>
<td>48.0%</td>
<td></td>
</tr>
<tr>
<td>2014</td>
<td>49.9%</td>
<td></td>
</tr>
<tr>
<td>2015</td>
<td>68.3%</td>
<td></td>
</tr>
<tr>
<td>2016</td>
<td>86.0%</td>
<td></td>
</tr>
<tr>
<td>2017</td>
<td>97.9%</td>
<td>Owed to China</td>
</tr>
</tbody>
</table>

**Figure 42. Pakistan: External Debt - Central Government & Guaranteed Debt**

<table>
<thead>
<tr>
<th>Year</th>
<th>IMF Debt</th>
<th>Ext Debt owed to Others</th>
<th>Ext Debt owed to China</th>
<th>Share of China to Ext Debt* (RHS)</th>
</tr>
</thead>
<tbody>
<tr>
<td>FY2008</td>
<td></td>
<td></td>
<td></td>
<td>0%</td>
</tr>
<tr>
<td>FY2010</td>
<td></td>
<td></td>
<td></td>
<td>4%</td>
</tr>
<tr>
<td>FY2012</td>
<td></td>
<td></td>
<td></td>
<td>8%</td>
</tr>
<tr>
<td>FY2014</td>
<td></td>
<td></td>
<td></td>
<td>12%</td>
</tr>
<tr>
<td>FY2016</td>
<td></td>
<td></td>
<td></td>
<td>16%</td>
</tr>
<tr>
<td>FY2018</td>
<td></td>
<td></td>
<td></td>
<td>20%</td>
</tr>
</tbody>
</table>

Source: Banque de Djibouti, Citigroup Research

Note: “We include commercial loans from BoC, CDB, ICBC. We include IMF debt in debt owed to others. Source: SBP, EAD, MoF, CEIC, Citigroup Research

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42 The Addis-Ababa-Djibouti Rail line was largely funded by commercial loans, according to Yun Sun “China and the East Africa Railways – Beyond full industry chain export”, *Brookings Institution*, (6 July 2017). The IMF Article IV Report in 2016 notes that Exim Bank of China’s loan to build a Multipurpose Port was also lent in commercial non-concessional terms.
This then leads us to Pakistan, the largest commitment of China’s BRI so far, and where 22 projects worth $19 billion out of 51 projects worth $62 billion have already been implemented, nine of which have been completed.\(^ \text{43} \) The figures look large but the debt implications are much more complicated to assess. On the one hand, transport and infrastructure projects (including Gwadar Port development) are financed largely by concessional loans from China. But on the other hand, energy sector projects, the bulk of the China-Pakistan Economic Corridor (CPEC), are comprised mostly of FDI and commercial borrowings from Chinese financial institutions by majority-owned foreign-owned joint ventures or Chinese investors. Thus, the structure of the latter is less directly onerous on government debt, but they have three major adverse (though not very transparent) fiscal implications:

- They will exert a significant outflow pressure on the balance of payments in the coming years. As power projects are completed, outflows in the form of loan repayments, profit repatriation and imports of input fuel will likely be larger than the expected import substitution/savings from cutting costly fuel. The IMF forecasts these outflows will peak in fiscal year 2024/25. Thus, rupee depreciation pressures will likely further inflate the foreign debt repayments. Any potential improvement in the country’s export-generating capacity from better energy infrastructure will likely be undermined by the next issue…

- Poorly negotiated energy independent power producer projects with very high upfront tariff rates and “exceptionally high internal rates of return — 20% for some projects” — will undermine the competitiveness of Pakistan’s exports, hurt consumers, and as likely to be the case in a democratic system of government, may lead to a reluctance to pass on the costs to the public, resulting in widening losses at power distribution companies, or arrears to power supply companies that the government will end up underwriting. Thus, this could pose a rising risk to the government’s contingent liabilities.\(^ \text{44} \)

- CPEC also resulted in significant tax breaks/exemptions for the Chinese companies involved, including breaks in customs, income, sales, federal excise, and withholding taxes, resulting in significant foregone fiscal revenues.\(^ \text{45} \)

\(^ {43} \) See: https://www.fmprc.gov.cn/mfa_eng/zxxx_662805/t1593886.shtml


China now accounts for 20% of the government and government-guaranteed external debt in Pakistan. Given the sheer size of the economy, China’s role in the build-up of public and external debt in Pakistan is less dramatic than Djibouti’s, but more significant than what we saw in Sri Lanka, and could continue to mount. China now accounts for 20% of the government and government-guaranteed external debt, but only 6% of total public debt. Thus, while macro imbalances have increased during the period of large-scale Chinese infrastructure investment, it also coincided with a period in which the country was not in an IMF program and adverse macro policies (rigid exchange rate, low rates, and income tax cuts) were pursued, alongside resistance to proper cost recovery and efficiencies in its public sector enterprises.

But highly imbalanced and opaque negotiated deals favoring Chinese interests over Pakistan that cloud CPEC, alongside likely austerity policies Pakistan now needs to do to address macro imbalances, some of which are not related to CPEC but may be tied to bad policies from the “aid curse” of easy Chinese money (we expect **Pakistan to enter its 22nd IMF program**), could lead to some political backlash on China, and closer scrutiny on CPEC. Despite the country being China’s staunchest ally, even the newly-elected Pakistan government made mixed comments about CPEC. CPEC projects will remain largely supported, albeit they are likely to slow in implementation and increasingly become multilateralized by opening up participation to others, most recently to Saudi Arabia. We think it is important for China to have Pakistan CPEC — the poster child of BRI — be viewed as an economic success for Pakistan, in order to ensure the sustainability and influence of China’s BRI program over the longer term.

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Who Else Is Vulnerable?

We look across a broader list of economies targeted by BRI (or were targeted even before BRI) and which have likely been significant recipients of Chinese debt flows based on the amount of Chinese cumulative investment announcement data from AEI, to assess who is vulnerable to financial stability concerns. Our first smell test is by looking at the economy’s overall level of general government debt ratio, as compiled by the IMF (Figure 44). One important caveat is that while this data seems to incorporate guaranteed government debt, it doesn’t fully capture the debt of public sector enterprise which can be used as the borrowing vehicle to implement infrastructure projects, and thus, a significant source of contingent risk. This is best illustrated in the case of Djibouti, which had a general government debt ratio of just 31% of GDP, but government and public sector enterprise external debt has risen to about 100% of GDP.

We then look at the economy’s twin current account and fiscal balances (Figure 45). Economies with larger twin deficits, especially assessed more on the current account deficit side (as fiscal balances can be misleading based on accounting rules; BRI-fueled imbalances may show in consolidated public sector balances). Combining the assessment of both debt stock/solvency vulnerabilities with “flow” vulnerabilities that could lead to a shortage of foreign exchange to meet re-payments, we assess “hot spot” countries more vulnerable to macro imbalances:

Figure 44. Select BRI Countries: General Government Debt, 2018E (Percentage of GDP)

Note: We include Angola and Zambia even though they are not officially one of the BRI signatories as they receive sizeable BRI-like Chinese investments

Source: IMF, Haver Analytics, Citi Research
In Central and South Asia, Maldives, Pakistan, Laos, Kyrgyzstan, and Tajikistan are economies to monitor in terms of high debt ratios, large twin deficits, and a pipeline of BRI projects (Sri Lanka has less now), alongside Cambodia, and Myanmar, where debt ratios are more moderate. For example, a key BRI project in Laos is the $6 billion railway from Laos to China, with a 70-30 joint venture split between the Lao government and China Railway and where Laos is funding its initial construction cash outlay via concessional loan from the Exim Bank of China. However, commercial viability of this project is unclear.\(^{47}\)

\(^{47}\) We earlier said it would need a significant uptake of rail passengers to make it viable, but 23% of the Lao population lives below the poverty line.

\(^{48}\) Nick Miller, “’Why are they giving us the money?’ Behind China’s plans to ‘rescue’ a decrepit rail link” Sydney Morning Herald (25 June 2018).

In Central and Eastern Europe, Montenegro looks the most vulnerable, with the IMF noting the China-funded Bar-Boljare highway was a key driver of Montenegro’s rising debt ratios, and fiscal space does not exist to fund the rest of the highway phases with debt. Serbia and Hungary need monitoring given their high debt levels and if the China-funded Belgrade-Budapest railway goes through, with some calling the project “insane”\(^{48}\).

In Africa, despite China’s increasing announcement of lending commitments to the continent, the size of actual Chinese-related lending still remains relatively small and mostly at preferential / concessional rates. Aside from Djibouti that we already described earlier, Senegal and Ethiopia may need to be monitored (latest Article IV report characterized Ethiopia as being at “high risk of distress”\(^{49}\)) alongside Angola (now seeking an IMF program\(^{50}\)) and Zambia who, though not officially a BRI country, has effectively folded into BRI, and is facing macroeconomic stresses.

\(^{48}\) In the IMF’s last Article IV report on Ethiopia published in January 2018, it characterized Ethiopia as being at “high risk of distress”\(^{48}\).

\(^{49}\) In the IMF’s last Article IV report on Ethiopia published in January 2018, it characterized Ethiopia as being at “high risk of distress”\(^{49}\).

\(^{50}\) See IMF: Statement by IMF Deputy Managing Director Tao Zhang on Angola.
Why China Should Care About Macro Imbalances of Borrowers?

If China’s aim of BRI is to move beyond just exporting excess capacity and creating short-term opportunities for its SOEs and laborers via overseas contract work, but also to generate some international “soft power” (increasingly important in a world of U.S.-China “strategic rivalry”) and longer-term growth opportunities, then China should care about how these public investment projects are funded and the quality of the projects:

- Countries with unsustainable debt and significant macro imbalances experience a negative feedback loop of rising borrowing costs and pro-cyclical policy tightening, amplifying growth downturns and leading debt ratios to rise even further. Escalating country risk premiums in its most extreme cases lead to a sudden stop of capital flows, foreign exchange and banking distress, and a significant shock to local incomes. This would undermine returns to Chinese investments and the ability to develop future export markets for Chinese companies.

- In its more extreme case, a default would incur credit losses to Chinese creditors, in the form of rescheduling and write-offs. A good example is the situation in Venezuela where the China Development Bank reportedly lent over $60 billion since 2007. Venezuela’s policy mismanagement culminated with the collapse of oil production which not only meant Venezuela could not make its contractual oil payment obligations, but loss of supply led to the higher oil prices, which undercut China’s interest as a net oil importer.  

- Bad economic outcomes in borrowing countries, and perception of governance issues, and “politicized loans” could have disruptive political consequences in countries where leaders are held accountable by the ballot box. While China was not directly implicated, governance issues was a big factor that led to the surprise electoral losses of two strong China-allies, Sri Lanka’s ex-President Rajapaksa in January 2015, and Malaysia’s UMNO/BN former Prime Minister Najib Razak in May 2018.

- Bad projects can weaken international cooperation/political relationships, leading to project cancellations and erosion of trust. Under the leadership of former Prime Minister Najib Razak, Malaysia was one of China’s strongest allies in Southeast Asia. A high-profile BRI project, East Coast Rail, could have given China an alternative route to the very narrow Straits of Malacca, where 80% of China’s energy supplies from the Middle East transit. As this could be potentially blockaded in the event of hostilities, securing an alternative route was strategically important. However, following UMNO’s surprise defeat in May, the new Prime Minister Mahathir Mohamad became an open critic of China’s debt trap diplomacy, and subsequently canceled three Chinese projects worth $22 billion (including the East Coast Rail Link).

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52 This is a problem termed by former Chinese President Hu Jintao as the “Malacca Dilemma”.

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Without an existing model to copy for BRI, China will need to analyze, learn, and experiment to get the right model.
5. ASEAN: The Core of the BRI

The Belt and Road Initiative (BRI) is gradually extending China’s economic relationship with ASEAN, from primarily being a trading partner, to an increasingly important direct investor and builder. China’s investment foray into ASEAN started around 2008, but was given a second tailwind after the launch of the BRI in September 2013. As a result, while China-ASEAN trade was more than 40 times larger than China’s FDI into 2005, this multiple had declined to 28 times by 2017. Similarly, construction contracts have risen from 3.2% of merchandise trade in 2010-2013, to 4.4% by 2017. These trends have brought benefits to ASEAN from both a growth and external financing perspective. Although the BRI has met setbacks in 2018 due to concerns over debt and leakages, broader geostrategic imperatives and China’s rising trade tensions with the US will likely drive an eventual recovery in BRI projects in ASEAN.

Since the launch of BRI, China’s enlarged investment and construction footprint in ASEAN has been evident in terms of *scale, scope, and significance*:

- In dollar terms, construction contracts awarded to Chinese firms in ASEAN were on average 55% higher each year during the post BRI period (2014-2017) compared the immediate pre-BRI period (2010 – 2013). These contracts represent 52% of China’s total project announcements (i.e., the sum of investment commitments and construction contracts awarded) in ASEAN since 2014 — consistent with the common association of the BRI with construction projects awarded to Chinese SOEs and funded by Chinese policy banks. Such contracts do not entail any transfer of ownership to Chinese entities, implying that the relationship with the host country is more transient and arms’ length in nature.

- But the surge in China’s construction activity needs to be viewed within the broader context of the concurrent surge in Chinese equity investments into ASEAN. Between 2014 and 2017 China’s annual investment commitments into ASEAN were around 120% higher compared to the 2010-2013 period. As a result, ASEAN and China’s mutual dependence as investment partners has only risen — China accounted for 12.4% of realized FDI inflows into ASEAN in 2014-2017, up from just 10.1% in the preceding three years. From China’s perspective, ASEAN has also become more important, with ASEAN increasing its share of realized ODI from China by 0.9 percentage points to 10.2% in the same period.

- Since the launch of BRI, Chinese investments in ASEAN have been increasingly diversified across a broader range of both “old economy” and “new economy” sectors. Although projects in transport and energy infrastructure have been the dominant focus of the BRI since 2014, investment commitments in manufacturing, financial services, distributive sectors, and technology firms have surged. ASEAN is thus emerging as a key node in transport networks under the BRI, while providing a conduit for China to export excess capacity in many of its “old economy” heavy industries, and for “new economy” tech firms to expand. With regards to the latter, recent investments by tech giants like Alibaba and Tencent in ASEAN are reducing constraints on logistics and e-payment adoptions that will boost e-commerce in the region.
Since 2014, **Malaysia** and **Singapore** have been larger recipients of Chinese projects, attracting project announcements worth an average of 2-2.5% of GDP, reflecting their strategic location and historically closer ties with China. Between the two, a heavier concentration in greenfield investments and construction contracts implies Malaysia has probably enjoyed a larger boost to real GDP growth from these projects. In contrast, more than two-thirds of projects in Singapore are in the form of M&A-type deals, which simply involve a transfer of ownership, rather than addition to capital stock, with greenfield investments largely in less productive real estate. While comparatively small in dollar terms, **Vietnam** has also enjoyed relatively large greenfield investments to the tune of around 0.5% of GDP since 2014, largely in the energy sector. While large in dollar terms, greenfield investments into **Indonesia** have averaged just 0.2% of GDP, but have been significantly augmented by large construction projects worth 0.4-0.5% of GDP, especially in the energy and railway sectors. **Thailand** and the **Philippines** have been relatively small recipients, overwhelmingly through construction contracts.

ASEAN has of course not been alone in receiving Chinese investments, but its primacy within BRI has been cemented since 2016, both **quantitatively** and **qualitatively**. ASEAN’s share of Chinese projects within BRI rose from slightly under a third in 2014, to 45% in 2017. Indeed, since 2016, ASEAN has overtaken West Asia in receiving the lion’s share of Chinese projects. Qualitatively, China has been more willing to acquire equity stakes in ASEAN. Investment commitments accounted for 48% of total project announcements in ASEAN versus 28% for the BRI regions as a whole, perhaps reflecting Chinese companies’ greater familiarity and confidence in ASEAN, and hence greater willingness to deepen their level economic involvement. In terms of sectors, there has been a slightly heavier emphasis on energy, transport, and real estate in ASEAN, though the importance of real estate will wane going forward amidst tighter Chinese restrictions on such “unproductive” outflows.
ASEAN has already felt some growth benefits from the positive Chinese investment shock since 2014. Beyond the cyclical lift, UNCTAD has estimated Chinese entities may have met around 17% of ASEAN’s infrastructure needs in 2014-17, in turn helping to reduce transaction costs and promote regional integration. This may have conferred a variety of longer-term structural benefits through the reduction in transaction costs, raising productivity, and promoting regional integration.

It is estimated that Chinese entities may have met ~17% of ASEAN’s infrastructure needs in 2014-17.
For example, land transport infrastructure investments could alleviate traffic congestion, which costs as much as 1.1-2.2% for Kuala Lumpur and 11% of annual GDP for Metro Manila. Investments in transport infrastructure also help promote economic integration both within ASEAN, and between ASEAN and China. The planned Kunming-Singapore Railway would integrate and promote trade and people flows between the northern (Thailand and the CLMV regions — Cambodia, Laos, Myanmar, and Vietnam) and southern economic corridors (Peninsular Malaysia) in mainland ASEAN, as well as between ASEAN and China.

Chinese projects are also likely to increase ASEAN’s exporting capacity in certain industries. For example, the share of aluminum in Malaysia’s exports more than doubled, since China invested $1.6 billion to build steel, aluminum, and palm oil processing plants and expand the Kuantan port in 2013. By helping to bridge the infrastructure gap in Indonesia and the Philippines, Chinese investments could play an important role in drawing more export-oriented FDI, hastening their transition towards an export-oriented industrialization growth model, just as Japanese investments did the same for Malaysia and Thailand in the late 1980s and 1990s.

Growth benefits aside, the influx of Chinese capital has also helped shore up ASEAN’s external balances, especially as current accounts deteriorate amidst the recovery in fixed investments. For example, realized inward FDI from China and Hong Kong accounted for nearly 14.3% of ASEAN-4’s basic balance (Current Account + net FDI) surplus in the period 2014-2017, more than double the 6.6% in 2010-2013. Clearly, the biggest beneficiaries of Chinese financing are economies with current account deficits (Philippines and Indonesia) or relatively small current account surpluses (Malaysia). Economies that are vulnerable to large foreign portfolio outflows (Indonesia and Malaysia) also benefit more from Chinese financing at the margin. In the current context of portfolio outflows from emerging markets, external financing support from Chinese capital may prove timely. As an example, FDI from China accounted for 20% of ASEAN-4’s balance of payments surplus in 2016, but was as much as 74% in 2013, during the Taper tantrum.

The influx of Chinese capital has helped shore up ASEAN’s external balances
Chinese capital dependence extends beyond FDI to loans from Chinese banks

Rising dependence on Chinese capital extends beyond equity-dominated FDI to loans from Chinese banks, which are often linked to construction contracts awarded to SOEs. Given the sensitivities involved in the ownership of strategic infrastructure assets, concessionary loans from Chinese banks could be a preferred means of project financing, as opposed to FDI, which involves ownership transfer via a sale in a minimum 10% equity stake. Our estimates suggest that loans from China’s state-owned and policy banks sector contribute financing for close to half of the planned BRI projects of $900 billion, with the remainder funded by loans from multilateral institutions such as the AIIB, and equity investments from regional cooperation investment funds.

We moreover have yet to include the indirect benefits that may accrue to ASEAN, as the BRI catalyzes more Japanese projects in the region. Bidding contests between Chinese and Japanese companies for a number of recent projects (e.g. Jakarta-Bandung Railway project, KL-Singapore High Speed Railway) are a clear example. Following Duterte’s “Pivot to China”, Japanese companies have also become more active competitors in bidding for infrastructure contracts in the Philippines. More recently however, Japan’s Prime Minister Abe expressed Japan’s intention to cooperate with China in the BRI. Media reports are suggesting that Japan could provide loans through government-backed financial institutions, with a focus on “green” sectors, industrial modernization, and logistics. More recently, Malaysia has revived the Look East policy of the 1980s, as a hedge against a possible pullback in Chinese investments. Whether motivated by competition or cooperation, these developments could point to indirect multiplier effects from an enlarged Chinese footprint in the years to come.

Overall, we are optimistic on the benefits that BRI can bring to ASEAN, but would also be careful not to overstate them. First, the relatively modest 8% per year increase in greenfield investments commitments since 2014 (versus a threefold increase in non-greenfield investments) suggests the immediate lift to headline GDP growth should not be exaggerated. Conceptually, greenfield investments occur when new facilities and operations are built from scratch, thereby adding to real GDP growth via higher gross fixed capital formation (GFCF). Non-greenfield investments are broadly M&A type transactions, which involve only a transfer of ownership, rather than a net increase in capital stock, though such transactions may involve a transfer of technical knowledge that could raise growth indirectly via productivity gains.

Second, the scope for leakages in both goods and services imports are significant, especially for construction contracts. Conceptually, construction contracts awarded to Chinese firms are classified as services imports, and by themselves, are subtracted from the current account balance and GDP growth. We previously found positive and somewhat significant correlations between China’s ODI and steel product exports, indicating that China exported the majority of steel to countries in which it invested substantially.

Third, we should not underestimate non-financial obstacles that can lead to project failure. Chinese companies and parties can bring financial resources and technical expertise, but it is not clear if they will be adequately prepared to tackle implementation challenges, which may differ from country to country, e.g., land acquisition in Indonesia and security challenges in Philippines. More recently, frictions with local ASEAN partners have emerged due to leakages and nationalistic concerns, culminating in a rise in troubled transactions, as we elaborate later.
Fourth, there are valid questions about the commercial viability of many of the infrastructure projects, including the East Coast Rail Line in Malaysia, and the Bangkok-Nakhom Ratchasima High Speed Railway in Thailand. Critics have noted for example, that the East Coast Rail Line (ECRL) in Malaysia will require an exponential increase in freight volume to 53 million tonnes of cargo per year by 2040 (vs. 6mn tonnes in 2016), especially if it is to cover the elevated construction cost of RM55 billion ($8bn). Commercial viability of the Laos-China High Speed Railway in Laos will require a sufficient uptake of domestic rail passengers (initial target: 4 million/year, medium-term target: 8.6 million/year) and ramped up economic vibrancy, but there are doubts given that 23% of the 6.8 million population still lives below the national poverty line and 8% of all employed workers still lack road access.

Finally, there is risk from rising external debt and contingent liabilities to ASEAN sovereigns from projects that lack commercial viability. External debt in ASEAN-5 (ex-Singapore) has already risen since the launch of the BRI to 38.6% of GDP (2013: 36.5%), led by Vietnam, Indonesia, and Malaysia. While the portion of this due to Chinese creditors is unclear, this trend is likely to continue against a backdrop of rising Chinese involvement. As of end-2017, loans guaranteed by the Indonesia government totaled $6.8 billion (IDR91tn) or 0.7% of GDP, of which about three-quarters are related to power plant / electricity related projects. With electricity tariff adjustments often delayed, concerns over commercial viability of power plant investments have risen.

These concerns have been building more recently, partly explaining the sharp 36% YoY drop in new project announcements from China in the first half of 2018, following the sharp increases between 2014 and 2017. The recent drop led mainly by weakness in greenfield investment commitments and construction contracts, with sharper drops in Indonesia, Malaysia, and Philippines, though stronger in Cambodia, Vietnam and Singapore.
We see at least three reasons for the recent slowdown:

- **First**, the high base of comparison in the first half of 2017, due to a bumper crop of mega railway projects, without which project announcements would have risen marginally by 6%.

- **Second**, Chinese restrictions on capital outflows in sensitive sectors effective March 1st 2018 may have stifled investment commitments. The list of “sensitive” sectors includes hotels, media, motion picture studios, real estate, and sport clubs. To the extent that such rules may have been partly intended to stem capital outflows from China, limit depreciation pressure on the renminbi and prevent a loss of confidence on renminbi-denominated assets, they may have contributed to the sharper fall in investment commitments.

- **Third**, Chinese projects have also met stronger pushback from ASEAN host countries, amidst rising fears of a “debt trap”, alleged weak governance structures for many of the infrastructure projects, complaints of limited positive spillovers for local firms and labor, and perhaps broader geopolitical concerns.

The pushback has been strongest in Malaysia. Following the May 9th elections, the newly elected government has suspended work on the East Coast Rail Line (ECRL) and cancelled gas pipeline projects, on the grounds of alleged wrongdoing by the previous Najib administration, and excessive debt burdens. Vietnam saw mass protests starting in June on government plans for draft laws on special economic zones (SEZs) which will allow foreigners to lease land for 99 years, amidst public concerns that these leases will be dominated by the Chinese. More recently, in the Philippines, rising concerns in the media that promised Chinese investments have yet to materialize have coincided with President Duterte taking a more assertive stance on security issues in the South China Sea.

As a result, troubled transactions – defined as projects which were impaired for non-market reasons - jumped threefold between the first half of 2018 and 2017 to $2.4 billion. Still, relative to the size of committed Chinese project announcements, troubled project rates in ASEAN remain far lower than other BRI regions in Eastern Europe and West Asia. Thus despite recent events and taking a broader perspective, ASEAN remains a relative “safe haven” for BRI related projects.
Notwithstanding the weak data in the first half of 2018, Chinese investments are likely to recover eventually. Most importantly, China’s overarching geostrategic imperatives in ASEAN suggest there is an incentive to accommodate the concerns of host countries to avoid derailing the BRI. ASEAN’s strategic importance to China should be understood not just from an economic perspective, but also a security perspective, given the former’s location at the confluence of China’s major land and maritime trading routes. Within ASEAN, three geographical regions stand out in particular:

- **The narrow Straits of Malacca waterway** – through which 80% of China’s energy supplies from the Middle East will transit - which could be potentially blockaded in the event of hostilities (a problem termed by former Chinese President Hu Jintao as the “Malacca Dilemma”).

- **The South China Sea (SCS)**, through which oil transits from the Straits of Malacca before reaching China, also contains proven oil reserves of seven billion barrels, and estimated 900trn cubic feet of natural gas. The SCS accounts for a very significant proportion of China’s annual fishing requirements, and so is critical for China’s food and energy security. Control of the SCS could thus partly alleviate the Malacca Dilemma for China.

- **Mainland ASEAN**, which shares a long border with China’s inland Yunnan province, will host the 3000km Singapore-Kunming high speed railway, through which China can better project its economic influence into a region which is clearly also important to it from the security perspective.

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*Figure 59. ASEAN’s Strategic Location at the Confluence of China’s Major Land and Maritime Trading Routes Could Be a Motivating Factor Behind Key BRI Infrastructure Projects*

Source: The World Factbook, Citi Research
In the current context of increasing geostrategic competition vis-à-vis the U.S., China’s security concerns in the South China Sea and Straits of Malacca can only intensify. Consequently, pragmatism will dominate the BRI agenda in our view. Thus China may be incentivized to be more accommodating towards concerns of its ASEAN partners. Over time, this may result in more favorable terms for major infrastructure projects. If and when capital outflow concerns subside, the Chinese authorities might be more amenable to shifting towards equity-based financing for major projects. On their part, the infrastructure focus of BRI remains aligned with regional development initiatives, which incentivize ASEAN governments to support BRI projects if terms are made more palatable.

Moreover, while ASEAN governments are concerned about debt-funded SOE led infrastructure projects, ASEAN countries will continue to welcome Chinese private sector FDI. Chinese private sector firms accounted for 95% of investment commitments in the first half of 2018, up from 79% in 2017. Private sector investments in the first half of 2018 alone totaled $3.8 billion, higher than the average annual rate of $3.7 billion in 2011-2016. Our data set moreover has yet to capture several high profile Chinese investments in recent months, such as Alibaba’s launch of a regional hub in Malaysia in June, and the signing of Memorandum of Understanding’s (MoUs) between Indonesia and China worth $23 billion.

Indeed, Chinese private sector FDI into ASEAN could be catalyzed by the need to circumvent rising U.S.-China trade tensions. Trade frictions between Japan and the U.S. in the 1980s for example saw Japanese firms increase direct investment into East Asia to build “export platforms” for the U.S. market. More recently, U.S. tariffs on China-made solar panels and washing machines prompted a shift in production to Malaysia and Vietnam. While production relocation away from China was led by foreign firms, there are growing signs that Chinese companies may do the same. For example, Chinese bike manufacturers have announced relocations to Vietnam, while a mattress company is reportedly opening a plant in Thailand. On aggregate, economies which benefit the most from such relocations are those with a similar export product structure (and hence supply chains) to China, and comparable or lower costs. Based on a higher degree of export product similarity vis-à-vis the $250 billion of Chinese exports to the U.S. that will likely be subjected to higher tariffs, we found Vietnam, Malaysia, Indonesia and Thailand to be bigger beneficiaries of production relocation.

Figure 60. Private Investment Contributed to 95% of Investment Commitment in ASEAN in 1H 2018, Higher than the 78% Recorded in 2017

Figure 61. Vietnam, Malaysia, Indonesia, and Thailand Have a Relatively High Similarity in Export Products Vis-à-vis China’s $250 Billion of Exports to the U.S. That Will Likely be Subject to Higher Tariffs

Source: AEI, Citi Research

Source: Comtrade, Citi Research Note: China, Hong Kong and Italy are removed
6. Russia, Eurasia, and China: The New Geopolitics

Russia views the BRI initiative chiefly through the prism of combining forces with the Eurasian Economic Union (EAEU) to promote its “Greater Eurasia” vision and less as an avenue for a pure economic integration. Since China’s announcement of the BRI in Kazakhstan in 2013, Russia’s view about this initiative has experienced a gradual evolution from suspicion to lukewarm acceptance and, finally, a full embrace. We argue two main events have shaped Russia’s thinking over the last five years. First, Putin’s idea about creating a harmonious society form Lisbon to Vladivostok has suffered a blow in the aftermath of the Ukraine crisis as tensions with the West have intensified. As a result, Russia has lowered its expectations by focusing on formalizing a more modest geopolitical and geo-economic formation to span the Saint Petersburg to Shanghai space (Greater Eurasia), but only within the framework of, or in cooperation with, the Russia-driven EAEU. Second, the U.S. designation of Russia and China as strategic rivals and revisionist powers at the end of 2017 has given a new impetus for both countries to work closer together, culminating in the decision to sign a formal agreement on trade and economic cooperation between China and the EAEU in May 2018. Beyond that it is hard to find convincing evidence that the BRI had delivered any significant economic benefits to Russia/CIS over and above China’s already increasing involvement in the region in the last 20 years or so.

Russia’s initial cold reaction to the BRI may be best understood as a legacy of the long-standing suspicion of China’s role in Central Asia/Eastern Russia. Russia and China cozied up to each other in the 1950s as communism was marching ahead, but this loose alliance was tested later by mutual suspicion that even led to some border clashes. While Post-Soviet Russia had the West as a priority, it did start to pay more attention to China in the late 1990s as relations with the West became tense. Nevertheless, Russian policy makers never lost their sense of suspicion of China’s intentions and these feelings were properly manifested in the initial reactions to the BRI. These ranged from emphasizing Russia’s and China’s competing interests in Central Asia to outright warnings that the BRI is an openly anti-Russian initiative aimed at economically stifling land and sea routes, including the Trans-Siberian Railway and the Northern Sea Route.

However, geopolitical considerations soon led to significant changes in the way Russia started to look at the BRI and, more broadly, China. The Ukraine crisis and the subsequent deterioration of relationships with the West changed the calculus and forced Moscow to reconsider its views with regard to China. A more favorable opinion of the BRI started to emerge and these focused on the view that only via collaboration with a rising China can Russia maintain its influence in Central Asia. There was even some resigning to the fact that Russia may not be strong enough to compete with China in the regions and, therefore, may need to play a second fiddle in the hope of enlisting China’s support in the greater antagonism with the West.

This process has culminated in Russia’s warm embrace of the BRI at the highest level. Whatever the exact reasons for this shift may be, there is no denying the fact that, currently, Russia shows strong support for the BRI as exemplified by President Putin’s recent statement that “Russia has always been a firm supporter of the BRI” because “it matches our effort to establish an alliance in the Eurasian economy”.54

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This indeed fits nicely with Russia’s strategic intentions to build a “Greater Eurasia”. This is now understood as a much less ambitious goal that Putin’s 2010 vision of creating a harmonious economic community stretching from Lisbon to Vladivostok, but it does underscore Russia’s goal to build a comprehensive partnership between Russia and Asia on the basis of openness and transparency, including the possibility of joining together the EAEU, the Shanghai Cooperation Organization (SCO) and ASEAN55 (Figure 62).

At the same time, the BRI should be set against Russia’s own attempts at consolidating the former Soviet space via the EAEU. Russia itself has advanced its own agenda in the former Soviet Union space via the creation in 2015 of the Eurasian Economic Union, now comprising Russia, Belarus, Armenia, Kazakhstan, and Kyrgyzstan. Even if the EAEU does not have an explicitly-stated foreign policy goal and a common foreign policy, being at least nominally created to promote trade in a customs union, it does have the trappings of a Russian effort to consolidate and formalize its influence at least on part of the Former Soviet Union.

As a result, Russia has been advancing the view that only a cooperative effort between the BRI and EAEU can lead to a successful collaboration of Russia and China in the region. Given the overlapping territories of the BRI and EAEU, and Russia’s own ambitions in the region, Russia has been advancing the view that the BRI can be successful only if the EAEU and BRI work together in the hope of creating that elusive, but tantalizing, common Eurasian space (Figure 63).

China was initially not enthusiastic about the EAEU. This related partly to China’s revealed preference for bilateral over multilateral talks with Central Asian nations. More pointedly, China saw EAEU as an artificial and unnecessary institution, only hindering regional cooperation.56

However, U.S. designation of Russia and China as strategic rivals and revisionist powers at the end of 2017 has given a new impetus for both countries to work closer together in the Eurasia space. This may have served as the accelerating force behind setting aside China’s own misgivings about moving beyond the 2015 agreement to loosely harmonize the BRI and EAEU by signing a formal agreement between China and the EAEU in May 2018.57 The agreement is expected to take effect as early as 2019 and it covers 13 chapters such as customs cooperation, trade facilitation, intellectual property rights, sectoral cooperation, and government procurement, including new topics like e-commerce and competition.

Can Russia and China avoid the Thucydides Trap in Central Asia or “Never against each other, but not necessarily with each other”? In our view, the deeper cooperation between China and Russia, including via the integration between the BRI and EAEU, should be chiefly viewed through the words of Andrei Denisov, the Russian Ambassador to China, who has argued that the relationship is “not a romantic union of one heart, but a calculated marriage”. Some have even alluded to the possibility of Russia and China falling into the Thucydides trap, referring to the Peloponnesian War when the rising power of Athens challenged the dominant power of Sparta. In the Eurasian space (in particular Central Asia), the trap is that the dominant power of Russia may feel challenged by China, leading to a dangerous conflict. However, as Trenin has argued, while Russia and China are unlikely to create a formal alliance, in the current geopolitical backdrop they will follow a strategy where they are “never against each other, but not necessarily with each other”. The BRI and the increasingly more intimate relationship with the EAEU is but only one manifestation of this approach.

In practical terms, this means an agreed compromise whereas Moscow accepts China’s more active role in Central Asia while China acknowledges the EAEU as an equal negotiating party. Russia probably needs to accept that it will be the junior partner in this dynamic relationship while China understands that its BRI goals in Central Asia may not materialize without Russia’s support given the latter’s influence in the region. This may result in a symbiotic relationship in which Russia exercises local political influence by providing security while China carries its weight by providing modest investment sweeteners.

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59 Trenin, “Russia’s Asia strategy: Bolstering the eagles’ eastern wing”, 2016.
Beyond this geopolitical compromise, it is hard to argue that the BRI has delivered any discernible independent economic benefits to the Commonwealth of Independent States (CIS) region. The significance of China’s trade with the region has been growing steadily in the last 20 years or so, reflecting its increasing weight in global economic growth and trade (Figure 64). Trade turnover peaked at around $140 billion in 2013, a 25-fold increase since 1995, but, ironically, dropped significantly in the next couple of years just as the BRI was ushered in. Of course, this was related to the fact that commodity prices, being the key CIS export item to China (Figure 65), fell significantly in value during 2014/15. Exports have now started creeping up in line with recovering energy prices. In any case, one fails to observe an independent positive effect of the BRI on trade with the region.

Russia’s own trade relationship with China exemplifies this point. As Russia courted the West (and vice versa) in the post-Soviet period, paying less attention to Asia, trade with China remained modest. Only 5% of overall goods exported headed there (Figure 66). However, this share had been trending up over the last 10 years, more than doubling to almost 11% in 2017, as both countries started to see more eye-to-eye in geopolitical terms. It is also fair to say that this was achieved mostly at the expense of Europe, with Russia’s share of exports to Europe falling from almost 60% in 2006 to less the 45% now.
It was more the booming energy trade vs. BRI that made China Russia's largest trading partner. Russia did not export any energy to China in 1996. But what a difference the last 20 years have made! In 2017 Russia overtook Saudi Arabia as the largest exporter of oil to China. Moreover, its share of energy exports, while still significantly lagging that to Europe, stood at 14% as of 2017 (Figure 67). This relationship will only get more robust with the expected completion of the Power of Siberia pipeline in 2019, which is set to expand the supply of energy to gas as well. In any case, even if China has now become the largest single-country trading partner of Russia, this has mainly to do with the booming energy trade rather than any additional benefits related to the BRI.

It was much more the booming energy trade than the BRI that made China Russia’s largest trading partner. Russia did not export any energy to China in 1996. But what a difference the last 20 years have made! In 2017 Russia overtook Saudi Arabia as the largest exporter of oil to China. Moreover, its share of energy exports, while still significantly lagging that to Europe, stood at 14% as of 2017 (Figure 67). This relationship will only get more robust with the expected completion of the Power of Siberia pipeline in 2019, which is set to expand the supply of energy to gas as well. In any case, even if China has now become the largest single-country trading partner of Russia, this has mainly to do with the booming energy trade rather than any additional benefits related to the BRI.
China provides higher value-added goods to the region. Equally true, China has transitioned from a relatively minor provider of goods to the region to becoming second only to Russia. In particular, China’s share in CIS-ex-Russia imports has grown from 4% in 1995 to almost 10% in 2017 (Figure 68). This is still lower than Russia’s 15% share, but it is clear that China’s involvement in the region has become bigger and more active. In return for the energy inputs it receives from the CIS, it provides higher valued-added manufacturing goods, machinery, and transport equation (Figure 69).

As a result, the symbiotic relationship in geopolitics is matched by a similarly intimate link in trade. The security-investment nexus in geopolitics where Russia provides security and China investment in Central Asia is thus matched by the energy-manufacturing nexus where Russia and the CIS export almost exclusively commodity exports to China in return for manufacturing goods.

In contrast, the relationship between Russia/CIS and China is much more one-sided in relation to investment. China invests incomparably more into Russia/CIS than vice versa. For example, Chinese investment contracts have increased more than tenfold since 2006. Russia remains the primary destination, but it is followed closely by Kazakhstan and, less so, by Turkmenistan and Uzbekistan.

A significant part of the post-2013 investments is clearly related to the BRI. BRI-related investments have gone up from virtually zero in 2013 to $40 billion by 2018. This currently represents about a third of all recorded investment contracts, suggesting that a major part of the enhanced investment activity in recent years is indeed related to the BRI (Figure 70 and Figure 71). While about half of these project investments are in Russia, they represent a smaller share of all investments in Russia than, for example, for Kazakhstan and other Central Asian economies that are set to serve as the key conduits for connecting China to Europe.

Data on Chinese FDI in the region confirms the point that countries that are alongside of the proposed Silk Road Economic Belt stand to be the key beneficiaries of BRI in the region. Even if Russia remains the largest FDI investor in the region, there are three countries where China had taken the lead. Kazakhstan, Kyrgyzstan, and Tajikistan stand out with significant share of Chinese FDI investment both as a share of GDP and total FDIs (Figure 72 and Figure 73). For example, Chinese FDI in Kyrgyzstan amount to 20% of GDP (versus Russia’s FDI to the country of 15% of GDP) and 40% of all FDIs (versus Russia’s share in all FDIs 35%). In Tajikistan, these shares amount to 15% and 30% and in Kazakhstan to 7% and 15%. Interestingly, these three economies stand alongside the Silk Road Economic Belt, which is set to establish a trading route, which stretches northwest of China’s coastal area through Central Asia, Middle East, and on to Europe.
Just like with trade, Chinese investments in the CIS region are mainly concentrated in energy projects. BRI investment projects financed by China are concentrated mainly in pipeline construction aimed at facilitating energy exports to China. The same applies to non-construction overseas investments like, for example, the acquisition of a 10% stake in Sibur by SAFE announced back in December 2016 or the purchase of a 50% stake in Uzbekneftegaz by CNPC in December 2017. There are also investments in greenfield projects like the development of the gas field at Amu River, Turkmenistan, by CNPC. Natural gas extracted from the Amu River accounts for around one third of China’s imports from central Asia during the winter season.\(^6^0\)

The city of Khorgos, connecting Kazakhstan to China by rail and dubbed the largest dry port in the world, exemplifies the benefits that the BRI may bring to Central Asia. Kazakhstan boasts the ninth largest territory in the world and is instrumental in China’s ambitions to connect itself to Europe. With more than 90% of trade done via sea and only less than 5% by rail, Khorgos presents a key opportunity for Kazakhstan to capture a growing trade avenue, which offers the possibility of cutting shipping time between China and Europe in half. PwC expects that by 2025 the share of goods shipped by rail from China to Europe will at least double to 10%, while Samruk Kazyna, Kazakhstan’s national welfare fund, estimates that the higher traffic via Khorgos will contribute around 0.2% annually to Kazakhstan’s growth over the next decade.\(^6^1\) Even if the railway between Kazakhstan and China via Khorgos was built in late 2012, i.e., before the official start of the BRI, China’s effort to advance the initiative and Kazakhstan’s desire to avail itself of its enviable geographical status have led to an enormous increase in traffic at the connecting point. The whole dry port facility has the capacity for 500,000 TEU (twenty-foot equivalent) containers. That looked absurd when first conceived as a target for 2020, but already volumes have doubled between 2016 and 2017 to exceed 100,000 a year.


Khorgos, however, is also an example of why Russia sees such routes with a certain apprehension. The key priority for China is infrastructure along the East-West corridor connecting China with Europe. In contrast, the critical issue for Russia is to develop the North-South meridian trajectories as exemplified by the Northern Sea Route, which connects north of Russia to South Asia. This has made some Russian experts fret about whether China, in pursuit of its quest to link itself to Europe, is not diversifying its transportation routes only via by-passing Russia.62

But this pales in comparison to the larger benefits related to geopolitics as perceived by Russia. Russia’s concerns may be overstated given that two out of the six economic corridors of the BRI, including the Eurasian Land Bridge and the China-Mongolia-Russia corridor pass though Russia. In any case, Russia’s commitment to the BRI is currently not under question, being seen as an instrumental ingredient in how Russia sees the current state of the world and its role in pushing against the perceived Western encroachment on its territories. In contrast to some Central Asian countries, Russia is not likely to enjoy any substantial economic benefits from the BRI, but the current geopolitical status-quo has forced Russia to find an avenue (the marriage of the BRI and EAEU) via which it can embrace the BRI as a way of enlisting China’s support in standing up to the West and the U.S. in particular.

Figure 74. Central Asia Plays a Key Role in the Proposed Silk Road Economic Belt

Source: Xinhua, United Nations, Citi Research
7. Africa and the BRI: Chaos and Coherence

Africa’s membership of the BRI is best understood as an attempt to put a policy framework around a reality that emerged over a long period of time. For example, the Chinese have been pushing to build railways from both Kenya and Tanzania into the interior for many years. And there is a strong argument that this has been largely driven by China Road and Bridge Corporation because of its sense that there were attractive commercial prospects. Given surplus capacity in China, the government was willing to provide a nudge in the direction. If this is the case, then the Belt and Road Initiative simply formalizes the reality on the ground.

China is now a major economic force in a considerable number of African countries, but there are huge challenges. But China is still only slowly absorbing the political implications this involves. Most notably, the Chinese government and its companies are finding out that operating in Africa is not always as easy as the large pledges of aid and investment might imply. In particular, the cherished principle of “non-intervention of the domestic political affairs of a country”, something the Chinese government has consistently stressed as central to its involvement in Africa, and a message that has been welcomed by many African governments, has not always proved the convenient get out clause that the Chinese government hoped it would be.

There are lots of ways to think about how China has become involved in Africa in the last fifteen years but trade and lending are the key indicators. IMF data show that Chinese exports to Sub-Saharan Africa (SSA) rose from only $6.9 billion in 2003 to a recent peak of $77.7 billion in 2014. And although they have fallen back modestly since then, they look as if they will re-bound to around $70 billion as SSA growth continues to recover in 2018-19. Chinese imports from SSA show a similar growth trend. However, what is interesting is that dominated by commodity imports, high commodity prices meant that until 2014 China actually ran a trade deficit with SSA. With the fallback in commodity prices, in 2015-16, this moved into trade surplus. But with the recovery in commodity prices, notably the oil price, China moved back into running a small trade deficit with SSA in 2017. These figures should also be viewed in a relative context. In 2017, Euro Area exports to SSA were $66.4 billion, while U.S. exports were $13.7 billion and Indian exports $18.9 billion. Moreover, given the price and nature of Chinese exports to Africa, mostly manufactured goods, the current value should not be surprising as it largely mirrors, although somewhat belatedly, China’s growing overall role in global trade over the last few decades.
Chinese lending to Africa has exploded, but transparency is low…

Chinese lending to Africa has exploded, but transparency is low. The formal channel for China’s financial support to the continent is the China-Africa Co-operation Forum (FOCAC), which held its sixth session in early December 2015, and is held every three years. At the 2009 FCOAC, the Chinese government committed $10 billion in support for Africa. In 2012 this was raised to $20 billion, and then in 2015 this jumped to $60 billion, although over exactly what time period this will be disbursed is unclear. Broadly, this commitment consists of:

- $40 billion of preferential loans and commercial SME and export credit lending, largely through the Exim Bank of China;
- $5 billion of equity investment through the China Africa Development Fund (CAFD);
- $10 billion pledge of finance through a new China-Africa Industrial Cooperation Fund; and
- $5 billion in direct aid, or grants and zero interest rate loans.

…and tracking disbursements is not easy

Tracking disbursements is not easy. Perhaps the most comprehensive effort to historically track the actual level of disbursements compared to pledges has come from the China-Africa Research Initiative (CARI) at Johns Hopkins University. CARI’s research efforts show that from 2000-14, Chinese pledges of financial support to Africa from various sources totaled $86.9 billion, with this figure dominated by pledges of $59.6 billion from the Exim Bank of China. But of this, only 56% was actually disbursed. Moreover, of this total, the reality is that bulk of the money was committed to a relatively small group of countries. In fact, 50% went to five countries: Angola, Ethiopia, Sudan, Kenya, and the Democratic Republic of Congo (DRC), with half of this going to Angola alone and a significant portion of this effectively a credit line extended to the state oil company, Sonangol.
It is also interesting to note that despite this rise in financial support, China is less visible in Africa’s big three economies: Egypt, Nigeria, and South Africa. Looking at CARI data for the three years from 2013-15 for example, average lending to Africa was estimated at $14 billion a year. But for the big three over this time only $33 million went to Egypt, $637 million to Nigeria and $137 million to South Africa, or only just under 6% of the total. Of course, this could change markedly, notably with respect to South Africa, although maybe in a somewhat indirect way. In late July, the New Development Bank set up by the BRICS governments (Brazil, Russia, India, China, and South Africa) approved $600 million of new loan projects for South Africa. In addition, on the way to the BRICS summit at which these loans were formally announced, the Chinese president, Xi Jinping, also announced a new financial package worth an apparent $14.7 billion for South Africa including new loans and grant, of which $2.5 billion is for the state power company Eskom.

**Chaotic and Coherence**

Though Africa fits explicitly into the BRI’s ‘Maritime Silk Road’, China’s relationship with the continent is best characterized by ‘chaos and coherence’. Indeed, this maritime component of the BRI largely mirrors the sailing route taken by the renowned Chinese navigator, Zheng He, during the Ming dynasty, and the ancient spice and slave route from Asia to Africa. At present, it seems that the existing ports of Djibouti and Mombasa are the chosen entry points to Africa. Yet it would be unsurprising if substantial new ports are built in Africa with Chinese assistance, either in northern Kenya, Eritrea, Mozambique, Tanzania, or even Somaliland, probably linked with a railway line heading into the African interior. As far as the formal ‘Maritime Silk Road’ is concerned, we suspect Tanzania is the most likely next location for additional port development on the continent. This could involve just using Dar-es-Salaam port, as this would tie in with the planned rail-link into Burundi and Rwanda, so would complement the existing rail links: from Djibouti to Addis Ababa in Ethiopia, and from Mombasa to Nairobi and potentially on up to Kampala in Uganda. Or it could involve building a new port around the Bagamoyo or Tanga areas, which would also potentially be tied up with the end of the planned oil pipeline which is planned to link the Lake Albert oil fields in Uganda, in which China National Offshore Oil Corporation (CNOOC) has a major share, with the coast.
Behind the clearly visible evidence of the China-Africa relationship — ports, airports, roads — investment by Chinese companies has also developed a life of its own. In recent years nearly all new airport terminals built in Africa have been by Chinese contractors, providing a very visible reminder of the Chinese presence to those visiting an African country. And this visibility is also evident in road and rail projects, especially when they start or finish in major urban centers. But the relationship China and Africa is organic in some ways. For one thing Chinese workers, who gained entry into Africa on the back of working on officially-funded projects, have often stayed on, either with appropriate immigration approvals, or without, to work on new projects, or to start their own businesses. As a result the number of Chinese now living in Africa has risen very sharply.

The rise in the number of Chinese living and working in Africa is still very unclear. According to CARI data, it is only just under a quarter of a million: the number derived from a range of official Chinese sources is 227,407 in 2016. But other sources, such as Howard French in his book, ‘China’s Second Continent: How a Million Migrants Are Building a New Empire in Africa’, estimate that the number is much higher. And a clear point to make is that not only are many of these new immigrants to Africa prepared to work and live in quite difficult conditions, but crucially, many still consider the hardships that they endure to be less than the conditions that still exist in China. What is less clear is how long they will stay? Some, for example, will marry locally become more firmly integrated into everyday African life. But there is also a group for whom we suspect their stay in Africa is merely a part of their life story with a goal ultimately to return to China — whether in retirement or earlier.

Part of understanding how many Chinese immigrants to Africa will stay is the extent to which Chinese immigrants feel welcome in Africa. At present, there are various narratives about sentiment towards Chinese workers and investment across Africa. On the one hand, the attitude seems to be broadly positive, but with worrying undercurrents. While there is admiration for the capacity to work, and the fact that they do not live the visibly wealthy lives of European and U.S. expatriates, there are also concerns about their involvement in corrupt practices, the quality of the work they do, the products they sell, and their limited interaction with local communities. The limited interaction of Chinese immigrants with local communities is mirrored by the absence of Chinese manufacturing in Africa. Away from the trade and lending data, the level of FDI seems much lower than from more traditional sources, notably the U.S. and Europe, South Africa (in the rest of Africa) and maybe even India. This may well change as China continues to try and push ahead with its program of building industrial, or special economic zones (SEZs) in Africa. At present, the Chinese government is committed to building in SEZs in Algeria, Egypt, Ethiopia, Mauritius, Nigeria, and Zambia. But it is still likely that these will be focused on export-oriented industries, mirroring China’s own success at driving exports from similar zones. In general it does seem to be the case that Chinese corporates remain wary of setting up manufacturing operations for the domestic market, away from some limited examples of vehicle assembly.

63 This may also reflect that despite rising investment in some commodity sectors, many of the big investors in this sector in Africa remain European and U.S. multinationals, notably in the oil sector. The Brookings Institute collected data from Chinese sources which show that its stock of “Overseas Direct Investment” in Africa was $26 billion in 2013. It argues this would be around 3% of the total FDI stock in Africa using data from UNCTAD’s World Investment Report (WIR). UNCTAD’s 2015 WIR shows the Chinese stock at around 4.4% of the total over the 2013-15 period.
This may be just that Chinese companies are concerned about getting too heavily involved in the additional obligations that many corporates investing in Africa face, notably in commitments to corporate social responsibility goals as well as the additional commitment that is often required in helping African governments meet the UN’s Sustainable Development Goals (SDGs).

In contrast, there are many examples around Africa of Chinese individuals setting up small scale businesses. Many of these are simply small scale “import-export” retail operations, based around shipping individual container loads of goods from contacts in China, but some are also involved in small-scale production, notably in the agricultural sector (such as chicken farming, or vegetable production). It is also worth highlighting, given the construction link, that there is also sharply rising involvement in the hotels sector where there are Chinese-owned hotels which are specifically targeted at Chinese clients and investors in Africa.

Zambia is a good example of ‘engagement without transparency’. Although Zambia has formally borrowed from China for various projects, it seems that in recent years, Chinese contractors have remained in the country beyond the life of these contracts and canvassed a range of government ministers for various new contracts. Having won ministerial backing for their projects, they have then sought finance from official Chinese sources for the projects. And the Zambian Ministry of Finance doesn’t necessarily have oversight and control over the lending. According to the IMF, the cumulative value of the new debt accumulated between 2011 and 2016 was around $11 billion, largely to Chinese contractors, and not necessarily included in the government’s official debt data. According to the latest official data, Zambia’s external debt at the end of 1Q 2018 was $9.4 billion! In response to the problem, the Zambian Minister of Finance has announced that the government will not contract new debt until the existing situation is resolved. Moreover, it will seek to potentially cancel some of the existing debt and/or undertake a degree of re-financing for the rest. A government team is due to visit China in August to start discussions on the various options available. The minister has also stressed that the only debt contracted with the approval of the Finance Ministry is legally enforceable. How this situation is ultimately resolved will be another interesting step in the development of the China-Africa economic story.

One lesson from China’s experience in Africa is the limits on the renminbi’s role in the BRI: the U.S. dollar remains central to the financial relationship. Given the foreign exchange shortages which have emerged in many African countries in the last few years, notably the oil exporters, both African central banks and the People’s Bank of China (PBOC) have been keen to encourage a greater use of renminbi in trade with Africa. The most significant attempt to push this has arguably been the RMB15 billion ($2.4bn) three year currency swap deal agreed between the People’s Bank of China (PBOC) and the Central Bank of Nigeria (CBN). Although the CBN has engaged in a considerable public education campaign around the benefits of using the facility, to date support has been lukewarm, with a preference on both sides to keep transactions in U.S. dollars, so we expect that while it will continue to help at the margin, the overall impact will be limited for several years to come.
To Interfere or Not?

One reason that China’s policy of non-interference in the domestic politics of an African country has changed since Xi Jinping came to power in 2012 is that China has faced some high profile failures with this approach, which have caused the government to partially re-evaluate its options, although it still likes to highlight that this remains its fundamental position.

The first failure arose in Sudan, where the Chinese government remained fully committed to supporting the government in Khartoum until it realized too late that the South, where the oil fields that CNOOC brought into development where located, would secure independence. The Chinese government then had to scramble to re-make policy and engage with the new state of South Sudan, while addressing the difficult political issue that the export pipeline still runs to the coast through its old ally. Moreover, since then, the on-off conflict in South Sudan means that China has around 750 peace keeping troops operating under a UN mandate in the country, at least indirectly to help protect the assets and staff.

The other significant issue arose in Libya, when again, the Chinese government probably remained too supportive of Muammar Gaddadi, and failed to build bridges with the opposition fast enough to be involved in any significant post-reconstruction deals, while also being squeezed in terms of oil shipments from the country.

The other issue facing China in Africa, is that to some degree it also feels there is a rising Asian military race playing out, notably with India, but to a lesser extent with Japan, based around military and economic dominance of the Indian Ocean. If one accepts the argument that the locus of world trade will shift from the Atlantic to the Pacific and eventually the Indian Ocean, then this is a strong rationale for the decision by the Chinese government to open its first overseas military base in Djibouti, located next door to the U.S. one.

However, in a firm nod to the policy of non-interference, the decision was still largely justified on the basis that the government needed it to improve its efforts to reduce piracy around the Horn of Africa. But the need to take sides will continue to be an issue, notably as China has also used Africa countries as an important opportunity for its army to become involved in UN peacekeeping operations, beyond just providing non-combat supporting roles.

Another way to think about this change in policy is to accept that China is using Africa as a continent to experiment with foreign policy, in a region where nationalist resentment is less of an issue than closer to home. In this discourse, there is a trial and error element to Chinese policy in Africa, in which it is trying to work out how best to re-invent itself as a global power through military engagement and diplomacy, as well as the use of soft power. Around 50 Confucius Institutes have been opened in Africa seek to teach Chinese language and culture and there are now thousands of students studying in China under Chinese government scholarships.

A New Debt Trap for Africa?

It is probably correct to say that Africa’s lack of infrastructure is a constraint on its growth, but making African infrastructure ‘pay’ has proved elusive. Past efforts to build infrastructure, notably with support from Europe and the U.S. in the 1970s, helped to push Africa into its first debt crisis in the 1980s. The result of this was the twin heavily indebted poor countries (HIPC) and multilateral debt relief initiative (MDRI) debt relief initiatives that wrote off a substantial amount of Africa’s external debt in the mid-2000s. Since then, there has been a reluctance to lend from these traditional sources, and there is a strong argument that the Chinese government, and other governments such as India, or even private sector investors through the Eurobond market, have been more than willing to step into this vacuum. This new surge in borrowing by African countries now means that a considerable number are starting to have troubling levels of debt again, only a decade after the last debt write-off. And some of this has already spilled over into default in the case of Mozambique.
Some countries will try and escape potential debt traps with a statistical sleight of hand, but the underlying problem is real. Often-substantial GDP revisions around the continent have generally proved very helpful in reducing the level of debt to total GDP. But they cannot hide the ongoing problem of the ability to service debts: the ratio of debt-service payments to government revenue is now very high in many countries in Africa and we think this is a critical issue facing many governments. And given the apparent scale of the Chinese lending involved, more recently these questions have also morphed into a new concern that the Chinese government is a key factor driving African countries into a new neo-colonial debt trap making it no different from those countries that have gone before.

In this environment, we think how to raise more revenue will be the central policy issue facing governments in Africa in the coming decade. If those efforts fail, the prospect of new debt write-offs can’t be dismissed, although this will be more complicated than in the past given the wider range of lenders involved. But Chinese lending to build infrastructure in Africa has interesting and unique elements. In particular, many of the projects are theoretically designed to pay for themselves. So in this case, the underlying rationale used to select projects and their quality are crucial issues in understanding the ability to repay the debt used to build them, outside of higher GDP growth associated with them driving higher levels of government revenue.

This raises the question of whether Chinese-funded projects will generate a stream of income that will repay the debt that has financed them. So far, the indications are not particularly positive. Perhaps the most high-profile BRI project in Africa to date, the Mombasa-Nairobi Railway, was opened in May 2017, but a year later seems to be struggling to make a meaningful profit. Notably, with freight usage of the railway seemingly failing to gain traction, Kenya Railways has been forced to significantly raise fares and introduce other charges such as parking fees, which may or may generate sufficient revenue to close the financial gap. Meanwhile, with a reported top speed of only 80km/h, important question remains as to whether the Kenyan government should have simply renovated the existing railway line at a much lower cost than the $3.5–$4 billion that was borrowed from the Exim Bank of China for the new line.

Similar concerns can be raised about most Chinese-funded infrastructure projects in Africa, except for energy projects. But this is not just a Chinese lending problem. A good example is the third bridge in Cote d’Ivoire built by France’s Bouygues. This provides a 1.5km link over the Abidjan lagoon between the upmarket northern suburb of Cocody and Marcory for a toll of CFA500, or around $1. But despite the time saving potential of using the bridge, the volume of usage is currently significantly below targets and its long term commercial viability may need to be re-visited. And we expect many similar outcomes for Chinese built projects, whether the Addis Ababa Adama Expressway or the Entebbe-Kampala expressway in Uganda.

At present, the Chinese government has provided very little indication about what it will do in response to this potential emerging problem. Our assumption is that it will adopt a ‘Venezuelan’ approach, or simply significantly extend the maturity profile of currently contracted debt. In addition, there are already numerous examples of debt relief implemented by the Chinese government around Africa.

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64 The Chinese government is not a member of the Paris Club and Chinese banks not represented in the London Club, which have been the main forces organizing previous debt write-offs and restructurings in Africa.
However, most are of a relatively small scale and where in 2006-07, so they effectively mirrored the wider HIPC/MDRI debt write-off.\textsuperscript{65} It also remains possible that the Chinese government will simply have to accept debt to equity swaps in the various projects it is helping build around Africa.

Of course, there is a lingering concern about whether the Chinese government may be willing to adopt a harder line over repayment of its lending to Africa. Moreover, this also raises potential concerns about a Chinese grab for assets more widely in Africa. This is where the political side of the equation becomes very interesting. And while there is often a focus on obtaining various natural resources for outstanding debt repayment, an additional area where the Chinese government may be willing to invest is agricultural, so being sold or leased land in exchange for debt is a potential option for it to consider. The problem with this is that recent history tends to show that land grabs are often an emotive issue in Africa and have the potential to generate complicated political consequences. Moreover, even with a longstanding interest in this area, Chinese efforts to secure agricultural land in Africa have been very limited to date: CARI data clearly shows that if you strip out the purchase of some large rubber plantations in Cameroon, the actual extent of land acquisition has been small-scale.

There is lingering concern about whether the Chinese government may adopt a harder line over repayment of its lending to Africa

But having a large Chinese diaspora in Africa could tilt Beijing towards generous treatment of non-performing debt

The politics of having a large Chinese diaspora in Africa could tilt Beijing towards generous treatment of non-performing debt. The potentially significant size of the Chinese diaspora in Africa potentially makes the Chinese government’s decisions over debt-sustainability issues very delicate. So the extent to which the Chinese government may also have concerns about the interests of its citizens in Africa may influence its decisions in terms of trying to adopt a more aggressive policy towards seeking full repayment of any debt obligation. As long as China’s exposure in Africa remains a small part of China’s overall foreign assets, our sense is that there might be strong incentives for China to write debt off, notably in the light of some of the political kudos it will have gained over the time it has increased its involvement in Africa.

\textsuperscript{65} A full list is provided in the March 2018, CGD Policy Paper 121, Examining the Debt Implications of the Belt and Road Initiative from a Policy Perspective.

\begin{figure}[h]
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\includegraphics[width=\textwidth]{figure79}
\caption{Chinese Land Acquisitions in Africa: 1987-2016}
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Rising Chinese trade, investment and lending to Africa in the last 15 years is helping change the continent, often for the better. But debt levels need to be addressed. As Chinese investors become more deeply involved, the Chinese government is finding that the politics associated with this is become more complicated to manage. This situation is only likely to continue going forward, although we expect the pace of growth of Chinese economic involvement in Africa to slow over the next decade having moved up to this new level from such a low base. But we also suspect that if the Belt and Road Initiative remains limited to simply proving additional official lending for infrastructure development, it is not clear whether it has a major future in Africa given than an important number of countries are now reaching potentially unsustainable debt levels. Instead, the real success of the Belt and Road Initiative in Africa may only be if it can catalyze more private investment, including in sectors that boost productivity in Africa. In this respect, high Chinese FDI into South Africa may be the most important initial outcome, although this could be followed by significant FDI into countries across the continent from Ghana and Kenya.
8. The BRI and Eastern Europe: Limited Synergies

Historically, the economic links between Central European economies and China were relatively weak with the geographical distance as one of the explaining factors. From a Central & Eastern European (CEE) point of view, China was also not a major partner in political sense as the region was looking more in the direction of Western Europe and was not very active in Asia. However, the rise of China as an economic and geopolitical power as well as the weakening position of Western European countries as a result of the sovereign debt crisis changed this status quo. Central European leaders as well as business circles started to hope to benefit from closer relations with the biggest Asian economy.

China's offer of a closer cooperation with Central European states was, at least initially, embraced by the CEE with some enthusiasm. The ‘CEE 16+1’ cooperation format was proposed in 2011 and the first summit was organized the following year in Warsaw. The ‘16’ in the name of the format stands for eleven European Union countries (Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, Slovenia) and five countries that – at least at this stage - are not EU members (Albania, Bosnia and Herzegovina, Macedonia, Montenegro, Serbia). Obviously the ‘1’ stands for China. The initiative aims to strengthen cooperation between the participating countries in a number of fields, including investments, transport, science, education, finance, and culture. Such a broad definition of goals means the cooperation can encompass various projects but based on declarations from CEE/China officials as well as the actual decisions it seems the focus is on projects related to infrastructure, energy, or high technologies. All in all, the ‘16+1’ format is separate from the BRI but the two seem to serve a similar goal and reinforce each other. From the CEE’s point of view, differentiating between the two initiatives doesn’t make much sense as they both are expected to result in larger inflows of foreign capital or potentially better access to the Chinese market. Not surprisingly, the initial reaction of Central Europe to the idea of closer cooperation with China was warm and a long list of summits or high level visits followed. However, the actual effects, as measured by exports and cross-border capital flows, are somewhat mixed.
Trade flows between Central Europe and China have increased since the CEE ‘16+1’ cooperation framework and the BRI

Since the ‘CEE 16+1’ cooperation framework and the BRI were launched, the trade flows between Central Europe and China have increased, reaching 4.2% of the region’s GDP in 2017. However, this was mostly due to a rise in imports from China, while exports barely changed. Total exports to Chinese markets amount to approximately 0.7% of CEE GDP and although there is some geographical variation, the exposure is generally small in every country (Figure 82). The data suggests the closer cooperation hasn’t translated into significantly higher access of CEE exporters to China’s markets. With share in total exports ranging from nearly zero to 3%, China is hardly an important export market for countries in the ‘16’ group. However, it matters significantly more as a source of imports. Even in larger CEE countries (Poland, Romania, Czech Republic, and Hungary) China accounts for 5-8% of total imports, thus being one of the top import partners. This trend is hardly surprising as it is consistent with the rising role of China in the global economy. One can even argue that imports from China would rise anyway even without the ‘16+1’ and BRI.

Figure 82. On Average, Exports to China Are Equivalent to Only 0.7% of GDP in Central Europe...

![Figure 82](chart1.png)

Figure 83. ...But China Is a Major Import Partner, Especially for Poland and Czech Republic

![Figure 83](chart2.png)

Source: Haver, IMF, Citi Research

The divergence between hopes and reality is nowhere as visible as in foreign investment positions. Depending on the sources, the estimates of Chinese foreign direct investment in Central Europe can vary significantly, but the general conclusion is the same — the stock of FDI in the region is low. The two countries that stand out in terms of nominal value of foreign investments are Hungary and Czech Republic but even in their case the FDI position is modest at best (Figure 84 and Figure 85). Looking at data on ultimate counterparty basis, the Chinese investment in Hungary is estimated at around $2 billion which is only 1.6% of GDP. Such a low exposure in the region may be due to the fact that some Chinese investments, like for example large BRI-related construction projects, are not classified as FDI and therefore do not appear in the statistics. From this point of view, the Chinese Global Investment Tracker (CGIT) data, which includes information on construction contracts, may be more useful to assess the exposure of Central European economies to Chinese capital.
Construction projects account for a large share of Chinese activity in Central Europe. CGIT data confirms that construction projects account for a large share of Chinese activity in Central Europe. Investments in the region reached around $10 billion, while construction contracts amounted to another $16 billion. This matters especially for smaller countries, like Montenegro where BRI construction projects are estimated at around 24% of GDP, while for example in Serbia the total exposure is around 16% of GDP (Figure 86). This is undeniably more than seemingly tiny exposure visible in FDI statistics. However, for bigger Central European economies, in particular Poland, Romania, or Czech Republic, even CGIT data suggests that the ‘actual’ exposure to Chinese capital has been surprisingly small. The total value of Chinese investments and construction contracts for the whole region is estimated at 1.9% of GDP, hardly anything that would match initial hopes and expectations.

Figure 84. China’s FDIs In the Region Are Small

Figure 85. ...And Even Data on Ultimate Counterparty Basis Doesn’t Change This Picture Much

Source: Coordinated Direct Investment Survey, Citi Research

Source: OECD, Citi Research

Source: AEI, CFIT, Citi Research estimates

Figure 86. China’s Presence in Central Europe Is Better Visible in Data on Construction Projects

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<th>Investment &amp; Construction ($mn)</th>
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<td><strong>Construction Projects</strong></td>
<td><strong>BRI Projects ($mn)</strong></td>
</tr>
<tr>
<td><strong>Bulgaria</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Croatia</strong></td>
<td><strong>$220</strong></td>
<td><strong>$470</strong></td>
</tr>
<tr>
<td><strong>Czech Republic</strong></td>
<td><strong>$1,880</strong></td>
<td><strong>$100</strong></td>
</tr>
<tr>
<td><strong>Macedonia</strong></td>
<td><strong>$3,820</strong></td>
<td><strong>$400</strong></td>
</tr>
<tr>
<td><strong>Hungary</strong></td>
<td><strong>$3,820</strong></td>
<td><strong>$2,490</strong></td>
</tr>
<tr>
<td><strong>Latvia</strong></td>
<td><strong>$690</strong></td>
<td><strong>$1,120</strong></td>
</tr>
<tr>
<td><strong>Montenegro</strong></td>
<td><strong>$1,580</strong></td>
<td><strong>$900</strong></td>
</tr>
<tr>
<td><strong>Poland</strong></td>
<td><strong>$690</strong></td>
<td><strong>$2,110</strong></td>
</tr>
<tr>
<td><strong>Romania</strong></td>
<td><strong>$1,390</strong></td>
<td><strong>$5,080</strong></td>
</tr>
<tr>
<td><strong>Serbia</strong></td>
<td><strong>$1,580</strong></td>
<td><strong>$390</strong></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$10,010</strong></td>
<td><strong>$16,140</strong></td>
</tr>
</tbody>
</table>

Source: AEI, CFIT, Citi Research estimates
It can be argued that some projects are probably still in an early phase and therefore may materialize only in the future. Indeed, the number of announced projects that would fall under either the ‘16+1’ or the BRI category significantly exceeds the number of those that were already finalized. Probably the most prominent example is the construction and modernization of a railway connection between Belgrade and Budapest. The line would be approximately 370 km long and is expected to facilitate the transport of goods from the port of Piraeus in Greece to Central Europe and eventually also Western Europe. The project would reduce shipping time as the ships would not need to pass Gibraltar to reach Western European ports. The whole cost is estimated at around €3.2 billion, largely financed by Chinese loans. The construction of the Belgrade-Budapest connection was delayed due to EU objections as the project did not meet European Union’s standards for public procurement process and Hungarian authorities currently estimate the project should be completed by the end of 2023.

Figure 87. Chinese Capital Investment Is Heavily Concentrated in the Energy and Transport Sectors ($mn)

<table>
<thead>
<tr>
<th>Country</th>
<th>Energy</th>
<th>Transport</th>
<th>Chemicals</th>
<th>Technology</th>
<th>Finance</th>
<th>Entertainment</th>
<th>Other</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bosnia and Herzegovina</td>
<td>$2920</td>
<td>$640</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>-</td>
<td>$120</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>$210</td>
</tr>
<tr>
<td>Croatia</td>
<td>$220</td>
<td>$340</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>$130</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>100</td>
<td>-</td>
<td>-</td>
<td>$1,570</td>
<td>-</td>
<td>-</td>
<td>$310</td>
</tr>
<tr>
<td>Macedonia</td>
<td>-</td>
<td>$400</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Hungary</td>
<td>-</td>
<td>$2,320</td>
<td>$2,110</td>
<td>$1,710</td>
<td>-</td>
<td>-</td>
<td>$170</td>
</tr>
<tr>
<td>Latvia</td>
<td>-</td>
<td>$110</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Montenegro</td>
<td>-</td>
<td>$1,120</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Poland</td>
<td>$1,240</td>
<td>$100</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>$250</td>
</tr>
<tr>
<td>Romania</td>
<td>$2,110</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Serbia</td>
<td>$3,070</td>
<td>$2,760</td>
<td>-</td>
<td>$170</td>
<td>-</td>
<td>-</td>
<td>$660</td>
</tr>
<tr>
<td>Slovenia</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>$1,050</td>
<td>$340</td>
</tr>
<tr>
<td><strong>Total ($mn)</strong></td>
<td>$9,560</td>
<td>$7,910</td>
<td>$2,110</td>
<td>$1,880</td>
<td>$1,570</td>
<td>$1,050</td>
<td>$2,070</td>
</tr>
</tbody>
</table>

Source: AEI, CGIT, Citi Research

There are reasons why the pace of actual inflows to the region could disappoint. First, the railway connection between Belgrade and Budapest is an example of potential challenges faced by Chinese investment in Central Europe. Given that CEE-China cooperation frequently concentrates on large, complicated infrastructure investments it is likely that delays will be an inherent element of the projects. In other words, despite a disappointing start Chinese investments will likely come to Central Europe but it will take much longer to see the effects than was initially hoped. Second, there may be simply a large divergence between what CEE countries expect from China and what China can or wants to offer. Unlike Russia or Kazakhstan the Central European region is not rich in resources. If the access to commodities or energy security is what China is looking for, the ‘16’ may not have much to offer. Or at least, the large scale of BRI investment in Central Asia should not be extrapolated to the CEE. Also, the data available so far suggest Chinese firms are interested in M&A opportunities especially in high technology sectors and Central Europe is not exactly the home to such firms, especially compared to Western Europe. Finally, based on numerous declarations of CEE politicians it appears the region would be most interested to see greenfield investments as they would bring benefits in the form of new jobs being created and rising export capacities. Yet, as Figure 86 shows, this is not necessarily what China is willing to bring in large scale.

Regarding motives, the Central European states are open to cooperation with China based on economic arguments, as they hope for increased investment inflow and easier access to the Chinese market. However, the approach of particular countries differs and in some cases is driven also by strategic or political motives. The example of Visegrád Group illustrates the variety of motivations for cooperation and how they evolve over time.

- **Hungary** has been particularly open to China, both in economic and political terms. It saw significant inflows of Chinese investment though this trend started well before the ‘16+1’ and BRI initiatives took off. According to Chinese Global Investment Tracker the largest inflows were in the chemical and telecommunication sectors but more recently also in the railway sector. The Hungarian government is also actively promoting its ‘Eastern Opening’ project which aims at facilitating exports of Hungarian goods to Asian markets but also attracting Asian investment. The BRI fits well into this project and is happily used by the Hungarian authorities. It can be argued that Hungary’s openness to Asian investment may be partly motivated by increasing export markets and finding new sources of capital investments to offset the expected decline in positive contribution to growth from EU funds after 2020. Hungary’s relations with the European Union have become more stressed since 2010 and the Budapest-Brussels conflict has escalated in recent years due to disagreements over EU migration policy and rule of law issues in Hungary. Growing conflicts with the EU encouraged Budapest to seek alternative political and economic partners, especially in Russia and China. These strategic motivations suggest that Hungary may be interested in developing closer ties with China even if the economic benefits do not meet initial expectations.

- **Czech Republic** was, as compared to other CEE economies, relatively successful in attracting Chinese capital and one can argue that significant improvement in China-Czech relations was partly due to President Zeman’s favorable view of the role that Chinese investments could play in the Czech economy. Since 2014 President Zeman has visited China three times and China’s President Xi visited Czech Republic in 2016. President Zeman’s enthusiasm may not necessarily be shared by all representatives of the political stage but the Czech approach to Chinese investment remains pragmatic. Nevertheless, the interest of Chinese companies in strategic sectors eventually raised questions about potential security issues especially in the longer term. And as a reflection of the EU trend, the Czech Ministry of Industry has prepared a law that introduces the requirement of state approval for transactions involving the sale of strategic private enterprises to foreign buyers from outside the EU or NATO. Moreover, the Czech central bank did not allow the inflow of Chinese capital into one local financial group in 2017.

- **Poland** The inflow of Chinese FDIs to Poland was driven by economic forces and — unlike in Hungary — the political/strategic considerations played a relatively limited role. When the ‘16+1’ initiative was announced, Poland counted on economic benefits related to larger infrastructure investment or stronger exports to Asian markets. Its central location on the way from Asia towards Western Europe and the size of its economy potentially make Poland an important partner for China. However, the reality did not live up to expectations and although Poland is the biggest economy in the ‘16’ group, the data shows that the stock of Chinese investment in Poland is lower than in Hungary or Czech Republic. This fact, and possibly also rising U.S.-China tensions, seems to have weakened the initial enthusiasm for Sino-Polish cooperation.
The change in position of Polish authorities has manifested itself during ‘CEE 16+1’ summit in Sofia in July 2018, where Poland was represented by a Deputy-Prime Minister, whereas China and 14 other countries were represented by Prime Ministers.

The relations between Central European economies and China should be viewed also in the context of EU membership. Most of ‘CEE 16’ are currently EU members or are aiming to join the EU at some stage. The rising presence of Chinese firms in Western or Central Europe has triggered concerns in Brussels and other European capitals. There are several issues that stand behind Brussels’ skepticism towards China’s role in the region. First, China’s rising economic presence and the fact that Chinese loans finance important projects fuels fear in some EU capitals that Beijing might try to use its leverage to influence policies of the European Union. This is particularly important in issues related to foreign policy where the opposition of a single member state can stop the EU from taking action. Although the fear of political influence on EU policy does not have direct impact on the size of inflows to CEE it might complicate the implementation of projects, especially where the approval of Brussels is needed. Second, some of investment projects planned in Central Europe, including the Belgrade-Budapest railway, did not meet transparency standards used by the EU. Third, Chinese acquisitions in strategic industries might open questions about security issues.

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**Figure 88. European Union Funds Constitute an Important Source of Financing for the CEE**

<table>
<thead>
<tr>
<th>Country</th>
<th>2014-2020</th>
<th>2021-2027</th>
</tr>
</thead>
<tbody>
<tr>
<td>BG</td>
<td>3.0%</td>
<td>3.0%</td>
</tr>
<tr>
<td>CZ</td>
<td>2.0%</td>
<td>1.1%</td>
</tr>
<tr>
<td>HU</td>
<td>2.4%</td>
<td>3.0%</td>
</tr>
<tr>
<td>PL</td>
<td>1.8%</td>
<td>2.1%</td>
</tr>
<tr>
<td>RO</td>
<td>3.1%</td>
<td>2.1%</td>
</tr>
<tr>
<td>SK</td>
<td>1.5%</td>
<td>1.1%</td>
</tr>
<tr>
<td>SI</td>
<td>3.9%</td>
<td>3.8%</td>
</tr>
</tbody>
</table>

**Figure 89. Trade Links with Germany Are in Most of CEE Countries Significantly Stronger than Links with China**

- **Exports to China & Germany as a Percentage of GDP**

<table>
<thead>
<tr>
<th>Country</th>
<th>Exports to China</th>
<th>Exports to Germany</th>
</tr>
</thead>
<tbody>
<tr>
<td>AL</td>
<td></td>
<td></td>
</tr>
<tr>
<td>BA</td>
<td></td>
<td></td>
</tr>
<tr>
<td>BG</td>
<td></td>
<td></td>
</tr>
<tr>
<td>CR</td>
<td></td>
<td></td>
</tr>
<tr>
<td>CZ</td>
<td></td>
<td></td>
</tr>
<tr>
<td>EE</td>
<td></td>
<td></td>
</tr>
<tr>
<td>MK</td>
<td></td>
<td></td>
</tr>
<tr>
<td>HU</td>
<td></td>
<td></td>
</tr>
<tr>
<td>LV</td>
<td></td>
<td></td>
</tr>
<tr>
<td>LT</td>
<td></td>
<td></td>
</tr>
<tr>
<td>ME</td>
<td></td>
<td></td>
</tr>
<tr>
<td>PL</td>
<td></td>
<td></td>
</tr>
<tr>
<td>RO</td>
<td></td>
<td></td>
</tr>
<tr>
<td>RS</td>
<td></td>
<td></td>
</tr>
<tr>
<td>SK</td>
<td></td>
<td></td>
</tr>
<tr>
<td>SI</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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67 For example in 2016 the opposition of Hungary made the EU soften its statement on the South China Sea Dispute.
It is fair to say that for the CEE-China cooperation to be smooth and successful it must be planned in accordance with EU rules. Although CEE economies count on new Chinese investment, the links with Western Europe remain too strong or too important to risk severing them. For example, CEE economies that are EU members are major beneficiaries of European Union funds that can be used to improve infrastructure or human capital. And although these funds are expected to decline over time, in most countries the annual inflow will be equivalent of around 2% of GDP (in Czech Republic and Slovenia 1.1% of GDP). This is significantly more than realistic projections could assume in the form of Chinese investments. Furthermore, EU funds are a kind of grant that does not need to be returned, unlike loans used to finance BRI projects. This makes EU funding particularly attractive even as compared to the potential benefits of projects under the umbrella of Belt and Road. Furthermore, closer cooperation with China doesn’t change the fact that trade links with Western European economies are disproportionally stronger. Due to geographic proximity Central European economies constitute an important part of supply chains of Western European firms. While exports to China account for 1.3% of exports from CEE, exports to Germany account for nearly 25% (Figure 89). As a source of FDI, Germany also exceeds Chinese investments by a large margin. For example, in Czech Republic German FDIs account for one fourth of all foreign investments, while China’s share is less than 1% (Figure 90). These economic links mean that the Central European states will need to find a way to attract Chinese investments but simultaneously keep the benefits of close ties with the EU.

The track record so far shows that the ‘16+1’ initiative is more a way to improve bilateral rather than multilateral cooperation. Instead of seventeen countries working together it seems in reality that China is working with sixteen countries separately. This means that potential synergies for CEE countries are limited. That can change gradually over time as the CEE states are becoming more disappointed with the current format and are expressing this view more openly. All in all, whatever their motives, not only China but also the group of sixteen countries in Central Europe can potentially benefit from closer cooperation. These incentives suggest that both sides will be willing to develop this collaboration further.
9. Latin America: The BRI’s Periphery

The presence of China in Latin America has grown significantly in the last two decades. The increased presence of China in Latin America can be essentially understood as an attempt to gain influence in a region that is strategic (for its proximity to the U.S. and representing a significant proportion of economic activity and population in the western hemisphere), that has significant financial and technological necessities, and that for a number of reasons, has been a low priority for U.S. foreign policy. The relationship between China and Latin America has become more intertwined, touching all areas from economic relationships (trade, investment, lending) to increased cultural and political ties. The increased ties between China and LatAm highlight how this process is unfolding in a region not traditionally under the sphere of China influence. Below we describe the increased ties, discuss the prospective for the coming years, and explore potential consequences of the increased exposure of Latin American economies to China risk.

In the Beginning Was Trade

Latin America is not formally part of the Belt and Road Initiative (BRI), but the increased commercial and financial ties with China are significant, as is the exposure to China’s economic developments. Since the ascension of China to the World Trade Organization (WTO) in 2001, the economic cycle in LatAm has been increasingly tied to Chinese economic activity. An important part of this increased dependence comes through the channel of China’s demand for commodities, which fueled the commodity boom in the second half of the 2000s and which has become a strong determinant for LatAm’s economic activity. Indeed, the LatAm cycle has become closely tied to the commodities cycle (Figure 91).

Although not part of the BRI, commercial and financial ties with China are significant for Latin America as is the exposure to China’s economic developments

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68 Latin America was not formally included in the original BRI. Panama was the first country in the region to sign a formal BRI agreement. This was followed by Antigua and Barbuda, Trinidad and Tobago, and Bolivia. It’s commonly believed that China would continue to expand its presence in the region without formally including LatAm in the BRI so as not to create a strong reaction in the U.S. And, although on paper LatAm is not part of the BRI, some observers have noticed a strong connection between the BRI and China’s Latin America Stance. In particular, in the “Ministerial Meetings of the Forum of China and the Community of Latin American and Caribbean States (the China-CELAC forum), the “Five principles” for China’s intention in the region mirror the “Five links” for One Belt, One Road, despite official separation. (“Belt, Road, and Ball? How China’s soccer diplomacy handles Latin America” August Rick, Forbes, May 24, 2018, and “The second China-CELAC ministerial forum” The Dialogue, January 22, 2018).
Trade with China has boomed. Exports from the region to China increased from practically nothing in 2000 to close to $100 billion in 2017. Imports, also from a negligible base, now add to close to $180 billion, for total bilateral trade of around $280 billion. LatAm has always had a trade deficit with China that increased consistently until reaching a peak of $100 billion in 2015 (1.8% of GDP). In 2017 the trade deficit between LatAm and China was $80 billion (or 1.3% of GDP), although Mexico explains most of that deficit (see Figure 92 and Figure 93), as it is not the traditional Latin American exporter of commodities to the Asian country. China’s importance as a trading partner for the region has continued to increase: it now represents 9% of all exports from LatAm, while 18% of all imports of the region now come from China (Figure 94 and Figure 95).
By and large, LatAm continues to be a commodity exporter to China. Seventy percent of all LatAm exports to China fall in four commodity categories: soybeans (and other oilseeds), iron ore (and concentrates), crude oil, and copper (including ores and concentrates) (see Figure 97). Brazil leads the market in soybeans and iron ore, Chile in copper, the oil export market to China is divided between Brazil, Venezuela, and Colombia, while Peru participates marginally in iron ore and copper. This is mostly a South American story. Indeed, China is now the main trading partner for Brazil, Peru, and Chile firmly displacing the U.S. to the second place in all three cases (see figures below). Brazil exports a more diversified mix of agricultural commodities, metals, and energy commodities, and some manufactures to China, while Peru and Chile have a non-diversified export mix of mostly copper (plus a few manufactured goods).
Figure 100. China Increasing in the League Tables as a Partner for LatAm

The share of China in the exports of Latam Countries has been increasing

<table>
<thead>
<tr>
<th>Countries of which China is the Main Trade Partner in 2016</th>
<th>2000</th>
<th>2004</th>
<th>2008</th>
<th>2012</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chile</td>
<td>5.3</td>
<td>10.2</td>
<td>13.2</td>
<td>20.6</td>
<td>26.3</td>
</tr>
<tr>
<td>Peru</td>
<td>5.1</td>
<td>8.8</td>
<td>12.7</td>
<td>17.7</td>
<td>23.2</td>
</tr>
<tr>
<td>Brazil</td>
<td>2.1</td>
<td>5.7</td>
<td>9.9</td>
<td>16.2</td>
<td>18.1</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Uruguay</td>
<td>4.4</td>
<td>4.7</td>
<td>7.2</td>
<td>12.1</td>
<td>16.1</td>
</tr>
<tr>
<td>Paraguay</td>
<td>5.8</td>
<td>8.3</td>
<td>16.6</td>
<td>17.1</td>
<td>14.6</td>
</tr>
<tr>
<td>Panama</td>
<td>0.5</td>
<td>1.9</td>
<td>9.7</td>
<td>16.7</td>
<td>14.4</td>
</tr>
<tr>
<td>Argentina</td>
<td>3.8</td>
<td>7.1</td>
<td>10.6</td>
<td>10.1</td>
<td>13.1</td>
</tr>
<tr>
<td>Colombia</td>
<td>1.5</td>
<td>4.1</td>
<td>6.5</td>
<td>11</td>
<td>12.9</td>
</tr>
<tr>
<td>Mexico</td>
<td>0.9</td>
<td>3.9</td>
<td>8.3</td>
<td>9.1</td>
<td>9.8</td>
</tr>
<tr>
<td>Costa Rica</td>
<td>0.8</td>
<td>3.1</td>
<td>5.9</td>
<td>6</td>
<td>8.4</td>
</tr>
</tbody>
</table>

Source: WITS, Citi Research

LatAm imports mostly manufactured goods, primarily capital goods but also some intermediate inputs and consumer goods. Figure 101 shows the composition of LatAm-China imports and exports for those countries with a stronger relationship with China. The commercial relationship between China and LatAm is skewed structurally from inception towards the supply of commodities in exchange for manufactured goods. Commodity exports add little value to the raw material, while value added increases with the complexity of manufactures. In this sense, China can progress through the complexity-value-added ladder (as has been the case\(^{69}\)), while LatAm cannot as easily under this growth model. This will be one of the important factors that will determine the China-LatAm relationship going forward as it leaves Latin America more vulnerable to commodity price swings and without a path for graduating from commodity exporter to a higher complexity economy — particularly when the production of a greater diversity of goods is associated with stronger future growth.\(^{70}\)

Figure 101. Our Commodities for Your Manufactured Goods

Source: WITS, Citi Research, Note: Some Metals are Manufacturers

\(^{69}\) Indeed, the “Made in China 2025” initiative is precisely a plan to move up the value chain to overcome the “middle-income trap”. Data shows that China is moving upward in the value chain (OECD, Trade in Value Added: China, October 2015; “China’s relentless rise up the value-added export chain”, Tom Hancock, Financial Review, 2018.)

Figure 102. South America Is Exposed to China While Mexico and Central America Are Exposed to the U.S.

Source: World Bank, Citi Research

Trade Evolved to Loans and Investment.

After solidifying the trade relationship in the 2000s, China has been a more important lender to LatAm since the Great Recession. According to an important database of loans from Chinese policy banks to LatAm (the China–Latin America Finance Database from the Inter-American Dialogue\(^7^1\)), since 2010 China has been more active as a lender to Latin America. From 2006 to 2016 about 10.5% of the total foreign credit to LatAm comes from China (see Figure 103). From 2010 to 2017, total loans have totaled $29.4 billion, up from $20.9 billion in the period 2005-2009. The bulk of this financing is associated with the energy sector (70% of the total) with close to an additional 20% going into infrastructure projects. Venezuela is a particular case, getting $62 billion (or 41% of the total). Other than Venezuela, Brazil (with 28%), Argentina (12%), Ecuador (12%), and Bolivia (2%) received most of the Chinese lending in the last years. It’s no surprise that the countries receiving China financing had political regimes more sympathetic to the Chinese government and further from the United States in the period when they received the loans. The extractive industries of oil and gas, mining and metals loomed large originally in Chinese loans in the region, accounting for more than $50 billion in cumulative investments (2013-2017), but they are shrinking in relative terms (see Figure 104) as China diversifies its investments in the region.

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\(^7^1\) Which provides up to date information on loans from the China Development Bank and the China Export-Import bank.
Unlike traditional Western loans, Chinese lending frequently takes the form of “patient capital”. It has been argued\(^72\) that as China (as the world’s largest saver) replaced part of the decline in Western capital financing after the great recession it has also changed the characteristics of the financial relationships between borrower and lender. Whereas “Western capital” constrains national policymaking — given its mobility — China’s state-led capitalism is characterized by a longer-term horizon that leaves borrowers with more room to maneuver. If this is the case, the sharp increase in indebtedness towards China does not necessarily raise traditional financial stability concerns but rather concerns more associated to increasing political influence of China in the region.

FDI figures paint a similar story with a few additional surprises. FDI data is inconsistent between China-based data and receiving country official statistics. The overall picture is similar albeit with substantial differences in some cases. As with trade, Chinese FDI to LatAm has been on an increasing trend from $5 billion in 2007 to nearly $30 billion in 2016, according to Chinese data.\(^{73}\) Although the share of total Chinese FDI is still small (15% in 2016) out of total inward FDI, it has increased significantly from 2008 (when it was only 6.6%), and now surpasses the FDI that China does in Africa, Europe, and the U.S., individually. The countries that receive most of the FDI are Jamaica, Chile, Mexico, Argentina, Brazil, and Peru, but this is after removing two very big outliers in the data: the Cayman Islands, and the British Virgin Islands. Indeed, the scale of Chinese FDI in these two destinations (roughly $12 billion each) dwarfs the FDI received by all other LatAm countries combined ($1.4 billion). The fact that these two important destinations of Chinese FDI are tax heavens\(^{74}\) (and small economies) indicates a channel from which China allocates investments to sectors or destinations on which there is a preference for diminished transparency.

Other sources show increased Chinese activity in LatAm since 2016. From a database on Chinese overseas investment and construction in the region (the China Global Investment Tracker by the American Enterprise Institute), one can also see a more consistent and deliberate presence of China in the region. In the period 2012 to the most recent figures of 2018, China has invested $110 billion in the region, compared to $70 billion in the years 2005-2011.

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\(^{74}\) Both are in the Watch List of the EU non-cooperative tax jurisdiction list, updated on March 13, 2018.
Surprisingly, 2010 had a record investment of $37.7 billion presumably given fire-sale prices of some assets after the great recession (see Figure 107). The bulk of these investments in the period 2005-2018 went to Brazil ($64 billion or 36%), followed by Argentina ($28 billion), Peru ($23 billion), Venezuela ($21 billion), Ecuador ($12 billion), but with Mexico and Colombia also registering Chinese activity in this period (with $3 billion and $1.9 billion respectively) (see Figure 108). It’s clear that China has been more cautious with Mexico and Colombia given their strong U.S. ties, but the situation has been changing in recent years. In Mexico, the administration of President Peña-Nieto deliberately increased its ties to China as a means of diversifying its economic relationships (with 5 summits happening between President’s Xi and Peña in the last five years). The proposed Chinese participation in an important railway project in the country (the Mexico City-Queretaro line, later cancelled in the midst of domestic corruption scandals), and the winning by China (CNOOC) of two deepwater oil fields very near the US border in the Gulf of Mexico in the first public auction, are but two examples of China becoming more interested in strengthening its presence in the country. In Colombia, also after a slow initial interest, China has been more active and might play an important role in the construction and financing of infrastructure going forward. The fact the US policy towards LaAm has been inconsistent throughout history, and close to non-existent with the current US administration, has opened the door to increased strategic interest by China in the region.75

Chinese investment in LatAm is diversifying away from the extractive industries. Originally, Chinese investment in LatAm consisted mainly in Chinese’s state-owned companies investing mostly in the extractive industries (oil, gas, metals and agriculture, see Figure 110), in order to ensure natural resources to fuel its economy. But now Chinese companies are shifting their investments towards alternative energy, real estate, finance, technology and transport. Since 2012 China has reduced its investments in mining, energy, and chemicals to 48% of its total commitments; a significant turnaround from 2005-2011 when China invested 73% on those industries. The diversification of Chinese investments in the region has ratcheted up in an important way.

75 The relations between the U.S. and Latin America have been multifaceted and complex. They can be broadly divided in two periods: the cold war and the post Berlin wall fall period. In the former period the U.S. had a geopolitical interest besides the traditional economic one, mainly due to the Cuban revolution. Kennedy’s Alliance for Progress is the main example of a strategic plan from the U.S. towards the region. In the past three decades, the interest of U.S. has gradually declined, and with the Trump administration there is little strategic involvement (save a few visits by the Secretary of State and the Vice President of the U.S. to countries in the region) — of course, excluding Mexico and the NAFTA renegotiation.
Figure 107. A Growing Presence in the Region

China's Investment in LatAm

Source: China Global Investment Tracker, AEI and Citi Research

Figure 108. Allocated All Across LatAm

China's Investment in LatAm Since 2005

Source: China Global Investment Tracker, AEI and Citi Research

Figure 109. China in LatAm: Not Only Energy and Infrastructure Anymore

China's Investment in LatAm Since 2005

Source: China Global Investment Tracker, AEI, and Citi Research
Chinese migration to the region has increased constantly in the last two decades, albeit from a very small base. It, however, still represents a small share of total outward Chinese migration. Either for distance, language, or cultural reasons, Latin America has not traditionally been the chosen destination of Chinese migrants. In 2015, out of 9.5 million Chinese that emigrated, 118 thousand went to LatAm. Only Africa receives less — with around 50 thousand in 2015. Nevertheless, the numbers have been increasing (from 66 thousand in 2000), and with a consistently strong growth of close to 20% across five-year periods, the second highest growth rate across regions in the world. At the same time, Confucius Institutes (meant to serve as a cultural spearhead by teaching Mandarin and spreading Chinese culture, but thought of in some quarters as political bodies76) have been more widely instituted in the region. There are already 39 such institutes in the region (out of 525 in the world) and most LatAm countries already have at least one each, with Brazil (10), Mexico (5), Peru (4), and Colombia (3) having the most.

76 “How China managed to play censor at a conference on U.S. soil”, Bethany Allen-Ebrahimian, Foreign Policy (FP), May 9, 2018.
China is more willing to deepen financial ties with renminbi swaps. The Chinese central bank also has been active in establishing swaps with some LatAm central banks. Argentina, Brazil and Chile have already established swaps at some point with the People’s Bank of China (see Figure 112). These links show a willingness to play a greater role of China across the region, particularly in periods of stress as in the case of Argentina.

Five years since the establishment of the BRI, China has markedly increased its ties to LatAm though trade, loans, investments and closer diplomatic relationships, and this process will intensify in the future. Although not officially part of the BRI, China has set out new priorities for engagement with the region. There is willingness to sign more Free Trade Agreements (FTAs) to deeper economic linkages (so far only Peru, Chile and Costa Rica have FTAs in place with China). Chinese Foreign Minister Wang Yi says Latin America has already become the second largest destination for Chinese Overseas investment. He also calls Latin America a “natural extension” and an “indispensable participant” in the BRI, offering a “strategy of mutual benefit and shared gain”. And there is a sense that China providing “patient capital” is being more pragmatic than ideological, particularly under a more polarized geopolitical environment. While this process helps Latin America in its diversification of trade and financing sources, it also leaves the region more exposed to China risk. A slowdown in China already has significant effects in the region both through the trade channel and the commodity price channel. An additional channel of contagion would be the reduction in investment and lending flows. And more importantly is how prepared is the region to deal with a more patient but less transparent lender, on which the full conditions on its participation might not be fully specified in advance. What is true is that now it has become impossible to forecast the prospects of the region without consideration of China’s outlook.

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GLOBAL REACH
Two-thirds of Chinese investment and construction in BRI countries is in the Energy and Transport sectors. Building and investing in these sectors lays the foundations for future markets and supply chains for China.

INFRASTRUCTURE
Infrastructure is often a key driver of national development and boosting a country's growth prospects. Financing infrastructure via debt financing is risky and China should care more about the financial stability of BRI countries and shift its strategy to adopting more international creditor norms, better governance standards, and multi-lateralizing projects.

SHIFTING WEALTH
Criticism that China's BRI is too little 'win-win' and too much 'China-win' has led to pushback and the suspension of projects. China may bring a 'kinder and gentler' BRI that is more sensitive to international criticism and more obviously meets China's ambition of being a 'many-to-many' platform linking countries through the development of infrastructure, trade agreements, a simplification of customs procedures, and cultural exchange.