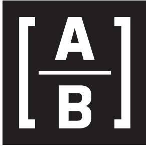

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ECONOMICS: GLOBAL MACRO PERSPECTIVES

# LONG BELT, WINDING ROAD: SCOPING CHINA'S INFRASTRUCTURE INITIATIVE

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China's Belt and Road Initiative (BRI) has captured the popular imagination as one of the world's largest infrastructure initiatives. Our analysis suggests, however, that its true potential may lie in long-term secondary effects rather than in directly improving the short-term global investment and economic outlook.

## BRI: WHAT IS IT?

BRI (formerly One Belt, One Road) is nothing if not grand and visionary—a pan-regional, land- and sea-based infrastructure programme that aims to deepen trade and investment between countries representing more than 60% of the world's population and nearly 30% of its GDP. Conceived and driven by China, it symbolizes the country's aspirations towards regional and global leadership, and is likely in the long term to have a profound impact on the world's economy as well as on its politics.

The programme's scope is such that it's hard to gain a sure sense of its overall dimensions. A list of key projects and other characteristics (as they currently stand) can point only suggestively to the potential long-term impacts, many of which are likely to be second-order effects not easily foreseeable now.

Six "economic corridors" radiating out of China form the land-based part of the template—they traverse Mongolia, Russia, Eurasia, Central and West Asia, Pakistan, Bangladesh, India, Myanmar and Indochina—while ports and maritime routes connect to East Africa and the Mediterranean. Nearly 70 countries, including China, are involved, with a combined population of 4.4 billion (*Display 1*).

At this stage, China has earmarked nearly US$900 billion in funding towards projects so far announced under the programme, ranging from ports in Pakistan and Sri Lanka to railways in East Africa and gas pipelines across Central Asia (*Display 2*). While this is a strong start, we are not sure that total investment will reach the US$2 trillion–US$3 trillion indicated by China's leadership when the project was unveiled two years ago. Nevertheless, BRI will indubitably be a very important contribution to infrastructure development in Asia, if not the world, as the Asian Development Bank (ADB) estimates that Asia will need US$1.7 trillion a year of infrastructure spending until 2030 to sustain economic growth and further raise the standard of living to fully utilize its economic potential and eradicate poverty.

Below, we look at the likely short- and medium-term effects and the possible long-term impacts of BRI across five areas—

Display 1
BRI: The Big Picture...

Key Facts

- Covers 69 countries, including China
- Involves 4.4 billion people, or 63% of world's population
- Combined GDP of US$21 trillion (29% of world GDP)
- Average GDP per capita of US$4,500, compared to world average of USD$10,000
- Six economic corridors linking China with Eurasia, Mongolia, Russia and Indochina
- China's trade with BRI countries amounts to about US$2 trillion or 55% of China's total trade
- Overseas direct investment has reached US$50 billion
- Chinese firms have set up 56 economic cooperation zones in 20 BRI countries and created 180,000 jobs

As of June 14, 2017
Source: Asian Infrastructure Investment Bank (AIIB), CEIC Data, Citigroup, Goldman Sachs, HSBC and AB

Display 2
...and the Big Bucks

Funding and Investment

- Total funding size, US$1.3 trillion–US$1.4 trillion
- US$900 billion underway or under planning stage (5.3 times China's overseas direct investment and 10% of its total fixed-asset investment)
- Disbursement (US$5.7 billion): AIIB, US$1.7 billion (vs. capital of US$100 billion); Silk Road Fund, US$4 billion (vs. capital of US$40 billion)
- Total accumulated investment so far is US$55 billion; AIIB is to lend between US$10 billion and US$15 billion a year

As of June 14, 2017
Source: AIIB, CEIC Data, Citigroup, GS, HSBC and AB

frontier markets, China, the global economy, bond markets and commodity markets.

## EFFECTS WILL BE UNEVEN

The most exciting aspect of BRI, in our view, lies in its potential to assist in significant trade and energy infrastructure developments across frontier economies in South and Central Asia, as well as the Middle East and East Africa. If managed well by the individual host countries, we believe that these projects can generate sustainable net benefits over the long term.

In the near term, foreign direct investment (FDI) and concessional loans can make meaningful contributions to frontier countries' external financing requirements, although this positive impact on the sovereign balance sheets can be tempered by corresponding increases in current account deficits and sovereign debt. Longer term, we believe that the benefits will be more tangible given the projects' scope to lift growth by encouraging domestic investment and integration into regional trade and supply chains.

While Southeast Asian countries are likely to see fewer mega projects than others affected by BRI, they are likely to experience more active participation by Chinese contractors in local infrastructure developments, and this will be an additional source of FDI and growth.

We believe that Pakistan, Kenya and Azerbaijan will be among the biggest overall beneficiaries of BRI funding, partly because their funding amounts have already been publicly confirmed and are expected to be disbursed over the next few years. In Pakistan and Kenya, BRI funding is likely to make a larger contribution compared to external financing than seen in other frontier markets. Russia and Kazakhstan, meanwhile, are planning to improve their railway infrastructure through BRI initiatives, but the size of BRI funding they are likely to receive, and the time frame in which they will receive it, are far less certain at this stage. Over time, Russian and Kazakh railway companies will certainly benefit from higher freight traffic. Meanwhile, some countries, like Georgia, will not receive direct BRI financing; they have, however, established their own investment plans, which will enable them to integrate into the regional BRI infrastructure network.

The likelihood that the effects of BRI will be distributed unevenly across participating countries should alert investors to the risks of generalizing and encourage them to assess the impact on each country on a case-by-case basis. One way to do this is to look closely at how projects are financed and the likely impacts that the projects will have, given each country's geographic and socio-economic characteristics. Pakistan, which is relatively advanced in its journey through the BRI process, provides an example of how nuanced the impact on individual countries might be.

## CASE STUDY: PAKISTAN

Pakistan has been the largest recipient of Chinese funding under BRI to date and so has more experience of the initiative's economic impacts than other countries. Infrastructure development projects along the China–Pakistan Economic Corridor[1] total more than US$60 billion, equivalent to more than 20% of Pakistan's GDP. They fall into three categories—energy, infrastructure and the deep-sea Gwadar Port in Baluchistan province on the Arabian Sea (*Display 3*). The energy projects, which deliver guaranteed returns enabled by tax exemptions, would be owned and operated by Chinese corporations financed by the China Development Bank and Export-Import Bank of China. The projects, therefore, qualify as FDI and will not add to Pakistan's external debt.

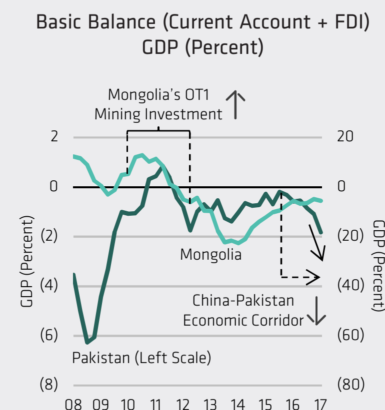
Infrastructure projects, however, will add to external debt as they will be financed by typical government-to-government concessional loans, which will incur repayment outflows to the external account in coming years. Lastly, the impact of the Gwadar Port special economic zone will be limited by the fact that, although it enjoys funding and grants with highly favourable terms and conditions, it's relatively small. From a balance of payments perspective, the projects have limited local content and rely on imports, mainly from China. Consequently, the FDI inflows from project construction during the last several quarters have been used to finance the current

Display 3
Summary of BRI Projects in Pakistan 2015–2030*

| Project Type/ Amount (USD Bil.) | Mode of Financing | Balance of Payment/ Fiscal Impact |
|---|---|---|
| Energy 34 | + CDB/EXIM† direct lending to Chinese companies<br>+ 17% IRR guaranteed | + FDI inflows largely offset by current account deficit<br>+ Estimate US$2 bil. annual dividend outflow since 2018 |
| Infrastructure 19 | + Concessional loans | + Add to external debt<br>+ Additional US$1.2 bil. repayment outflow |
| Gwadar Port 0.7 | + Interest-free loans and grants | + Special economic zone with potential to expand manufacturing capacity<br>+ Potential fiscal revenue losses with 23-year tax holiday |

As of July 27, 2017
FDI: foreign direct investment
*Energy = 2015–2023
†China Development Bank and Export-Import Bank of China
Source: CEIC Data and AB

Display 4
Projects Affect Countries Differently




Through July 27, 2017
OT1: Oyu Tolgoi mine
Source: CEIC Data and AB

Display 5
BRI Funds Are Part of the Mix

Cofinancing of Trans-Anatolian Natural Gas Pipeline

| Financing Sources | Amount (USD Billions) |
|---|---|
| Private Commercial | 2.0 |
| Borrower's Contribution | 1.4 |
| European Investment Bank Loan | 1.3 |
| BOTAS Petroleum Pipeline Corporation, Turkey | 1.0 |
| BP | 1.0 |
| World Bank | 0.8 |
| AIIB (BRI Funding) | 0.6 |
| EBRD | 0.5 |

As of December 31, 2016
EBRD: European Bank for Reconstruction and Development
Source: AIIB

1 The China–Pakistan Economic Corridor is officially considered to be "closely related" to the BRI rather than an integral part of it, but we regard this as a technical distinction. In reality, the corridor provides a crucial link between land-based and maritime aspects of the programme.

account deficit, and there has been little residual addition to the external balance.

Pakistan's basic balance—the combination of FDI and the current account balance—provides a simple and clear way of evaluating the net impact of such projects on the country's external position. As *Display 4, previous page,* shows, however, the basic balance has been deteriorating since construction on the projects started in 2015. We can see two reasons for this: first, the extent to which the projects rely on imported materials and, second, the spike in domestic demand triggered by the expansionary turn in fiscal policy that followed the conclusion of the country's International Monetary Fund bailout in August last year.

Pakistan's experience in this respect contrasts with that of Mongolia, where large-scale FDI contributed to positive basic balances and generated positive external income during construction.

Not only will Pakistan reap only limited benefits during the construction phase, which will peak in 2017–2018, but it will also endure average additional outflows of US$3 billion a year in the medium term, consisting of US$2 billion in dividends from the energy projects (to fulfil the guaranteed 17% return for Chinese investors), with the balance consisting of repayments under the concessional infrastructure loan.

Given these challenging fundamentals, how likely is it that the improved infrastructure will induce further FDI, which, in turn, would expand export capacity and generate external income?

We are sceptical. The lack of reliable energy supply has been just one of numerous structural constraints that explain why Pakistan has failed to attract FDI and expand export capacity in the past. The country is also disadvantaged by uncompetitive labour costs, bureaucratic inefficiencies and security issues, including the Taliban resurgence outside the main cities. In the medium term, if the improvement of Pakistan's infrastructure under BRI fails to generate sufficient export capacity, those additional US$3 billion outflows will become a further burden to Pakistan's external position.

## NO SHORT-TERM BOOM FOR BONDS

Even after considering the potential macro benefits, we believe that the impact on bond markets—especially US-dollar sovereign bonds—will be limited in the medium term. That's partly because several projects supported by the BRI have been running for quite some time, especially in the Commonwealth of Independent States and Africa, and thus do not necessarily provide significant new impetus. Aside from the fact that the funds are disbursed over several years, BRI funding in many cases constitutes only a relatively small share of the overall project finance. For example, Azerbaijan's Trans-Anatolian Natural Gas Pipeline Project was first conceived in 2011 with a total cost of nearly US$9 billion. The BRI component of the financing—through the Asia Infrastructure Investment Bank (AIIB)—amounts to only US$600 million or 6.6% of the overall cost. The rest of the financing comes from private commercial sources, sovereign borrowing and a host of international financial institutions (*Display 5, previous page*).

## IMPACT ON CHINA

Assuming an average construction period of five years, the BRI's initial impact on China's growth will not amount to much. Based on estimates by Citibank,[2] the extra demand for major commodities that BRI would create amounts to only about 18%, 8% and 9% of China's 2016 production of crude steel, copper and aluminium, respectively.

Of course, this is a static assessment and the wider impact from China's providing most of the start-up funding to Chinese enterprises' direct investment, as well as the selling, shipping and other logistics of commodity supply, should have a much broader effect than just the investment amount suggested.

Longer term, however, the BRI should provide China with an additional growth channel. We don't believe that it will compare with, say, the Marshall Plan of the post–World War II period, which resulted in a US-led reconstruction of Europe and, subsequently, a marked economic revival not only among European countries but of the US as well. According to Citibank, the Marshall Plan sustained US GDP growth at 8% a year from 1946 to 1952, compared to 8.5% a year from 1940 to 1945.

At this juncture, we also doubt that the BRI will match the economic benefit of Japan's aggressive overseas direct investment and official development assistance program to Asian economies during the late 1980s and early 1990s. In a nutshell, Japan's GDP growth tripled to some 16% a year between 1986 and 1992, from about 5% a year in the prior five-year period. And the relocation of manufacturing production, transfer of manufacturing know-how and job creation significantly stimulated the beneficiary countries, ultimately triggering their economic transformation into the so-called "Four Little Dragons"—South Korea, Taiwan, Hong Kong and Singapore.

## SUPPLY CAPACITY WILL DELAY IMPACT ON GROWTH AND COMMODITIES

Longer term, the BRI is one of two potential sources of upside surprise on the demand side. Irrespective of the BRI, most incremental growth in global GDP over the next decade will probably come from emerging-market (EM) economies, largely in the form of urbanization and infrastructure development. While the rebalancing of the Chinese economy towards consumption-led growth will be a headwind, the upside surprise could come from EM economies in Asia stepping up to the challenges of poverty and climate change. As noted earlier, the ADB estimates that these countries will need to invest about US$1.7 trillion a year in infrastructure over the next 15 years to maintain the growth momentum necessary to achieve these objectives. Currently, they spend about US$900 billion a year in total on infrastructure.

The BRI itself might contribute significantly to increased demand if, as is likely, it succeeds in stimulating trade flows and making transportation more efficient across participating countries. This would effectively create a new round of industrialization and urbanization in many currently low-income countries—perhaps enough to cause the kind of structural shift in demand for commodities seen from 2001 to 2011.

An important caveat needs to be made here, however, which is that we are living with the legacy of the 2011–2016 commodities supply surge. The proximity of that last capital

2 Source: "China's One Belt One Road Initiative: Will It Boost Global Commodities Demand?" Citibank, May 11, 2017

expenditure boom (resource expansion plus associated infrastructure), coupled with the amount of "near" supply (that is, capacity that has been mothballed but could be brought back on line fairly quickly), means that there should still be a considerable amount of supply flexibility—certainly much more than there was in the early 2000s, prior to which there had been a drought of new capital expenditure in the mining sector for two decades. Indeed, part of the BRI's objective is to absorb some of that near supply, to the extent that it occurs in China.

The effect of this supply flexibility would likely be to delay any strong response in commodity prices, rather than diminish the prospect of a structural shift in demand if the pro-growth scenarios outlined above take place. Barring any unforeseen negative macroeconomic or geopolitical developments, the potential for such a shift clearly exists; it's only a question of how far beyond the medium- and long-term horizons the potential lies.

## TAKE A CASE-BY-CASE APPROACH

On balance, it's hard to escape the conclusion that the BRI is more impressive for what it symbolises—the rise of China as a global power—than for what it promises to deliver in terms of solid economic and investment gains. While there is little doubt that the country's global influence and international prestige will be enhanced by the project (and already has been, to some extent), it will take time for the broader benefits to be felt.

Undoubtedly, however, there will be opportunities in time, as the BRI empowers participating countries, through improved transportation and other infrastructure, to generate an economic momentum that wasn't previously available to them. These opportunities will be real and worthwhile, but are unlikely to be distributed evenly across BRI participants. Investors who wish to explore them should be prepared to do their research, and to assess carefully each country and project on a case-by-case basis.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