

THE VIEW

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YEAR OF THE PIG: CAN CHINA'S BELT AND ROAD INITIATIVE SAVE THE WORLD FROM A MUD FIGHT?

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EXECUTIVE SUMMARY



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With the support of Patrick Liao.

- Born in late 2013, the Belt and Road Initiative (BRI) is a development and cooperation strategy launched by China. It includes 80+ countries mainly from Asia, Europe and Africa and spans an area accounting for nearly 36% of global GDP, 68% of world population, and 41% of global trade.
- We expect merchandise trade flows between China and BRI partners to grow by +USD117bn in 2019 (after an estimated +USD158bn in 2018). This would boost global trade by +0.3pp, and add +0.1pp to global GDP in 2019.
- For China, exports to BRI markets are expected to grow by +USD56bn in 2019 (after +USD76bn in 2018). BRI will support: business internationalization, overcapacity reduction, economic upgrading, RMB internationalization and the reduction of regional imbalances. Central and Western Chinese provinces will likely be the first direct winners of the project.
- For partner countries, we see the impact being threefold: a boost in capital (already +410bn Chinese investment to BRI over 2014-18), a boost in external demand (+USD61bn additional exports to China in 2019) and an improvement in competitiveness thanks to lower transaction costs (transportation costs and time of travel, e.g.) and better infrastructure. ASEAN and the Eastern European market are best positioned to take advantage of the project.
- However, the BRI will not be a walk in the park. Three challenges remain unaddressed:
 - * Financial sustainability, given China's limited financial resources (total non-financial debt at 253% GDP) and only partial control over the underlying risks in BRI markets (country risk, e.g.). Funding needs are considerable. We estimate that the capital needs to fund infrastructure for Asia (excluding China), Europe and Africa combined would amount to USD1.7tn per year.
 - * Legal and regulatory risks, given the absence of a uniform regulatory framework among countries with different law regimes (common law, continental law, Islamic law). This creates uncertainty and complexity for trade and cross-border investment.
 - * Political risks, as political tensions among BRI members (Saudi-Iran, India-Pakistan), some BRI members with China (India or ASEAN vs China, e.g.), and battles for influence with other superpowers (with the US, EU) hamper partnerships.



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USD117billion

**growth in merchandise trade between
China and BRI members in 2019**

BRAND, CONNECT AND FINANCE

Born in late 2013, the Belt and Road Initiative (BRI) is a development and cooperation strategy launched by China which consists of five goals, six corridors under two roads namely (i) the New Silk Road Economic Belt going from China to Europe through Russia and Central Asia and (ii) the 21st Century Maritime Road running west towards Europe through South Asia and Southwest Africa (see Figure 1). The objective is to promote development through greater cooperation on matters such as trade, financing, investment and culture along Belt and Road routes.

At the core of the project lies a large infrastructure investment program to improve connectivity across Asia, Africa and Europe. The initiative gathers 80+ countries which represent nearly 36% of global GDP, 68% of world population, 41% of global trade and 46% of global savings. It represents 10 Marshall Plans and is an essential piece of China's future growth opportunities

and release of debt overhang. On top of passive financial liberalization, China decided to take the bull by the horns by creating a unique platform (massively financed and structured) to uberize trade and trade financing from the South East Asian economies all the way to Europe. This is an all-inclusive approach that neither the US, nor Europe have dared to push for, and position China as a major actor in the future of global trade and internationalization.

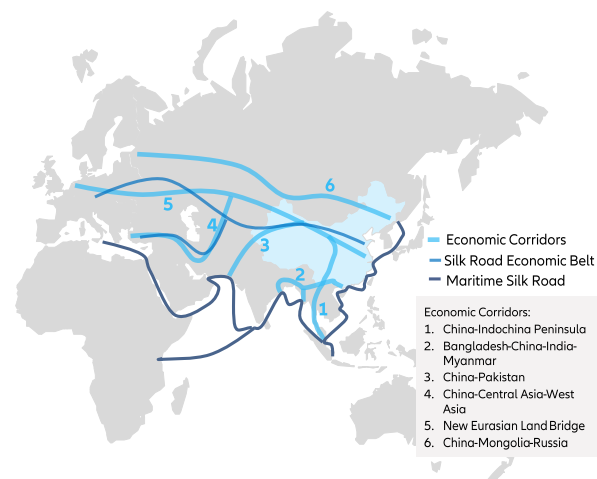
Perceived as a pipe dream in the beginning, the project gained a lot of stature over the past five years for three reasons: China continues to develop as a global economic and political superpower; Belt and Road projects become concrete; and China expands its financial capabilities to support the initiatives (with the support from Asian Infrastructure Investment Bank, New Development Bank, e.g.). We estimate that the amount invested by China Development Bank, Exim

Bank, the Silk Road Fund, the AIIB and the New Development Bank so far has reached USD460bn in 2018.

The project is of critical importance for China. First, it is a branding strategy for Chinese foreign policy. It is a marketing tool which aims at improving China's brand equity and soft power. It is a label applied to a wide a range of project and it is now clearly identified as China's proposition to strengthen globalization. Second, it is a medium to help corporates connect to other markets through both trade and investment. Last, it is a framework for financial resources allocation while the country advances on financial liberalization. It provides a plan for Chinese investors by identifying specific countries and projects (telecommunication, energy infrastructure, e.g.) that should get their attention but also a means to internationalize the RMB as a currency of choice.

Figure 1 Five goals, two routes and six economic corridors

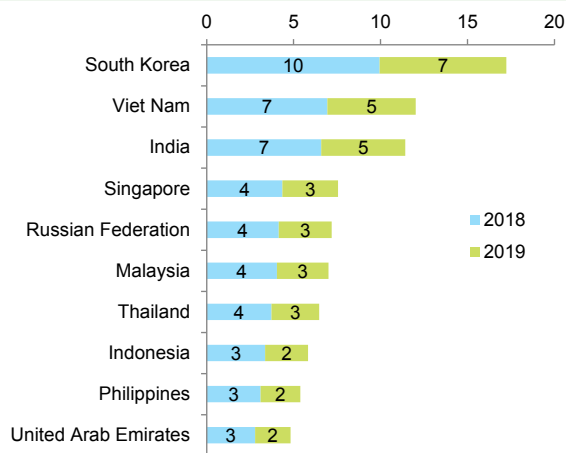
Goals	Description
Cultural Exchange	Promoting people-to-people connection and cultural exchange
Financial integration	Enhancing monetary policy coordination and financial cooperation
Trade and investment	Facilitating cross-border trade and investment
Policy coordination	Planning and supporting large-scale development projects
Facilities connectivity	Building facilities to connect BRI countries/regions



Sources: Various, Euler Hermes

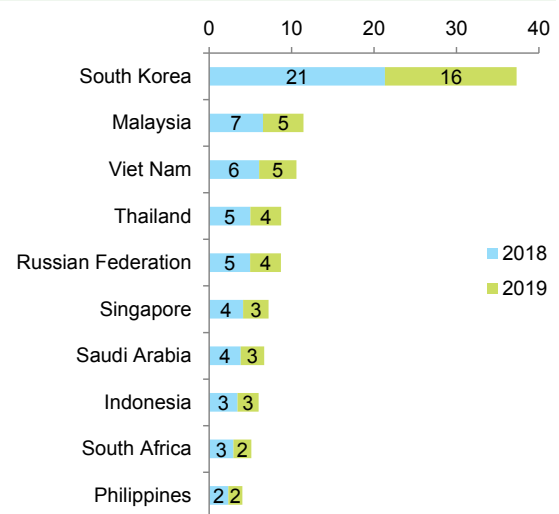
THE BELT AND ROAD INITIATIVE: +USD117BN TO MAKE IN 2019

Figure 2a China's exports to BRI markets: top destinations (gains in USD bn)



Source: Euler Hermes

Figure 2b Top BRI exporters to China (gains in USD bn)



Source: Euler Hermes

Based on our import needs expectations, we calculated trade gains for Belt and Road markets. Merchandise trade flows between China and BRI partners could grow by +117bn in 2019 (after an estimated +USD158bn in 2018). This should boost global trade by +0.4pp in 2018 and +0.3pp in 2019 and would add +0.2pp and +0.1pp to global GDP respectively.

In China specifically, exports to BRI partners could increase by +USD56bn in 2019 (after +USD76bn in 2018). Top destinations include South Korea, ASEAN, India and Russia. For mature markets such as South Korea and Singapore, better export market penetration from Chi-

nese corporates would reflect improved trade relations and competitive advantages especially on high tech products. In ASEAN and India, mainland companies are expected to benefit from a strong growth in domestic demand. In Russia, the main driver will be diversion as Western sanctions force Russian corporates to look for other suppliers.

BRI countries' exports to China are set to grow by +USD61bn in 2019 (after +USD81bn in 2018) driven by stronger trade integration with China. South Korea will likely be the main winner. Korean exporters are expected to profit from the rise of Chinese middle class and improved political relations between both mar-

kets. On top of a demand boost from the Chinese middle class, ASEAN and India are set to benefit from the development of the Chinese supply chain.

WHAT DOES IT MEAN FOR CHINA?

FIVE POTENTIAL LONG TERM BENEFITS

1. Business Internationalization and supply chain management

Corporates could get access to new clients (through exports and investment) and cheaper suppliers (through imports). On trade, China's partnership with BRI markets should help diversify exports: exports to BRI countries represented 34% of Chinese merchandise exports in 2018 versus 31% in 2012. It should also help China to access cheaper goods suppliers, namely primary commodity producers such as Mongolia or Myanmar. On investment, it should support Chinese companies investing abroad. A first motive would be to become global players in infrastructure investment. Chinese infrastructure related companies (energy, telecom, roads, etc.) will likely be well positioned to obtain tenders in relation to infrastructure projects as China is the sponsor of the overall initiative. Other motives should be a reduction in production costs (e.g. outsourcing to Cambodia, Laos) and increasing external growth by getting closer to large growing markets (e.g. Indonesia, India). For example, large Chinese textile companies (from Jiangsu province, e.g.) have already started to move their production facilities to Cambodia due to rising labor costs. Assuming that infrastructures (electricity, transport) improve, this move could accelerate.

2. Overcapacity Reduction

The Belt and Road initiative will also help reduce Chinese overcapacity, especially concentrated in the raw materials' industry such as steel and coal. In-

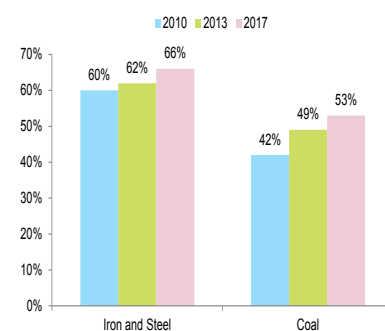
frastructure investment is expected to grow in China considering large infrastructure needs: +USD0.7tn per annum by 2040. Moreover, infrastructure development in BRI countries triggers a high demand for raw materials. BRI countries absorb 53% of total China's exports of coal, coke, and briquette now (compared to 42% in 2010) (see figure 3). They also absorb 66% of total Chinese exports of iron and steel (from 60% in 2012).

3. Economic Upgrading

The upgrading of the economy (to high tech and high value added production as well as improved Business practices) is a critical aspect of China's development plan. While the Made In 2025¹ strategy focuses mainly on building production capacity domestically, the Belt and Road Initiative provides a framework for technology transfer, distribution and sales. In fact, high tech exports to BRI countries such as electrical machinery are already growing: BRI countries accounted for 30% of electrical machinery exports of China in 2017 compared to 25% in 2012. China could benefit from significant economies of scale while it increases its customer base, it could also learn and share knowledge with other and use its knowledge to produce and sell to BRI markets. In that respect, China has signed several *Memoranda Of Understanding* with different partners on the topic of science and technology. There are South-South cooperation programs such as the Belt and Road Technology Transfer Agreement signed with the United Nations Development Program.

China and the UN plan to work together to improve innovation for development, support technology transfer and knowledge sharing across Belt and Road markets. There are North-South initiatives such as the EU-China connectivity platform that are expected to foster collaboration on green transport. Not only would this help accelerate the manufacturing upgrading of the economy but it would also help improve business practices through further alignment with partners.

Figure 3 China's exports to BRI (% of product total exports)



Sources: UNCTAD, Euler Hermes

¹The "Made In 2025" industrial strategy aims to significantly upgrade Chinese manufacturing sector. The plan identifies 10 priority sectors 1) New generation information technology; 2) High end numerical control and robotics; 3) Aerospace and aeronautical equipment; 4) Maritime equipment and high-tech shipping; 5) Modern rail transport equipment; 6) New-energy vehicles and equipment; 7) Power equipment; 8) Agricultural equipment; 9) New materials; and 10) Biopharma and advanced medical products.

4. RMB Internationalization

The BRI could also be a catalyst for RMB internationalization through China's overseas investment but also through the selection of RMB as reference currency for Belt and Road related transactions (trade, insurance, e.g.). As there is no dominant currency across the regions, this is clearly a good opportunity for the RMB. The mobilization of financial resources to encourage RMB usage (Overseas Fund Business in RMB at RMB300bn) and cooperation initiatives (the set-up of a China-Russia RMB Investment Cooperation Fund worth RMB68bn) are supporting examples of such a trend. Moreover, RMB usage would particularly be appealing for markets that are under US sanctions such as Iran or Russia.

5. Reduction of China's Regional Imbalances

The BRI could also help reduce the wealth gap existing between Chinese provinces. The 1978 Chinese economic reform has contributed to the strong economic development of coastal areas. Nevertheless, it also resulted in strong inequality and regional imbalances. Beijing, Shanghai, Tianjin, and Jiangsu have over RMB100,000 GDP

per capita (c. USD15,000, similar level as Chile), while almost half of the provinces (15 out of 31) fall below the RMB50,000 (c.USD7,400, similar level as Bulgaria, lower than Kazakhstan) income per capita watershed. The BRI could provide a framework for a more sustainable development with all provinces capitalizing on different aspects of the project. We see four clusters of growth.

- **The construction block.** Central and Western regions would be the first direct winners. They are currently benefitting from a rise in infrastructure spending. Most provinces in Southwest China and Northwest China recorded above 10% y/y growth in nominal construction investment in 2017 (see figure 4). Tibet leads the pack with business income in construction representing 30% of total GDP.

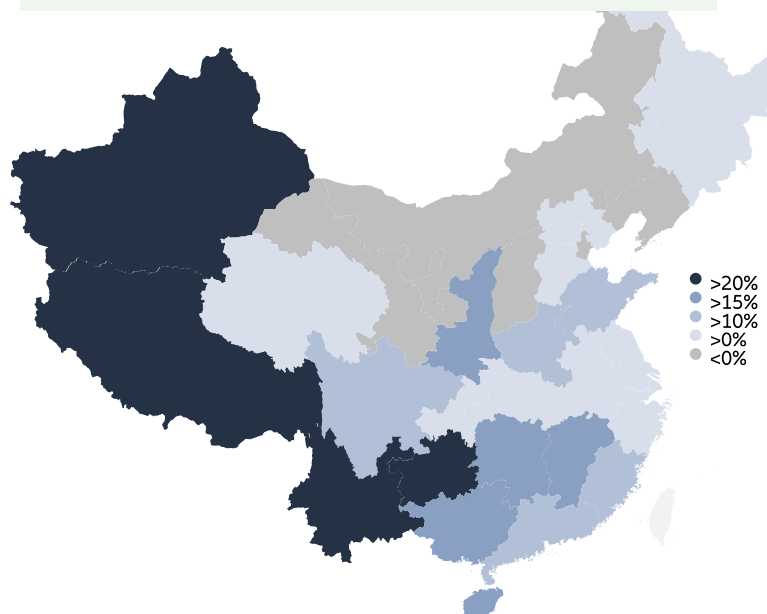
- **The natural resources providers.** The northern regions would be the second in line as natural resources producers. If we look at the Mining and Quarry business income as a percentage of provincial GDP, seven out of ten highest ranked provinces are located in North China and Northwest China. With higher demand from BRI provinces and countries, these provinces are expected

to see their exports rise.

- **The high tech hubs.** Guangdong and Jiangsu provinces are expected to benefit from technology exports for Telecommunication and Machinery Equipment. High tech industry contributed to more than a third of these provinces' GDP level.

- **The financial platforms.** Last, increasing financial liberalization and need for financial services will benefit financially integrated provinces. Shanghai is the country's international financial center, while Beijing hosted major banks as well as Silk Road Fund and AIIB. Hong Kong also has tremendous opportunities as a global financial center and a gateway to China.

Figure 4: Nominal investment completed in construction, growth in 2017



Sources: Wind, Euler Hermes

WHAT DOES IT MEAN FOR BRI COUNTRIES?

China will certainly reap benefits from its new development strategy. But what's in it for partners? For countries taking part in the BRI, the impact is and will continue to be threefold: capital and demand boosts from China as well as enhanced competitiveness through better infrastructure.

Capital boost from China: China's investment in BRI countries has increased by USD410bn from 2014 to June 2018, compared to USD261bn over 2009-2013 (see figure 5). This boost coincides with the implementation of the Belt and Road Initiative late 2013. Markets that have benefitted the most are mainly located in Asia and Europe. Pakistan and Malaysia

top the league in Asia; Russia leads in Europe.

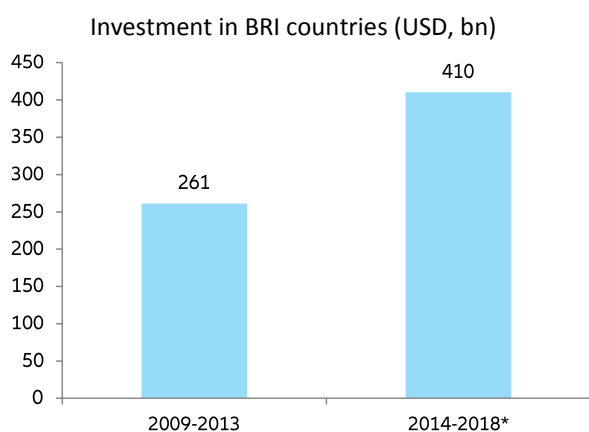
Demand boost from China: We expect BRI exports to China to grow by +61bn in 2019 (after +81bn in 2018). China's demand for goods from BRI countries is picking up speed. China's (USD denominated) imports from BRI countries increased by an estimated +22% y/y in 2018 compared to an average growth of +16% y/y for total imports. As a whole, BRI markets now account for 38% of China total merchandise imports. Moreover, except for EU markets where intra-regional trade is high, China is systematically among the top three outlets for BRI markets. Total

exports of BRI economies to China account for 4% of BRI markets' GDP and 14% of BRI markets' exports

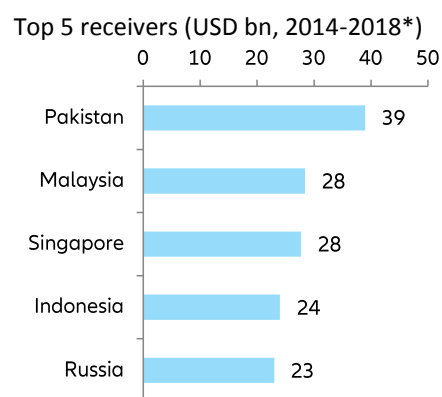
Improved competitiveness: Improved infrastructures are expected to boost competitiveness of BRI markets through lower transaction costs. Energy infrastructure would help gain productivity. Top notch infrastructure would facilitate trade.

One example is the construction of the rail line connecting China to Iran. The Yiwu –Tehran rail track reduced significantly travel time (less than 14 days). This compares to travel by sea, from Shanghai to the Iranian Port of Bandar Abbas which takes 45 days.

Figure 5 Investment in BRI countries



Sources: China investment tracker, AIE and HF



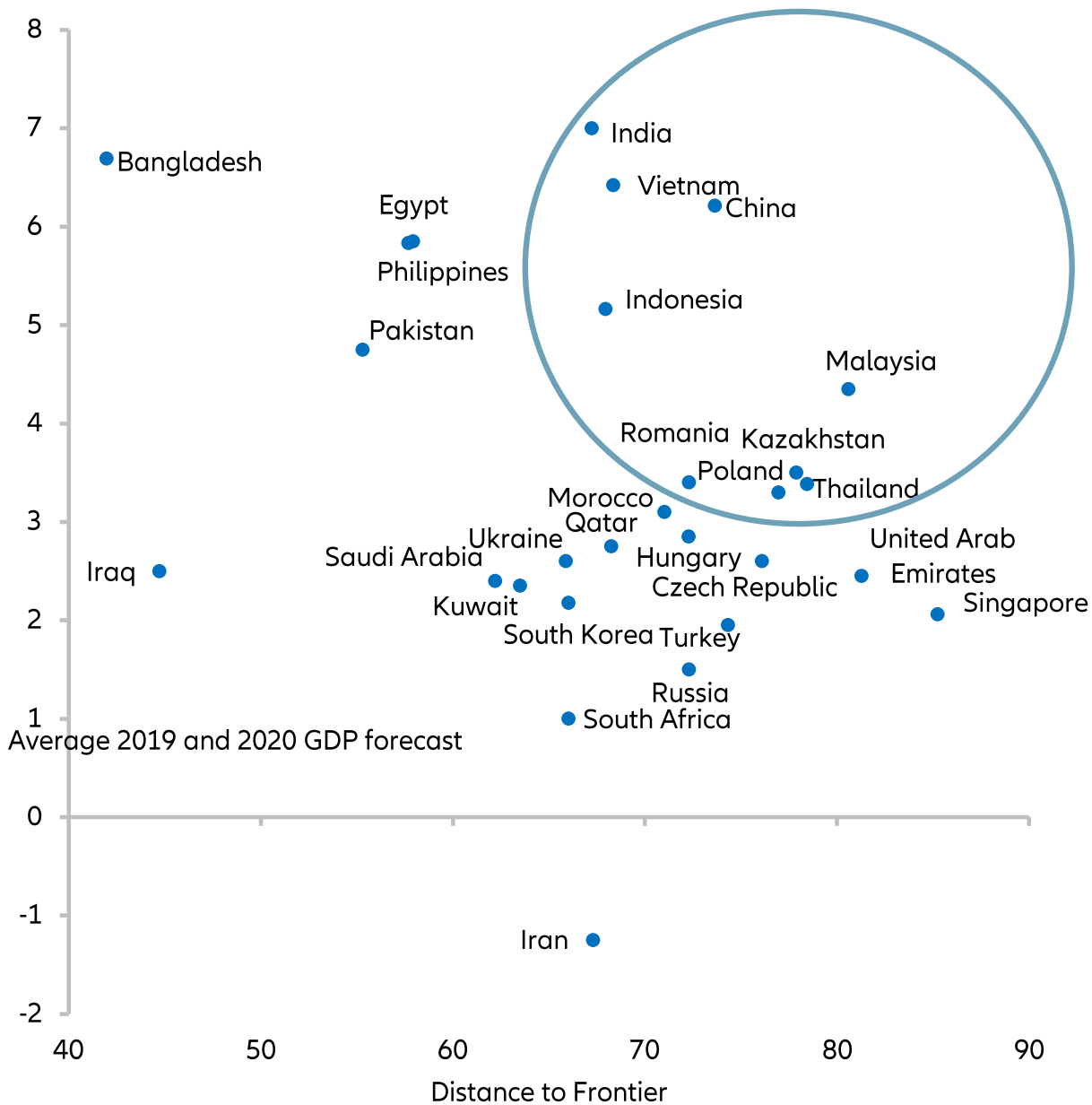
The largest opportunities will be in ASEAN and Eastern Europe. ASEAN and Eastern Europe markets will likely be the potential winners from the BRI. First, these two regions are home of countries that are large enough to attract investors. Second, economic growth in these markets is generally stronger than in other regions. Third,

the business environment is also relatively better, which would comfort investors. Figure 6 illustrates our view. We first restrict the sample to large markets of the BRI (Nominal GDP>USD100bn). Then we plot our 2019-2020 average economic growth forecasts for Belt and Road markets (vertical axis) against the Distance to

Frontier" score² from the World Bank Doing Business survey (horizontal axis).

²According to the World Bank, the distance to frontier score helps assess the absolute level of regulatory performance over time. It measures the distance of each economy to the "frontier," which represents the best performance observed on each of the indicators across all economies in the *Doing Business* sample since 2005. An economy's distance to frontier is reflected on a scale from 0 to 100, where 0 represents the lowest performance and 100 represents the frontier. Source: www.doingbusiness.org

Figure 6: Risk and reward of BRI countries



Sources: World Bank, IHS, Euler Hermes

USD410billion
 worth of investment from China
 to BRI countries over 2014-2018

THREE REMAINING CHALLENGES: FINANCIAL SUSTAINABILITY, LEGAL RISKS, POLITICAL RISKS

Yet the implementation of the Belt and Road Initiative will not be a walk in the park. As evidenced above, potential is important in trade and infrastructure financing but realization of this potential entails a leap of faith with the long-term Chinese view that only selected countries, private financiers and companies outside China are ready to take. Hence the toddling start. Financial sustainability, legal and regulatory risks, as well as political defiance, are to be managed for this platform to accelerate trade and growth in China and partner countries.

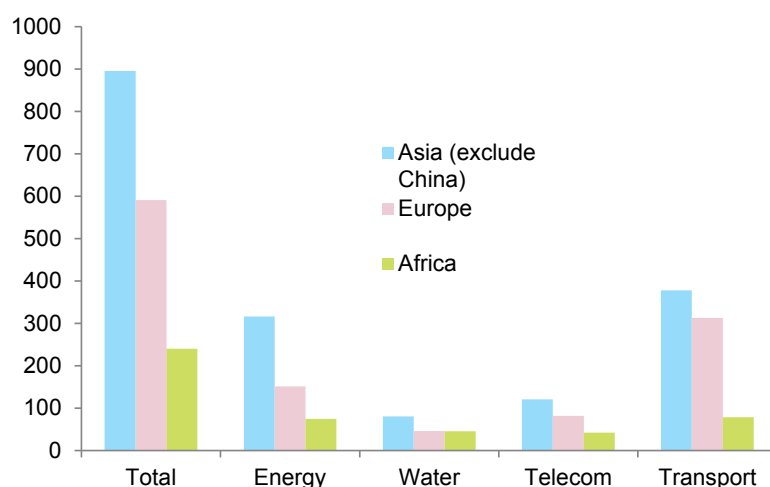
Challenge #1

Financing Sustainability of the Project. The first issue relates to China's finan-

cial capabilities. China cannot finance BRI alone considering its domestic financial situation (total non-financial sector debt estimated at 253% GDP, BIS estimate) and the amounts at stake. In fact, using the Global Infrastructure Hub forecasting tool from the World Bank, we estimate that the capital needed to fund infrastructure in Asia (excluding China), Europe and Africa combined would amount to USD1.7tn per year until 2040. In that context, partnership with countries willing to finance the project and private capital will probably be needed. The Chinese government already made some moves to lure investors. In 2018, China's regulators started to allow the issuance of "Belt and Road" bonds in Chinese stock exchanges in order to fund the initiative: the finan-

cial instrument is denominated in RMB and local currencies; foreign companies and government agencies of Belt and Road countries can participate. The second issue relates to the financial viability of BRI projects as more BRI-related borrowings could increase the financial vulnerability of already fragile (with heavy public debt) states. Markets such as Pakistan and Sri Lanka are already heavily indebted and being involved in the BRI strains their public finances. Sri Lanka, especially, had to hand over its strategic port of Hambantota to China as it was struggling to pay its debt to Chinese companies.

Figure 7: Infrastructure investment needs by sector (USD bn per year until 2040)



Sources: Global Infrastructure Hub, Euler Hermes



Photo by Pexels

Challenge #2

Legal and Regulatory Risks. It is worth noting that there is no commonly shared legal regime among BRI countries. Some countries abide by common law (Singapore, Malaysia, Hong Kong), other by continen

-tal law (Central Asia) or Islamic law (Middle East). Consequently, businesses have often failed to comply with local regulatory frameworks. To address the legal disputes, China has decided to establish internation

-al courts in Beijing, Xi'an, and Shenzhen to tackle issues arising from BRI. While this solution might work for Chinese corporates, it might not fit the interest of corporates in the EU for example.

Challenge #3

Political Risks. First, the BRI spans an area with territories in conflict. This includes hard conflict (e.g. Afghanistan) but also strong political tensions (Saudi-Iran, India-Pakistan). Second, the BRI is unfolding against a backdrop of political tensions of China itself with countries targeted

by BRI investments. For example, it wrestles with India on border issues while it faces backlashes in ASEAN countries. Last, China encounters competition with large economic powers such as the US and the EU. It contends with the US in fields ranging from political and economic

leadership to military influences especially in Asia. BRI also overlaps with the EU's Juncker plan, rivaling for influence in Emerging Europe.

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