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Development Finance in the Context of 'One Belt, One Road' Initiative: An Evolution or Devolution?

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Research Report

Author: Jin Sheng

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Centre for Banking & Finance Law
Faculty of Law
National University of Singapore
Eu Tong Sen Building
469G Bukit Timah Road
Singapore 259776
Tel: (65) 6601 3878
Fax: (65) 6779 0979
Email: cbfl@nus.edu.sg

http://law.nus.edu.sg/cbfl/

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- Due to severe weather forecast, the author is not able to attend the conference. This report has been written before the super typhoon Mangkhut hits Hong Kong.

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I. Introduction: OBOR vs. Indo-Pacific Strategy

Quality and sustainable infrastructure boosts economy. Globally, there are tremendous global infrastructure needs - USD 57 to 93 trillion from 2016 to 2030, of which approximately two thirds infrastructure needs are in Asia. On the other hand, pension funds, insurance companies and institutional investors manage around USD 120 trillion funds that are potentially or partially for investments, but few of the funds have been invested in long-term infrastructure projects, considering the economic, financial, regulatory, and geopolitical risks. Aside from failing to attract adequate funds of the private sector, lack of a pipeline of bankable projects is another bottleneck for infrastructure development.

Additionally, urbanization will play a key role in Asian development in the next two or three decades. It is noted that around 60% of the world population is in Asia. Within the region of Asia, the infrastructure is not distributed evenly. For example, China and Japan have overinvested in infrastructure. Singapore has the best ranking. So the demand for infrastructure is mostly from Central Asia, South and Southeast Asia.

In terms of the infrastructure finance, Asia accounts for approximately two thirds of the global infrastructure needs, but there is a substantial gap between the supply and the demand. In 2017, the ADB almost doubled the estimation on Asia's annual infrastructure investment through 2030. It is estimated that from 2016 to 2030 Asia needs to invest $ 22.6 trillion (or $ 1.5 trillion per year, in 2015 prices), which is equal to 5.1% of the region's GDP. However, there is a huge financial gap, which is equal to 2.4% of projected GDP. The ADB also estimates that the South and Southeast Asia (SSEA) should spend US$9.5 trillion on infrastructure between 2016 and 2030.

There are competing visions on development strategies. Globally, the G20 has proposed GII; there are also "Sustainable Infrastructure" (SI) Initiative and the Global Infrastructure Facility (GIF). Regionally, ASEAN has the "Master Plan on ASEAN Connectivity 2025"; Africa has the "Silk Road" program and the European Union has "Trans-European Transport Network". For individual countries, China has the Belt and Road Initiative and Japan has the "Partnership for High Quality Infrastructure". Therefore, there are many belts and roads as regional or international public goods out there.

The "Grand Chess" game is between China and the United States. The Belt and Road Program may substantially change the balance of power in the region; it may also challenge the development strategies established by the World Bank Group and other development institutions. Whilst the Obama administration responded with the "Asia-Pacific Rebalancing" strategy, the Trump administration has proposed the "Indo-Pacific Strategy".

II. OBOR's Financial Vehicles

China has developed a series of financial vehicles for OBOR, including Asian Infrastructure Investment Bank (AIIB), Silk Road Fund (SRF) and New Development Bank (NDB), although China's policy banks including China Development Band and Export-Import Bank of China, and state-owned banks (such as Industrial and Commercial Bank of China, China Construction Bank, Bank of China and Agriculture Bank of China) are major lenders of various OBOR projects. Besides, China has organized quite a few inter-government investments, such as China ASEAN Fund (CAF), China Eurasia Cooperation Fund, Eurasia Economic Union (EAEU) and China-Africa Development Fund.

The AIIB was founded in December 2015 as a multilateral development bank. As of August 27, 2018, it had 44 regional members, 23 non-regional members, and 20 prospective members.[1] AIIB utilizes a three-tier governance structure, including the Board of Governors, the Board of Directors and the management. A majority of Governors representing not less than two-thirds of the total voting rights of the members shall be composed of a quorum for meetings of the Board of Governors. The Board of Directors and the management (President, five Vice-Presidents, Officers, and Staff of the Bank) are responsible for the general operation of the Bank. The AIIB does not have a residential Board of Directors.

Under the AIIB's "Corporate Procurement Policy", there are four procurement methods – direct purchasing, competitive procurement (with eight circumstances of "Exceptions" stipulated in Article 7.3), framework agreements and retroactive contracts.[2] The direct purchase applies to orders for goods and services estimated at less than $10,000 and can be issued by User Departments.[3] Normally, the Corporate Procurement shall be open to competitive tendering, subject to the "Corporate Procurement Policy" and the Directives. For all purchase orders and contracts estimated at $ 70,000 or more, a Technical Evaluation Committee (TEC) is required to evaluate the technical proposals.[4] [Alternatively, the AIIB can use framework agreements for saving the delivery time.[5]] As to the settlement currency, non-sovereign-backed financing loans is committed and repayable in US Dollars; while equity investments are the local currency in which shares of the investee company are denominated by.

[1] AIIB, www.aiib.org.
[2] Article 7 of "Corporate Procurement Policy", AOA
[3] Ibid, Article 7.1
[4] Ibid, Article 7.2.3
[5] Ibid, Article 7.4

In China's OBOR strategy, the NDB is an important partner of the AIIB. In 2009 after the Global Financial Crisis (GFC), the BRICS states started to alter the global financial architecture, although the International Monetary Fund (IMF) finally made a major reform in January 2016 in increasing BRICS' voting share to 14.7%, very close to a blocking share of 15%. To some extent, the emergence of BRICS Bank is to challenge the existing order of international financial institutions – as a rival of the WBG and the IMF. But NDB operates slower than AIIB. In July 2016, the NDB Issued its first $448 million green bonds in China's interbank bond market. The green bonds are yuan-denominated green bonds with five-year tenor.[6] In April 2016, the NDB issued its first set of loans. The NDB plans to lend $2.5 billion in 2017.[7] It is estimated that the likely loan portfolio of BRICS Bank will reach $45-65 billion and the likely loan portfolio of the AIIB will be close to IADB's $120.4 billion respectively by 2025.[8] This estimation indicates the AIIB will have a greater loan portfolio than the NDB, as far as the potential operational scale is concerned.

The NDB set up a self-managed Contingency Reserve Arrangement (CRA) of $100 billion in July 2014. The initial contributions of member states are as follows: China - $41 billion; Brazil/India/Russia - $18 billion each; South Africa - $5 billion.[9] The objective of this Arrangement is to provide support of liquidity and short-term balance of payments pressures at the request of any member state. Access to the precautionary and the liquidity instruments is limited to a multiple of a member's contribution as follows: China – 0.5; Brazil/India/Russia – 1; South Africa – 2.[10] Compare with the IMF's, whose total quotas were $689 as of September 13, 2016, the NDB's emergency reserve pool is much smaller.

Both BRICS Bank and AIIB initiated by emerging economies have similar objective and common interests in providing financial resources for infrastructure connectivity and sustained development projects in emerging economies and developing countries. Unlike the AIIB's shareholding structure and voting rules, the NDB has an "equal shares and equal voting power" governance structure. Not any single member state has veto power.

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[6] The New Development Bank Newsroom, http://www.ndb.int/newsroom/medias/.
[7] Ibid.
[8] Chris Humphrey, "Developmental Revolution or Bretton Woods Revisited? The Prospects of the BRICS New Development Bank and the Asian Infrastructure Investment Bank" (April 2015) *Overseas Development Institute Working Paper No. 418,* at 15, online: https://www.odi.org/sites/odi.org.uk/files/odi-assets/publications-opinion-files/9615.pdf.
[9] *Treaty for the Establishment of a BRICS Contingent Reserve Arrangement,* Brazil Russia India China and South Africa, 15 July 2014, online: http://brics.itamaraty.gov.br/media2/press-releases/220-treaty-for-the-establishment-of-a-brics-contingent-reserve-arrangement-fortaleza-july-15.
[10] Ibid, at Article 5.

Chinese policy banks, commercial banks and state-owned enterprises have invested USD 900 billion in the OBOR Initiative; however, sovereigns with identifiable OBRO projects are rated of speculative grade with potential credit risk and market risk, ranging from the "B" to "BBB".[11] In addition, even if this strategy will enlarge China's economic and geopolitical influence and bring forth alternative development finance in the current global financial system, infrastructure financing projects face the challenge of low return with high risk.[12] For example, in the 65 countries along the OBOR program,[13] nearly half of the countries do not have credit ratings; while only 58.8% of the rest rated countries reached ratings of "BBB" or above,[14] although the project finance is based upon infrastructure project revenue.

III. OBOR's Financial Risks and Case Study

Economies benefit from quality infrastructure investment. The World Bank Group has developed a rule of thumb for this stimulation effect – "Turning One Dollar into Two". That is, each dollar invested in the transport, energy and residential infrastructure generates two-dollar economic performance. Infrastructure investments can generally promote a "multiplier effect" - an increase of spending 1% of GDP runs a multiplier effect as high as 2.5 in three years; and this effect functions greater in developing economies than developed economies. For instance, the multiplier effects in U.S., China and India are 1.7%, 2.2% and 2.0% respectively.[15] The positive spill-over effects were obvious at the early stage of China's economic reform. However, overinvestment in infrastructure results in debt-fuelled investment bubble. For example, both Japan's real estate bubble in the 1980s and China's heavy investment on infrastructure stimulus after the global financial crisis hurt or may hurt long-term economic development.

Nowadays, financial risks may directly or indirectly threaten the completion of a project. Many OBOR countries adopt foreign exchange control or capital control policies. Aside from the risk of currency

[11] Fitch Ratings, News Release, "China's One Belt and One Road Initiative Brings Risks" (25 January 2017), online: https://www.fitchratings.com/site/pr/1018144.
[12] Ben Hillman, "Silk Road Blocks: The Problem with China's One Belt, One Road Polity" *The Diplomat* (November 2015) online: http://thediplomat.com/2015/06/the-trouble-with-the-chinese-marshall-plan-strategy/.
[13] The OBOR Initiative covers 65 countries, which occupy 41.3% of the global size. The economic aggregate in this region is up to US$27.4 trillion, which accounts for 38.2% of the global economic aggregate. The OBOR Initiative covers sixty-five countries. Many of them are developing countries, which are short of infrastructure of water, roads and electricity. Developing infrastructure in this region will greatly benefit a large population of 4.67 billion. See the OBOR Research, http://www.oborr.com/Index/countrys/cid/0.
[14] "Fitch Credit Rating for Each Country", http://chartsbin.com/view/1176.
[15] The Standard & Poor's Ratings Services, "Global Infrastructure Investment: Timing Is Everything (And Now Is the Time" (February 2015), *Infrastructure Finance* Outlook, pp. 1-2, https://moorgateblog.files.wordpress.com/2015/02/ifr-february2015-hr.pdf.

depreciation, foreign investors will have to avoid losses from inability to convert local currency into foreign exchange or transfer constraints of outbound funds in the host country. Such factors as illiquidity premium, Greenfield risk premium, and emerging market risk premium also have impacts on returns of an infrastructure project.[16] In particular, some counterparty developing countries may suffer from heavy debt burden and financial risks. For instance, the $15 billion China-Uzbekistan investment transaction agreed by both parties is almost equal to 25% of Uzbekistan's GDP. In another example, the $24 billion China-Bangladesh agreement signed in October 2016 is around 20% of Bangladesh's GDP.[17] A research report issued by the Centre for Global Development (CGD) in March 2018 found that 23 countries were "at risk of 'debt distress today'" due to BRI lending.[18] In addition, 8 of the 23 countries, including Djibouti, Tajikistan, Kyrgyzstan, Laos, Maldives, Mongolia, Pakistan and Montenegro, were "vulnerable to debt distress due to future BRI-related financing".[19] It is reported that Pakistan may have to ask the International Monetary Fund (IMF) for a bailout as its economy is heavily indebted. As a matter of fact, debt sustainability has become a serious challenge for many BRI loan recipients.

The Case of CPEC: "Debt Trap"?

The China-Pakistan Economic Corridor (CPEC), a 3,218 kilometer long route, connects "Gwadar - Turbat - Hoshab - Panjgur - Besima - Kalat - Quetta - Qila Saifullah - Zhob - Dera Ismail Khan - Mianwali - Attock - Hasanabdal - and onwards". In November 2015, China and Pakistan reached an agreement on the CPEC, after negotiations and signing MOU on this more than 15-year term project. In its early phase, China provides $ 46 billion as a commitment for investment and concessional loans in highways, railways and pipelines. The CPEC Projects are composed of 21 energy projects (15 power projects, 4 actively promoted projects and 2 potential energy projects), 8 infrastructure projects, the Gwadar Sea Port (12 projects), 4 rail-based mass transit projects, and 3 Information and communication technology (ICT) projects.[20] By early 2017, China had invested $ 62 billion in the CPEC,[21] which is regarded as the flagship of the BRI routes. It is estimated the actual cost will be US$75 billion and China plans to complete most constructions by 2020.[22]

[16] Asian Development Bank, "Bangladesh: Road Maintenance and Improvement Project" (2014), https://www.adb.org/sites/default/files/in435-14.pdf.
[17] Dipanjan Roy Chaudhury, "UN Warns about Financial Risks in China's One Belt One Road Project" (25 May 2017) *The Economic Times*, https://economictimes.indiatimes.com/news/defence/un-warns-about-financial-risks-in-chinas-one-belt-one-road-project/printarticle/58831087.cms.
[18] John Hurley, Scott Morris and Gailyn Portelance, "Examining the Debt Implications of the Belt and Road Initiative from a Policy Perspective" (March 2018) *CGD Policy Paper 121*, https://www.cgdev.org/publication/examining-debt-implications-belt-and-road-initiative-a-policy-perspective.
[19] Ibid, p.6
[20] Official website of the China-Pakistan Economic Corridor (CPEC), http://cpec.gov.pk/progress-update.
[21] Salman Siddiqui, "CPEC Investment Pushed from $55b to $62b" (12 April 2017) *Tribune*, https://tribune.com.pk/story/1381733/cpec-investment-pushed-55b-62b/.
[22] Deloitte, "How Will CPEC Boost Pakistan Economy?" (2017), available on line: https://www2.deloitte.com/pk/en/pages/ccg/articles/how-will-cpec-boost-pakistan-economy.html.

From the China side, the object to build the CPEC is to shorten the maritime transport from Middle East to Shanghai, since the current distance for about the freight of 80% of China's oil to Shanghai through the Strait of Malacca is nearly 16.000 kilometers. After the Gwadar Sea Port comes into operation, the distance will be shortened to less than 5,000 kilometers.[23] Compared with other OBOR routes, the CPEC appears to have less opportunity costs in acquiring land and dis-allocation compensation. In this 40-year deal, China obtains 91% shares in gross revenues from the Gwadar Sea Port, as well as 85% shares from revenues of the free trade zone around the port; China will operate the Gwadar Port for 40 years through BOT (build-operate-transfer) and China plans to recoup its CPEC expenditure by 2020 from earnings of Gwadar Port. Aside from the major shares of earnings, companies in the 2,282-acre free zone around Gwadar Port, including factories, warehouses, logistics hubs and display centers, are exempted from customs duties, provincial and federal taxes.[24]

As far as Pakistan is concerned, the government of Pakistan expects that the CPEC would directly create 700,000 jobs from 2015 to 2030 and boost its economic growth up to 2.5%.[25] Nevertheless, there is criticism against some contractual terms of Gwadar Port between Pakistani authorities and the China Overseas Port Holding Company. Mir Hasil Bizenjo, Pakistan's federal minister for ports and shipping, disclosed that Pakistan would pay back $ 16 billion for loans from Chinese banks at rates of more than 13% (including 7% insurance charges). Some senators worried that this deal might be a heavy debt burden and may undermine Pakistan's national interests. Business people argued that infrastructure, roads, machinery and other facilities would not be in workable condition after 40 years and upgrading needed substantial costs. Moreover, contractors and sub-contractors associated with China Overseas Port Holding Company are offered an exemption of "an exemption from income and sales taxes, and federal excise duties, for a period of 20 years, besides a 40-year tax holiday granted for imports of equipment, material, plant, appliances and accessories for port and special economic zone". [26]

IV Debt Sustainability

The "Achilles' Heel" of the Belt and Road Strategy is not a shortage of funds – there are tremendous amount of public and private funds to be invested in infrastructure projects – but lack of bankable projects. In other words, it is difficult for the OBOR initiator to earn a decent return from infrastructure projects in developing countries; instead, the program

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[23] Ibid
[24] F.M. Shakil, "Bad Terms: Pakistan's Raw Deal with China over Gwadar Port" (29 November 2017) *Asia Times*, http://www.atimes.com/article/bad-terms-pakistans-raw-deal-china-gwadar-port/.
[25] Syed Kamal and Hussain Shah, "CPEC boost Pakistan economy" (20 June 2017), http://www.cpecinfo.com/cpec-news-detail?id=MzI4NA==.
[26] F.M. Shakil, "Bad Terms: Pakistan's Raw Deal with China over Gwadar Port" (29 November 2017) *Asia Times*, http://www.atimes.com/article/bad-terms-pakistans-raw-deal-china-gwadar-port/.

may bring various risks.[27] On the other hand, after more than two-decade rapid growth, financial risks such as real estate bubble, heavy indebtedness, and currency oversupply have accumulated due to over-investments and misallocation of financial resources. During economic transition from an investment-driven and export-oriented economy to consumption-driven economy, China has to face the challenges of economic slowdown and a potential financial crisis. In May 2017, Moody's downgraded China's issuer ratings of long-term local currency and foreign currency from "A1" to "Aa3", with a "negative" outlook.[28] In December 2017, Moody's announced that the outlook for China's regional and local governments (RLGs) was negative.[29] China's potential financial crisis and historical territorial disputes with some countries alongside the NSEB are uncertain factors for the OBOR program and AIIB financing.

Yet, the bottleneck of infrastructure development is how to attract infrastructure financing from the private sector and how to create a pipeline of bankable projects. The demand for assets from institutional investors, especially institutional investors such as pension funds, insurance corporations and sovereign wealth funds, is increasing and huge; but the actual investments from these long-term investors are small (around 0.5%) and far from what is needed.

In summary, quality, sustainable and inclusive infrastructure boosts productivity growth. Today, both public infrastructure investment and private sector investment are important for development finance. And the key issue is how to coordinate different development strategies and thus promote trade and economic growth.

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[27] Fitch Ratings, "China's One Belt, One Road Initiative Brings Risks" (25 January 2017), online: https://www.fitchratings.com/site/pr/1018144.

[28] Moody's Investor Services, "Rating Action: Moody's Downgrades China's Rating to A1 from Aa3 and Changes Outlook to Stable from Negative" (24 May 2017), https://www.moodys.com/research/Moodys-downgrades-Chinas-rating-to-A1-from-Aa3-and-changes--PR_366139.

[29] Moody's Investors Service, Inc., "Moody's: Funding gap continues to weigh on creditworthiness of China's regional and local governments" (10 December 2017), https://www.moodys.com/research/Moodys-Outlook-for-Chinese-RLGs-is-negative-in-2018-as--PR_376452.