Economics & Strategy

Understanding China

Recalibration of BRI strategy?

Group Research

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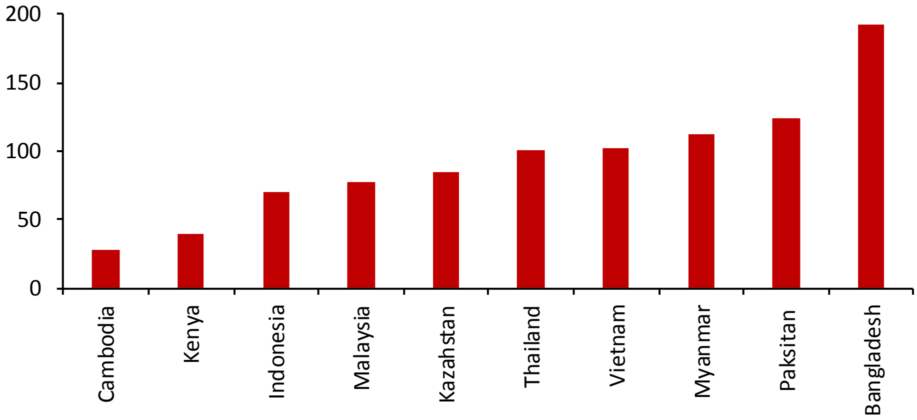
- *Concerns about debt-trap diplomacy can undermine the credibility of China's Belt-Road Strategy*
- *Limitations of the mercantilist approach are evident*
- *Defining common interest matters*
- *A greater degree of diplomatic finesse and soft touch foreign policy will help*

Notions of debt-trap diplomacy has gained momentum in recent months to negate the advocacy of BRI. This has stemmed from the rapid debt accumulation experiences of Maldives, Pakistan, and Sri Lanka. In fact, China stands to lose a lot more than the host in this context. Heightening oppositions from new governments mired in debts offset any political influence China wants to project. Options are difficult to work out should counterparties fail to repay the debts because sovereign nations do not go bankrupt like companies. Taking the ownership of substandard state assets is the last resort; it fuels local resentment even more.

Table 1: Selected BRI projects	Status	USD bn
Hungary: Huawei logistic centre	Completed	1.5
Sri Lanka: Hambantota deep sea port Phase I and II	Completed	1.3
Iran: Rudbar Lorestan hydropower dam	Completed	0.6
North Korea: New Yalu Bridge	Completed	0.4
Indonesia: Sumsel-5 power plant	Completed	0.3
Kazakhstan: Khorgos dry port	Completed	0.2
Pakistan: Gwadar Port construction of breakwaters	Completed	0.1
Cambodia: National Road No. 214, Stung Treng-Mekong River Beidge	Completed	0.1
Laos: China-Laos railway	Under construction	5.8
Bangladesh: Payra power plant	Under construction	1.7
Israel: Haifa Bay port	Started	1.1
Turkey: Third nuclear plant	Announced/ under negotiation	25.0
Mongolia: Travan Tolgoi rail project	Announced/ under negotiation	1.0
Ukraine: Kiev metro's forth line	Unknown	1.3

Source: CSIS Reconnecting Asia Project (reconnecting asia.csis.org)

Chart 1: Infrastructure gaps of selected BRI participants



Source: Global Infrastructure Hub

More finesse is required on top of the mercantilist approach.

The BRI is a gigantic undertaking (Chart 1). Debt is just one of the many problems. Absence of a holistic long term plan is the prime culprit. The mercantilist approach in the past 4 years has run its course. Some infrastructure projects have halted abruptly due to absence of sustainable funding. Others have come under scrutiny due to the opaqueness of labour/environmental standards. Absence of timetable and incremental progress report is another plight. Progress of the BRI would be hampered further if these issues are not resolved.

A new holistic long term strategy is needed

First, in view of the enormous geographical coverage, it is wiser to focus on geographical areas deemed higher probabilities of success due to better diplomatic relationships, such as Pakistan and Thailand.

Relating tangible economic benefits to the local builds up common interest.

Second, China must broaden the evaluation of foreign stakeholders spanning from environmental groups, NGO, labour unions, and private enterprises. The tactic is to build up a platform of common interest. The existing approach fixates narrowly on state interest. The presentation of the BRI should avoid over-estimating physical economic gains but under-estimating socioeconomic harms.

Third, Chinese construction companies should use more local labour to participate in projects. Compensations should be in line with local requirement at the least. Empirical experiences confirm resentment stems from the sole employment of Chinese workers in the participating countries often plagued by high unemployment rates. What China can do to strengthen her soft power is to bring in skilled labour such as surveyors/engineers and to employ more local unskilled labour. The objective is to relate tangible economic benefits to the locals.

Fourth, an international governance structure involving participating countries to institutionalize common objectives must be established to safeguard common interests. The decision-making structure for the execution of BRI should be based on consensus to avoid potential disputes in the future. The platform for executing such reforms is clearly the Asian Infrastructure Investment Bank (AIIB).

Fifth, Chinese banks should heighten stringency in granting loans forthcoming with a BRI label (chart 2). Many projects juxtapose the official ones to take advantage of easy credit support. The relaxation of credit by Chinese policy banks to comply with political imperatives sent non-performing loans of China EXIM bank to USD5bn per year since 2015. In the same year, China's Ministry of Finance made a cash injection around USD45bn to the bank (another USD45bn to China Development Bank). The capital adequacy ratio of EXIM bank was only 2.26% prior the cash injection.

Long term funding of BRI requires innovation in financial instruments.

Loans should be extended in a selective manner with viable economical projects facilitating trade. As the construction cycle of transport infrastructure is long, the duration of risk is high. Delivery of loans by tranches upon incremental successful completion of project should be the dominant credit strategy.

Sixth, financial experts should create new financing instruments to fund the BRI in the long run. Equity investors of infrastructure are burdened with long term capital commitment to illiquid assets. Debt investors are incapable of pricing such long-term risks as well. Hence the establishment of a bond fund specialized in infrastructure is one desirable option. That would entail the securitization of bank loans. The goal is to diversify risks away from banks and make it as a tradeable asset class tapping into the depth of international capital market.

It is wise to cooperate than to compete in some cases.

Seventh, in the case of fierce competition with Japan to win the bid of infrastructure projects particularly in SE Asia, it makes strategic sense to cooperate in some cases. Intense price competition forces state owned enterprises to take more unnecessary financial risks onto the balance sheet.

The bidding for the 150km high speed railway from Jakarta to Bandung is a good example. China won the bid eventually by sacrificing full loan guarantee from the Indonesian government. Still, this does not guarantee a monopolistic status. A contract was awarded to Japan in October 2016 to upgrade the railway from Jakarta to Surabaya. It is in the interest of the recipient country to maintain a competing environment between China and Japan. In fact, competition extends throughout Asia and goes as far as Africa.

Early signs of cooperation are emerging. In May 2018, the Japan Bank for International Cooperation proposed a joint Japan-China consortium to build a high-speed railway system in Thailand. Both governments plan to establish a public-private council to discuss common infrastructure projects. This is the right direction to go in spite of political differences. The common interest is clear for both: higher margin, lower risk, higher business volume and ultimately more political influence far field.

Conclusions

Then, the relevant authorities should recalibrate short/long term objectives with executable means. Tides are moving fast against the BRI. Resolving the debt phenomenon sooner shores up the confidence of BRI members.

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Sources: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations).