

Navigating the New Silk Road

Expert Perspectives on China's Belt and Road Initiative



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INTRODUCTION

The articles contained in this publication have been selected for the ways they examine critical issues surrounding China's Belt and Road Initiative (BRI), namely the initiative's economic impacts, both domestic and abroad, as well as its geopolitical implications. In many ways, the Belt and Road Initiative represents China's vision as a global leader alongside the US.

This compendium collates knowledge and expertise from the world's leading experts to provide practical and timely insights on the various risks and opportunities associated with Belt and Road Initiatives.

All articles first appeared on BRINK, the digital news service of Marsh & McLennan Companies' Global Risk Center, managed by Atlantic Media Strategies, the digital consultancy of The Atlantic. BRINK gathers timely perspectives from experts on risk and resilience around the world to inform business and policy decisions on critical challenges.

ONE BELT, ONE ROAD: CHINA'S GRAND ENTERPRISE

Tianjie He

Economist at Oxford Economics



Dubbed by some as a modern-day Marshall Plan, China's One Belt, One Road (OBOR) initiative will build roads, ports and railway tracks along ancient trading routes to Asia, Europe, the Middle East and Africa.

Launched in 2013 by President Xi Jinping, OBOR is a China-backed global connectivity initiative, aimed at creating a better infrastructure network across 65 countries that cover 60 percent of the global population and about one-third of global GDP.

While the OBOR will boost China's global influence and benefit Chinese construction firms, we do not expect the initiative to have a major impact on mopping up excess capacity in China's heavy industry.

ONE BELT, ONE ROAD, MULTIPLE ENDS

The OBOR also seeks to boost "soft" connectivity, such as trade and investment liberalization and social and cultural exchange. Originally a political slogan forming part of Xi's "China Dream," One Belt One Road was fleshed out in more detail in the action plan for the implementation of the initiative released in March 2015.

The plan maps out the land-based "Silk Road Economic Belt" (the Belt) and the oceangoing "21st Century Maritime Silk Road" (the Road). The Belt connects China with Central Asia and Europe, focusing on a "Eurasian land bridge" – a logistics chain from the east coast

of China to Western Europe – and economic corridors connecting China with Mongolia and Russia, central Asia, west Asia and Southeast Asia. The Road links China's east coast to Europe via the South China Sea and the Indian Ocean, aiming to build efficient transport routes between major sea ports and to connect China with Southeast Asia, Oceania, the Middle East, and North Africa through the Mediterranean.

The initiative is a means to multiple ends. Explicitly, it is intended to increase prosperity for the underdeveloped parts of China, particularly in the west of the country, through domestic investment and economic integration with Asian neighbors. It is also meant to foster greater connectivity and economic development along the routes, promising an infrastructure boost for Asia's least connected regions. Moreover, Beijing expects the OBOR to secure China's energy supply through diversification of import sources and transport routes.

Among the more implicit goals, China tries to find new sources of growth abroad, especially for construction companies and various industries suffering from excess capacity. OBOR also supports outward investment and RMB (renminbi) internationalization.

It helps to diversify export markets and promote the international expansion of Chinese technology as part of its broader plan to upgrade its place in global production and value chains.

Moreover, the OBOR also expands the political influence and the reach of Chinese power in Asia and elsewhere.

Furthermore, OBOR could boost the internationalization of the RMB by encouraging its use in both trade and financial transactions. RMB trade settlement increased to an average 30 percent of China's total cross-border trade in 2015 from a mere 7 percent at the beginning of 2012. However, its share fell in 2016, largely because of the pressure on the RMB and measures to contain capital outflows.

China's capital controls present a fundamental constraint for RMB internationalization. Without an open capital account and unfettered access to onshore financial markets, the incentive for nonresidents to hold the RMB is limited. But if China eventually liberalizes its capital account, we expect the room for RMB internationalization will be boosted by the OBOR initiative as regional trade and investment networks further expand and deepen.

For China's domestic economy, some policymakers see OBOR as a way to find new sources of demand abroad, especially for Chinese construction firms and industries with excess capacity. While Chinese construction firms will benefit significantly from OBOR, we do not expect a major impact on the excess capacity in China's heavy industry.

Based on the scale of OBOR investment, the annual demand for heavy industry products in OBOR projects will simply not be large enough compared to the scale of overcapacity in China's heavy

industries. In our rough estimation, total annual OBOR spending of \$140 billion per year would generate around 22 million tons of annual steel demand at current prices. That compares to estimates of excess capacity in China's steel industry ranging from 250 million to 450 million tons per year.

Moreover, it is expensive to transport heavy industry products over long distances; sourcing closer to the project will often be more economically efficient, especially for cement.

Finally, political considerations make it unviable for OBOR projects to rely too much on imports and services from China. Recipient countries, especially those with relatively strong governance and sizable local domestic industries, such as India and Indonesia, are very unlikely to be willing to see Chinese companies doing all the work and/or accept large amounts of Chinese debt. While this may be different in countries with weaker governance that are more accommodative, such as Pakistan or Cambodia, that is a double-edged sword since the financial risk of projects will be higher.

A GREATER ROLE IN THE GLOBAL FINANCIAL ARCHITECTURE

OBOR helps to boost China's regional and global influence by providing public goods and taking on significant financial risks that other investors would shy away from. The establishment of the Asian Infrastructure Investment Bank (AIIB) shows China's attempt

to reform the global financial governance system to accommodate its increased economic influence.

Setting up the AIIB may have sped up the long-stalled reform to the International Monetary Fund governance and given emerging market contributors greater voice – this was finally approved by the US Congress in late 2015.

Meanwhile, the Asian Development Bank pledged to increase its lending capacity to remain relevant and effective in the region. Regardless of whether these moves were directly motivated by the AIIB, healthy competition will improve the efficiency of resource allocation and stimulate global financial governance reform.

**A follow-up piece by this author on the implications of OBOR on countries outside of China will be published on BRINK Asia later in June 2017.*

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CHINA'S RISE: THE AIIB AND THE "ONE BELT, ONE ROAD"

David Dollar

Senior Fellow with the Foreign Policy and Global Economy and Development for the Brookings Institution



China's six years of breakneck growth leading up to 2007 were accompanied by a rising trade surplus. But when that surplus fell sharply after the global crisis, Chinese authorities made up for the shortfall of demand with an increase in investment. Today, China is using a lot more investment to fuel slower growth than in the past: The real-world result of this falling capital productivity has been empty apartment buildings, unused airports and serious excess capacity in manufacturing. Meanwhile, consumption is very low, especially household consumption.

One response China has taken to this changing growth dynamic is to try to spur external demand for Chinese investment, specifically for major infrastructure projects. The other response has been internal: To initiate reforms that rebalance its economy from investment to consumption. The latter effort has

a better chance of success than the former.

DOMESTIC ROADS TO REFORM

Domestic reform is a much more promising road to deal with China's surplus problem, and to rebalance its economy away from such a heavy reliance on investment. The resolution that came out of the Third Plenum in November 2013 sketched out dozens, if not hundreds, of reforms. The ones that are likely to have the greatest effect are the household registration system (hukou), intergovernmental fiscal reform and financial liberalization, opening up China's service sectors to competition.

Under hukou, 62 percent of the population is registered as rural residents, and it has been difficult for them to change this designation.

Rural migrants to the cities cannot bring their families or truly become citizens of the cities. Reforming the system would help reallocate labor from low productivity (farming) to higher productivity (urban manufacturing and service employment) activities. But local governments worry that they will lack the resources to fund greater social services for migrant families.

China's Ministry of Finance has announced general plans for fiscal reform to support rebalancing. First are measures to bolster local government revenue, potentially including a nationwide property tax. Second is to collect more dividends from its state enterprises. If this happens at both the local and the central level, it would reduce some of the bias towards investment and help ensure resources for government services. Third is to allow municipalities to issue bonds to fund their infrastructure projects, rather than relying on shorter-term bank loans.

The final aspect of fiscal reform may be the hardest: Local officials are generally rewarded for their ability to provide investment and growth. While the system has been successful at that, it has been less successful at meeting other objectives, such as clean air, food safety and high-quality education and health services. Changing the incentives of local officials to align with rebalancing is a key institutional reform.

SPURRING INVESTMENT – BUT NOT ENOUGH

It is no coincidence that this period of excess capacity at home is the moment at which China launched expensive new initiatives, such as the Asian Infrastructure Investment Bank (AIIB), the BRICS Bank and the “One Belt, One Road” initiative in order to strengthen infrastructure both on the westward land route from China through Central Asia and on the southerly maritime routes from China through Southeast Asia.

Developing countries understand the purpose for the AIIB: Many have moved away from using the existing multilateral infrastructure investment banks because they are so slow and bureaucratic. The US made a mild effort to dissuade some allies from joining the AIIB, fearing China would use it for narrow political or economic ends. But a diverse group of nearly 60 countries has signed up, making it difficult for China to use the bank to show favoritism in financing projects. In fact, the AIIB should be viewed as complementary to – and not competitive with – America’s own main economic initiative in the Asia-Pacific, the Trans-Pacific Partnership trade agreement.

But the AIIB will be too small to make a dent in China’s excess capacity problem. If the AIIB is very successful, then in five years it might lend \$20 billion per year, comparable with the World Bank’s International Bank for Reconstruction and Development. But China would need \$60 billion per year of extra demand to absorb excess capacity in the steel sector alone.

The “One Belt, One Road” initiative is larger than the AIIB. It started with the idea that nearby countries in Central Asia could benefit from more transport infrastructure,

some of which China could finance bilaterally. However, the economies of Central Asia are not that large, and the potential for investment is limited. For that reason, China added the idea of a maritime “road.”

Because “One Belt, One Road” will be implemented bilaterally between China and different partners, it may seem that there is more potential for China to use this initiative to vent some of its surplus. But I still doubt that this will be on a scale to make a macroeconomic difference for China.

Among the various developing countries along “One Belt, One Road” routes, there are some with relatively strong governance – India, Indonesia and Vietnam, for example – that will be hard for China to push around. Those countries will not want to accept large numbers of Chinese workers or take on large amounts of debt relative to their GDP.

On the other hand, there are weak governance countries – Cambodia and Pakistan, for instance. It may be more feasible for China to send some of its surplus production to these countries, but there is a reasonable prospect that in the long run, China will not be paid.

LIBERALIZING CHINA’S FINANCES

China’s repressed financial system is a third area of reform. Real interest rates that are close to zero amount to both a tax on household savers and a subsidy to investment by firms and local governments able to borrow from the banking system. Almost everywhere in the world has had zero real interest rates in recent years, but in China, they go back more than a decade. The government has taken some initial steps to raise deposit

Changing the incentives of local Chinese officials to align with fiscal rebalancing is a key institutional reform.

and lending rates, as well as to allow a shadow banking system to develop with better returns to savers and higher-rate loans to riskier clients.

The problem with the current arrangement is that most shadow-banking wealth products are marketed by commercial banks and treated as low-risk by households. Total shadow banking lending has grown at an explosive rate in recent years and, not surprisingly, some of the funded investments are starting to go bad. The first corporate bond default occurred last year, and that result should help ease the moral hazard that has built up in the system. The announcement of the formal introduction of deposit insurance this year is another important step in the separation of a cautious commercial banking sector from a risky shadow-banking sector. Central Bank Governor Zhou Xiaochuan recently announced that interest rate liberalization would be completed within one to two years.

Recent moves to liberalize the bond and stock markets so that private firms can more easily go to the capital markets are also in the right direction, as are moves to increase the flexibility of the exchange rate. The IMF assesses that China's exchange rate has gone from "substantial undervaluation" to "fairly valued" in recent years, so it should not be too difficult for the authorities to reduce their intervention and allow a more market-determined rate. Finally, opening up the capital account should be the last step in financial liberalization.

OPENING SERVICE SECTOR TO COMPETITION

A final area of reform is to open up China's service sectors to competition from private firms and the international market. The modern service sectors are the domain in which state-owned enterprises continue to be dominant, including financial services, telecom, media and logistics.

The rebalancing from investment toward consumption means that, on the production side, industry will grow less rapidly than in the past while the service sectors expand. China will need more productivity growth in the service sectors, which is hard to achieve in a protected environment.

For other developing countries, successful rebalancing in China will create both challenges and opportunities. While China's appetite for commodities is likely to moderate, rebalancing should lead to a rise in its demand for manufactures and services from other developing countries. And China is rapidly emerging as a major source of foreign direct investment. A world without Chinese rebalancing, by contrast, is likely to be more volatile.

A more in-depth version of this piece appears on the Brookings site and was condensed from a paper titled, "China's rise as a regional and global power: The AIIB and the 'one belt, one road,'" which was released in Summer 2015.

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ONE BELT, ONE ROAD: RISKS AND COUNTERMEASURES FOR CHINESE COMPANIES

Miao Lu

PhD Executive Secretary General of the Center for China and Globalization



China proposed its “One Belt, One Road” initiative in 2013. This ambitious scheme seeks to connect China more closely with Europe, Southeast and Central Asia, the Middle East and Africa. The project is bound up with the promotion and exercise of China’s “soft power,” aimed at devising Asian solutions for Asian problems.

One Belt, One Road is strongly influencing the flow of Chinese outbound investment. The initiative is creating significant opportunities for Chinese state-owned enterprises, especially those involved in transportation infrastructure, railway construction, energy and resources exploitation and shipping and logistics firms.

Small- to medium-sized enterprises involved in manufacturing light goods and technologically advanced products are also boosting their investment activity in One Belt, One Road countries.

According to the Chinese National Bureau of Statistics, Chinese investment in One Belt, One Road countries amounted to \$92.46 billion in 2014, 15 times higher than it was in 2005.

Like any large-scale and ambitious undertaking, One Belt, One Road entails not just great opportunities, but considerable risks as well.

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POTENTIAL RISKS

POLITICAL RISKS

One set of risks stems from the complicated political situation prevailing across large stretches of overland and maritime covered by One Belt, One Road. Myanmar is a case in point. Chinese investment in the country fell from \$407 million in the 2012 fiscal year to just \$46 million in the 2013 fiscal year, a drop of nearly 90 percent. This plunge was caused by rising anti-Chinese sentiment and opposition to key projects in Myanmar, notably the \$3.6 billion Myitsone dam in the northern part of the country.

Big power rivalry in ASEAN countries, South Asia and Central Asia may also threaten Chinese investment activities in these areas. China and Japan are competing to raise their influence in South Asian countries. At the beginning of 2016, Japan secured Dhaka's approval to begin building an 60-foot-deep port in Matarbari, on the southeast coast of Bangladesh. Meanwhile, China and Bangladesh were continuing to negotiate approval for the Sonadia deep water port, which is located about 15 miles away from Matarbari.

Potential risks also exist in the One Belt, One Road Central Asian countries. Conflicts exist between Kyrgyzstan, Tajikistan and Uzbekistan. For example, Uzbekistan strongly opposes China's hydropower project in, as the proposed dam is located upstream on the Amu Darya River in Tajikistan. This investment could therefore adversely affect Uzbekistan's access to water, a scarce resource in Central Asia.

SECURITY RISKS

Chinese investment in countries along One Belt, One Road may be exposed to regional turmoil and

conflicts, terrorism and religious conflicts. It is worth noting that Chinese enterprises investing overseas have yet to devise a comprehensive security strategy for dealing with such risks. They currently rely mainly on Chinese consular and diplomatic protection, which are certainly inadequate safeguards against major threats such as terrorism and ethnic and sectarian religious violence.

For its part, China has repeatedly stated that One Belt, One Road is for promoting economic and cultural exchange, as opposed to being a Trojan horse for extending Chinese geopolitical influence. But China still seems to have problems establishing the credibility of this message.

ECONOMIC RISK

Chinese enterprises with investments in One Belt, One Road countries face economic risks. One major risk is the potential of these countries defaulting on foreign lending and investment projects. Many of the One Belt, One Road countries, especially those in Central Asia, are among the poorest economies in the world and have dysfunctional and corrupt governments. This lack of creditworthiness makes them poor bets for investment on the part of China's government and Chinese financial institutions and businesses.

Another source of risk lies within the Chinese companies themselves doing business in One Belt, One Road countries. A great deal remains to be done with respect to engineering safety and management issues. At times, firms also have difficulties obtaining sufficient intelligence and financing to effectively carry out investment projects. When these fail to properly gather information and conduct due diligence, they are more prone to engage in speculative, bubble-

like investment behavior. Chinese companies planning to "go global" by undertaking One Belt, One Road projects need to up their game when it comes to corporate governance and investment decision-making.

COUNTERMEASURES

OUTSOURCING EXPERTS TO CONDUCT RISK ANALYSIS

Chinese enterprises need to be business-like and realistic in factoring potential risks into the cost of investment projects. They need to make the best use of top-flight foreign risk analysis firms, while also employing the expertise of leading Chinese think tanks doing risk analysis, such as the Chinese Academy of Social Sciences.

LET THINK TANKS PLAY A BIG ROLE IN RISK MANAGEMENT OF ONE BELT, ONE ROAD INITIATIVES

Think tanks, particularly those run independently, are in a better position to evaluate development risk. Firms investing in One Belt, One Road should involve such organizations in planning for such projects and attempting to balance the interests of the stakeholders involved in them. Setting a network of cooperative the One Belt, One Road zone think tanks should promote in-depth and comprehensive discussion of the problems and concerns of the relevant parties.

SET UP A SECURITY MECHANISM TO ADDRESS SECURITY CONCERNS

In the short term, Chinese companies ought to beef up their internal security by making use of good private security contractors.

In the long term, however, they need to establish trust and build durable partnerships with local stakeholders in the One Belt, One Road countries targeted for investment.

ATTACH MORE IMPORTANCE TO CORPORATE SOCIAL RESPONSIBILITY

Chinese companies investing abroad should be more concerned about corporate social responsibility, which can be a key element in enhancing China's "soft power" in the One Belt, One Road area. Firms should pay especially close attention to their treatment of local workers and the environmental impact of investment projects (both issues in Myanmar). Effective corporate social responsibility can go a long way in reducing the internal security risks faced by firms seeking to invest in One Belt, One Road countries.

CAPACITY BUILDING IN NURTURING PARTNERSHIP WITH NGOS AND THE CIVIL SOCIETY

Chinese enterprises with outbound investments need to pay more attention to local nongovernmental organizations and work with civil society actors in One Belt, One Road countries. One road countries where NGOs are very active are becoming important spokesmen for civil society. While doing projects, NGOs should be invited to express their concerns and interests.

RECRUITING AND NURTURING TALENT WITH AN INTERNATIONAL MINDSET

To better understand conditions in diverse and complex foreign environments, Chinese companies investing in One Belt, One Road must effectively integrate knowledgeable foreign talent into the management of overseas investment operations.

Equally important, two-way educational and cultural exchange between Chinese and local people in One Belt, One Road areas should be promoted. This can play a crucial role in promoting cross-cultural awareness between China and One Belt, One Road countries. To this end, a One Belt, One Road scholarship fund ought to be established to enable students from these countries to study in China, and likewise, Chinese to live and learn about places like Kazakhstan, which have very different and unique cultures and social norms.

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WILL THE NEW SILK ROAD BE PAVED WITH RICHES?

Ji Xianbai Jason

PhD Candidate at the S. Rajaratnam School of International Studies, Nanyang Technological University, and Europa Visiting Fellow at The Australian National University



Until recently, there was “responsible competition” between two transcontinental economic arrangements: the US-led Trans-Pacific Partnership (TPP) and the China-initiated Belt and Road Initiative (BRI). The BRI will surely come to the fore in 2017 as the TPP fizzles out due to the incoming US administration likely embracing retrenchment rather than engagement.

The BRI, consisting of the Silk Road Economic Belt and the 21st Century Maritime Silk Road, draws inspiration from the historical imageries of the millennia-old overland trading routes traversing the Eurasian landmass and the ancient sea lanes linking China with the Middle East and East Africa via Southeast Asia that dated back to

the 15th century. It could cover a geographical area that is home to 4.4 billion people who produce more than half of global GDP and preside over three-quarters of known energy reserves.

There is little wonder why China would invoke, or even mildly mythologize, its glorious past to serve contemporary policy interests, but the BRI is not an empty political slogan. It is a long-term, multi-pronged international economic strategy aiming to link Afro-Eurasian economies through policy coordination, facilities connectivity, trade facilitation, financial integration and people-to-people exchanges.

Developing Asia alone needs \$8 trillion in infrastructure investment to accommodate its growth until 2020.

DEVELOPMENT AND SECURITY

When China, in 2013, broached the idea of revitalizing the routes of commercial and cultural exchanges explored by the “diligent and courageous” silk traders of Eurasia, Beijing had two major domestic policy objectives in mind.

First, the BRI is an outward-looking national strategy for hinterland development. In the past decades, China was almost synonymous with “growth,” but China’s socioeconomic progress is highly unequal (the country becomes poorer as one goes west). One explanation of the regional disparities is the availability of extensive, inter-modal infrastructural networks – expressways, high-speed railways, air and sea ports – along eastern China’s coast that allow “Made in China” goods to be transported all over the world. The BRI is devised to close this infrastructural gap in the hope that the ensuing inland economic integration with neighboring markets will catalyze economic development in its relatively backward western and central provinces.

The other geo-economic rationale behind the BRI relates to China’s Malacca Dilemma. The term refers to China’s over-reliance on energy imports transiting the Strait of Malacca, a strategic choke point that is often patrolled by the US Navy. According to a Pentagon report, over 80 percent of Chinese maritime oil imports and 30 percent of natural gas imports have to pass through the Malacca Strait. To buttress its energy security, China is determined to circumvent the narrow strait by developing more reliable, alternative land and maritime routes for energy imports along the Belt and Road.

A case in point is the planned Gwadar-Kashgar pipeline, which is envisioned to carry one million barrels of oil directly to China’s Xinjiang province every day.

Despite the overarching domestic motives, the BRI has an explicit international dimension. It places due emphasis on connectivity, inclusiveness and multilateralism when isolationism, xenophobia and unilateralism are becoming increasingly commonplace in other parts of the world. Specifically, the BRI provides a timely boost to the wobbling world economy and ailing globalization sentiment through infrastructure, investment and policy channels in the context of win-win cooperation.

WIN-WIN COOPERATION

Infrastructure is essential for economic vitality and unimpeded trade and investment, but the financing needs of infrastructure development are daunting across Eurasia. Developing Asia alone needs \$8 trillion in infrastructure investment to accommodate its growth until 2020. On the other hand, Europe’s public spending on infrastructure stagnated in the shadows of financial crises, austerity measures and a deflationary economic outlook, shrinking to \$449 billion in 2015 – around 6 percent less than in 2009.

The BRI is China’s policy response to plug the funding shortfall. It establishes a multilateral platform for leveraging China’s core competences in infrastructure construction and pooling the region’s foreign reserves to overcome logistical barriers to trade and development. According to Bruegel economists, a 10 percent

reduction in railway, air and maritime transport costs could translate to increases in exports of 2 percent, 5.5 percent and 1.1 percent respectively for countries along the routes. In total, China reckons that the BRI will have a cascading effect of creating some \$2.5 trillion in extra trade among countries in the loop.

Also riding the Silk Road is China’s booming outbound investment as China is transitioning from the world’s largest goods exporter to the world’s largest capital exporter. China’s BRI-related foreign direct investment (FDI) grew 23.8 percent year-on-year in 2015, and was up 60 percent in the first half of 2016, outpacing the growth in China’s overall outbound non-financial investments. There is a general consensus that China’s FDI stock will reach a staggering \$2 trillion by 2020, more than three times the level at the end of 2014, and then \$4 trillion in time.

Taking advantage of the Chinese investments that arrive under the banner of BRI, participating countries can modernize their economies, lock in key structural reforms, tap into new sources of growth, raise productivity and increase reciprocity of trade patterns. And as labor and land costs go up in China, Chinese enterprises have started to invest in manufacturing and industrial capacities in neighboring countries. This westward and southward flow of investment will likely ensure that developing countries reap the long-term benefits of the BRI and emerge as integral parts of global value chains, rather than mere transit points. Of equal importance is that competition for Chinese capital will encourage BRI countries to adopt better economic policies, cut red tape, improve investment

climate and strengthen coordination with adjacent countries in a race to the top.

INCLUSIVENESS

Moreover, the network-based conceptualization of the BRI is more inclusive than institutional integration projects such as the TPP where membership, rules and principles, and benefits and obligations are legally specified since day one. It is telling that China abandoned the popular nickname OBOR (One Belt, One Road) and showed reluctance to publish an official list of involved countries in an attempt to promulgate its intention of engaging as many countries as possible. Except for a few geographical considerations, there is virtually no restriction as to whether a particular country can or cannot take part in this open-ended, collaborative development project. The BRI's openness contrasts sharply with the exclusiveness and discriminatory nature of the TPP whereby non-members have to comply with so-called high standard trade rules – in which they have no say – before they can be admitted.

Precisely because of its openness and inclusiveness, the BRI will always be a work in progress that cannot be defined in its entirety. Interested countries and companies should proactively shape the agenda of the BRI by identifying, developing and proposing projects that can be bracketed under the rubric of BRI, pondering how to cash in on those commercial opportunities while, in the spirit of the ancient Silk Road's trailblazers, contributing to BRI's vision of a closely integrated Afro-Eurasia with new and enhanced physical, commercial, cultural and digital ties.

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CHINA CAN'T FINANCE "BELT AND ROAD" ALONE

Alicia García-Herrero

Senior Fellow for BRUEGEL and Chief Economist for Asia Pacific at Natixis



The One Belt One Road Initiative holds great promise for the global economy, but it needs a huge amount of financing. Initial presumptions that China would be able to provide all of the financing are now unrealistic. Other partners should consider providing finance for some aspects, especially Europe, which has much to gain from the project.

There is no doubt that Asia needs infrastructure. The Asian Development Bank (ADB) recently increased its already very high estimates of the amount of infrastructure financing needed in the region to \$26 trillion in the next 15 years, or \$1.7 trillion per year (Exhibit 1). The great thing about the China-driven Belt and Road

Initiative is that it aims to address that pressing need for infrastructure, especially in transport and energy infrastructure. But this is easier said than done. The theory is that the financing will be there thanks to China's massive financial resources.

Chinese authorities have come up with their own estimates of the projects that will be financed. The numbers start at \$1 trillion and go all the way to \$5 trillion in only 5 years. In the same vein, the official list of countries does nothing but increase over time to more than 65 – but there is a limit to how much China can finance.

Such reasoning was probably well taken when China was flooded with capital inflows and reserves had nearly reached \$4 trillion and needed to be diversified. Chinese banks were then improving their asset quality if anything, because the economy was booming and bank credit was growing at double digits.

The situation today is very different. China's economy has slowed down and banks' balance sheets are saddled with doubtful loans, which continue to be refinanced and do not leave much room for the massive lending needed to finance the Belt and Road Initiative.

This is particularly important as Chinese banks have been the largest lenders so far (China Development Bank in particular with estimated figures hovering around \$100 billion while Bank of China has already announced its commitment to lend \$20 billion). Multilateral organizations geared toward this objective certainly do not have the financial muscle. Even the Asian Infrastructure Investment Bank (AIIB), born for this purpose, has so far only invested \$1.7 billion on Belt and Road projects.

As if this were not enough, China has lost nearly \$1 trillion in foreign reserves due to massive capital outflows. Although \$3 trillion of reserves could still look ample, the Chinese authorities seem to have set that level as a floor under which reserves should not fall so that confidence is restored (Exhibit 3). This obviously reduces the leeway for Belt and Road projects to be financed by China, at least in hard currency.

HOW TO FINANCE THE BELT AND ROAD?

The first, and least likely, step is for China to continue such huge projects unilaterally. This is particularly difficult if hard-currency financing is needed for the reasons mentioned above. China could still opt for lending in yuan, at least partially, with the side benefit of pushing yuan internationalization. However, even this is becoming more difficult.

The use of the yuan as an international currency has been decreasing as a consequence of the

FIGURE 1 ASIA: INVESTMENT NEEDS BY SECTOR
Sources: Natixis, ADB N.B. Climate-adjusted estimates

2016-2030, US\$ TRILLIONS

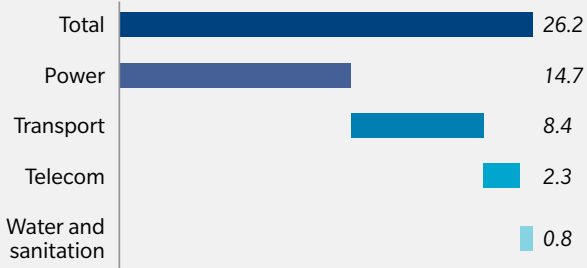


FIGURE 2 ASIA: INVESTMENT NEEDS BY COUNTRY
Sources: Natixis, ADB N.B. Climate-adjusted estimates

2016-2030

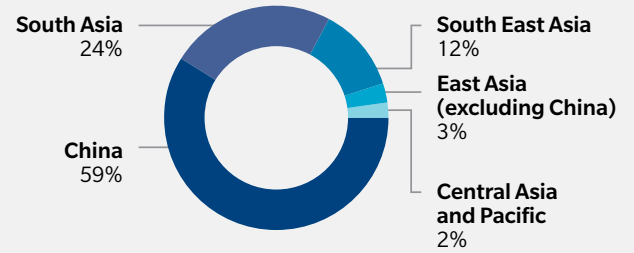


FIGURE 3 GROWTH AND FOREIGN RESERVES
Sources: Natixis, Bloomberg

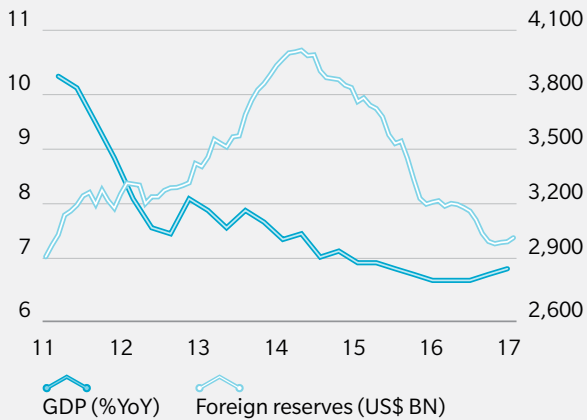


FIGURE 4 SHARE AS INTERNATIONAL PAYMENT CURRENCY
Sources: Natixis, Bloomberg, SWIFT

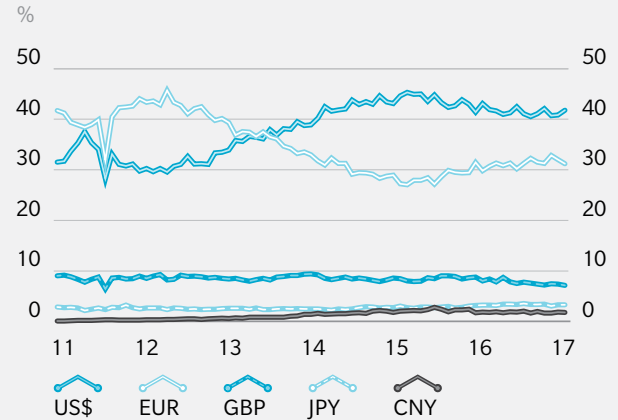


FIGURE 5 STRESSED LOAN
Sources: Natixis, CEIC

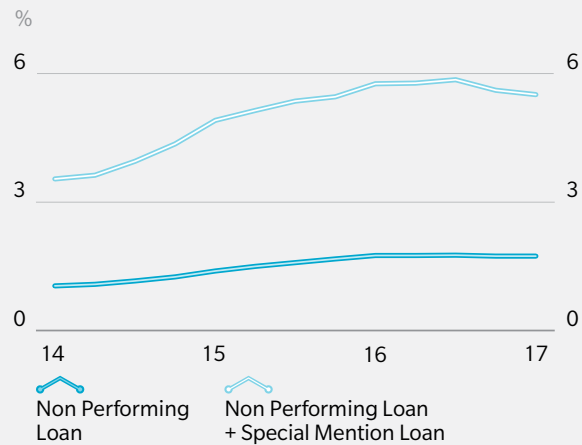


FIGURE 6 INTERNATIONAL CLAIMS
Sources: Natixis, BIS NB locational statistics used for China, available from 2015 Q4

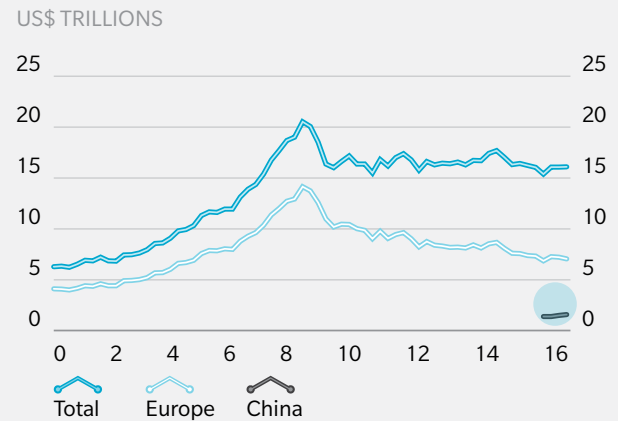


FIGURE 7 BORROWING COUNTRIES
Sources: Natixis, BIS

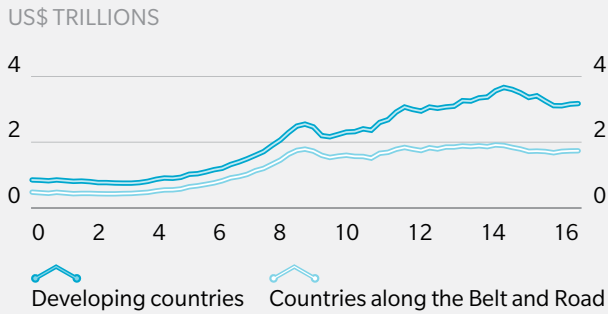


FIGURE 8 CHINA LENDING TO THE WORLD THROUGH MULTILATERAL BANKS
Source: Natixis

US\$ BILLIONS

	Capital	Announced	Disbursed
	240	17-23	>3.1
Asian Infrastructure Investment Bank (AIIB)	100	10-14	1.7
New Development Bank (NDB)	100	5-7	1.4
Silk Road Fund	40	2	-

FIGURE 9 LOAN TO THE BELT AND ROAD COUNTRIES
Sources: Natixis, BIS

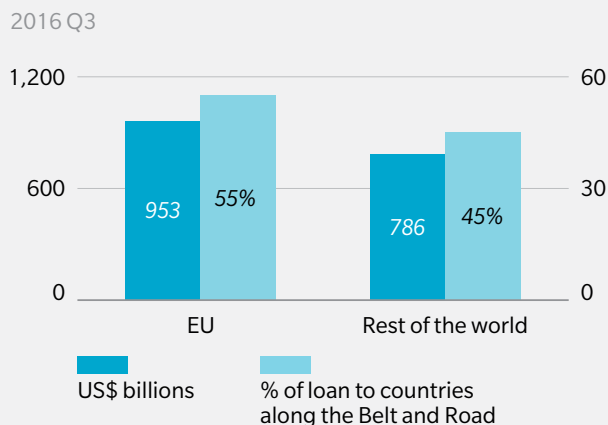
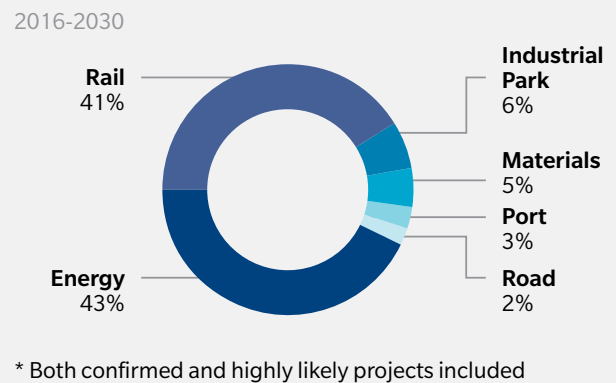


FIGURE 10 BELT AND ROAD INVESTMENTS BY INDUSTRY
Source: Natixis



stock market correction and currency devaluation in 2015, but still some of the Belt and Road projects could be financed in yuan in as far as the borrowing of a certain host country would be fully devoted to pay Chinese construction or energy companies (Exhibit 4). This quasi-barter system can solve the hard-currency constraint but poses its own risks to the overly stretched balance sheets of Chinese banks. In fact, their doubtful loans have done nothing but increase during the last few years, which is eating up the banks' room to lend further (Exhibit 5).

A second option is for China to intermediate overseas financial resources for the Belt and Road projects. The most obvious way to do this, given the limited development of bond markets in Belt and Road countries, as well as the still-limited size of China's own offshore bond market, is to borrow from international banks. Cross-border bank lending has been a huge pool of financial resources, especially in the run up to the global financial crisis. Since then they have moderated, but the stock of cross-border lending still hovers above

\$15 trillion, out of which, nearly half is lent by European banks. Out of the \$15 trillion, about 20 percent is already being directed to Belt and Road economies, again with European banks being the largest players (Exhibit 7).

Still, in order to finance the \$5 trillion targeted in Xi's grand plan for the next five years, we would need to see growth rates of around 50 percent in cross-border lending. While such a surge in cross-border lending is not unheard of (in fact, it happened in the years prior to the global financial crises), the real bottleneck would be the rapid increase in China's external debt, which would go from the currently very comfortable level (12 percent of GDP) all the way to more than 50 percent if China were taking on the debt, or something in between if co-financed by Belt and Road countries.

A mix of options one and two lies on the use of multilateral development banks to finance the Belt and Road projects. In fact, China is a major shareholder of its newly created multilateral banks (AIIB and New Development Bank) but less so in existing ones (such as ADB, EBRD or the World Bank). This means that the financing burden can be shared (to a lesser or larger extent) with other creditors, while still keeping a tight grip on the construction of such infrastructure (at least in new China-led organizations). While apparently ideal, the problem with this option is that the available capital in these institutions is minimal compared to the financing needs previously discussed (Figure 8).

It seems that China cannot rely on its banks alone – no matter how massive – to finance such a gigantic plan.

The key source of co-finance would logically be Europe, at least as long as bank lending dominates, which will be the case for quite some time in the countries under the Belt and Road. In fact, European banks are already the largest providers of cross-border loans to these countries, so it is only a question of accelerating that trend. Furthermore, the geographical vicinity between Europe and some of the Belt and Road countries could make the projects more appealing (Exhibits 9 and 10).

In addition, the European Union has its own grand plan for the financing of infrastructure – among other sectors – namely the Juncker Plan, which could serve as a basis to identify joint projects of interest to both the EU and China. The EU-China connectivity platform was launched by the European Commission in late 2015 to identify projects of common interest for the Belt and Road and EU connectivity initiatives, such as the Trans-European Transport network. All of this bodes well for Europe to become an active part of China's Belt and Road Initiative, not only in providing the financing, but also in identifying projects of common interest.

It goes without saying that other lenders, beyond Europeans, are welcome to finance Belt and Road projects as the ensuing reduction in transportation costs and improved connectivity should be good for the world as a whole. However, Europe's particular advantage in this

project should make it a leader on the financing front bringing the old continent closer to China.

The Belt and Road is great for supporting high demand in Asian infrastructure, but there is a limit on how much China can finance. The slowdown of the economy and the limits on the use of foreign reserves are two of the impediments. Additionally, Chinese bank balance sheets, the largest source of financing so far, are increasingly saddled by doubtful loans, which limit their lending capacity. As for official multilateral development agencies, their funding sources remain limited for the extent of the project.

Against this background, European banks – the largest cross-border lenders in the world – are well placed to step-up their already large financing to Belt and Road countries. Europe's proximity with some of these countries can make certain projects more appealing for Europe as well. Thus, we should expect private and public European co-financing of Belt and Road projects to increase over the next few years and, with it, European interest for Xi Jinping's grand plan. This should bring Europe closer to China.

This article first appeared on BRINK on May 23, 2017.

CHINA'S BELT AND ROAD INITIATIVE: MANAGING RISKS AND DISPUTES

Philip Teoh

Partner and Head of International Trade and Shipping at Azmi and Associates Malaysia



President Xi Jinping reaffirmed China's commitment to the Belt and Road Initiative during a recent trade summit of world leaders held in Beijing. Xi pledged an investment of up to \$78 billion for countries touched by the Belt and Road Initiative, which he has called the "project of the century."

Since 2013, Xi has been rolling out his Belt and Road plans, committing funds from China and the Asian Infrastructure Investment Bank and engaging global financial institutions such as the World Bank. This ambitious plan covers a large swath of territory from China through the former Soviet republics to Russia, Africa and parts of Europe and is expected to boost trade and infrastructure development.

While the Belt and Road Initiative (BRI) has the potential to boost economic growth and prosperity through increased trade and deeper economic ties, it can also lead to a series of challenges around business contracts and their enforcement.

ASSOCIATED RISKS

The BRI involves Chinese companies investing in or with companies in the countries along the Belt and Road. Many of these investments will be in infrastructure and development projects such as roads, rail and ports. The initial phase of these projects will involve a gamut of activities including preliminary risk assessments, project financing and setting up joint ventures to build

the infrastructure assets. Other investments will be made in logistics and manufacturing.

As the partner countries are at different stages of development and have different legal systems, there will be related challenges. For instance, it can be challenging to match the companies capable of undertaking the BRI projects. At the beginning, parties will need to be certain of both their partners' standing and their capabilities. In addition to that, the structures of the legal systems in countries receiving the investment will need to be considered.

In most cases, the partner countries will require the projects to be undertaken by local companies. This necessitates setting up joint venture enterprises, which would be locally incorporated. Setting up these enterprises will be an important prerequisite even before the projects commence.

For complex projects, the joint venture entity may comprise more than two parties. Two of these parties will likely comprise a Chinese party and a party from the BRI partner country, and the third will likely be a foreign party with the necessary technical expertise. Apart from this, there may also be a need to engage foreign consultants and experts to conduct comprehensive studies. These are all areas of potential disputes, particularly if the contractual parties and experts are not properly selected.

The parties' challenge will be to secure one another's commitments through secure, comprehensive and – most importantly – enforceable contracts. This is because legal contracts are not going to be useful if laws and regulations keep shifting, which is something that happens in many emerging markets. Apart from the terms themselves, which will be dependent on the tightness and clarity of contractual provisions, it will also be important to understand the legal environment of the relevant BRI partner country or the chosen system of law. These contracts need to be based on an agreed, stable and understandable system of laws.

If the partner countries that are home to BRI projects do not have developed and reliable systems of law, there will be a risk of institutional voids – or the absence of specialized intermediaries, regulatory systems and contract-enforcing mechanisms.

These voids in turn affect the enforceability of contractual commitments and could jeopardize the projects or partnerships.

Clearly, each party will be most comfortable with its own laws – for example, the Chinese investor will be comfortable with Chinese laws and the investee or BRI companies will be comfortable with the laws of their respective home countries. There may also be a cultural element as international lawyers and consultants may be familiar with common law rather than the civil law systems of the BRI countries.

Therefore, determining which laws will govern specific contracts will be a challenge as there will be multiple parties involved with a diverse set of preferences – often differing ones. Failure to agree upon the law will mean that there could be disputes about the governing law itself,

even before the deciding tribunal embarks on addressing the actual dispute.

RESOLVING DISPUTES

Once the governing law has been decided, parties will need to decide how they would want to resolve disputes. This decision must be prompted by objective criteria and not parochialism – there is no point in settling disputes in a particular court when a decision of that court cannot be enforced in the country where the losing party may be located.

In international contracts, the primary advantage of international arbitration over court litigation lies in its enforceability. An international arbitration award is enforceable in most countries in the world according to the mechanism set up under the New York Convention. Other advantages of international arbitration include the ability to select a neutral forum to resolve disputes; that arbitration awards are final and not ordinarily subject to appeal; the ability to choose flexible procedures for the arbitration; and confidentiality.

For the most part, the general acceptance of the New York Convention worldwide means that enforcement is not problematic. However, there has been some evidence of problems of enforcement in China. If this is the case, parties in large infrastructure contracts will do well to explore obtaining independent security – for example, by way of performance bonds that are enforceable in neutral jurisdictions. These bonds are often subject to a neutral law different from the governing law in the operational contract.

Determining which laws will govern specific contracts will be a challenge for Belt and Road Initiative participants.

Another area that parties need to be mindful of is the language of arbitration. It cannot be assumed that English will be the default language even in cases where the contract is laid out in English. The Chinese party may nominate a CIETAC Centre as its chosen arbitration venue. Lawyers advising the BRI partners would do well to be familiar with the available arbitration centers before agreeing to a particular center. Regional arbitration centers such as the Kuala Lumpur Regional Centre for Arbitration, the Singapore International Arbitration Centre and the Hong Kong International Arbitration Centre would be able to offer parties independent and neutral venues for dispute resolution.

China's BRI is likely to change the world economic landscape and propel development in many countries; and it will certainly provide opportunities to international contractors, advisors and professionals. In their eagerness to participate in this initiative, however, participating parties should not neglect the need to have proper contracts in place, including having appropriate law and dispute resolution provisions.

This article first appeared on BRINK on June 9, 2017.

ONE BELT, ONE ROAD: HOW WILL PARTNERS PROFIT?

Tianjie He

Economist at Oxford Economics



China's One Belt, One Road (OBOR) initiative has been the subject of awe and skepticism alike. There are those who believe it will support the long-term growth of partner economies through the development of infrastructure and better connectivity, while others have concerns.

The initiative can bring benefits if managed well, particularly in some of the least developed parts of the world; but at the same time, China needs to avoid its engagement with recipient countries becoming unbalanced. For example, it should avoid that its manufacturing exports crowd out domestic production and result in trade deficits that may lead to economic and/or political tensions in countries party to the initiative.

LARGE-SCALE IMPACT

Since its launch four years ago, OBOR has gradually gained traction with new projects and

financing coming on stream, such as the flagship 418-kilometer rail link with Laos and the \$46 billion China-Pakistan Economic Corridor. More than 100 countries and international organizations have joined the initiative, with nearly 50 having signed intergovernmental cooperation agreements with China on joint construction.

While there is no official data on the total number/value of OBOR projects, the China Development Bank said in 2015 that it had reserved \$890 billion for over 900 projects (in transportation, energy, resources and other sectors) across 60 countries. Meanwhile, the Export-Import Bank of China said in early 2016 that it had started financing over 1,000 projects in 49 OBOR countries. Most of the existing projects are concentrated in South Asia, Southeast Asia and Central Asia, given their geographical proximity and close relationship with China, but there are investments in East Africa and Southeast Europe also.

While the impact of the plan is hard to quantify at this stage, China's trade, investment and construction activity in OBOR countries is on the rise. Its bilateral trade with 65 countries along the OBOR was \$962 billion in 2016, one quarter of the total. The share of exports going to the OBOR region has grown steadily to 28 percent in 2016, nearly 12 percentage points higher than the share of exports to the EU and 10 percentage points higher than that to the US.

The share of China's imports coming from OBOR countries has fallen in recent years (measured in US dollars). While this is in part because of the fall in commodity prices, it also points to possible problems with China's economic engagement with the OBOR countries – that China's manufacturing exports crowd out domestic production and result in trade deficits.

According to China's Ministry of Commerce, nonfinancial outward direct investment to OBOR countries totaled \$14.5 billion last year, slightly less than in 2015, when China's overall overseas direct investment (ODI) – including nonfinancial ODI – to OBOR countries rose twice as fast as total ODI. Also, the value of new engineering contracts signed by Chinese companies in the OBOR region has increased steadily – it rose 36 percent year-on-year in 2016.

Moreover, China established 56 economic and trade cooperation zones in 20 countries along the route by end-2016, with investment exceeding \$18 billion.

FIGURE 11 FUNDING MECHANISMS

Sources: Oxford Economics, company annual reports and press releases

US\$ BILLIONS			
INSTITUTIONS	AUTHORISED CAPITAL SIZE	RECENT LENDING PER YEAR	POSSIBLE LENDING PER YEAR BY EARLY 2020S
Multilateral development banks			
Asian Infrastructure Bank (AIIB)	100	1.7	10-15
New Development Bank (NDB)	100	1-1.5	5-7
Silk Road Fund	40	2-3	2-3
Commercial banks	An estimated US\$90 billion annual lending by the "big four" banks in 2016		
Policy banks			
China Development Bank (CDB)	...	15 (2015)	...
Export-Import Bank of China (EXIM)	...	24 (2015)	...

CHINA REPLACING MULTILATERALS?

To provide development funding for the OBOR, China launched three new initiatives recently: the Asian Infrastructure Investment Bank (AIIB), the New Development Bank (NDB) and the Silk Road Fund, with a total initial capital base of \$240 billion.

While these new institutions have started to play an active role in project financing, most of the funding for OBOR projects actually comes from China's policy banks and commercial banks. Based on the annual reports and public announcements by the "big-four" state-owned banks, we estimate that together they have extended \$90 billion loans to the OBOR countries in 2016, while China's policy banks are also major lenders.

Thus, bilateral financing from China's commercial and policy banks dwarfs multilateral financing, and we expect that to remain the case in the future.

Nevertheless, even the combined annual financing flows likely to be generated by these and other international multilateral institutions (such as the World Bank and Asian Development Bank) are modest when compared

to infrastructure spending needs in the vast OBOR region – the ADB estimates the annual infrastructure investment needs at \$1.7 trillion until 2030, for example.

Thus, the OBOR scheme is unlikely to "crowd out" other international development cooperation.

LIKELY IMPACT OUTSIDE CHINA

Responding to criticism that OBOR seems a solo act by China, President Xi Jinping instead describes it as a "chorus." This language is meant to alleviate concerns abroad that China will dominate the initiative and projects.

We expect OBOR to support long-term growth and development in the economies involved. If OBOR is managed well, better infrastructure should facilitate trade and investment, create new market demand and contribute to global development. OBOR-generated infrastructure may, in particular, benefit some poorer countries, including in Central and South Asia, which have especially large infrastructure gaps and often have difficulties financing new projects.

There is clearly much room for developing infrastructure in

OBOR countries. The level and quality of logistics and infrastructure is generally low, compared to developed countries. Infrastructure deficiencies mean high transport costs, which hamper market access, cross-border trade and economic development.

If China's own experience is any guide, better infrastructure and greater regional connectivity should improve access of OBOR countries to the global market, better leverage comparative advantages and underpin long-term development.

OBOR infrastructure could further boost growth in an already rapidly growing part of the world. GDP growth in OBOR countries averaged 4.2 percent in 2014-16, compared to the global average of 2.6 percent. We estimate that the region contributed 68 percent of global GDP growth in 2016, with Asia's contribution (including China) well above 50 percent.

We estimate that by 2050 the OBOR region will contribute 80 percent of global GDP growth, with China's share remaining broadly stable at around 40 percent and that of the rest of Asia doubling from the current 15 percent to over 30 percent.

This fairly constructive projection of the OBOR region is subject to downside risks, including global trade protectionism and, domestically, supply side constraints. OBOR infrastructure, as well as regional trade and investment collaboration, reduce those downside risks.

A previously published piece on BRINK Asia by Tianjie delved into the implications of the OBOR for China's economy and global standing.

This piece first appeared on BRINK on June 13, 2017.

THE GEOPOLITICAL IMPACT OF CHINA'S ECONOMIC DIPLOMACY

BRINK Editorial Staff



The prevailing conventional wisdom of a singularly powerful, hegemonic China is too simplistic; the interconnected geo-economics of today's world, though often stark and abrupt, are woven from a set of complex and nuanced political realities surrounding the execution of China's economic diplomacy.

That was the uptake from a recent public forum, hosted by the Brookings Institution, in which a panel of Asia experts made the case that despite the enormous influence China exhibits across the globe today, the story of Asia's future would be written by many Asian countries.

Although much of the event's conversation avoided China – focusing instead on other players such as Japan, South Korea, the United States and Australia – the economic superpower loomed over the talk much as it looms, politically and economically, over Asia.

The event, titled The Geopolitical Impact of China's Economic Diplomacy, wove an intricate tapestry of competing political interests and subverted economic expectations to be played out by a cast of nations hoping for a reshuffling that might tip the balance of the region in their favor.

David Dollar, a senior fellow at Brookings' Thornton China Center, began by laying out the stakes: according to a recent Asian Development Bank report, developing countries in Asia need to invest roughly \$26 trillion into infrastructure by 2030, far more than previously anticipated.

"In recent years, the rich countries as a group have not been doing very much to meet these needs," Dollar said.

China, on the other hand, is well-positioned to help developing countries meet those needs,

"China is not the only country that is proposing huge cross-border international projects."

Dollar said. “You’re seeing some labor-intensive value chains moving out of China,” he continued. “You see Chinese construction companies that do not have enough business at home. So I think from China’s point of view this capital going out makes enormous economic sense.”

‘NOT JUST A CHINA STORY’

In light of the Belt and Road Initiative, China might appear to be the strongest candidate to help fund infrastructure demands in the region. However, China’s leadership in this area was disputed by Masahiro Kawai, the director-general of the Economic Research Institute for Northeast Asia.

“Internationally there are so many initiatives, even for the Northeast Asian countries,” Kawai said. “Mongolia has its own initiative called the Steppe Road initiative which connects Mongolia with neighboring countries and distant countries,” Kawai said. “Korea has the Eurasia[n] Initiative, which connects Korea with Eurasian countries. And Russia has its own initiative – Siberian transport system and Eurasian economic partnership initiative [Eurasian Economic Union]. And there are many other such projects driven by various national governments.”

“China is not the only country that is proposing huge cross-border international projects,” Kawai said.

Moreover, although Kawai acknowledged the expectation that China would reshape the international economic system to be consistent with its interests, he pointed out that other, smaller countries were the ones pushing for change. China, instead, appeared to be pulling back in the interest of maintaining the status quo.

One example of this, Kawai said, were the efforts of Australia, Japan and New Zealand to finalize large free trade agreements despite a withdrawal of support from China or India, the expected key players in the region.

“The US is backtracking, which is very unfortunate,” Kawai said. “But does this make China an aggressive leader? [...] China doesn’t seem to be taking leadership by opening its economy and then embracing many other countries to consolidate a [free trade agreement] under [the Regional Comprehensive Economic Partnership]. That’s not what’s happening.”

Evan Feigenbaum, vice chairman of the Paulson Institute, reiterated this point, and suggested that Asian history could serve as a helpful guide for assessing the current geopolitical reality.

“[When China announced the Belt and Road Initiative] people said ‘Oh my god, China’s got this new big strategic initiative, how are we going to react to this?’ as if connectivity in Asia had been invented in China, invented in 2013, and like Athena from Zeus’s head had sprung from the head of President Xi Jinping,” Feigenbaum said. “It’s easy to forget that for most of its history Asia was an astonishingly interconnected place.”

Feigenbaum insisted current changes in the region were far more than “just a China story” or “just an infrastructure story.” Instead, the region’s new connectivity was indicative of Asia at large – not just China – becoming more Central Asian than Eurasian. These were the first signs of a reversion back to historical norms, and away from the “anomaly” of the past century – which had been instituted by Western countries.

THE US ON THE BRINK OF ECONOMIC IRRELEVANCE

During his presentation, Kawai raised the following question: “Does China want to challenge the existing system and somehow change [it] in a way that is consistent with China’s overall political, economic, and even security interests, or is China [executing trade policy] in a way consistent with the existing economic system?”

An underlying assumption of this question, and of the event’s discussions at large, was that the US had retreated from Asia: this had the result of disempowering one set of economic elites, and subsequently empowering another.

Dollar explained that the US and China had previously complemented each other economically in the region. The real question about Asia’s future, then, is whether China will fill the gap left by the US and other Western powers whose influence is waning.

This piece first appeared on BRINK on March 13, 2017.

CHINA-EUROPE TRAINS: A GAMECHANGER FOR HONG KONG BUSINESSES?

Wing Chu

Senior Economist of Greater China Research Team at Hong Kong Trade Development Council



FAST EXPANSION FOR GREATER COVERAGE

China's Europe-bound freight train service was launched in March 2011, with the first train setting off from Chongqing to Duisburg, Germany. As of August 2016, more than 2,100 trains have been dispatched via the Yuxinou (Chongqing-Xinjiang-Europe) International Railway.

Currently, the CR Express provides regular rail services to at least 16 Chinese cities, including Chongqing, Chengdu, Zhengzhou, Wuhan and Suzhou, stopping at more than 12 cities in eight European countries. Of particular interest is the fact that CR Express services have grown rapidly in the past year, with increasing numbers of mainland companies relying on rail to transport goods to Europe.

The CR Express provides not only direct railway transport to Europe from China, but also a one-stop service in cargo inspection, quarantine and customs clearance, thanks to the support of relevant government authorities.

Since the launch of the China-Europe Railway Express (CR Express), linking China with Europe by fast-track cargo rail, freight volume has increased substantially, particularly in the past year. The CR Express is of increasing interest to companies that want to transport Chinese products to Europe while tapping markets along the Belt and Road routes, including manufacturers in western China and companies in the coastal region looking for an alternative to sea freight. Some companies even take advantage of these freight trains' speed and customs clearance facilitation to bring imports into the booming domestic market.

As the CR Express service improves, Hong Kong manufacturers and traders could consider using rail as an adjunct to sea transport to develop inland market opportunities along the Belt and Road routes in both Asia and Europe. Logistics providers could also strengthen cooperation with railway logistics companies to connect with logistics networks in Hong Kong, so as to further strengthen their niche in international transport and their logistics in sea and air transport.

Notably, the technical specifications of the railway system and rail tracks are different between China, countries in Central Asia and Europe. Trains need to change from one rail track system to the others when crossing the China-Russia border, entering Central Asia (countries such as Kazakhstan), and arriving in Eastern and Western Europe. However, such technical issues have been resolved owing to the concerted efforts of the railway and shipping companies concerned. Today, most logistics operators are capable of monitoring the cargo during the whole process and provide the consignor with clearance on arrival at the railway terminus, warehousing and transshipment to the desired destination.

SUPPLEMENTING AIR AND SEA FREIGHT

By helping companies to export goods to Eastern and Western Europe, the CR Express is playing an important role in China's Belt and Road strategy and helping to strengthen bilateral trade and investment with countries along the route. Furthermore, some logistics operators also provide clients with transit services from the terminuses in Germany and Poland to neighboring areas, effectively extending the coverage of the CR Express.

The CR Express was earlier used primarily for transporting Chinese exports to Europe. But Chinese companies are now increasingly using the service to import goods from Europe. In the first half of 2016, the CR Express operated 619 train services (a 150 percent increase year-on-year), of which 410 departed from China, and 209 returned (a 318 percent rise year-on-year), representing 51 percent of departures.

IT and other electronic products are now the major categories of export goods currently carried by the CR Express. Others include household appliances, machinery and equipment, auto parts, food, clothing, general goods, and e-commerce merchandise. Although many e-commerce items are mainly transported by air, they are being carried increasingly via the CR Express. Imports mainly include wood products, food, agricultural goods, auto parts and finished vehicles.

Generally, these China-Europe freight trains transport cargo to their destinations three times faster than shipping by sea for one-fifth of the cost of transport by air. While rail freight is still more costly than sea freight, the CR Express can work as an adjunct to sea and air transport, and rail connections are likely to increase as more and more companies use rail services to expand China-Europe trade.

Europe-bound services from the Guangdong province have also been launched, such as the service from Guangzhou to Vorsino in Kaluga, Russia via Manzhouli in Inner Mongolia, which began in August 2016. This was the second Europe-bound train service from the province, following the service from Shilong, Dongguan to Duisburg, Germany, which started operating in April 2016. According to China Daily, the line covers a distance of 11,500 km, taking about 14 days.

Clothing, footwear, computer accessories and electronic equipment produced in the Pearl River Delta (PRD) region were shipped using a standard 40-foot container. The railway company is planning to strengthen Europe-bound train services from Guangdong, and is actively working on rail connections with Kazakhstan and Uzbekistan in a bid to transport

Generally, CR express freight trains transport cargo to their destinations three times faster than shipping by sea.

more goods manufactured in the PRD region and southern China to markets in Central Asia and Europe.

IMPLICATIONS FOR HONG KONG COMPANIES?

The recent rapid expansion and increasing frequency of Europe-bound rail services, and the significantly shorter lead time of 10-12 days for the fastest routes, means rail has gradually become a viable alternative to sea and air transport for export and import enterprises exploring European trade opportunities. Meanwhile, the related railway transport companies are actively working with countries along the CR Express route to negotiate not only transit arrangements, but also the feasibility of stopovers to collect cargoes halfway on the route. This is to align with the current China-Asia CR Express service, which has freight trains departing from China and heading to Asian countries like Nepal, Kazakhstan and Uzbekistan.

These developments will effectively enhance the transport links between China and countries in Asia and Europe and strengthen the capabilities of related logistics providers of cargo transportation and distribution. Under such circumstances, Hong Kong companies may need to consider the feasibility of the further use of rail transport to enhance their flexibility in expanding into Eurasian markets. Furthermore, logistics operators can strengthen partnerships and cooperation with the relevant railways, helping to connect them to logistics and transport networks in Hong Kong, enhancing their advantage in the international transportation and logistics business.

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CHINA'S BELT AND ROAD INITIATIVE: WHAT IT MEANS FOR MALAYSIA

Philip Teoh

Partner and Head of International Trade and Shipping at Azmi and Associates Malaysia



Malaysia has been China's largest trading partner in the ASEAN region since 2008, and it is its third biggest Asian trading partner after Japan and South Korea. Bilateral trade between the two countries, which grew at 4.4 percent in 2016, is expected to continue expanding.

These economic bonds will be further strengthened with Chinese president Xi Jinping's efforts to enhance regional connectivity and maritime linkage through the Belt and Road Initiative. China's activism on the world stage comes at a time when America appears to be pursuing a more isolationist approach under President Donald Trump, and this can lead to a new wave of cooperation between Malaysia and China.

The Belt and Road Initiative vision comprises two initiatives – the land-

based Silk Road Economic Belt and the ocean-based Maritime Silk Road Initiative – and includes two routes stretching from China's southeast ports and the South China Sea. One passes through the Indian Ocean and ends in Europe, while the other ends in the southern Pacific Ocean.

Both of these have ramifications for Malaysia and Malaysian businesses.

WHAT MALAYSIA OFFERS

Malaysia is better placed than most of its ASEAN neighbors to embrace the opportunities created by the surge of infrastructure development and trade deals that come with increased Chinese overseas investment and participation in these areas. The overall infrastructure risk in Malaysia is among the lowest

in the ASEAN region, just after Singapore. Moreover, Malaysia holds the Strait of Malacca, which can serve as China's gateway to the ASEAN Economic Community.

Besides being strategically well-positioned geographically in the ASEAN region, Malaysia also benefits from a particularly strong transport and logistics infrastructure and ecosystem that draws businesses.

Owing to these factors, Malaysia stands to benefit from the Belt and Road Initiative.

Chinese interest in Malaysia is already being witnessed in the form of the recent spate of investments by established Chinese businesses. For example, Alibaba recently announced plans to set up a regional distribution hub in Malaysia.

MALAYSIAN RESPONSE TO THE BELT AND ROAD INITIATIVE

Malaysia's attitude toward the Belt and Road Initiative has been generally positive. Prime Minister Najib Razak agreed in principle to support China for the Maritime Silk Road at the Boao Forum for Asia 2015 – the Maritime Silk Road will establish ties between Malaysia and China's Guangdong Province in the country's southeast.

Malaysia's Transport Minister, Liow Tiong Lai, also indicated that Malaysia had looked into

how it should prepare itself for developments relating to the Belt and Road Initiative, with the emphasis being on ports, railways and the aviation sector, and seaports in particular. “We already see this as an important initiative to benefit the world, and ASEAN in particular,” Lai said.

Moreover, the wider Southeast Asia is faced with a dearth of financing required for infrastructure development. ASEAN will require up to \$110 billion in infrastructure investment each year through 2025 to fully address the region’s infrastructure needs – specifically power, transport, ICT, and water and sanitation. Malaysia is no different – its infrastructure spending is expected to grow by 9 percent a year until 2025, and the government is aiming to attract \$118 billion of local and foreign private-sector-led investment by 2020.

The Belt and Road Initiative can play a major role in helping Malaysia procure this amount of investment.

SECURING TRADE ROUTES

Strategically located, Malaysia is no stranger to foreign direct investments in its seaports, some of which are among the busiest in the world. As early as 2000, Maersk-SeaLand had bought 30 percent of the Port of Tanjung Pelepas. More recently, in 2013, China’s Guangxi Beibu Gulf International Port Group bought a 40 percent stake in Malaysia’s Kuantan Port Consortium from construction group IJM Group for a total of \$102 million.

Meanwhile, China, which some believe is pursuing a “String of Pearls” policy to contain the influence of the US and India in

the region, has already started participating in port projects in Sri Lanka – the Hambantota and Colombo Port City projects, for example – and the port in Gwadar in Pakistan.

One example of the multi-layered nature of these Chinese-led infrastructure projects is the Kribi Port project in Cameroon. The contract value for the first phase of the deep-water port was set at \$568 million and the next phases of the project will continue to expand the port by building new shipping berths, with a capacity of over 100 million tons per year. There is other work underway to link the new port to major urban areas. It is said that the ultimate goal is to have an urbanization master plan designed to modernize Kribi’s roads and buildings.

China has been seen as vulnerable when it comes to the protection of its trading routes in key geopolitical areas, especially the Strait of Malacca. This anxiety is also known as the “Malacca Dilemma.” Since the Maritime Silk Road passes through the Strait of Malacca, it is not surprising that the expansion of an international shipping port in Malacca is being planned such that it meets international standards.

The chief minister of Malacca, Idris Haron, acknowledged the urgency with which the state needs to build a new seaport terminal, and has said there is a lack of related facilities in Malacca at the moment, where more than 300,000 ships pass every year. On the other side of the Strait, Chinese companies such as Tianjin Port and China Harbour Engineering have recently shown interest in financing the development of the Kuala Tanjung Port in Indonesia, situated close to the Strait of Malacca.

China has been seen as vulnerable when it comes to the protection of its trading routes in key geopolitical areas.

Malacca Gateway in the Southern part of Malaysia has been earmarked as a key port of call along the Belt and Road Initiative's Maritime Silk Road. The strategic masterplan of Melaka Gateway's development aligns with the principles of the Belt and Road Initiative as strategized by China – "improving road connectivity, promoting unimpeded trade, enhancing monetary circulation, accelerating policy communication and increasing understanding and people-to-people relations."

CHINESE PLANS, GLOBAL IMPACT

The Maritime Silk Road is a plan of global proportions that is expected to impact 4.4 billion people across 65 countries, and is expected to boost annual trade volume between China and other Belt and Road Initiative countries to more than \$2.5 trillion over the next decade. China insists that both the Maritime Silk Road and its investment in regional maritime infrastructure are just economically motivated.

Whether they are or not, Malaysia will still benefit from the vast opportunities that will come about from the Maritime Silk Road, and the expansion of the Malacca port will only mark the commencement of its participation in this new vision of the Belt and Road Initiative. This will also boost opportunities for Malaysian businesses that are ready to grasp opportunities emanating from the evolution of relations between the two countries.

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IS CHINA PIVOTING TOWARD THE MIDDLE EAST?

Mirek Dusek

Head of Middle East and North Africa, Member of the Executive Committee, World Economic Forum

Maroun Kairouz

Community Lead, Regional Strategies, MENA at World Economic Forum



ONE BELT, ONE ROAD

Unveiled by President Xi in October 2013, the “One Belt One Road” (OBOR) initiative will direct considerable Chinese financial resources toward infrastructure projects across 60 countries. In particular, the economic belt component would aim to integrate countries that lie along the original “Silk Road,” running through Central Asia, the Middle East, and all the way to Europe.

Through OBOR, China is striving to achieve three objectives. On one hand, it hopes to stimulate the economies of trading partners to prop up demand for its exports. By establishing a land route for its wares, it would also seek to rebalance its economy from the port cities on its east coast toward its more deprived western and southern provinces. At the same time, such a trade route would reduce its dependency on the Strait of Malacca for its international trade, through which flows an estimated 80 percent of its oil imports. China would thus be at the mercy of a maritime blockade, should tensions escalate over the South China Sea, for instance, grinding its economy to a halt. At the heart of three continents, the MENA region would therefore constitute an indispensable element of that strategy.

For this purpose, China has endowed the New Silk Road Fund (NSRF) with \$40 billion, and the Asian Infrastructure Investment Bank (AIIB) with \$100 billion, with a mandate to invest in partner

At this year’s World Economic Forum Annual Meeting in Davos, Chinese President Xi Jinping declared his intention to host the second Belt and Road Summit for international cooperation, to which most countries from the Middle East and North Africa (MENA) have been invited.

This follows China’s first Arab Policy Paper, outlining the government’s vision for an enhanced relationship with the countries of the Middle East. The document indubitably reflects the Middle East’s soaring importance in Beijing’s eyes and could very well be a harbinger of its future plans. Indeed, in the decade to 2014, trade flows between the two sides have surged by 600 percent.

But does this development indicate a Chinese pivot to the region? And what are the key issues around the intensifying relationship between China and the countries of the

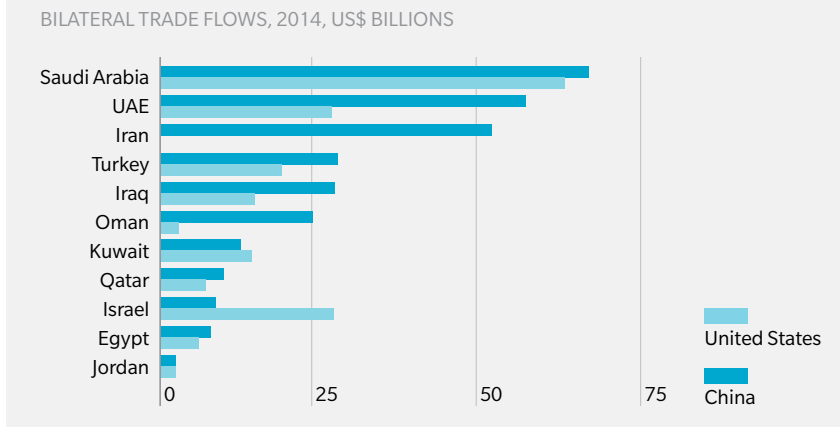
MENA region throughout the past decade?

NEED FOR OIL

In 2015, China overtook the US as the world’s top importer of crude oil. Of the 6.2 million barrels per day (bpd) that China currently imports, more than half are extracted in the MENA region. This has turned China into the top destination for several countries’ exports, including both Saudi Arabia and Iran. Underpinned by solid growth, and as a mounting number of its citizens acquire automobiles, its thirst for crude oil is not likely to be quenched anytime soon. In fact, the International Energy Agency (IEA) expects its imports from the MENA region to double by 2035. The region is believed to sit on half of the world’s proven petroleum reserves. As a consequence, China’s interest in its stability is only likely to grow.

FIGURE 12 JOURNEY TO THE EAST

Sources: Natixis, ADB N.B. Climate-adjusted estimates



countries' infrastructure projects. AIIB's board includes – among other countries – the region's two rival heavyweights, Iran and Saudi Arabia. In 2016, the AIIB provided \$1.7 billion in loans, including \$300 million of financing to expand Oman's Duqm Port and to lay the groundwork for the country's first railway system. Given the relatively long return horizon for Chinese investors, their experience in investing in areas with high political risk, and MENA's immense need for long-term investment in infrastructure, this first loan could be the forerunner of many more to come.

CHINESE EXPERTISE AT WORK

As oil prices are expected to remain subdued, MENA countries will be compelled to wean their populations off the costly subsidies bestowed upon them in the past. In particular, energy and fuel subsidies will not only affect the state of their public finances as their revenues from energy proceeds dwindle, but are also regressive in nature, which means they benefit the well-off

more than they do the poor. The International Monetary Fund (IMF) estimates that energy subsidies were worth 22 percent of regional public revenue and 8.6 percent of regional GDP in 2011.

To manage this transition, governments will need to adopt more efficient systems for energy generation and distribution. China has become the world's largest producer of solar electricity generation equipment. Given its geographic position, the MENA states would be particularly well-suited to benefit from Chinese technology and know-how in the field. With the leaps that technology has made in recent years, and the significant decrease in its cost, it will possibly become competitive even in the absence of subsidies in sunny regions like MENA.

Additionally, being one of a handful of countries that have not grown weary of nuclear power plants in the wake of the Fukushima Daiichi disaster in Japan, China is on track to triple its nuclear generation capacity by 2020. With interest rising from MENA countries, in particular in the Persian Gulf, a mutually beneficial partnership could very

well emerge in this domain as well. Having recently abandoned 103 coal power plants, China's leadership is increasingly focused on ameliorating its environmental conditions by becoming a world leader in renewable energy.

Likewise, according to the World Bank's Global Financial Inclusion Database, MENA has the highest regional percentage of a population that is without access to financial services, with more than 85 million unbanked adults. At the forefront of financial technology (fintech), with trailblazing services offered by the likes of Alipay, Baidu, and WeChat, Chinese expertise has the potential to become a gamechanger in helping the region's poor bypass conventional banking altogether.

A DEEPENING RELATIONSHIP

Having complementary interests in the fields of energy, renewables, infrastructure, trade, and possibly technology, the cooperation between China and the MENA countries is only likely to deepen in the years to come. Still, with yet more room to grow, this burgeoning relationship has the potential to play a decisive role in their quest for economic transformation and diversification. Chinese participation in the World Economic Forum on the Middle East and North Africa on May 19-21 in Jordan – as well as MENA countries' participation in the upcoming Annual Meeting of the New Champions in Dalian in June – will be watched closely for any telling signs of increased mutual engagement between the two sides.

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IRAN: EUROPE EYES A NEW SILK ROAD

Moritz Pieper

Lecturer in International Relations at the University of Salford



The cake is quite big, but everyone wants a slice. Italian prime minister Matteo Renzi visited Iran last month accompanied by business leaders from the energy, transportation and defense sectors. It was a return visit after the Iranian president, Hassan Rouhani, had made Italy his first destination in Europe on a trip intended to drum up European investments in Iran.

Such investments are now possible, thanks to the implementation of the JPCOA nuclear agreement, which lifts all UN-mandated nuclear sanctions as well as EU and US economic, financial and banking sanctions over the Iranian nuclear program. The path is clear for Iran to pursue a new engagement with the world. European businesses are eager to jump in, but it will be no easy trick to challenge the position of Russia and China.

The enthusiasm is obvious. EU high representative Federica Mogherini traveled to Tehran last month accompanied by business representatives and seven EU commissioners – including those for transport, energy and industry – signaling the high-level interest. German industrial giant Siemens, the oil and gas company Shell and French automakers Peugeot and Renault have indicated their interest. Airbus secured a contract with Iran for the delivery of 118 aircraft just two weeks after sanctions were lifted.

NOT SO FAST...

The Iran rush is tugged back, however, by the persistence of sanctions not related to the nuclear deal, which can very easily apply to European companies.

Complicating matters for EU companies wanting to deal with Iran: parts of the economy still subject to sanctions.

The US, in particular, will retain secondary sanctions that target dealings with Iranians on their Specially Designated Nationals List (SDN), a collection of individuals the US deems to be a risk on grounds of terrorism, nuclear proliferation or human rights. According to White House guidance, anyone found to have had dealings with those on the SDN list would “put themselves at risk of being cut off from the US financial system. This includes foreign financial institutions, who would risk losing their correspondent account with US banks.”

European subsidiaries of US companies can get operating licenses for businesses in Iran, but will need to “firewall” their US activities from their foreign operations. This may prove to be a challenging requirement, given the intertwined nature of companies and the banking sector. It remains unclear whether even emails going through US servers could be considered as using the US to facilitate transactions.

Complicating matters still further for European companies is the extent to which parts of the Iranian economy will continue to be controlled by entities still subject to sanctions. For example, there are banks on the US’s SDN list for carrying out terrorism-related transactions; construction, trading and transport companies tied to the Iranian Revolutionary Guards Corps or telecom companies.

RIVALS STAND IN THE WAY

These obstacles will leave European firms struggling to catch up with China, which has largely benefited from western embargoes. Russia is also well-placed in Iran’s nuclear energy market. Both China and Russia are simply less likely to be as affected by the “foreign subsidiary”

regulation because Chinese or Russian subsidiaries of larger US corporations are far less common.

Chinese companies had been willing to provide goods that Iran could no longer receive from the West. In 2014, the Sino-Iranian trade volume totaled \$52 billion (compared to a Russian-Iranian trade volume of only \$1.6 billion and \$10 billion between Iran and the entire EU-28). During nuclear sanctions, China was Iran’s most significant foreign trade partner, exporting capital goods and engineering services and investing in infrastructure projects. With nuclear sanctions now lifted, China seems to be aware that, whatever the obstacles for European firms, it might face increased competition.

Losing no time Chinese president Xi Jinping paid a visit to Iran in January, signing a Sino-Iranian comprehensive strategic partnership and announcing 17 agreements in the energy, trade and industrial sectors. Iran is important for China’s One Belt, One Road initiative that would join markets from China to Central Asia and the Middle East.

MOSCOW’S INTERESTS

Russian commercial interests in Iran concentrate on the restart of arms sales and the nuclear industry. Russia has made it clear that it was planning to capitalize on the eventual lifting of arms embargoes from Iran. While the UN weapons embargo will only be lifted in five years, states can apply for UN authorization beforehand.

The nuclear industry is more lucrative in the mid-term. Russia’s state-owned nuclear company Rosatom has held a relative monopoly position on the Iranian nuclear energy market – having built Iran’s only nuclear power reactor in Bushehr – and is currently closely involved in the implementation of

the JCPOA agreement. It is unlikely Russia will face serious competition in this sector of the Iranian economy.

But it’s not a one-way street: With economic sanctions gone, the prospect of increased Iranian oil supply to Europe could signal tough competition on the European energy market. This comes after the oil price slump, which has strained the Russian state budget. It means that any hindrance to growth in Iran’s oil infrastructure, thanks to continued sanctions, might be met with a sigh of relief in Moscow. This does not mean that Russia is desperate to prevent Iran from emerging as an energy competitor. But it does buy time for Russia, and indeed Europe, to prepare for a shift in global oil supply dynamics.

It’s a tough call for European businesses. They can only challenge China’s position in Iran’s capital goods and construction market in as much as the complex sanctions architecture allows them. Russia also stands in a stronger position as far as its “traditional” sectors of interest are concerned. The truth is that banks and businesses are risk-averse, and the ambiguities in US financial legislation will feed this concern. It ensures that the lifting of sanctions is no “free for all,” but a slow, tentative walk through a legal minefield.

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CHINA'S BELT AND ROAD INITIATIVE: CAN EUROPE EXPECT TRADE GAINS?

Alicia García-Herrero

Senior Fellow for BRUEGEL and Chief Economist for Asia Pacific at Natixis



Although there are many interpretations as to the ultimate objectives of China's Belt and Road Initiative, there is one that nobody can deny: support of its exports.

Indeed, the initiative seeks to improve trade connectivity by upgrading transport infrastructure across much of Eurasia. The undertaking spans a massive geographic area covering as many as 63 countries, accounting for 60 percent of world's population and 30 percent of global GDP.

This massive project is centered on two main routes over land and sea. On land, the focus is on transport and energy infrastructure. By sea, investments in new ports serve as pillars for promoting trade. Heavy investment will ease transportation bottlenecks affecting cross-border trade, and thereby impact Europe massively.

Among the many benefits of improved connectivity, trade is at the forefront. The idea that improved transport infrastructure fosters trade is intuitive, but which countries win or lose the most depends partially on their distance from the improved infrastructure.

In a recent Bruegel working paper, results show that 10 percent reductions in railway, air and maritime costs would increase trade by 2 percent, 5.5 percent and 1.1 percent, respectively.

CAN THE INITIATIVE GO ANOTHER DIRECTION?

While the current focus is centered on infrastructure, there is another way it may evolve: dismantling trade barriers.

In fact, Chinese authorities have begun to consider free trade agreements (FTAs) with Belt and Road countries. The issue is that EU countries have yet to be included. More problematic is that it is only possible for EU countries to collectively strike trade deals with China. This means that the chance for the EU to benefit from FTAs is slim.

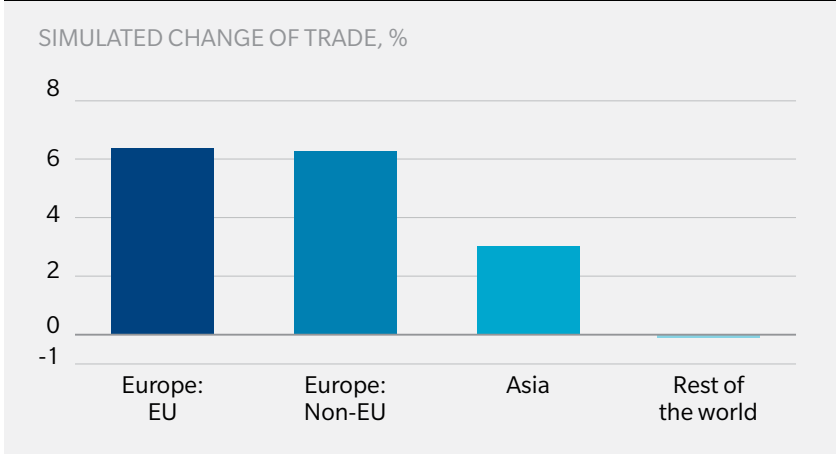
If the Belt and Road Initiative focused on FTAs instead of infrastructure, the EU would be isolated from a sizable free trade area next to its borders. As one can imagine, this scenario is much less appealing than the previous one focused on infrastructure.

THREE POSSIBLE SCENARIOS

When the transportation cost is reduced, the EU is the largest winner of the Belt and Road Initiative from a regional perspective. Halving the cost of railway transportation is responsible for the large gains in rail transportation within Europe, particularly for landlocked countries.

If China establishes an FTA zone with Belt and Road countries, the EU – previously the biggest winner from the reduction in transport costs – now suffers slightly. Enhanced integration means that China and Belt and Road countries will substitute EU trade with trade among themselves.

FIGURE 13 REGIONAL TRADE IMPACTS OF REDUCTION IN TRANSPORTATION COSTS
Source: Bruegel working paper



The Asia region then becomes the biggest winner, followed by non-EU European countries, which also benefit from the elimination of trade tariffs.

Under a situation with both improved transportation infrastructure and FTAs, most Asian countries become the biggest winners since they benefit from both a reduction in transport costs and the elimination of trade tariffs. Some EU countries also benefit significantly, but less so than Asian ones.

POLICY IMPLICATIONS FOR THE EU

With the scenarios above, it may be in the EU's interest to more actively take part in the Belt and Road Initiative. The EU is better positioned to take advantage of cheaper rail and maritime transport than Belt and Road countries financed by China. The EU clearly benefits from stronger trade links – and without an attached financial cost, at least for now.

On the other hand, a free trade agreement between China and Belt and Road countries – which leaves out the EU – would hurt EU trade slightly. The negative effects on the EU of a neighboring free-trade area are much smaller than the benefits of improved transport infrastructure. And a potential FTA would benefit Asian countries the most.

Therefore, the effects of the Belt and Road Initiative on Europe are considerable. Trade is only one of the many channels through which the initiative may affect Europe. Financial channels, such as FDI and portfolio flows, are also very relevant and should also be studied. It goes without saying: more research is needed.

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