Belt and Road – Making its presence felt

- In this report, we look at the latest developments on the Belt and Road Initiative. We provide an on-the-ground perspective on the ‘new Silk Road’, which aligns with our research footprint in Asia, Africa and the Middle East.

- Trade and investment links between China and BRI countries continue to deepen, cementing alliances, improving competitiveness and shifting the global supply chain amid the US-China trade war.

- Rapid BRI expansion comes with challenges and risks – BRI partner countries face widening trade deficits and rising external debt. Bilateral debt relief offered by China should help to avoid systemic debt fallout.

- Increased transparency would likely improve project quality, address growing concerns and facilitate debt resolution. Commercial, environmental and social viability would help ensure project sustainability.

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Overview

Belt and Road progress across our research footprint

Proposed by President Xi Jinping in 2013, the Belt and Road Initiative (BRI) – a China-led development strategy that connects almost half the world’s population and one-fifth of global GDP – has come a long way since its launch. China’s leadership released a Belt and Road action plan in 2015, incorporated the initiative into its 13th Five-Year Plan (2016-20) in 2016, and formally added it to the Party Constitution in 2017. The BRI is well into the implementation stage, and has already achieved much in terms of promoting common development and building a platform for international cooperation. Trade and investment along this modern-day Silk Road are booming; the expansion of South-South trade corridors and rising investment in regional connectivity along the Belt and Road are becoming particularly relevant in an environment of US-China trade tensions and potential resulting shifts in the global supply chain.

The BRI’s fast-expanding scope and the inherently large financial commitments required for its infrastructure projects have, unsurprisingly, created implementation problems. The significant cost of many BRI infrastructure projects has proven prohibitive in the recent past for countries such as Pakistan, Sri Lanka and some African nations. Political risks arising from questions about a project’s economic and social viability are also a factor, as evidenced by Malaysia’s recent decision to call off landmark BRI developments. China’s ability (and apparent willingness) to provide bilateral debt relief suggests a low risk of systemic debt fallout. However, we believe a more transparent BRI development framework and improved debt management are more sustainable ways to promote the BRI going forward.

Our research footprint matches the Belt and Road’s extensive reach, giving us an on-the-ground perspective of the initiative. This report includes an in-depth country analysis of Pakistan, focusing on the China-Pakistan Economic Corridor (CPEC); as well as regional overviews of ASEAN and South Asia (ASA), Africa and the Middle East (see ‘Country and regional analysis’ section).

Belt and Road connections continue to strengthen

China’s trade with BRI partner countries increased to 36.1% of its total trade in H1-2018 from 33.9% in 2013; over half of this was with ASEAN and North Asia (Figure 1). In the past five years, China’s direct investment in BRI countries has...
exceeded USD 70bn, with an average annual growth rate of 7.2% y/y. China’s outward direct investment (ODI) dipped in 2017, reflecting Beijing’s tighter scrutiny of outflows, but ODI to BRI countries remained robust and expanded its share of the total (Figure 2).

The BRI’s presence has been felt even more by its partner countries. About 7% of ASA’s foreign direct investment (FDI) in 2014-16 was from China, and investment from China alone accounted for 2-3% of GDP in Laos and Cambodia. Meanwhile, China now absorbs a fifth of Sub-Saharan Africa’s (SSA’s) exports, and the region’s imports from China have grown fast in recent years due to capital-goods imports for BRI projects. The BRI is also reshaping investment flows into SSA: Ethiopia and Kenya, which signed MoUs for BRI projects early, are now the top destinations for inbound contract work from China, whereas oil exporters Nigeria and Angola were the top destinations for such work in 2010. The BRI’s impact on the Middle East, North Africa, Afghanistan and Pakistan (MENAP) region is demonstrated in the region’s shift from a trade surplus with China to a deficit in recent years due to lower oil prices and rapid growth in BRI-related imports from China.

**Belt and Road is increasingly relevant amid US-China trade tensions**

The BRI is becoming increasingly relevant for both China and its BRI partner countries amid the current US-China trade dispute. China could stand to gain more allies and reduce its dependency on the US via the BRI, as trade tensions could persist long enough to reshape the global supply chain. The BRI seeks to expand the China-ASEAN trade corridor – accelerating a trend that we believe was long in the making as China-based manufacturers sought cheaper production sites and ways to tap emerging markets’ growing consumption power. The surge in capital-goods exports from China to BRI destinations has generated a trade surplus for China, which should be positive for the current account (C/A) balance; still, we forecast a 0.2% GDP deficit in 2019.

From BRI partner countries’ perspective, China exporting capital to help ASA fill its sizeable infrastructure investment gap is an attractive proposition. It should allow countries like Vietnam, Malaysia and Cambodia to emerge as winners as US-China trade tensions accelerate factory relocations. China’s commitment to expanding the BRI in Africa was recently reinforced at the Forum on China-Africa Cooperation, where Beijing pledged an additional USD 60bn of investment and concessional lending to the region. A notable takeaway from the event was an emerging shift in the
BRI’s focus beyond East Africa, with trans-regional infrastructure development becoming a key future theme. In MENAP, we believe oil exporters would welcome the prospect of China sharing the burden of infrastructure spending, as lower oil prices have lowered government revenue.

**Negative trade and debt implications**

The South-South trade pie is growing for everyone involved in the BRI. China’s size advantage – and the large scope of its investments in most bilateral relationships – could create stress for its BRI counterparts, however. A common challenge is a surge in capital-goods imports from China, which is widening trade deficits for countries at the receiving end of BRI projects. These are inevitable short-term growing pains, in our view, as infrastructure projects have long gestation periods and are likely to boost exports only at a later stage (assuming they are commercially viable). EM countries with weakening external trade positions have been shunned by global investors amid recent bursts of risk aversion. Pakistan is an example – its widening C/A deficit, exacerbated by rising imports to sustain the CPEC, has intensified the need for fresh IMF aid.

There are growing concerns that BRI countries are being overburdened with rising debt due to substantial investment from China. An example of this is Sri Lanka, which took on heavy debt from China for two controversy-ridden BRI projects (on page 29). China is already a significant creditor to several African economies, accounting for as much as three-quarters of Djibouti’s debt, a third of Ethiopia’s and over 20% of Kenya’s (Figure 4). Worsening fiscal positions in these countries, the crowding-out of more viable investments, and rising country risk premia could all contribute to a growing debt sustainability problem.

High public and external debt ratios, after accounting for BRI lending in the pipeline, point to pockets of debt vulnerability (on page 17). Smaller economies tend to be more at risk of debt distress, as they are easily overwhelmed by an influx of investment from China linked to large infrastructure projects. Still, we believe the risk of systemic debt fallout remains low, as long as China continues to offer debt relief to less developed and poorer BRI countries on a case-by-case basis.

**Quality and transparency over quantity**

However, we think debt relief is inadequate recourse if countries involved in the BRI do not ensure that a project is commercially viable. The next key challenge will be to ensure that the BRI “only travels where it is needed”, said IMF Managing Director Christine Lagarde in a speech at the April IMF-PBoC conference on the Belt and Road; another challenge, she said, will be to select projects that fill genuine infrastructure gaps. In addition, a challenge for BRI projects will be to meet high international environmental and social standards.

China also needs to improve its transparency in BRI deals, including establishing an overarching development framework and an open and fair procurement process. Disclosing debt pricing and other contractual arrangements is also important to encourage market scrutiny of a project’s viability. We think China should rely less on bilateral resolution of debt issues (which appear to be on the rise), as this may further strain relationships. Rather, China may benefit more from aligning its policies with multilateral conventions, such as having a Paris Club-like collective approach to handling distressed debtors. China could also help domestic companies involved in the BRI select appropriate BRI projects and better manage related risks.
Figure 1: China’s trade and investment links with 71 BRI countries
China’s total trade and accumulated ODI with BRI countries (USD mn)

Source: CEIC, Standard Chartered Research
Figure 2: China’s outreach is creating a sprawling web of infrastructure projects

Major railroads, ports and pipeline projects tracked by the MERICS BRI database

* This is based on the MERICS BRI database and its interactive map; Source: Mercator Institute for China Studies, Standard Chartered Research

Downloaded by Alyson Roach at Standard Chartered Bank [09 Oct 2018 15:11 GMT]
The good, the bad and the future
Belt and Road ploughs ahead

US-China trade tensions could fuel the initiative’s growth

Market focus on setbacks to the Belt and Road Initiative, especially on the issue of debt sustainability, has increased this year. However, we think the market is under-appreciating the extent to which underlying trade and investment between China and its BRI partner countries has flourished since the launch of the BRI, now well into the implementation stage. Before delving into the challenges and risks related to the BRI, we take stock of progress so far, particularly on expanding South-South trade corridors; exporting capital from China to fill infrastructure gaps; and mobilising financing channels to fund these massive projects.

The Belt and Road’s share of trade has been rising. Shipments to BRI countries accounted for 35.3% of China’s total exports in H1-2018, up from 34.4% in 2017 and less than 31.0% prior to 2013. Interestingly, the rise in BRI countries’ share of China’s imports has been much less pronounced (37.0% in H1, versus 36.5% in 2013), possibly because of the offset from earlier declines in global commodity prices.

China likely wants to increase its exports to BRI countries further to counter headwinds from the prolonged trade dispute with the US, in our view. The likely shrinking of China’s trade surplus with the US over time could be offset by a growing surplus with BRI countries (which is likely, at least in the implementation stage). BRI countries, especially in ASEAN, are a natural destination for China-based manufacturers looking to relocate production, diversify risks and expand their end-markets. We see BRI countries such as Malaysia and Vietnam emerging as winners of the US-China trade dispute, in terms of demand being diverted away from China. China could also use the BRI to drive globalisation.

ODI is likely to become more targeted. The Chinese yuan (CNY) may become more volatile amid a cloudy trade outlook. Much like in 2017, China is likely to keep close tabs on outflow channels, including ODI, with BRI-related ODI likely to be prioritised. We also expect improved gate-keeping and a greater emphasis on quality with BRI investments, given increased international scrutiny of their commercial viability.

Figure 1: China’s trade connectivity with BRI partner countries has improved

China’s exports/imports to/from BRI countries, USD bn (LHS), % growth (RHS)

Source: State Information Center, Standard Chartered Research

Figure 2: ASEAN dominates China’s BRI trade; Eastern Europe shows resilient growth

China’s 2017 trade with B&R countries across regions, % of trade (y-axis), growth rate (x-axis), trade in USD mn (bubble)

Source: State Information Center, Standard Chartered Research
Deepening trade links with Belt and Road countries

In the five years since the BRI was launched, China has actively promoted trade connectivity with and among BRI countries, improved trade facilitation, and fostered new growth engines of cross-border trade. The value of trade between China and BRI countries in the past five years has exceeded USD 5tn, and China has become the biggest trade partner of 25 countries along the Belt and Road.

Trade between China and BRI countries rebounded in 2017 after retreating in 2015-16. China’s total trade with 71 BRI countries reached USD 1.44tn in 2017, growing 13.4% y/y, reversing two consecutive years of contraction. Imports from BRI countries jumped 19.8% y/y in 2017, outpacing export growth from BRI countries (8.5% y/y in 2017) for the first time (Figure 1). China’s trade with BRI countries as a percentage of its total trade continued to rise, reaching a record high of 35.2% in 2017, and exceeding its trade with the EU (15.1%) and the US (14.2%); shares of both exports and imports increased, contributing to the headline improvement.

We have tracked China’s trade with six key regions along the Belt and Road. ASEAN remains China’s largest trade partner. China’s total trade value with ASEAN and North Asian economies exceeded USD 800bn in 2017, accounting for 56.8% of its trade with all BRI countries, followed by West Asia (16.2%) and Eastern Europe (11.2%); see Figure 2. Central Asia enjoyed the fastest bilateral trade growth with China, at 19.8% in 2017. Eastern Europe also saw strong growth in trade with China, at 17.8% in 2017, after having reaching record-high growth in 2016.

China’s key exports to BRI countries reflect its move to higher-value-added manufacturing, while its imports from BRI countries are dominated by raw materials and electric components. Electrical equipment and machinery tools remained the top two export products in 2017, together accounting for 38.2% of China’s total exports to BRI countries, up from 36.7% in 2016. This reflects China’s competitive advantage in these industries and rising demand for capital goods to support BRI projects, which is boosting China’s trade surplus with BRI countries (Figure 3). Growth in output of chemical products, electrical equipment and optical and medical instruments outpaced that of other industries, suggesting China’s capacity in these industries is strengthening.

Figure 3: High-value manufactured goods were China’s main export items in 2017

Top 10 China exports to BRI countries, USD bn, %y/y

Figure 4: Electricals and resources were China’s main import items in 2017

Top 10 China imports from BRI countries, USD bn, %y/y

Source: State Information Center, Standard Chartered Research
Electric components surpassed minerals and fuels as China’s largest import item from BRI countries, mainly from ASEAN economies (Figure 4). China continues to import strategically important raw-material and energy products from West Asia, Eastern Europe (mainly Russia) and Central Asia.

China is also improving trade facilitation and opening up further, to improve trade connectivity. The government has signed free-trade agreements (FTAs) with 15 BRI countries, upgraded FTAs with five BRI countries, and has set up free-trade zones (FTZs) with 13 BRI countries. It has BRI-related cooperation agreements with more than 40 countries and international organisations, and cooperates on production capacity with more than 30 BRI countries. In the past five years, Chinese companies have set up 82 Economic Cooperation Zones (ECZs), with a total investment of USD 28.9bn as of April 2018, creating 244,000 jobs in local markets and generating USD 2bn in tax revenue for local governments.

Strengthening trade relationships between China and BRI countries are laying the groundwork for Renminbi internationalisation. China has expanded bilateral local-currency (LCY) swap programmes to 36 economies, worth a total of CNY 3.3tn by 2017, with a third of the currency swap lines meant for 22 BRI countries. China has established a Renminbi settlement system in 23 economies, including seven BRI countries.

While China has not reported 2017 Renminbi trade settlement statistics with BRI countries specifically, broader trends suggest that corporate sentiment and Renminbi usage have bottomed out. Renminbi trade settlement rebounded to c.12.6% of China’s total goods trade in Q3-2018 after having remained below 12% for the previous year. The resilient YTD performance of the Standard Chartered Renminbi Globalisation Index (RGI) – our proprietary measure of international Renminbi usage – confirms that the currency’s global foray continues and has weathered the latest bouts of Renminbi depreciation (albeit with more selective drivers, such as a strong rise in northbound investment flows to onshore markets).

Figure 5: China’s outward investment has entered the fast lane
China’s non-financial ODI flows to BRI countries, USD bn (LHS), % of China’s total non-financial ODI flows (RHS)

Figure 6: China’s outward contracted projects have accelerated
China’s outward contracted projects in BRI countries, USD bn (LHS), % of China’s total outward contracted projects (RHS)
Expanding investment along the Belt and Road

ODI is another key element of China’s economic ties with BRI countries. In the past five years, China’s direct investment in BRI countries has exceeded USD 70bn, posting average annual growth of 7.2% y/y. The value of China’s newly signed contracted projects has exceeded USD 500bn, registering average annual growth of 19.2% y/y.

China’s non-financial ODI flows to BRI countries remained robust in 2017, despite a decline in overall ODI value. Total ODI flows to BRI countries were at USD 14.4bn in 2017, slightly below USD 14.5bn in 2016, but their share of China’s total non-financial ODI flows rose to 11.5% as of end-2017 from 8.0% as of end-2016 (Figure 5). The momentum strengthened further in 2018, with ODI flows to BRI countries reaching USD 8.6bn by H1-2018, accounting for 13.1% of total ODI from China. China’s tighter restrictions on ODI have slowed the pace in 2017. However, as long as China’s cross-border capital flows stay largely balanced and exchange-rate expectations remain anchored, we expect the authorities to loosen capital account controls over time, with BRI-related investment likely to be prioritised.

Construction of overseas-contracted BRI projects has accelerated. Growth in the value of completed projects in BRI countries accelerated to 12.6% in 2017 (USD 85.5bn) and 17.8% y/y in H1-2018 (USD 45.1bn) from 9.7% in 2016 (USD 76.0bn). Its share of China’s total completed projects value rose to 53.4% from 47.7% over the same period (Figure 6). In 2017, Chinese companies signed new project contracts worth USD 144.3bn in BRI partner countries, up 14.5% from 2016; this bodes well for the continued expansion of construction in these countries.

Although removing infrastructure bottlenecks in partner countries remains a key BRI investment focus, Chinese companies have also extended investment to other sectors – such as financial services, entertainment and hi-tech – to further their own business interests, development strategies and production capacity advantage, as well as to meet other countries’ development needs.

- Of China’s total ODI in BRI countries from 2014 to H1-2018, we estimate that half went to the energy and transport sectors, c.16% to logistics and real estate, and about 15% to more diverse sectors such as hi-tech, entertainment and financial services (Figure 7). The services sector has attracted more direct investment interest.

Figure 7: China’s direct investment in BRI countries expands to more industries

<table>
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<tr>
<th>Industry</th>
<th>BRI direct investment value by sector, %</th>
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<tr>
<td>Energy</td>
<td></td>
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<tr>
<td>Transport</td>
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<tr>
<td>Real estate</td>
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<td>Logistics</td>
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<td>Hi-tech</td>
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<td>Entertainment</td>
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<td>Financial services</td>
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<td>Others</td>
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Figure 8: Infrastructure dominates BRI contracted construction projects

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<th>Industry</th>
<th>BRI project construction value by sector, %</th>
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<tr>
<td>Energy</td>
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<tr>
<td>Transport</td>
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<td>Real estate</td>
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<td>Public utilities</td>
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<tr>
<td>Others</td>
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<tr>
<td>Chemical industry</td>
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<td>Others</td>
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Source: China Global Investment Tracker (CGIT) database, Standard Chartered Research
For contracted BRI construction projects from 2014 to H1-2018, we estimate 43% of investment was in energy projects and 30% in transport projects, while real estate took c.12%, followed by public utilities and chemicals (Figure 8). Clean-energy projects have been popular; key infrastructure projects such as railways, waterways and ports have been mostly welcomed by host countries and have significantly improved economic efficiency.

**Expanding various financing mechanisms for the BRI**

In the past five years, multiple tiers of financial institutions have been involved in BRI funding, including international financial institutions, multilateral development financial institutions, investment cooperation funds, China’s policy banks, commercial banks (both Chinese and foreign), and insurance companies (Figure 9). Various financing mechanisms have been explored by these financial institutions.

The Asian Infrastructure Investment Bank (AIIB) and Silk Road Fund (SRF) were set up primarily to support the BRI. By August 2018, the AIIB had provided USD 5.4bn of funding for 28 BRI projects across Central Asia, South Asia, Southeast Asia, and the Middle East. The SRF has concluded contracts for over 20 projects in infrastructure, energy and industrial cooperation, with a total committed investment of over USD 8bn, and it has invested USD 2bn in establishing the China-Kazakhstan Production Capacity Cooperation Fund.

China Development Bank (CDB) and the Export-Import Bank of China (EXIM) have taken the lead in ‘development financing’ (开发性金融) for BRI projects. CDB has provided a CNY 250bn special-purpose loan quota for infrastructure, industrial capacity cooperation and financial cooperation in the Belt and Road initiative, of which 65% was used as of March 2018. China EXIM focuses on promoting external trade and project financing. It has outstanding BRI-related loans of over CNY 830bn, which accounted for about 28% of its total outstanding loans as of March 2018. The two policy banks have also been involved in setting up investment cooperation funds, such as the China-UAE Joint Investment Fund, the China-Africa Development Fund and the Silk Road Fund.

Arrangements have been made to promote multilateral collective financing via government cooperation funds. China’s Ministry of Finance has approved the ‘Guiding Principles on Financing the Development of the Belt and Road’ – along with the finance ministries of 26 BRI countries – to strengthen the use of multilateral investment cooperation funds and industry cooperation funds to provide joint financing, investment and guarantees for cross-regional BRI projects. For instance, the China-Africa Development Fund has decided to invest USD 4.6bn in over 90 projects.

Commercial banks have expanded their coverage to take the opportunities presented by the Belt and Road. Ten China commercial banks had set up 68 branches in 26 BRI countries as of end-2017, and 55 foreign commercial banks from 21 BRI countries have set up subsidiaries in China. Substantial expansion of overseas networks has boosted their businesses related to BRI projects. China’s commercial banks have participated in over 2,700 BRI projects, providing loans worth over USD 200bn since the BRI launched. Several foreign commercial banks have committed to increase support for BRI projects. In addition to traditional trade finance and commercial loans, many commercial banks have provided a more comprehensive financing solution, including syndicated loans, project finance, hedging instruments and FX services to clients in overseas markets.
Insurance companies have played a more important role in BRI financing. Sinosure underwrote USD 130bn of BRI-related trade, investment and contracted construction projects in 2017, up 15% y/y. Commercial insurance companies in China invested c.CNY 960bn in BRI-related projects in the form of debt or equity investment plans as of end-July 2018.

Bond financing has been explored to support companies’ financing activity under the BRI. In March 2017, Russian aluminium producer UC Rusal issued Renminbi-denominated bonds worth CNY 1bn on the Shanghai Stock Exchange, becoming the first company from a country involved in the BRI to sell bonds in China. In January 2018, China cement producer Hongshi Group raised CNY 300mn through its bond offering at the Shanghai Stock Exchange to fund its projects in Laos, becoming the first Chinese company to issue BRI bonds at the stock exchange.

In March 2018, China’s securities regulator announced that the Shanghai and Shenzhen stock exchanges will carry out the pilot BRI bond programme, allowing domestic and overseas companies to issue bonds on onshore stock exchanges to finance BRI-related projects. Government-backed institutions in economies participating in the BRI can also sell bonds in China. Seven domestic and overseas companies have gained regulatory approvals to issue BRI bonds worth a total of CNY 50bn; four have already raised CNY 3.5bn through bond issuance, according to the China Securities Regulatory Commission (CSRC). The move is China’s latest effort to further open its capital markets and boost BRI investment and financing.

Figure 9: Belt and Road project investment is supported by multi-tier financing institutions

Financial institutions involved in the B&R initiative

[Diagram showing various financial institutions involved in the BRI initiative]

Source: Standard Chartered Research
Belt and Road – Challenges and risks
More than just growing pains

The BRI has made significant headway since its launch in 2013, but it has not been all smooth sailing given the ambitious scale of the initiative. A key ‘growing pain’ has been the deterioration in trade balances of countries receiving BRI investment. These countries have increasingly needed to import capital goods for BRI projects, but will only see returns (through higher productivity and exports) at later stages of the investment cycle. Weaker external trade positions increase these countries’ exposure to currency volatility and reduce their policy support options.

Other challenges facing the BRI are largely inherent. Transportation and energy projects are typically costly and often funded with substantial debt, especially relative to the size of many BRI partner countries. The long gestation periods of such projects make debt servicing more difficult. Worsening fiscal positions in BRI partner countries, the crowding-out of other viable investment, and rising country risk premia could all become part of a growing debt sustainability problem, although we see low systemic risk at the current stage.

In addition to BRI partner countries, creditors and Chinese companies investing in BRI projects also face risks. Creditors could face as many (if not more) problems as debtors if projects end up being unviable. The long duration of projects may also make them prone to political uncertainty – a recent example of this is Malaysia’s new government calling off landmark BRI deals. There is a risk that Chinese companies responding to the government’s call to invest in BRI projects overseas may not make adequate returns, or may even lose their investments. This would be a significant setback for investment, particularly by the private sector, which has yet to get fully on board with the BRI. As such, we think participating companies need to manage risk proactively, while China’s government could add protections for companies investing overseas.

Such setbacks could also deter potential BRI partners and taint the Belt and Road’s brand as an inclusive initiative promoting economic openness and global cooperation. Quality control is another key challenge for an open-ended framework like the BRI’s, with scope for improvement. China could become more transparent in its debt arrangements with BRI partner countries, which would allow the market to better determine a project’s viability. We also think China needs to align its policies more with multilateral conventions – for example, adopt a Paris Club-like collective approach to handling distressed debtors – and meet international environmental and social standards. Ensuring local stakeholders’ endorsement and aligning with partner countries’ development goals would help ensure BRI projects’ sustainability. China could also benefit from establishing an overarching framework to manage Belt and Road projects and ensuring an open and fair procurement process.

The coming year will be crucial for China to demonstrate its role in ensuring BRI debt sustainability, in our view. Economies such as Ethiopia, Djibouti, Mozambique, Zambia and the Maldives could see a restructuring of their debt with China. Pakistan is also in focus as the country has announced that it will seek another round of IMF funding while navigating its sizeable (and far from transparent) debt commitment with China.
Belt and Road and trade balances

Emerging markets have been hurt in Q3-2018 by escalating US-China trade tensions, continuing US rate normalisation, and external risks related to Turkey and Argentina; during this period, global investors actively sought out pockets of resilience within EM FX. A prominent theme was the outperformance of current account (C/A) surplus currencies versus those with deficits. This drew greater scrutiny of BRI partner countries’ worsening trade balances due to increased capital-goods imports for BRI projects.

For example, Pakistan’s widening C/A deficit – already exacerbated by a pick-up in imports to sustain China-Pakistan Economic Corridor (CPEC) projects – is a key driver of the country’s need for IMF assistance.

Indonesia, which runs twin (current account and fiscal) deficits, has seen sharp currency depreciation, prompting a potential government review of its capital-goods imports for large projects. This is in addition to the central bank hiking rates more than it otherwise would have to stem FX outflows. Lingering concerns about the C/A deficit and currency volatility could slow or bring into question such countries’ future participation in the BRI, despite the likely long-term benefits via improved productivity and competitiveness, and ultimately greater resilience to external shocks.

China’s trade surplus versus BRI countries has widened in the first five years of the initiative (Figure 10). This has been helped by lower imports due to weak oil prices as well as resilient exports (especially to ASEAN and South Asia) amid weak global demand (Figure 11). While the increase in BRI partner countries’ capital-goods imports should be offset by higher exports post-implementation, the long gestation periods of infrastructure projects make this a tough pill to swallow in the short term. Furthermore, BRI commitments bring outflow pressures stemming from profit repatriation, dividend payments and debt repayments over time. Given these growing pains, it is crucial to ensure long-term BRI projects are commercially viable.

C/A dynamics could play out differently in the Middle East, where oil prices play a much more dominant role. Oil-exporting countries may welcome China sharing the burden of infrastructure spending, in view of oil revenue becoming less dependable (see MENAP section on page 36).

Figure 10: BRI has widened China’s trade surplus

*China’s trade balance with BRI countries (USD bn)*

![Figure 10 Chart]

Source: State Information Centre, Standard Chartered Research

Figure 11: Resilient exports to BRI countries

*China exports with BRI countries (% of total China exports)*

![Figure 11 Chart]

Source: State Information Centre, Standard Chartered Research

Weak external trade positions increase a BRI country’s exposure to currency volatility.
Belt and Road and debt sustainability

While we note pockets of debt vulnerability among participating countries, the BRI is unlikely to cause a systemic debt problem in regions of the initiative’s focus. This is one of many takeaways from a study conducted by the Center for Global Development (CGD Policy Paper 121, March 2018), which identifies 23 BRI partner countries as being vulnerable to debt distress, and constructs a BRI project lending pipeline for each of the countries using publicly reported sources (Figure 12). Eight countries in this subset are considered at ‘high risk’ of debt distress due to future BRI-related financing (those in bold). Considering their estimated BRI lending pipelines, these countries all share the same red flags of (1) high debt/GDP ratios; and (2) large exposure to China debt, as a share of all public external debt.

Most of the ‘at risk’ economies, except perhaps Pakistan, have small GDPs, which puts them at greater risk of being overwhelmed by an influx of Chinese investment linked to large infrastructure projects. They may not be able to make such megaprojects profitable, and may be economically unable to repay BRI loans over time. At the same time, their size discrepancy with China makes it difficult for them to decline Chinese investment. For such countries, distressed debt is likely to be resolved bilaterally. China has shown its willingness to grant debt relief or

Figure 12: Selected debt metrics and ratios for countries highly vulnerable to debt distress
USD mn, unless otherwise stated; countries in bold = high risk to suffer from debt distress due to future BRI financing

<table>
<thead>
<tr>
<th>Country</th>
<th>GDP</th>
<th>PPG debt *</th>
<th>PPG ED **</th>
<th>Debt to China</th>
<th>BRI lending pipeline</th>
<th>PPG debt/GDP (%)</th>
<th>PPG debt/GDP (with BRI pipeline, %)</th>
<th>Debt to China/PPG ED (%)</th>
<th>Debt to China/PPG ED (with BRI pipeline, %)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Djibouti</td>
<td>1,727</td>
<td>1,496</td>
<td>1,464</td>
<td>1,200</td>
<td>1,464</td>
<td>86.6%</td>
<td>92.8%</td>
<td>82.0%</td>
<td>91.0%</td>
</tr>
<tr>
<td>Kyrgyz Republic</td>
<td>6,551</td>
<td>4,068</td>
<td>3,976</td>
<td>1,483</td>
<td>4,564</td>
<td>62.1%</td>
<td>77.7%</td>
<td>37.3%</td>
<td>70.8%</td>
</tr>
<tr>
<td>Lao, PDR</td>
<td>15,903</td>
<td>10,782</td>
<td>8,604</td>
<td>4,186</td>
<td>5,471</td>
<td>67.8%</td>
<td>76.0%</td>
<td>48.7%</td>
<td>68.6%</td>
</tr>
<tr>
<td>Maldives</td>
<td>4,224</td>
<td>2,775</td>
<td>879</td>
<td>240</td>
<td>1,107</td>
<td>65.7%</td>
<td>72.8%</td>
<td>27.3%</td>
<td>67.8%</td>
</tr>
<tr>
<td>Mongolia</td>
<td>10,951</td>
<td>9,593</td>
<td>7,392</td>
<td>3,046</td>
<td>2,469</td>
<td>87.6%</td>
<td>89.9%</td>
<td>41.2%</td>
<td>55.9%</td>
</tr>
<tr>
<td>Montenegro</td>
<td>4,374</td>
<td>3,412</td>
<td>2,406</td>
<td>200</td>
<td>1,535</td>
<td>78.0%</td>
<td>83.7%</td>
<td>8.3%</td>
<td>44.0%</td>
</tr>
<tr>
<td>Pakistan</td>
<td>278,913</td>
<td>195,239</td>
<td>58,014</td>
<td>6,329</td>
<td>40,021</td>
<td>70.0%</td>
<td>73.8%</td>
<td>10.9%</td>
<td>47.3%</td>
</tr>
<tr>
<td>Tajikistan</td>
<td>6,952</td>
<td>2,906</td>
<td>2,252</td>
<td>1,197</td>
<td>2,807</td>
<td>41.8%</td>
<td>58.5%</td>
<td>53.2%</td>
<td>79.1%</td>
</tr>
<tr>
<td>Afghanistan</td>
<td>19,469</td>
<td>1,558</td>
<td>1,227</td>
<td>0</td>
<td>1,280</td>
<td>8.0%</td>
<td>13.7%</td>
<td>0.0%</td>
<td>51.1%</td>
</tr>
<tr>
<td>Albania</td>
<td>11,864</td>
<td>8,969</td>
<td>4,069</td>
<td>100</td>
<td>0</td>
<td>73.3%</td>
<td>73.3%</td>
<td>2.5%</td>
<td>2.5%</td>
</tr>
<tr>
<td>Armenia</td>
<td>10,572</td>
<td>5,825</td>
<td>4,916</td>
<td>341</td>
<td>60</td>
<td>55.1%</td>
<td>55.4%</td>
<td>6.9%</td>
<td>8.1%</td>
</tr>
<tr>
<td>Belarus</td>
<td>47,407</td>
<td>25,552</td>
<td>17,588</td>
<td>3,094</td>
<td>3,828</td>
<td>53.9%</td>
<td>57.3%</td>
<td>17.6%</td>
<td>32.3%</td>
</tr>
<tr>
<td>Bhutan</td>
<td>2,213</td>
<td>2,370</td>
<td>2,341</td>
<td>0</td>
<td>0</td>
<td>107.1%</td>
<td>107.1%</td>
<td>0.0%</td>
<td>0.0%</td>
</tr>
<tr>
<td>Bosnia and Herzegovina</td>
<td>16,910</td>
<td>7,474</td>
<td>5,124</td>
<td>0</td>
<td>2,329</td>
<td>44.2%</td>
<td>51.0%</td>
<td>0.0%</td>
<td>31.2%</td>
</tr>
<tr>
<td>Cambodia</td>
<td>20,017</td>
<td>6,465</td>
<td>6,385</td>
<td>3,191</td>
<td>3,495</td>
<td>32.3%</td>
<td>42.4%</td>
<td>50.0%</td>
<td>67.7%</td>
</tr>
<tr>
<td>Egypt</td>
<td>332,791</td>
<td>333,124</td>
<td>43,096</td>
<td>4,779</td>
<td>740</td>
<td>100.1%</td>
<td>100.1%</td>
<td>11.1%</td>
<td>12.6%</td>
</tr>
<tr>
<td>Ethiopia</td>
<td>72,374</td>
<td>39,154</td>
<td>21,785</td>
<td>7,314</td>
<td>3,719</td>
<td>54.1%</td>
<td>56.3%</td>
<td>33.6%</td>
<td>43.3%</td>
</tr>
<tr>
<td>Iraq</td>
<td>171,489</td>
<td>114,726</td>
<td>67,395</td>
<td>7,010</td>
<td>1,000</td>
<td>66.9%</td>
<td>67.1%</td>
<td>10.4%</td>
<td>11.7%</td>
</tr>
<tr>
<td>Jordan</td>
<td>38,655</td>
<td>36,761</td>
<td>14,496</td>
<td>200</td>
<td>0</td>
<td>95.1%</td>
<td>95.1%</td>
<td>1.4%</td>
<td>1.4%</td>
</tr>
<tr>
<td>Kenya</td>
<td>70,529</td>
<td>36,957</td>
<td>19,325</td>
<td>4,089</td>
<td>6,879</td>
<td>52.4%</td>
<td>56.6%</td>
<td>21.2%</td>
<td>41.9%</td>
</tr>
<tr>
<td>Lebanon</td>
<td>49,599</td>
<td>71,224</td>
<td>18,848</td>
<td>500</td>
<td>0</td>
<td>143.6%</td>
<td>143.6%</td>
<td>2.7%</td>
<td>2.7%</td>
</tr>
<tr>
<td>Sri Lanka</td>
<td>81,322</td>
<td>69,268</td>
<td>32,565</td>
<td>3,850</td>
<td>2,136</td>
<td>85.2%</td>
<td>85.6%</td>
<td>11.8%</td>
<td>17.3%</td>
</tr>
<tr>
<td>Ukraine</td>
<td>93,270</td>
<td>79,186</td>
<td>50,832</td>
<td>1,590</td>
<td>2,475</td>
<td>84.9%</td>
<td>85.3%</td>
<td>3.1%</td>
<td>7.6%</td>
</tr>
</tbody>
</table>

PPG debt/GDP (with BRI pipeline) ratio > 60%  
Debt to China/PPG ED ratio jumps 9ppt or more after including BRI lending pipeline

* PPG Debt = Public and publicly guaranteed debt; ** ED = external debt; Source: Center for Global Development, Standard Chartered Research
restructuring – promised by President Xi Jinping at the 2018 Forum on China-Africa Cooperation (FOCAC) – which should limit contagion and prevent systemic fallout for now. However, this does little to ease ‘debt trap’ concerns and other controversies already brewing. The Hambantota Port experience in Sri Lanka is a relevant example (see page 29).

### Belt and Road and transparency

For an initiative that was meant to be all-encompassing and open to multilateral cooperation, the BRI has so far largely been defined by China’s extensive bilateral engagement with its 70+ BRI partners. Bilateral engagement has come by way of sovereign loans, free trade agreements, cooperation agreements and currency swaps (see Appendix); even debt relief for BRI countries suffering from debt distress has been addressed on a case-by-case basis. The problem with this bilateral approach is the lack of transparency in areas ranging from China’s overarching BRI decision-making framework to the finer details (amount, pricing, tenor) of most of the loans extended.

All of this probably reflects China’s greater leverage to protect its own interests in a bilateral relationship. However, such lopsided bilateral relationships are becoming strained, based on the recent rise in calls to re-examine expensive BRI deals. The opacity of China’s bilateral approach is also adding to international scepticism about the strategic and geopolitical motives behind the BRI initiative.

Increased transparency would help to demonstrate that China can align its strategy more closely with the interests of BRI partner countries; that the initiative can bring growth and development opportunities in both the short and long term; and that BRI projects can meet high environmental and sustainable development standards. Furthermore, transparency would help to ensure BRI projects’ commercial viability. IMF Managing Director Christine Lagarde highlighted in her speech at the IMF-PBoC Conference in April 2018 that the BRI’s next challenge was to ensure it “only travels where it is needed”, and selects projects that fill genuine infrastructure gaps. Ensuring clarity in project terms and a level playing field for all parties would help BRI projects survive potential political and legal obstacles in the implementation stage, which are likely given the long lifespans of infrastructure projects.

We believe it would not be in China’s interest for BRI partner countries to become unsustainably indebted to China. In addition to the reputational risk over time, creditors (Chinese companies/institutions) could face as many problems as debtors if projects became unviable. At home, we think China needs to support investing companies in selecting appropriate projects, controlling investment timing, achieving post-M&A integration and dealing with host countries’ regulations and procedures, in order to better identify and manage investment risks. While the risk of project failure cannot be completely avoided, we think it would be in China’s interest to align its dispute resolution systems with multilateral conventions; for instance, committing to a multilateral framework similar to the Paris Club would add certainty to an otherwise potentially messy debt collection process.
Country and regional analysis
Pakistan – Deep dive into a BRI flagship
The China-Pakistan Economic Corridor (CPEC)

Scope and scale
The China-Pakistan Economic Corridor (CPEC) is a flagship project of China’s Belt and Road. CPEC involves a variety of energy and infrastructure projects worth over USD 60bn (c.20% of Pakistan’s GDP) to be implemented in Pakistan over the next decade. Pakistani policy makers see the implementation of CPEC’s network of rail, road and power projects as transformational for Pakistan’s economy. The hope is that the mega-project will revive fixed investment and growth, by bridging the country’s savings-investment gap. CPEC is to be implemented in multiple phases, stretching through 2030.

The rationale
For China, CPEC will link its western provinces to the Arabian Sea through Gwadar in southern Pakistan. The land route via Pakistan could cut the current shipping route between the Persian Gulf and China to a land route of less than 3,000km from a shipping route of more than 10,000km (Figure 1).

Pakistani officials have described CPEC as a ‘1+4’ project: CPEC at the centre, with the four key arms being the development of Gwadar port, energy-sector projects, infrastructure projects and industrial cooperation. So far, the implementation focus has been on the first three; Special Economic Zones (SEZs) are intended as the next phase.

Financing
Our understanding is that China’s public capital will finance CPEC infrastructure projects, while its private capital will finance energy projects. In the case of infrastructure and transport-network projects, funding is to come primarily from loans extended by China’s government to Pakistan’s government. These projects are to be implemented primarily through Pakistan’s flagship development-spending budget, the Public-Sector Development Programme (PSDP). Meanwhile, energy projects are to be financed by private investors from China, who will obtain loans from their domestic financial institutions and invest the funds in Pakistan as FDI.

Figure 1: The China-Pakistan Economic Corridor (CPEC)
China’s current shipping routes to the Middle East, North Africa and Pakistan (MENA) and the CPEC land route

Source: Ministry of Planning, Development and Reforms, Standard Chartered Research
CPEC projects

Transport and infrastructure

CPEC infrastructure projects include the upgrade and extension of existing road and railway tracks to connect Kashgar in China’s western Xinjiang region to the southern port of Gwadar in Pakistan’s Baluchistan province (Figures 11 and 12). In the first phase, the focus is on building a six-lane motorway between Karachi and Peshawar, through Islamabad, Lahore and Multan at an estimated cost of USD 3bn. The project is expected to be completed by August 2019 (Figure 2).

Energy projects

Cumulatively, power projects under CPEC will add over 17GW of generation capacity (over two-thirds of Pakistan’s existing capacity) through more than 20 projects. These power plants will be set up under independent power producers (IPPs; i.e., as private-sector enterprises). They will sell their output to the national grid through power-purchase agreements (PPAs), underpinned by sovereign guarantees. IPP contracts (some of which have already been approved by Pakistan’s power-sector regulator) allow for an internal rate of return (IRR) of over 20% and guarantee tariffs for the entire 30-year period of the PPA.

The bulk of generation will be coal-fired, with hydro, wind and solar power having smaller shares. The projects are to be constructed in two main phases – ‘prioritised’ (which will add 10.4GW of power; we see this as Phase 1) and ‘actively promoted’ (over 6GW; Phase 2); see Figure 3.

Special Economic Zones (SEZs)

Although the focus so far has been mainly on the construction of infrastructure and energy projects, the next stage would be CPEC implementation. Nine SEZs are to be set up across Pakistan, focusing on a range of sectors from fruit and food processing to electrical appliances and steel to pharmaceuticals and chemicals. The SEZs appear to be at the feasibility-study stage at present.

Figure 2: CPEC infrastructure projects*

<table>
<thead>
<tr>
<th>Cost, USD bn</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gwadar includes new airport, highways and port infrastructure</td>
</tr>
<tr>
<td>Rail expand and upgrade ML-1, 1,736km and build Havelian Dry Port add-on to original CPEC plan</td>
</tr>
<tr>
<td>Road KKH Phase II (Railkot-Islamabad section) and Peshawar-Karachi motorway (Multan - Sukkar section) 392km</td>
</tr>
</tbody>
</table>

Source: CPEC Fact Book 2016, Standard Chartered Research

Figure 3: Coal-fired power plants to dominate fuel mix*

<table>
<thead>
<tr>
<th>Cost, USD bn</th>
</tr>
</thead>
<tbody>
<tr>
<td>Phase 1 Coal (imported) Hydro Coal mines</td>
</tr>
<tr>
<td>Phase 2 Solar Wind Transmission</td>
</tr>
</tbody>
</table>

Source: CPEC Fact Book 2016, Standard Chartered Research
CPEC – An opportunity with challenges

CPEC is an ambitious undertaking for Pakistan. The scope of the project, at c.20% of Pakistan’s GDP, would test the absorptive capacity of most emerging economies. Given its scale, a key criticism of CPEC has been the lack of transparency on the entire scale and scope of the terms of agreement between China and Pakistan. This makes any macroeconomic analysis subject to significant uncertainty. Based on publicly available information, we assess CPEC’s implications for Pakistan below and summarise our findings in a risk assessment heatmap (Figure 10).

Security risks

Although Pakistan’s security situation has improved significantly, it remains an ongoing challenge. In this context, a Special Security Division has been set up by Pakistan’s army to provide security to CPEC projects under construction and the workforce. The division is expected to recruit a total 15,000 troops, and reflects the Pakistani military’s direct involvement in the CPEC. The cost of maintaining the division will be factored into the pricing of power for consumers.

Balance of payments

Implementation stage

In recent years, Pakistan’s current account (C/A) gap has widened significantly, despite lower oil prices. Strong domestic demand in the face of an inflexible currency and accommodative monetary and fiscal policies, along with increased capital goods imports for CPEC projects, have contributed to a sharply higher import bill (Figure 4).

Although the impact of CPEC imports on Pakistan’s balance of payments (BoP) should be neutral given FDI inflows likely provide an offset, FX reserves have declined sharply. To maintain BoP stability, Pakistan has increasingly relied on borrowings, including from China’s financial institutions. The People’s Bank of China (PBoC) recently also doubled the size of a bilateral swap line with the State Bank of Pakistan (SBP) to CNY 2bn, and extended it for a period of three years. The SBP subsequently drew on the facility to support its FX reserves, increasing its FX liabilities (Figure 5) – highlighting Pakistan’s external vulnerabilities. External stability is likely to be Pakistan’s biggest near-term macro challenge, in our view.

Figure 4: Pakistan’s import bill has ballooned

Non-oil goods imports, USD bn (12mma)

Source: State Bank of Pakistan, Standard Chartered Research

Figure 5: International liquidity is under pressure

SBP FX assets and liabilities, USD bn

Source: CEIC, Standard Chartered Research
Medium- to long-term phase
Assessing the BoP impact is likely to be more difficult in the post-implementation phase. This is mainly because the impact depends on whether the new infrastructure can support enough export-oriented economic activity to meet FX requirements arising from profit and dividend repatriation for power plants and debt servicing for official loans.

For energy projects, FX requirements would arise mainly from profit repatriation, which should begin when operations commence. Based on our assumptions, we estimate roughly USD 2.5bn of FX outflows from the repatriation and debt-servicing needs of IPPs in the power sector (see Pakistan – Counting on China).

Evaluating the overall impact on the BoP may be harder still, as much will depend on the degree to which Pakistan’s private sector is to productively use the power supply to revive flagging exports. The second is the country’s ability to attract foreign investment (primarily from China) to export-oriented sectors through SEZs. If Pakistan can attract low-value-added manufacturing from China, higher export earnings could offset some of the FX outflows due to repatriation.

Earnings from China’s transit trade through CPEC are another potential source of inflows, though these are more difficult to predict and quantify. These would also depend on bilateral agreements for China’s exports and imports that would be routed to and from the Middle East and North Africa through CPEC in Pakistan. Even so, it appears unlikely that CPEC infrastructure projects alone would help Pakistan to reduce its growing bilateral trade deficit versus China, particularly as land transit routes between the two improve (Figure 6).

Long-term, CPEC could act as a catalyst for regional trade beyond China and Pakistan. If Pakistan can reinvent itself as a regional transit and trading hub, it could generate higher growth and FX earnings. However, given the project is still in its early stages, the economic benefits are difficult to estimate given the ‘known unknowns’ (e.g., security) and ‘unknown unknowns’ (e.g., the future of regional trading blocs and geopolitical relations in the region; see geopolitics section).
Debt and liabilities related to CPEC

Although the financing sources for CPEC infrastructure projects are not entirely clear, much of the funding is likely to come via loans from China to the Pakistan sovereign. We therefore expect an acceleration in Pakistan’s official borrowings from China. This, along with wider sovereign borrowing to support the external accounts is likely to raise public external debt further (Figure 7).

Beyond direct outlays, we note fiscal risks in the form of contingent liabilities through sovereign guarantees. Although these tariffs will largely be borne by Pakistani consumers, the guarantees (within the PPAs) make investment in IPPs similar to investment in a sovereign bond. In the past, IPPs in Pakistan have invoked these guarantees when cash-flow concerns delayed payments to IPPs and curtailed their production due to liquidity constraints in the power sector.

To manage these risks, we think deregulating Pakistan’s power sector at the distribution stage (i.e., publicly owned distribution companies) will be necessary to minimise the fiscal costs via subsidies or contingent claims if recovery of power bills falls short – as has historically been the case in Pakistan.

A geopolitical hotspot

US versus China

Pakistan’s pivot towards China has coincided with a deterioration in its bilateral relations with the US. Sino-Pak ties, which have largely been at the military level in the past, have evolved to become increasingly economic; CPEC reflects both military and economic ties with China. In the past couple of years, China has quickly emerged as Pakistan’s largest trading partner, particularly following the FTA signed between the two in 2006 (as a single country; Figure 8).

More recently, under CPEC, China has also emerged as a larger source of FDI for Pakistan than the US (Figure 9). Meanwhile, as the US has suspended military assistance to Pakistan over long-standing differences, Pakistan’s reliance on China has increased further.

China’s growing economic role in Pakistan has also raised questions on the future of IMF engagement in Pakistan. In a sign of CPEC contentions, US Secretary of State Mike Pompeo recently said that any IMF support for Pakistan should not fund the country to repay loans from China’s lenders; however, he later said during a visit to...
Pakistan that the US would not seek to block Pakistan’s request for IMF assistance. Regardless, it remains likely that calls for greater disclosure of the scale and scope of CPEC-related agreements are likely to continue in the near term.

**Figure 10: CPEC – Our assessment of the macroeconomic implications**

*Risk assessment heat map*

<table>
<thead>
<tr>
<th></th>
<th>Short term</th>
<th>Medium term</th>
<th>Long term</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>GDP growth</strong></td>
<td>Positive impact on aggregate demand and improved energy supply, balanced by higher imports of capital goods</td>
<td>Improved power supply and forward/backward linkage of projects with the rest of the economy</td>
<td>Positive, but degree of pick-up and sustainability depends on broader structural reforms/inward FDI</td>
</tr>
<tr>
<td><strong>Energy availability</strong></td>
<td>Timelines may be slower than planned, but supply to improve gradually as projects come online</td>
<td>Increased power supply, but eventual impact conditional on broader power-sector reforms/deregulation</td>
<td>Policy making will be key to sustainability of increased power supply</td>
</tr>
<tr>
<td><strong>Current account</strong></td>
<td>Higher imports of capital goods, along with a rebound in oil prices</td>
<td>Power plants begin repatriating profits, dividends and service debts – eventual impact conditional on export revival</td>
<td>Power plants’ debt servicing complete after first 10 years, but profit repatriation to continue; final impact depends on exports and transit-trade agreements</td>
</tr>
<tr>
<td><strong>Fiscal deficit</strong></td>
<td>Fiscal deficit to widen to accommodate higher development spending, while tax revenue growth is likely to slow</td>
<td>Policy makers to focus on consolidation post-CPEC implementation, but impact conditional on power subsidies</td>
<td>Direct impact of CPEC mainly via power-sector allocations in fiscal deficit</td>
</tr>
<tr>
<td><strong>External debt</strong></td>
<td>Likely to increase due to sovereign loans for CPEC, but stabilise as a share of GDP (if USD-PKR remains stable)</td>
<td>External borrowing continues to help sustain reserves; debt/GDP depends on USD-PKR parity</td>
<td>Debt/GDP ratio stabilisation is conditional on sustained higher growth and stability in USD-PKR parity long-term</td>
</tr>
<tr>
<td><strong>Inflation</strong></td>
<td>Little to no direct impact</td>
<td>Coal-fired power cheaper than oil, but IPP margins could offset this; rising US and Pakistan interest rates and CPI inflation could be negative</td>
<td>Depends largely on global coal prices, and US and Pakistan interest rates and inflation</td>
</tr>
<tr>
<td><strong>FX reserves</strong></td>
<td>C/A deficit widens; capital inflows and borrowing contain FX reserves drawdown</td>
<td>C/A still under pressure, but FDI inflows to resume, conditional on broader business environment reforms</td>
<td>Impact conditional on export revival, trading relationships and compensation for use of CPEC routes</td>
</tr>
</tbody>
</table>

Source: Standard Chartered Research
**Figure 11: CPEC road network**
*Existing and planned routes*

**Figure 12: CPEC railway network**
*Existing and planned routes*

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Source: CPEC Fact Book 2016, Standard Chartered Research

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Source: CPEC Fact Book 2016, Standard Chartered Research
ASEAN and South Asia leading the way

The BRI has generated significant interest among ASA countries since its implementation in 2013. This is not a surprise given their substantial infrastructure needs and given China offers the expertise to deliver large-scale infrastructure projects. According to the Asian Development Bank (ADB), Southeast Asia requires an average investment of USD 184bn per annum from 2016-30 and South Asia requires USD 365bn. Based on the ADB’s calculations, there is an annual spending gap of USD 92bn in Southeast Asia (excluding Singapore, Brunei and Laos).

Besides the allure of infrastructure, China’s increasing economic influence in the region has also sparked interest in the BRI’s other goals, including enhanced and broader connectivity – in policy coordination, unimpeded trade, financial integration and ‘people-to-people bonds’. The focus is on infrastructure for now, however.

While the BRI holds much opportunity and promise, it also comes with its risks and challenges. For many countries, the significant cost of infrastructure projects is a major stumbling block. While few would argue against the long-term benefits of better infrastructure, the short-term cost can be prohibitive, as some countries have discovered in the past few years. Besides a heavy debt burden, poor project planning, financing hurdles, inadequate legal frameworks to facilitate infrastructure development, and a lack of local cultural awareness have posed problems.

Trade is a strong driving force for the Belt and Road

With China now the largest contributor to global growth, involvement in the BRI should help to strengthen links within the region and with China. Already, China’s economic relationship with the region has deepened in the past decade. Improved trade is the most obvious indicator of this closer relationship. Imports from ASA accounted for 14% of China’s total imports in 2017, versus 10% in 2000. Similarly, exports to ASA made up 16% of China’s total exports in 2017, double 8% in 2000.

Likewise, from ASA’s perspective, China’s imports were close to 11% of its total exports in 2016, up sharply from 4% in 2000. Similarly, China accounted for close to 20% of ASA’s imports in 2016, up substantially from 4% in 2000.

Lower cost of logistics is another key reason for the region to increase connectivity. In addition, the long-term growth outlook for the region and for China remains upbeat, which should generate further trading opportunities.
FDI from China has also risen steadily, accounting for c.7% of total FDI to ASA from 2014-16. For smaller economies such as Laos and Cambodia, China is already a major FDI source, accounting for 2-3% of the countries’ GDPs. China’s ODI to the region rose to USD 11bn in 2017 from c.USD 1bn in 2007.

**Challenges**

The cost of infrastructure projects can be significant and is therefore a major consideration for countries to participate in the BRI. For example, the high-speed railway line linking Vientiane, Laos to Yunnan reportedly costs USD 6bn, which would be about 20% of Laos’ GDP. The long gestation period of a high-speed railway project further means that revenue flows could be a long way off, and in the meantime, debt servicing can be substantial.

Increases in capital goods imports should also be monitored as this can affect currency stability in times of market stress. For example, heavier capital goods imports have led to a wider trade deficit for Indonesia, undermining the currency during recent EM weakness.

Long-term infrastructure projects are also vulnerable to shifts in political regimes; differing political views on a project’s viability could pose a risk to its continuity. A recent example was the change of government in Malaysia in May this year; the new Pakatan Harapan government called off ongoing project developments, including the East Coast Rail Link and two gas pipelines, reportedly due to their heavy debt burden.
Sri Lanka – Belt and Road opportunities and challenges

Belt and Road projects in Sri Lanka cover transportation, water supply, electricity, ports and an airport. While there are various estimates of China’s investment in Sri Lanka, broader estimates put BRI project investment at c. USD 5bn (5.5% of GDP). Most of the projects are funded by debt, provided mostly by China EXIM bank, and the development work is conducted by Chinese companies, except in the Colombo Port City project, where China Communication Construction Company (CCCC) has a 99-year land lease right on a significant portion of the land parcel.

Some of this investment in infrastructure, such as improving rail links, highways and the power plant, have been fruitful and beneficial to Sri Lanka. However, two large projects – Hambantota and Colombo Port City (CPC), each nearly worth USD 1.2-1.5bn – have been controversial, as they include leasing out significant and strategic parcels of land to Chinese companies for an extended period (99 years). These projects are crucial parts of a network of access points in the Indian Ocean acquired by China, which helps to avoid the Strait of Malacca, which was identified as a strategic chokepoint by former President Hu Jintao in 2003.

The CPC project is controversial in Sri Lanka because a significant part of the developed area is being leased out to CCCC for 99 years. The CPC project is being built by CCCC, a subsidiary of China Harbour Engineering Company, in cooperation with the Sri Lanka Port Authority, with an investment worth USD 1.4bn. As of July 2018, 85% of the reclamation work has been completed and China’s premier is scheduled to visit in October/November to commemorate the completion of the land-fill. The total area to be reclaimed is 269 acres.

The new site is to be transformed into a modern city with towering skyscrapers, luxury hotels, shopping malls, a marina, embassies, health-care and educational institutions, as well as other facilities. The project has now been renamed the Colombo International Financial City (CIFC) and is estimated to be worth USD 15bn in 10-15 years. It was re-started in 2016 after having been stalled for almost a year in 2015 following the election of a new government.

The Hambantota port project was another controversial project domestically. Chinese companies built the Hambantota Port, Mahinda Rajapaksa International Airport (MRIA) and a cricket stadium in former president Rajapaksa’s political constituency, Hambantota; loans worth USD 1.2bn were obtained from China to build the project. The Hambantota port and Mattala airport projects incurred losses, as they were not commercially viable. Hambantota port sees little traffic (one or two ships per day currently) while the Mattala airport also lies empty, with a large portion of the airport used to store food grain. Given its stretched financials and vulnerable external position, Sri Lanka was unable to repay the debt for these projects.

In December 2017, Sri Lanka formally handed over the southern sea port of Hambantota to China on a 99-year lease. Under the recent deal between Colombo and Beijing, the so-called Hambantota International Port Group (HIPG) and Hambantota International Port Services (HIPS), overseen by the China Merchants Port Holdings Company (CMPort) and the Sri Lanka Ports Authority, will own the port and the adjacent 5,000-acre investment zone. Sri Lanka was paid a total consideration of USD 1.1bn under the agreement. (While this deal is frequently referred to as a debt to equity swap, the Hambantota debt remains intact, and the proceeds from the port have been earmarked for the repayment of the sovereign...
bond maturing early 2019). The state-run conglomerate CMPort, China’s largest port owner and operator, is expected to invest up to USD 1.1bn in the port and additional facilities. The SEZ was created with the promise of further Chinese investment in return. While Hambantota is intended to become the main China-operated transhipment hub in the Indian Ocean, the port in Colombo will probably handle cargo destined mainly for Sri Lanka’s domestic market.

Colombo and the Hambantota port could boost China’s economic presence across South Asia. India and Sri Lanka have an FTA which allows Sri Lankan goods to enter the vast sub-continental market duty-free. China’s manufacturers could thus use future assembling facilities in Hambantota and the India-Sri Lanka FTA to export consumer goods to South Asia.
China’s imports from the SSA are largely dominated by commodities, while China exports capital goods to the region.

China’s pace of investment in East Africa in particular has jumped post-BRI.

## Building roads to and across Africa

### A strengthening relationship even before Belt and Road

#### SSA’s trade with China has grown rapidly

China has become an increasingly important trading partner for Sub-Saharan Africa (SSA); it is the region’s largest bilateral trading partner, absorbing a fifth of the region’s exports (although the euro area remains its main trading partner). The trade and investment relationship between China and Africa has grown rapidly since the turn of the century. Trade increased to USD 170bn in 2017 (having peaked at USD 222bn in 2014) from just USD 11bn in 2000. China’s top trading partners in the region are South Africa, Nigeria, Ethiopia, Zambia, Ghana and Kenya.

China’s imports from Africa have largely been commodity driven; in 2017, over 95% of China’s imports from SSA were primary commodities. Manufactured goods accounted for just c.3%. China became a net exporter to SSA following the commodity price downturn at the end of 2014. However, we think trade is likely to rebalance in the coming years as China’s imports from SSA rebound in 2018, driven by higher oil prices.

China is an important source of imports for a number of economies in the region, including Ethiopia (24% of imports in 2017), Kenya (23%), Nigeria (21%) and South Africa (18%). 94% of SSA’s imports from China are manufactured goods, of which c.50% is machinery and transport equipment.

Belt and Road investment has shaped recent trade relations

Investment from China, and more specifically BRI-related investment, has driven some of the recent increase in SSA’s imports from China. This is particularly notable in East Africa, where imports from China have risen sharply since the BRI was launched in 2013 and following sizeable investment by China in transport infrastructure in Kenya (Standard Gauge Railway), Ethiopia (light railway) and Djibouti (military base).

Investment by China is not new, with some pre-dating the BRI. But the pace of investment in East Africa in particular has increased markedly since the BRI’s launch, with infrastructure investment seen in Ethiopia, Tanzania, Kenya, Uganda and

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**Figure 17: SSA remains a small trading partner for China, but China accounts for a fifth of SSA’s exports, and its importance as a source of imports is growing**

![Graph showing SSA's trade with China and SSA's trade with SSA, % of total China trade and SSA's trade with China, % of total SSA trade](attachment:graph.png)
Djibouti. The turnover of China’s projects in these East African economies was USD 46.6bn in 2013-16, up from USD 15.6bn in 2009-12, with many projects being infrastructure related.

China’s top two SSA destinations for contract work on BRI projects are Ethiopia and Kenya, countries it had signed MoUs with early. As of 2016, the turnover of Chinese projects in these two economies was USD 4.7bn and USD 4.5bn, respectively. In contrast, in 2010, oil exporters Nigeria and Angola were the top destinations for such work.

In 2016, China’s top five export partners in SSA included two East African economies – Ethiopia and Kenya – versus none in 2010. While China’s investment in infrastructure projects drove demand for imports from China from these countries, this demand has fallen after project completion. As such, China may seek other potential export markets in the region. East African economies primarily import from China, and their exports to China are negligible. China has been developing industrial parks and FTZs in Ethiopia, Mauritius, Nigeria and Djibouti, often also funding transport links to the countries.

**The next phase – Beyond East Africa**

**More explicit regional BRI cooperation**

The Belt and Road initiative was a key topic at the Forum on China-Africa Cooperation (FOCAC) on 3-4 September 2018 in Beijing, where China pledged an additional USD 60bn of investment and concessional lending to Africa. The FOCAC Beijing Action Plan (2019-21) stated that ‘the two sides believe that Africa is an important partner in Belt and Road cooperation, and pledge to leverage the strengths of the Forum and support China and Africa in jointly building the Belt and Road.’ The focus at FOCAC has more explicitly shifted beyond East Africa, with trans-regional infrastructure development being a key theme.

The BRI initially focused on East Africa (the official map only labels Kenya on China’s new maritime Silk Road), but the recent FOCAC summit has signalled a broadening of the initiative’s engagement in Africa. Prior to the summit, just Kenya, Ethiopia and South Africa in SSA had signed MoUs with China on Belt and Road cooperation. At the summit, several other economies signed cooperation agreements and MoUs, including Mozambique, Zambia, Ghana, Cameroon and Nigeria, showing China’s broader infrastructure investment intention for the region.
Although China has already made significant investments in transport infrastructure in SSA, formalising engagement via the BRI would provide a further impetus. Several SSA economies are already among China’s top destinations for contract work in Africa; in 2016, Angola, Nigeria and Zambia were the top destinations for contract work outside East Africa.

BRI’s expansion in the region may be constrained by the following factors. First, the capacity to launch large-scale projects is limited, as several large projects have already been implemented, such as the USD 4bn Standard Gauge Railway (SGR) in Kenya, a military base in Djibouti, and an electric railway between Djibouti and Ethiopia. Following concerns about the size of funding, the management of funds and debt repayment, President Kenyatta of Kenya has reportedly requested China to switch half of the USD 3.8bn funding for phase 2 of the SGR to a grant from a loan.

Second, debt sustainability is a concern. China is already a significant creditor in SSA’s BRI partner economies, accounting for as much as three-quarters of Djibouti’s debt, around a third of Ethiopia’s debt and over 20% of Kenya’s. Given such significant exposure, we anticipate less appetite from SSA economies to borrow further for big projects, as well as from China to lend to these economies.

Debt sustainability is a major concern

Sustainability of Chinese lending to SSA economies has been a major issue for China-Africa relations in 2018. Debt levels have risen significantly across the region in recent years, with the increase in some cases driven by Chinese funding. China accounts for a large portion of external debt in several SSA economies: 40% of Angola’s, a third of Ethiopia’s and 28% of Zambia’s.

A number of SSA economies have expressed an intention to restructure their China debt in recent months. Following the FOCAC summit, Ethiopian Prime Minister Abiy Ahmed announced that China had agreed to restructure loans, including part of the funding for the USD 4bn Addis Ababa-Djibouti railway, with the maturity extended to 30 years from 10 years. Zambia, which owes 28% of its external debt to China, is also looking to extend the maturity of some of it.

At FOCAC 2018, Xi Jinping pledged debt relief to ‘least developed, heavily indebted and poor countries, landlocked developing countries and small island developing countries that have diplomatic relations with China’. The amount of relief and list of eligible countries have not been disclosed yet, although countries such as

Figure 20: Shifting pattern of Chinese contracts in Africa

Turnover of Chinese contracted projects, USD bn

Source: China MOFCOM, Standard Chartered Research

Figure 21: China has become a significant SSA creditor

Debt owed to China, % of external debt

Source: Local sources, Standard Chartered Research
Djibouti and Ethiopia are likely to be candidates, given that both have seen a surge in lending from China in recent years. Mozambique’s President Nyusi has said that Mozambique will benefit from a pardon of its interest-free China debt maturing in late 2018; the amounts are likely to be small and probably cover purely interest-free Chinese government loans maturing by year-end (not including concessional lending, which forms a larger part of China’s past engagement).

**Kenya – BRI’s landing spot in SSA**

**BRI engagement in Kenya started early on**

China’s official Belt and Road map labels Nairobi, Kenya in SSA as its landing spot for the maritime Silk Road, likely because, geographically, East Africa is a natural access route to the continent. We think this early labelling of Kenya on the BRI map is significant given its position as a regional hub, signalling China’s investment intentions for East Africa quite early. Kenya signed an MoU with China to develop the BRI in 2017, joining the Asian Infrastructure Investment Bank (AIIB), along with Ethiopia, in May 2018. China has said that it aims to help Kenya build an economic belt and industrial parks along railway lines.

BRI engagement between China and Kenya started early after the BRI’s launch in 2013, with the development of the Standard Gauge Railway connecting Mombasa and Nairobi. The first phase of the project, which cost USD 3.8bn (c.7% of Kenya’s 2013 GDP) was 85% funded by China, with a funding agreement signed between Kenya and the China Road and Bridge Corporation in May 2014; USD 1.6bn of the funding was on concessional terms (20Y at 2% interest with a seven-year grace period), and an additional USD 1.633bn was via a 15Y proprietary concessional loan, with a five-year grace period.

The second phase of the SGR (with China Communication Construction Company as the contractor) is to cost an additional USD 3.8bn, but there have been concerns around funding after President Kenyatta approached China to switch half of the funding to a grant rather than a loan. China already accounts for over 20% of Kenya’s debt (USD 5.3bn); further lending for completion of the second phase could increase this exposure further to as much as 30%.

**Kenya’s imports from China have grown with Chinese investment**

While the trade and investment relationship between Kenya and China has been growing since the turn of the century, it accelerated after the BRI was launched.

Growth in bilateral trade has correlated closely with a pick-up in China’s BRI-related investment in Kenya. China is now Kenya’s largest bilateral lender, extending USD 5.3bn in loans, 21.3% of Kenya’s total external debt, as of end-Q1-2018. The turnover of China’s contracts in Kenya grew to USD 4.5bn in 2016 from USD 265mn in 2007.


In 2014, Kenya’s imports from China almost doubled to USD 4bn from USD 2.1bn after the Kenyan government signed a contract with China Road and Bridge Corporation for the first-phase funding for the SGR. Kenya’s imports from China have fallen after the completion of the SGR’s first phase, although they remain well above pre-BRI levels. Kenya still exports very little to China, although this grew to USD 100mn in 2017 (from just USD4mn in 2000).
Figure 22: Kenyan imports from China jumped with SGR investment

Kenya’s imports from China, USD bn (RHS); turnover of China’s contracts in Kenya, USD bn (LHS)

Figure 23: China is now Kenya’s largest bilateral lender

Debt owed to China, USD bn (LHS), % of total external debt owed to China (RHS)

Figure 24: Among SSA countries, Kenya is one of China’s largest net importers

% of export/import/total trade with China

Figure 25: China has overtaken Kenya’s traditional trade partners

Kenya’s private-sector external debt liabilities (KES mn)
MENAP in search of a win-win with China

Belt and Road at MENAP’s current juncture

Trade balance with MENAP to remain in deficit as imports rise

The Middle East, North Africa, Afghanistan, and Pakistan (MENAP) region’s consumption of goods from China is significant – its imports from China rose to USD 142bn in 2017 from USD 27bn in 2005. MENAP’s exports to China have traditionally overshadowed imports given the predominance of oil exports, resulting in a trade surplus for the region versus China (Figure 26).

In the past few years, however, this surplus has turned to a deficit, driven by a decline in export value following the oil-price drop in 2014 and rapid import growth, with imports from China increasing fivefold since 2005. The oil-price decline led to a period of slower growth, with the region unusually underperforming global growth. The economic slowdown has been evident even in weaker imports from China, probably due to a slowdown in non-oil growth and infrastructure projects. Imports from China have recovered since 2017, while exports to China remain subdued on lower oil prices. The trade deficit versus China is set to widen with China’s growing commitment to invest in the region, and as imports from China pick up in tandem.

Investment ties – If not now, when?

We think China’s Belt and Road initiative has come at a favourable juncture for MENAP. The region’s oil exporters and importers will likely welcome delegating and sharing the burden of infrastructure spending, albeit for different reasons. Oil-exporting countries have had to re-adjust government spending lower as government oil revenues weakened following the 2014 drop in oil prices. This increasingly cautious spending has had second-round effects on the private sector, given the public sector’s key role in driving projects and non-oil sector growth. Measures to increase non-oil government revenue, such as value-added taxes (VAT), have further weighed on private-sector activity. For oil-importing countries, lower oil prices have provided little relief to funding needs, particularly on the external front; they continue to run wide current account deficits, reflecting their savings-to-investment imbalances.

Figure 26: MENAP’s trade deficit with China is set to widen as its imports grow along with infrastructure investment (USD bn)

Source: IMF Direction of Trade Statistics (DOTS), Standard Chartered Research
Financial sector to reap benefit of closer bilateral ties with China

We think closer trade and investment ties between the region and China will lead to further integration of their financial sectors. Examples of such integration include the establishment of the Renminbi Clearing Centre in the UAE, and the UAE Central Bank and the People’s Bank of China’s bilateral currency-swap agreement signed in 2015. The Clearing Centre provides cross-border clearing and remittance services, and money-market lending. This should ultimately lead to the use of the Renminbi for the direct settlement of bilateral trade and investment flows.
Oman – Plugging into global trade and supply chains

The China-Oman trade relationship pre-dates Belt and Road

China and Oman have a long-standing and close trade relationship. China is Oman’s main export partner: Oman’s exports to China grew to USD 14bn in 2017 from USD 4bn in 2005; and in volume terms, 77% of Oman’s total oil exports (or 226mn barrels) went to China in 2017.

By contrast, Oman imports much less from China: while the value of its imports grew to USD 1.6bn in 2017 from USD 200mn in 2005, it still made up only 6% of total imports in 2017. As a result, Oman ran a USD 12.5bn trade surplus with China in 2017 (Figure 27). We think this trade surplus will narrow as investment from China gets disbursed and infrastructure projects begin, leading to an increase in imports of building material and equipment from China.

Investment ties – When economic interests converge

China’s BRI has coincided with a period of tighter liquidity in MENAP’s oil-exporting economies. Oman’s public debt rose to c.50% of GDP in 2018 from only 5% in 2014. The government responded to the 2014 oil price drop by turning more cautious in spending. This re-adjustment followed a decade of expansionary fiscal policy, supported by high oil prices, which contributed to Oman’s GDP per capita rising to USD 44,300 from 39,700 from 2005-15.

While FDI inflows to Oman rose significantly to c.USD 2bn in 2017 from USD 1.3bn in 2014, they pale in comparison to government capex, which peaked at USD 9.1bn in 2014. This provides some context for the significance of the Sino Oman Industrial City, for which a consortium of Chinese companies has earmarked USD 10.7bn of investment. The town of Duqm is set to be transformed into an industrial and logistics hub, from a small fishing town with a population of 12,000. China’s commitment has helped attract investment from other countries, with India expressing interest in constructing a USD 1.2bn aluminium plant and Iran partnering with Oman on a USD 200mn car manufacturing plant. Kuwait and Oman’s oil companies have entered into a joint venture to build a 230,000 barrel per day refinery; the project value is estimated at USD 5.7bn, according to media reports.

Figure 27: Oman’s trade surplus with China is set to narrow as its imports grow along with infrastructure project investment (USD bn)
## Appendix – Trade and financial partnerships between China and BRI partner countries

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## Infographic

### The good, the bad and the future

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