China's Belt and Road Initiative: Regional Outlooks for 2018

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Excerpts from our Belt and Road Initiative: Risk Insights report. This section, co-authored by Joanna Eva, Qi Lin, and James Tunningley, focuses on the 2018 outlook for different regions receiving Chinese investment.

Southeast Asia

The Pivot of China's Belt and Road Initiative

China has targeted Southeast Asia as one of the central nodes of its Belt and Road Initiative (BRI) through projects such as the China-Laos high-speed railway, hydropower plants in Cambodia, and Indonesia's first high-speed railway, connecting the cities of Jakarta and Bandung. This region's growing markets, numerous manufacturing hubs and abundant natural resources offer Beijing considerable economic opportunities. The region also plays a key role in securing sea routes in the South China Sea and Strait of Malacca.

According to a report by the Asian Development Bank, Southeast Asian states will need investment equal to 5% of their GDP to cover infrastructure growth between 2016 and 2030. Through the BRI, Chinese investments can fill a critical funding gap for Southeast Asian countries, especially when funding through private investors and international financial institutions remains limited and falls short of the region's demand. China has already made huge investments in Southeast Asian infrastructure and will seek to continue to build on these given the increasing willingness of Southeast Asian economies to turn to Japan and India – who are themselves funding infrastructure projects.

In September 2017 during Prime Minister Shinzo Abe's visit to India for the 12th Indo-Japan annual summit, a memorandum of understanding was signed to set up the 'India Japan Act East Forum' with an aim to marry India's Act East Policy with Japan's Free and Open Asia-Pacific strategy. This forum is part of the Indo-Japan corridor which was conceived in 2016, the 'Asia Africa Growth Corridor (AAGC), and provides an alternative to the BRI. Hoping to better integrate the economies of South, Southeast, and East Asia with Oceania and Africa, the idea is to "create a 'free and open Indo-Pacific region' by rediscovering ancient sea-routes and creating new sea corridors."

Beijing's Interest in the South China Sea

New infrastructure and an expanded maritime presence has allowed China to establish more secure sea lines of communication through the vital waterways of the South China Sea and Straits of Malacca.

These efforts include ambitious port projects in countries like Indonesia, Malaysia, Singapore, and the Philippines.

In Indonesia, Beijing has strived to accommodate Jakarta's domestic priorities with its BRI projects. For example, in 2015, Indonesia chose China over Japan to build its first fast-train rail link connecting Jakarta to Bandung. Several Indonesian state-owned enterprises, in a consortium with China Railway International Co Ltd., signed a $4.5 billion loan with the China Development Bank this past May. China is also investing $6 billion in Indonesia's Tanjung Sauh Port on the island of Batam. In Malaysia, China is pouring $1.9 billion into the Melaka Gateway port along the strait's northern shore and the Kuantan port on the South China Sea.

Involvement with these countries provides China a strategic opportunity to shape the contentious maritime sphere in its interests, raising concerns that China would use the BRI as economic leverage to support its claims over disputed territories in the South China Sea. It is likely that the other claimant states would be constrained in their ability to challenge China's claims if these countries become dependent on China's BRI investments.

South Asia

China's Port Investments: Gwadar, Hambantota and Chittagong

In 2015, China and Pakistan launched the China-Pakistan Economic Corridor (CPEC), signing 49 agreements to finance a variety of projects with a total expected value of $46 billion, including upgrades to Pakistan's Gwadar Port, oil and gas pipelines, road and railway infrastructure, and a series of energy projects. CPEC aims to connect Kashgar in China's Xinjiang Province with Gwadar, via 2,000 miles of railroad and pipelines, which can cut transportation costs and distance for shipping commodities. Chinese efforts to invest in the Gwadar Port is motivated by the fact that it offers an important foothold in the region, due to its proximity to the Strait of Hormuz. This is a strategically important choke point providing sea passage to the open ocean for many of the petroleum-exporting States. With a strong presence in Gwadar, China is also able to provide safe passage to its oil tankers and monitor U.S. naval activities in the Persian Gulf and Indian activity in the Arabian Sea.

Besides Pakistan, Sri Lanka has been the leading beneficiary of Chinese infrastructure investment in South Asia, with nearly $15 billion worth of projects between 2009 and 2014. Since construction began in 2008, China has taken an increasingly prominent role in development in Hambantota. Billions of dollars have gone towards construction in this town on Sri Lanka's southern coast, including a $1.4 billion port, an airport, numerous highways, and an as-yet-unbuilt 15,000-acre industrial zone. In particular, China Merchants Port Holdings plans to invest approximately $1.12 billion to develop port and related facilities.

China's interest in Sri Lanka is driven by the country's strategic location at the centre of the Indian Ocean and is equidistant from the eastern coast of Africa and Indonesia. As China's interest in East Africa rises, huge quantities of bulk energy and other raw supplies will be transported from Africa to China. As such, investing in ports in Sri Lanka becomes a strategic imperative.

China has also financed the modernization of the Chittagong Port, which handles around 92% of Bangladesh's trade. China has also expressed interest in investing in the proposedSonadia Island deep-water port in Cox's Bazaar. Similar to both Pakistan and Sri Lanka, Bangladesh is also located at a strategically significant location, which can provide the Southern Chinese province of Yunnan access to the Indian Ocean via Myanmar or India. Bangladesh also has a huge economic potential to provide a big market opportunity for Chinese entrepreneurs as its economy has grown roughly 6% per year since 1996 and has maintained steady export growth in the garment sector. More importantly, Bangladesh has confirmed reserves of 200 trillion cubic feet of natural gas; the government has already offered exploration rights to China at Barakpuria.

Potential Backlash from BRI Partners

CPEC and other Chinese investment projects in South Asian countries have met with some resistance, reflecting a rising trend of internal disagreements among China and its BRI partners. High interest rates, strict commercial conditions, and lack of transparency are some of the biggest drawbacks of Chinese financing.

Some of the typical conditions attached to Chinese loans stipulate that project contracts be given to Chinese companies and at least 50% of material, equipment, technology, or services to be sourced from China. For example, loans extended by the Chinese government owned Chinese Exim Bank require that recipients use such funds topurchase Chinese products and services and to use Chinese labor and raw material.

In Pakistan, BRI and CPEC face growing criticism. The CPEC projects have remained under the control of Chinese companies and banks, and the project bidding, contracting, and financing processes lack transparency. In addition, the financing of these projects is done through market-rate loans and equities. Pakistan government has given the sovereign guarantee of 17-34 percent returns on Chinese equities in projects.

Chinese banks have also charged an 8 percent interest rate on loans to Pakistan for projects under CPEC whereas international interest rates for energy projects are only about 1.6 percent. Pakistan is expected to start repayment in 2020; however, its fiscal deficit continues to increase and the balance of payment situation remains critical.

In the Gwadar Port Project, a revenue-sharing agreement dictates that 91 percent of therevenue generated goes to China for the next 40 years. Recently, Pakistan canceled the $14 billion Diamer-Bhasha Dam project because of China's tough financing terms. In Nepal, the $2.5 billion contract for construction of Budhi Gandaki hydro-electricity project recently met the same fate, with the Nepalese government accusing the Chinese company of financial irregularities and lack of transparency.

China's alleged predatory behavior has yielded another type of risk: civil unrest. In late 2016, Sri Lanka announced a deal to trade an 85 percent stake in the Hambantota port project, which would include a

99-year lease on land there, to China Merchants Port Holdings (HKG:0144) in exchange for $1.1 billion in debt relief.

However, China's leasing in Hambantota has sparked violent protests and drawn a backlash from parliament, fueling fears in the region that Beijing seeks to establish what is effectively a Chinese colony in another sovereign state. Although the Sri Lankan government has worked out a compromise to decrease the Chinese share from 85 percent to 65 percent over a decade, it does not limit China's 99-year lease on the land or preclude a future security or military role for Beijing in this country.

Chinese vs Indian Interests in Iran

The Trump administration's opposition to the JCPOA and recent U.S. sanctions on Iran create value opportunities for China in the Middle East. Some believe the new sanctions will worsen Iran-U.S. relations and prevent future economic cooperation between Iran and the West, further establishing China as Iran's only reliable economic partner. As Western firms stall, China's CITIC Trust has pushed a $10 billion credit line to support projects in Iran; China Development Bank is considering a further $15 billion.

India's investment interest in Iran has focused on the expansion of Chabahar Port. By funding the Port in Iran, India expects to establish a secure transit route to markets in Iran, Afghanistan, Central Asia and the Gulf region. For India, easy access to Chabahar would connect the country to Afghanistan and the energy-rich Central Asia through the Jawaharlal Nehru and Kandla ports. Additionally, the port will promote Indian strategic interests in the Persian Gulf and Strait of

Hormuz. Despite the United States' tough stance on Iran, the American government has not yet objected to increased cooperation between India and Iran. In his October visit, US Secretary of State Tillerson said that there is no contradiction with US-Iran sanctions and India's bilateral port development deal in Chabahar. Considerable uncertainty remains as to U.S. policy and how it will affect funding and partnerships for projects endorsed by India and its partners like Japan.

East Africa

China's ongoing investment on the African continent has been the subject of controversy and suspicion for some time now, investing in 293 FDI projects since 2005 to the value of some US$66.4 billion.

The benefits of the move are obvious, with Chinese money filling major potholes on the road to African economic development while opening up both markets to a booming middle class on either side of the globe. Bilateral trade has soared to more than $160 billion in revenue each year, at the same time as the West axes its foreign aid budgets and own FDI flows.

But it's not a balanced relationship: in 2016, Chinese exports to Africa amounted to $82.9 billion, with African outflows levelling out at just $54.2 billion. Chinese investment is in some ways just as political as the actions of Africa's former colonisers, a means of securing critical pressure points between East and West.

Securing waterways via Djibouti

Hot on the heels of a polished opening ceremony at China's first ever overseas military base in Djibouti, a tiny African nation of just 875,000 people, People's Liberation Army troops have begun holding live-fire drills in the surrounding sands under the banner of peacekeeping missions. Traditionally the playground of bases belonging to the US and its allies, Djibouti has emerged as a vital security beachhead in the struggle to secure global maritime routes, the BRI included, and China's perceived intrusion has not goneunnoticed.

China first announced plans for the base in 2015, beginning construction soon afterwards. Signing an initial 10-year lease for the site, the Chinese Foreign Ministry hasalleged that the base will support Chinese troops escorting ships in the Gulf of Aden and pirate-infested waters off the Somali coast. With a military budget second only to the US, and expanding by the year- spending is set to double to $233 billion in 2020- China is bound to continue its current trajectory of military investment on the continent in coming years.

The militarisation of Djibouti has raised concerns that the Chinese may be doing the same thing with Gwadar Port in Pakistan – part of the China Pakistan Economic Corridor (CPEC). However, it is more likely that China will seek to build another port – specifically for military purposes – near Gwadar. Sources close to the People's Liberation Army (PLA) in Beijing have said that this new port near Gwadar will be used to "dock and maintain naval vessels as well as provide other logistical support services".

Egypt at the centre

Further north, Egypt stands at a critical juncture of the Maritime Silk Road, the Suez Canal forming the main transit point between the

Indian Ocean and the Mediterranean Sea. Without Egypt's partnership, the entire "Road" section of the BRI is redundant; fortunately for Xi, Egyptian President Abdel Fattah el-Sisi has expressed a keenness to make his country a "pivot" for the entire project.

The planned expansion of the China-Egypt Suez Economic and Trade Cooperation Zone isset to take a decade to complete and over $230 million in financing, at the same time as Egypt undertakes its own internal economic reform. An industrial zone of 7.23 square kilometers in Ain Sokhna on the Red Sea coast well underway; the first phase has beencompleted and successfully attracted investment from some 68 enterprises.

A memorandum of understanding has already been signed between the two leaders, with China promising an additional $1 billion in financing for Egypt's central bank and $700 million in loans to the National Bank of Egypt. China has been less than subtle about its intentions in ensuring regional stability, labelling itself the "new" choice as Middle Eastern relationships with the US sour ever further.

Kenya holds the key

At the inauguration of a new railway line connecting Kenya's capital, Nairobi, and the coastal Mombasa city earlier this year, Kenyan President Uhuru Kenyatta hailed the project as one ushering in a "new chapter" for the country. Funded with Chinese money, the railway is the largest project in the country since Kenya achieved independence in 1963, with ties evolving in line with the government's new focus on multifaceted engagement.

Under the former President Mwai Kibaki, Kenya launched a deliberate policy to distance itself from traditional investment partners in Europe and the US, instead resolving to "Look East". Since then, China has formulated several major projects in the country, including a 50-kilometer, eight-lane highway linking Nairobi to Thika (inaugurated inNovember 2012) in addition to the Nairobi-Mombasa railway. With projects wellunderway in Tanzania, Nairobi holds the key to China's expanding network among Africa's southern-most states.

Outlook for 2018

Despite the fanfare, 2018 presents very real challenges to Chinese attempts to secure alliances throughout the African continent. Local discontent with rising Chinese influence on the continent will need to be managed effectively; commodity prices and rising debt levels are a concern along the entirety of the BRI, and Africa is no different. China's propensity to hire Chinese firms and Chinese workers on overseas infrastructure investments has not gone unnoticed; paired with a never-ending, and seeminglyunquestioning, line of credit from Chinese banks to African governments, the question of repayment is less sexy than the overall BRI hype- but no less important. Africa is weary of colonial-style inflows, and China must constantly manage domestic perceptions and ensure stability if BRI projects are to succeed in the long-term.

Finally, it must be noted that a pervasive infrastructure deficit in Africa has not emerged simply out of a global blindspot; there are broader societal and political barriers at play that China's cash-heavy approach may be failing to address. China's disinterest in ensuring the

transparency of local governance may ultimately backfire, exacerbating existing fragility instead of ensuring the stability China seeks.
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