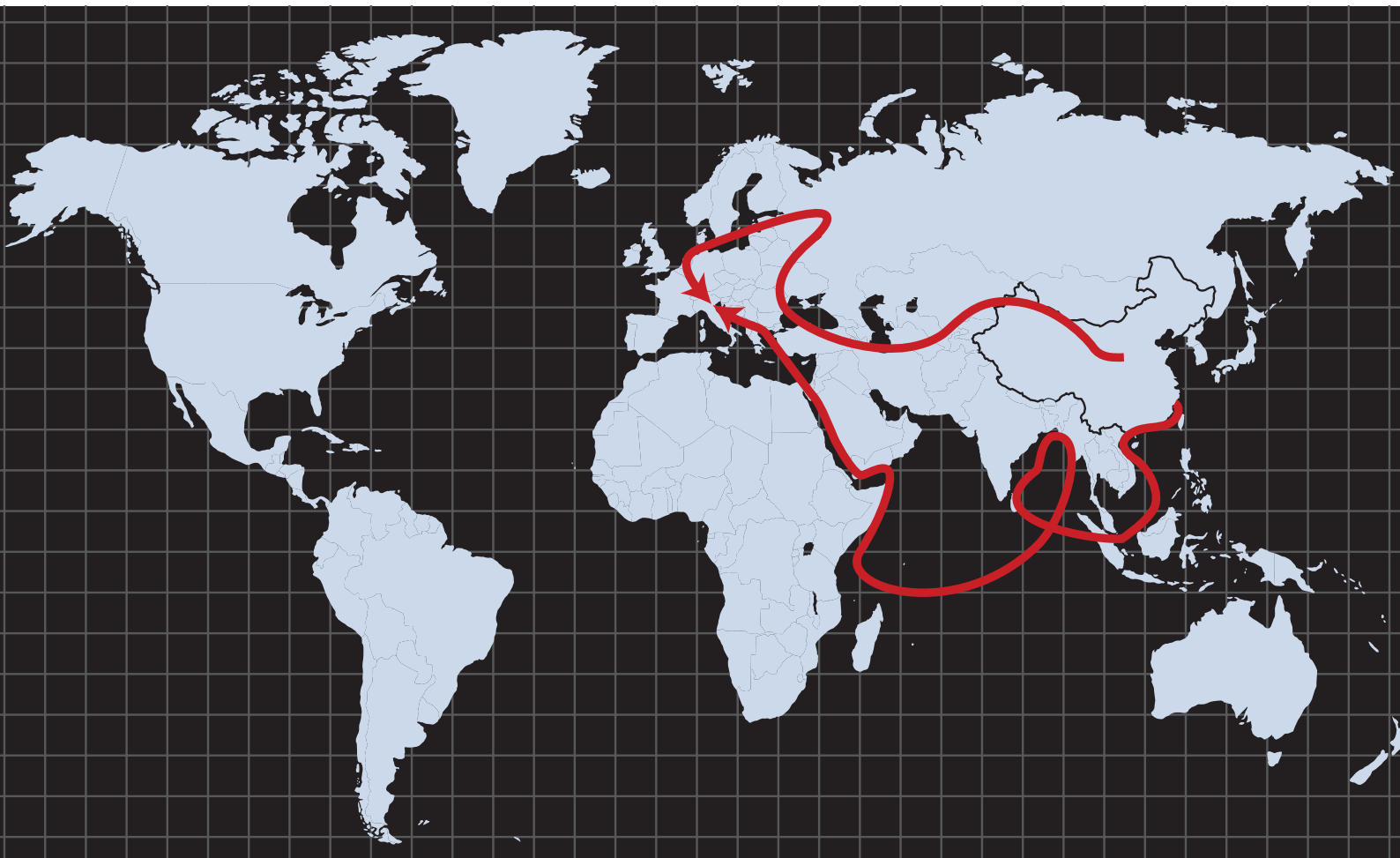


Prospects and challenges on China's 'one belt, one road': a risk assessment report

From The Economist Intelligence Unit





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Introduction

China's approach to international diplomacy is evolving. Having long sought to maintain a "low profile" on the global stage, it has in recent years begun to advocate a greater role for itself in the international order. Chinese companies are also leaving the comforts of their home market and going overseas, seeking to tap fresh markets and acquire new technologies.

China's president, Xi Jinping, is ramping up efforts to strengthen China's global position. He has announced a number of high-profile multilateral initiatives intended to advance China's international presence and cultivate closer ties with more countries. The main initiative under this push, "one belt, one road" (OBOR), promises to be among the widest-reaching of these. It not only represents a renewed, stronger and better co-ordinated push to expand China's influence overseas, but it is also coupled with a domestic investment drive, in which nearly every Chinese province has a stake.

Diplomatic efforts have begun. China's ambassadors to countries ranging from Afghanistan to Yemen are securing assurances of co-operation on the OBOR initiative. The investment drive has begun as well. Provinces have begun to build logistics centres and cultural expos in anticipation of growing trade and interaction with OBOR countries.

While the strategy promises opportunities for domestic companies, the route is unlikely to be an even one. The proposed countries along OBOR range from Singapore to Syria. The companies involved could be heading into territories that may be strategically important for China's foreign relations, but challenging to navigate.

In this report, The Economist Intelligence Unit (EIU) will unpack "one belt, one road" plan and explore the risks that will face companies seeking opportunities in this territory. It supplements the research that the EIU has done previously on the overseas investment for Chinese companies. This was first published in 2013 as the China Going Global Investment Index, and updated a year later.



The plan

OBOR is a combination of two outward-facing concepts introduced by Mr Xi in late 2013 to promote economic engagement and investment along two main routes. To date, reports suggest that the first route, the New Silk Road Economic Belt, will run westward overland through Central Asia and onward to Europe. The second route, the 21st-Century Maritime Silk Road, will probably loop south and westward by sea towards Europe, with proposed stops in South-east Asia, South Asia and Africa.

At the time of writing, the list of countries on the two routes had not yet been finalised. However, the geographic spread of future initiatives is expected to be ambitious. Official media have indicated that up to 60 countries may be included: preliminary maps published by the official news agency, Xinhua, show stops in countries across three continents.

Besides its political objectives, OBOR brings a strategic focus to the government's "go out" initiative, which encourages Chinese firms to go abroad in search of new markets or investment opportunities. The OBOR push is being led from the highest levels of the government, and involvement will run across several ministries. Its initial stated emphasis will be on regional connectivity projects.

OBOR is backed by substantial financial firepower. The government has launched a US\$40bn Silk Road Fund, which will directly support the OBOR mission. The fund, which became active in February 2015, is backed by the China Investment Corporation (China's sovereign wealth fund), China Development Bank, the Export-Import Bank of China and the State Administration of Foreign Exchange. It will be used to improve connectivity along the "one belt, one road" by financing infrastructure, resources, industrial and financial co-operation projects, probably with an initial focus on Central and Southeast Asia. Transport infrastructure such as railways, roads, ports and airports will be a particular focus. The projects are expected to generate returns, however, and thus represent a departure from traditional aid. The chair of the fund, Jin Qi, has said that the fund will work in line with "market-oriented principles" and should generate adequate returns for its shareholders.

The Asian Infrastructure Investment Bank (AIIB), which is being spearheaded by China and was officially established just two months previously, in October 2014, is meant to help to finance construction along OBOR as well. The bank's stated aims are to combine China's core competencies in building infrastructure with deep financial resources to help development in other parts of Asia. China will provide much of the US\$100bn in proposed initial capital. At its announcement, it sought participation by other Asian governments and signed a Memorandum of Understanding (MoU) with



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21 of them, with assurances that it would co-operate with other funding sources such as the Asian Development Bank (in which China is a member).

Despite concerns expressed by the US government about the AIIB's governance structures and lending practices, it has quickly gained momentum. By end of March 2015, more than 40 governments from five continents have applied to join the institution, including the UK, France, Australia, Brazil and Russia. Japan may sign up later, although it remains "cautious".



Broad involvement

According to state media, OBOR will cover nearly two-thirds of the world's population and one-third of global GDP. The initiative is a departure from broader trends in Chinese outbound investment, which is increasingly being led by private firms. At least in the initial stages, the state—China's state-owned enterprises (SOEs) and largest financial institutions—will be leading the charge. In its discussion of OBOR, the national government work report encourages active involvement in overseas infrastructure investment and construction, such as through the export of equipment and machinery.

Another element of OBOR is its integration into provincial government objectives. All 31 Chinese provinces have indicated that they will actively participate in the implementation of the OBOR strategy. Two-thirds of these provinces have included it as a development priority and have featured it in their annual work plans for 2015. They include a wide range of projects. The western province of Qinghai, for example, has listed in its government work report that it will build a stronger aviation, rail and highway network to link up with neighbouring provinces and countries along the OBOR. A logistics centre and bonded warehouse are in the works. Xining Special Steel, a state-owned company, was selected to be one of the firms spearheading Qinghai's OBOR efforts, with its products to go into ports, shipping and other infrastructure in destination countries.

China's richest provinces are just as involved. The coastal powerhouse of Guangdong has chosen several projects to support as part of OBOR, including a power plant in Vietnam, banana plantations in South-east Asia and an oil-refining project in Myanmar.

Preparations within China are being ramped up rapidly. National and provincial-level planners see the development of OBOR as a release valve for the country's massive overcapacity in steel, cement and construction materials. Much of the financing will come from Chinese institutions, and encouraging the broader use of the renminbi through contracted projects, currency exchange and trade will be part of the push. UnionPay, China's bank card organisation, has pledged to support the OBOR strategy and is rapidly expanding its services in included countries. It announced that since the end of 2014, UnionPay card acceptance in Kazakhstan has been raised to nearly 60% of the country's automated teller machines (ATMs) and 40% of the country's point-of-sale (POS) terminals. A bigger push in card issuance is being made this year.

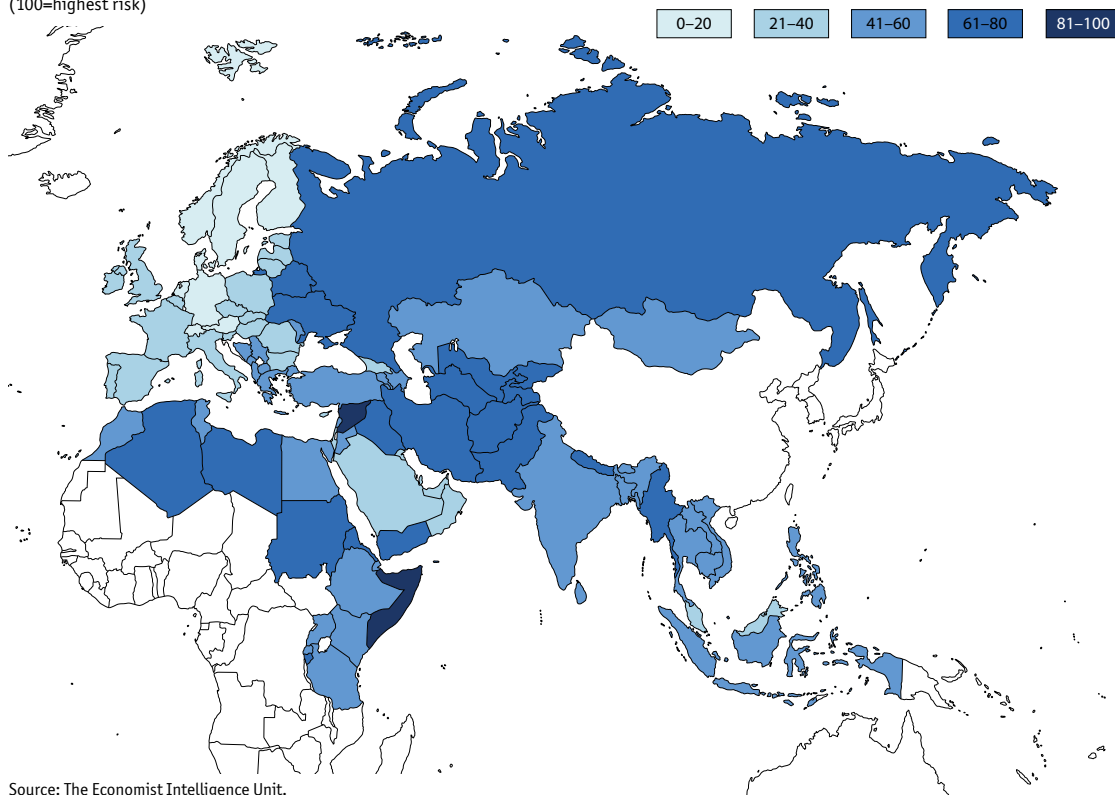


Risk assessments

However, a proper assessment of the challenges in destination countries will be necessary, given the wide range of countries and the sums of money involved. Financial institutions will need to be cognizant of the range of credit risks present in OBOR countries. Construction firms and other enterprises building their presence in countries along OBOR will need to prepare for potential threats to their operations in these new markets.

The EIU makes robust analyses of operational and credit risk. The operational risk scores of countries mentioned by Chinese media as likely to be part of OBOR vary dramatically. Unsurprisingly, Afghanistan and Iraq, which are beset by conflict, score the highest with regards to overall risk. But the central Asian countries of Tajikistan and Uzbekistan, where the OBOR push is likely to be strong, are very close behind. Appendix A at the end of the paper describes the EIU's methodology.

Overall country operational risk on 'One Belt, One Road'
(100=highest risk)



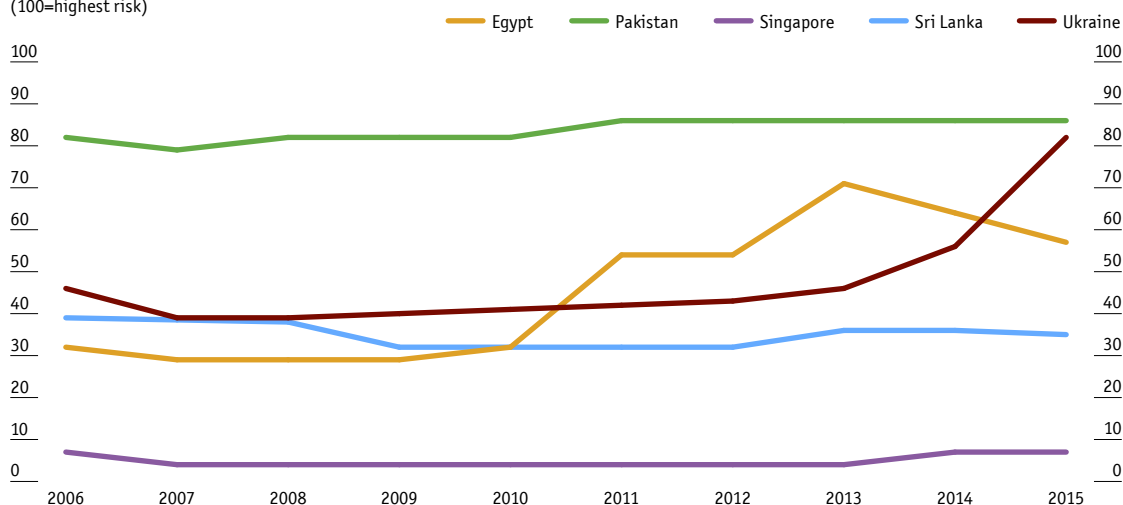
Source: The Economist Intelligence Unit.



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Overall scores include risks across ten different categories, including security, legal and regulatory, government effectiveness, political instability and infrastructure. In determining potential operational challenges in these countries, it is important to consider score distribution between categories as well. Thailand, for example, received a moderate overall risk score of 49 (out of 100). However, this masks a fairly low risk score for macroeconomic risk, coupled with a high risk score for government effectiveness. Companies planning to do business there would do well to prioritise preparations for red tape first.

Security risk on 'one belt, one road'
(100=highest risk)



Source: Economist Intelligence Unit.

Political risks may weigh heavier on OBOR efforts than overseas direct investment (ODI) activities led by private firms. Many OBOR projects are slated to be high-profile construction projects, which means that the deals will be made with the heavy involvement of the destination country's government. Political changes need to be anticipated, as they can change the outcome of a deal.

For example, the election in January 2015 of a new prime minister in Sri Lanka, Maithripala Sirisena, threw the future of a US\$1.4bn port project in the country's capital, Colombo, into doubt. The former prime minister, Mahinda Rajapaksa, had close ties to the Chinese government: his administration awarded several large infrastructure projects to Chinese state-owned companies, and loans from China rose to nearly US\$4bn by mid-2014. After coming into office, Mr Sirisena promised to review the terms of these loans and investigate foreign-funded projects for corruption, and suspended work on the port. Although a visit by Mr Sirisena to China in March suggested that work on the project may restart, the delay is likely to have had significant financial cost for the developer.



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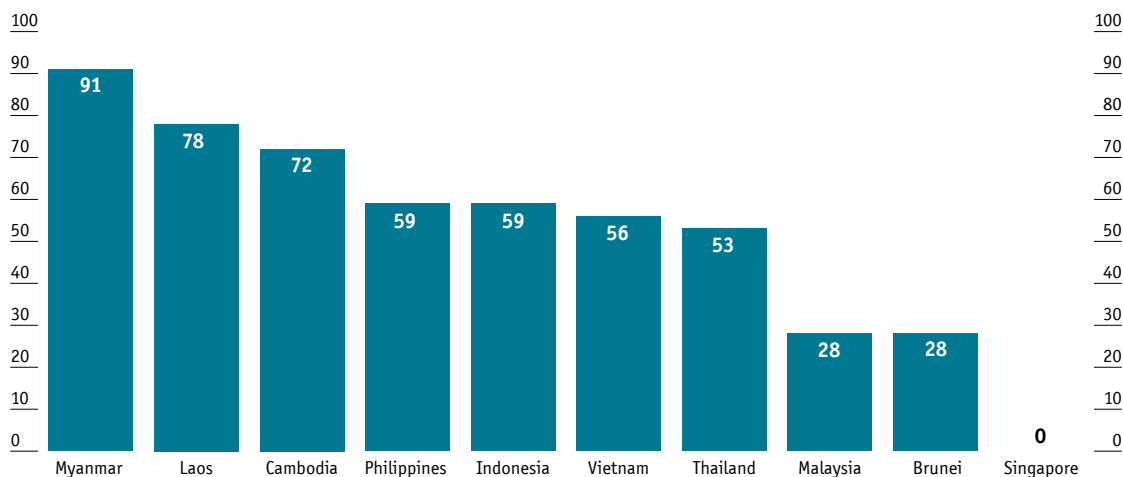
Operational risk in Sri Lanka (100=highest risk)



Source: Economist Intelligence Unit.

The problems faced by Chinese developers in Sri Lanka are not unique. In February 2015 the Cambodian government announced that approval for a US\$400m dam project to be built in the country by Sinohydro Corporation had been suspended until at least 2018. The dam had been criticised by non-governmental organisations on environmental grounds. The problems faced by Sinohydro in Cambodia echo those that another company, China Power Investment, has encountered in its effort to develop the Myitsone hydro-electrical dam in Myanmar. Work on the project was suspended in 2011 following the appointment of a new, reformist government.

Infrastructure risk in the Association for Southeast Asian Nations (ASEAN) (100=highest risk)



Source: Economist Intelligence Unit.

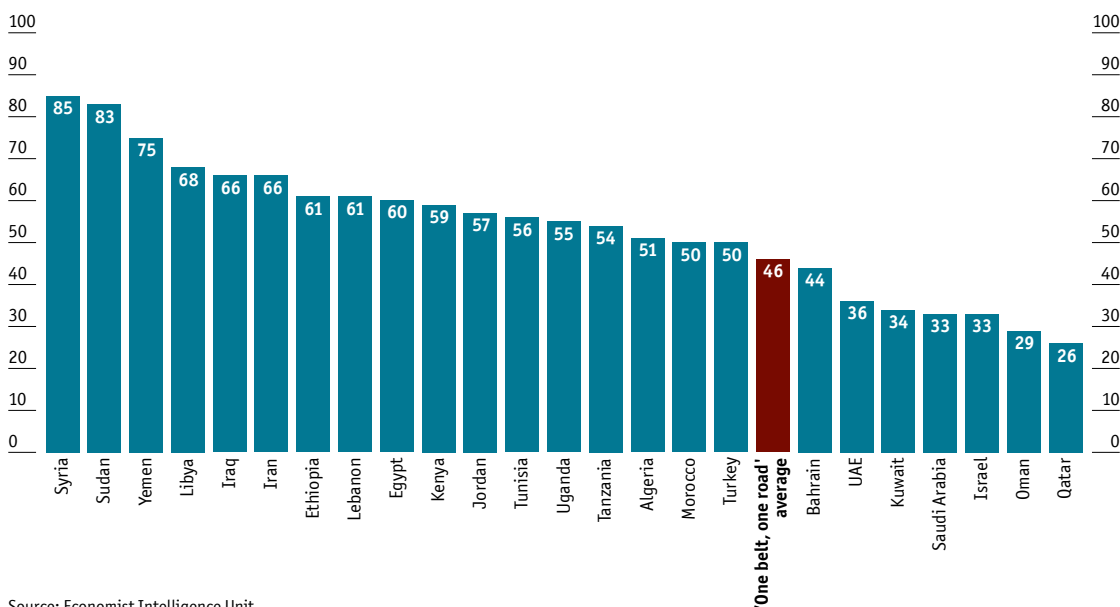


Sudden project suspensions would make most creditors jumpy, as would any inability to pay back loans. Financing for OBOR projects will mostly be supported by China's banks. In March 2015 the Bank of China promised US\$5bn in credit to Anhui Conch Cement to support its OBOR endeavours abroad. The company is an SOE and the largest cement manufacturer in China. On its website, Bank of China stated that more broadly, it would increase financial support for enterprises implementing the country's OBOR strategy this year. Over the next three years, the bank expects that its OBOR construction-related credit could reach up to US\$100bn.

With such large outlays, a rigorous assessment of credit risk in the countries in which these companies will be operating would be advisable. The EIU's overall country credit risk rating is derived by evaluating risk across sovereign, currency, banking sector, politics and economic structure categories. (A more thorough discussion of the indicators that go into the assessment of credit risk categories can be found in Appendix B at the end of the paper.) These categories of risk are important to consider; for example, monitoring the risk of a massive devaluation will be important for Chinese companies that use local currencies in their operations.

Our analysis of credit risk in OBOR countries indicates that scores can vary widely within regions. For example, Myanmar and Cambodia receive higher risk scores than fellow Association of South-East Asian States (ASEAN) countries Thailand and Malaysia.

Overall country credit risk in the Middle East and Africa
(100=highest risk)

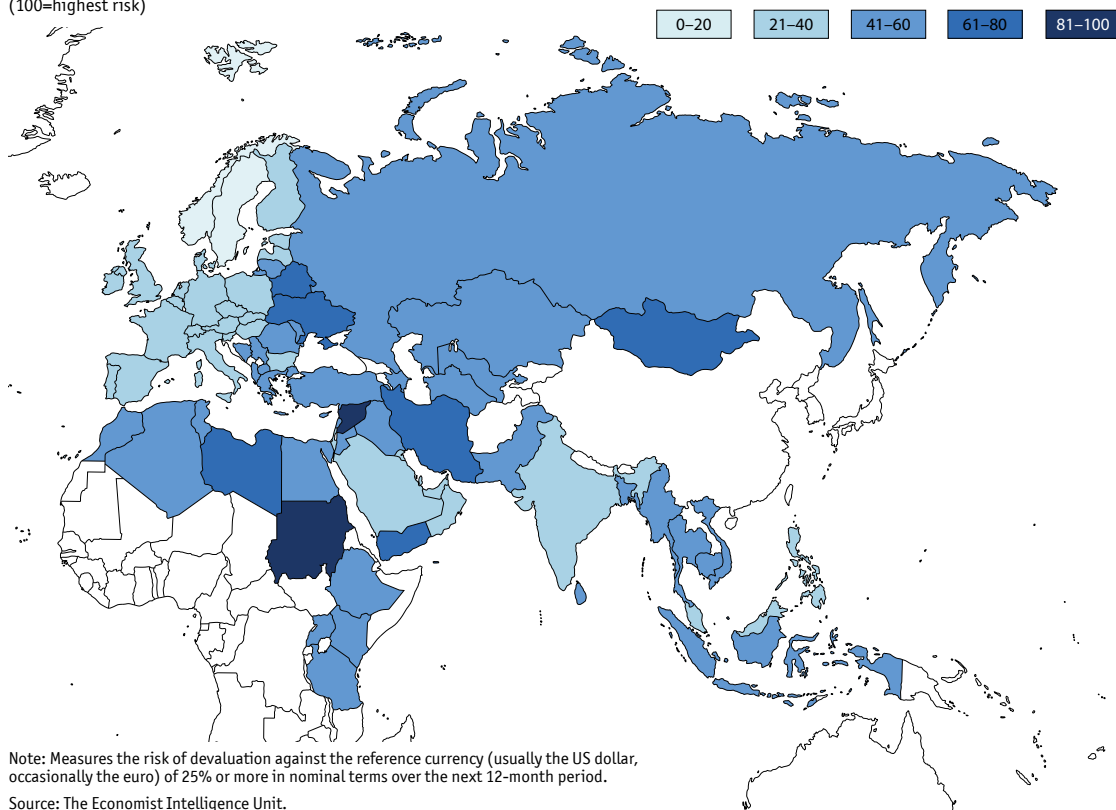


Source: Economist Intelligence Unit.



Sovereign risk will loom large in the minds of creditors as Venezuela, another country that has received a sizeable share of Chinese credit, struggles to repay its US\$56bn in loans as the oil price tumbles and its economy falters. Among OBOR countries, scores for sovereign risk are the highest (with 100 being the most risky) in the Middle East countries of Syria and Iraq, where war has left government finances in shambles. Greece, which is trying to hammer out a deal with its creditors, receives a high risk score as well. As OBOR will probably include a component of lending to overseas governments to finance select projects, the likelihood of country default will be important to monitor.

Currency risk on 'one belt, one road'
(100=highest risk)





Risk scenario analysis

EIU analysts provide scenario analysis across 180 markets. Several scenarios that may affect countries on OBOR are included below:

Kazakhstan: Political stability risk

Scenario: Popular protests drive increasingly nationalist agenda

Assessment: Low likelihood; Moderate impact

The risk of mass protests such as those in Ukraine that led to the overthrow of the former president, Viktor Yanukovich, is very low. However, isolated protests have become more common, driven by concern over social issues, corruption and income disparities. There is potential for these protests to acquire an anti-business or xenophobic aspect, which could in turn have an impact on the authorities' attitude to foreign investment. There is widespread popular anxiety regarding the effect of Russian and Chinese investment, the two largest external investors, on the country's sovereignty and control of its natural resources. Small anti-Chinese rallies took place in Almaty, the largest city, in 2010 amid reports that the government was preparing to sell agricultural land to Chinese companies. The share of the oil and gas sector owned by Chinese companies is an area of particular controversy. Compared to its Central Asian neighbours, Kazakhstan has been relatively open to foreign investment. Should the scale of popular protest increase, however, the authorities may adopt a more nationalist agenda in order to deflect popular anger. The risk of nationalist policies will increase following the eventual withdrawal from power of the president, Nursultan Nazarbayev, as the absence of established democratic institutions means that any successor may struggle for legitimacy. Foreign firms should take steps where possible to publicise the contribution they make to the local and national economy, and consider hiring Kazakh nationals wherever feasible.

Vietnam: Legal and regulatory risk

Scenario: A foreign firm suffers an unfair ruling on a contractual dispute in the local courts

Assessment: High likelihood; Moderate impact

Contracts in Vietnam are rooted in statute, but laws are complex, inconsistent and open to interpretation. Judges think little of contradicting themselves or the rulings of other courts. Moreover, there is little in the way of historical case law to provide foreign investors with fair warning of potential pitfalls. Contract negotiations can be lengthy and obtaining project approval from the government is often delayed. Businesses are advised to consider whether it is worth including clauses in contracts that allow disputes to be dealt with by the Singapore Court of Arbitration. Before attempting to resolve a contractual matter in the courts or through arbitration, it is advisable first to exhaust all avenues of negotiation.



MALAYSIA: Labour market risk

Scenario: Labour shortages persist

Assessment: High likelihood; High impact

Strong rates of recent economic growth in Malaysia have been supported by a young, moderately well-educated workforce (which numbered some 14m at the end of 2014) and generally low rates of unemployment (3% at the end of December 2014). However, there remain persistent shortages of skilled labour. English is widely spoken, but standards have declined since the 1960s. A distinguishing feature of the labour market is the large number of foreign workers: there are officially around 2m, but when illegal immigrants are included the figure is probably closer to 3m. Foreign workers, mostly unskilled, are essential to the Malaysian economy, carrying out tasks that Malaysians are unwilling to. Illegal immigration is impossible to prevent, especially from Indonesia, where there is high unemployment. The government wants to reduce the economy's reliance on foreign labour, but has provided no specific plans on how to do this without harming the country's economic expansion. Over the short-to-medium term foreign companies are likely to have to import skilled or specialist workers for their Malaysian operations, which will significantly raise production costs.



Cost of bad planning is high

The strong policy support behind OBOR may prove a weakness if Chinese actors, be they government planners, SOEs or private companies, fall into a false sense of security that government support will guarantee their success. Preliminary provincial government plans for OBOR all indicate that a very strong investment push is already under way to support the initiative through building up domestic infrastructure. The business strategies of many of these provinces' local champions are incorporating OBOR into their near-term plans to absorb output that will not be used domestically. Local banks are promising financial banking, as are provincial governments.

Sichuan's plans for OBOR provide an illustrating example of the level of provincial ambitions. It is encouraging its industrial enterprises to transfer surplus production capacity abroad, anticipating that this will, in turn, facilitate the export of equipment, raw materials and products from Sichuan. It is especially promoting contracts in electricity, construction and oil pipeline construction, with another list of products that can target these markets including around 140 categories. The president of Dongfang Electric Corporation, a state-owned manufacturer of power generators headquartered in Sichuan, has hailed OBOR for presenting a rare opportunity for Sichuan equipment to be sold abroad. Its efforts are supported by local authorities. The provincial government has committed to raising the "supporting level of credit" to help participating enterprises. It will offer training for local enterprises to apply for national funds. A three-year action plan will soon be issued, and it will probably include trade and bilateral investment targets.

The OBOR holds rich promise for Chinese companies looking to expand overseas. But if companies stumble in the markets into which they have expanded, there will be ramifications for both them and the financial institutions that have backed these efforts. Failing to assess risks appropriately may mean that the domestic preparations were wasted. OBOR is China's grand plan, but careful planning will be needed for it to succeed.



Appendix A: Operational risk methodology

Operational risk methodology

The EIU's Risk Briefing service assesses a country's overall business operating risk via our in-house operational risk model. The model provides a standard framework for the analysis provided on Risk Briefing. It quantifies the risks to business profitability in each of the countries covered by the service. In these assessments we take into account present conditions and our expectations for the coming two years.

Twenty-four additional indices, in which indicators are weighted to reflect the concerns of a range of investors covering seven industrial sectors, provide more targeted risk assessments. The operational risk model considers ten separate risk criteria:

- security
- political stability
- government effectiveness
- the legal and regulatory environment
- macroeconomic risks
- foreign trade and payments issues
- labour markets
- financial risks
- tax policy
- the standard of local infrastructure

The risk rating in each category is determined by their scores in the following sub-categories:

Overall Evaluation

Security risk

- Armed conflict
- Terrorism
- Violent demonstrations
- Hostility to foreigners/private property
- Violent crime
- Organised crime
- Kidnapping/extortion

Political stability risk

- Social unrest
- Orderly transfers
- Opposition stance



Excessive executive authority

International tensions

Government effectiveness risk

Policy formulation

Quality of bureaucracy

Excessive bureaucracy/red tape

Vested interests/cronyism

Corruption

Accountability of public officials

Human rights

Legal & regulatory risk

Fairness of judicial process

Enforceability of contracts

Speediness of judicial process

Discrimination against foreign companies

Confiscation/expropriation

Unfair competitive practices

Protection of intellectual property rights

Protection of private property

Integrity of accounting practices

Price controls

Macroeconomic risk

Exchange-rate volatility

Recession risk

Price instability

Crowding out

Interest-rate volatility

Foreign trade & payments risk

Trade embargo risk

Financial crisis

Discriminatory tariffs

Excessive protection

Capital account

Current-account convertibility

Capital controls risk

Financial risk

Devaluation risk

Depth of financing

Access to local markets



Marketable debt
Banking sector health
Stockmarket liquidity

Tax policy risk

Stable regime
Discriminatory taxes
Level of corporate taxation
Retroactive taxation

Labour market risk

Trade unions
Labour strikes
Labour laws
Skilled labour
Specialised labour
Meritocratic remuneration
Freedom of association

Infrastructure risk

Port facilities
Air transport facilities
Retail and distribution network
Telephone network
Road network
Power network
Rail network
IT infrastructure



Appendix B

The EIU's Country Risk Service provides financial institutions and companies with authoritative and trusted assessments of credit risk. It monitors emerging and developed markets on a continuous basis, with updated two-year forecasts for the economic variables that are most important for risk assessment.

Data is presented in a consistent format across all reports, making country-by-country comparisons easy.

Country Risk Service uses quantitative and qualitative indicators to assess six categories of risk.

- **Sovereign risk** This risk category assesses the risk of the sovereign or an entity guaranteed by the sovereign defaulting on its debts. Sovereign default is defined as a build-up in arrears of principal and/or interest on foreign- and/or local-currency debt owed by a government or a government-guaranteed entity. The sovereign risk rating is informed by scores for a combination of political, policy, cyclical and structural variables.
- **Currency risk** This risk category measures the risk of a devaluation against the reference currency (usually the US dollar, occasionally the euro) of 25% or more in nominal terms over the next 12-month period. The currency risk rating is informed by scores for a combination of political, policy, cyclical and structural variables.
- **Banking sector risk** This risk category gauges the risk of a systemic crisis whereby bank(s) holding 10% or more of total bank assets become insolvent and unable to discharge their obligations to depositors and/or creditors. A banking crisis is deemed to occur even if governments restore solvency through large bail-outs and/or nationalisation. A run on banks facing a temporary lack of liquidity rather than underlying solvency problems is not deemed to constitute a crisis, provided that public confidence in the banking system is quickly restored. Banking crises are typically associated with payment difficulties in the corporate or household sectors; the bursting of asset price bubbles; and currency and/or maturity mismatches. The rating can therefore serve as a proxy for the risk of a systemic crisis in the private sector. The banking sector risk rating is informed by scores for a combination of political, policy, cyclical and structural variables.
- **Political risk** This risk category evaluates a range of political factors relating to political stability and effectiveness that could affect a country's ability and/or commitment to service its debt obligations and/or cause turbulence in the foreign-exchange market. The political risk rating informs the ratings for sovereign risk, currency risk and banking sector risk.



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- **Economic structure risk** This risk category is derived from a series of macroeconomic variables of a structural rather than a cyclical nature. Consequently, the rating for economic structure risk will tend to be relatively stable, evolving in line with structural changes in the economy. The economic structure risk rating informs the ratings for sovereign risk, currency risk and banking sector risk.
- **Overall country risk** This risk rating is derived by taking a simple average of the scores for sovereign risk, currency risk and banking sector risk.



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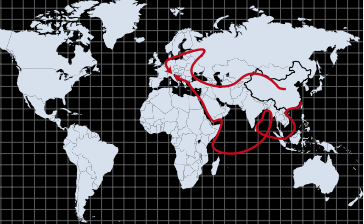
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