Beyond the Myths – Towards a Realistic Assessment of China's Belt and Road Initiative: The Development-Finance Dimension

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Chinese and Thai officials at the opening ceremony of the Chiang Rak Noi Station in Thailand, 19 December 2015. Copyright: Vichan Poti/ Pacific Press/LightRocket via Getty Images.

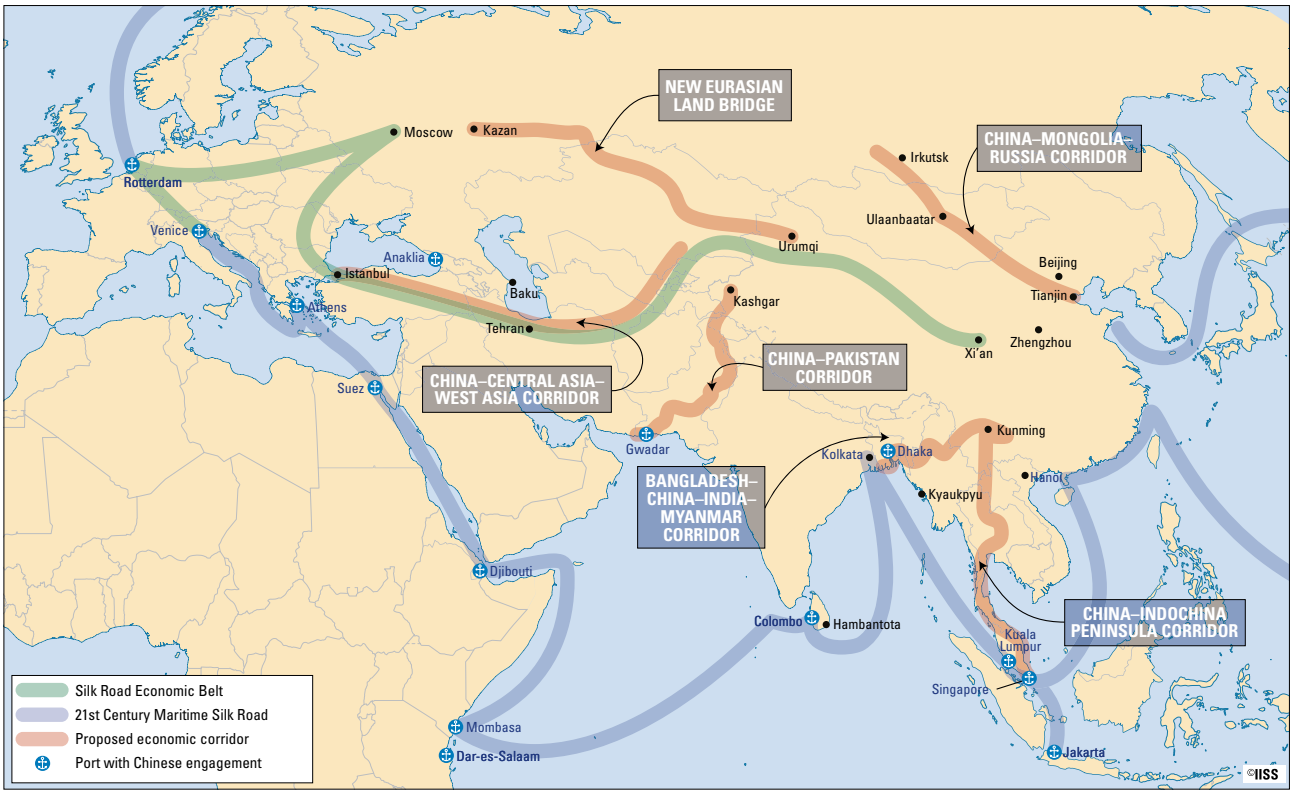
Introduction

This report is the first of two synthesising the findings of a major research workshop convened in Washington DC on 26 June 2019, by The International Institute for Strategic Studies (IISS), as part of its multi-year project on China's Belt and Road Initiative (BRI). The IISS commissioned ten papers that addressed development-finance and security issues in the BRI, prepared by leading scholars and policy practitioners. They were joined at the workshop by more than two dozen other experts on China's international behaviour. This first report focuses on development-finance issues in the BRI; the second will address security issues broadly cast.

China's Belt and Road Initiative is now six years old. Announced by (then) newly ensconced President Xi Jinping, it has since become the centrepiece of Xi's ambitious drive to make China a more active global leader, and to break free from the cautious approach set out more than 30 years earlier by then-paramount-leader Deng Xiaoping – that China's strategic approach should be to 'hide its capacities and bide its time'. At the Chinese Communist Party's (CCP) 19th Congress in 2017, the BRI was integrated into the party's charter.

Much of the early analytical work on the BRI has focused on questions surrounding China's motivations – economic or geopolitical. Is Xi's initiative a response to changing domestic economic circumstances? Or does it signal evidence of China's intent to build a twenty-first-century imperium modelled on the post-war United States-led experience, more than on European colonial or earlier Asian empires? The emerging consensus on this question is that it has been a bit of both. At the same time, an often overlooked factor is Xi's constant need to further consolidate his power inside China, as the economics versus geopolitics debate about the motivations for the BRI gives too little attention to the more purely political dimension. The BRI cannot be

Map 0.1: **The Belt and Road Initiative**



Sources: IISS; Mercator Institute for Chinese Studies, merics.org; Asian Infrastructure Investment Bank, aiib.org

separated from Xi's efforts to cast himself domestically as an exceptional leader for an exceptional moment in China's history.

Encompassing some 125 countries, the BRI aspires to improve the economic prospects of more than two-thirds of the world's population.[1] China has pledged to spend US$1 trillion over the coming decades, which it believes will leverage up to US$8trn in development finance from other sources, both private and public.[2] The geographical scope of China's BRI is critically important to the future of the world. In a circle of roughly 6.4 thousand kilometres' diameter around Shanghai lives 50% of the world's population. Asia will generate a large majority of the next 40 years' GDP growth.[3] Most of the world's known hydrocarbon reserves are located in Asia, Eurasia and West Asia.

The BRI attempts to universalise China's own development experience

Initially, the BRI found an enthusiastic audience among its prospective recipient countries. Firstly, owing to the enormous infrastructure needs of the BRI geographies. Secondly, due to Xi's casting of the BRI in a multilateral narrative that emphasised China's contribution to expanding the purview of globalisation and, in particular, the creation of key infrastructure to promote connectivity between Asia and the Middle East and Europe. For the low-income and developing economies in the BRI geographies – which stretch from Southeast Asia to South and Central Asia; to the Middle East and Africa; and to Eastern and Central Europe – China's focus on hard infrastructure was welcome given the turn away from such projects by the multilateral development banks and Western state and non-state donors, and the fact that Chinese projects did not come with sensitive conditions around governance and policy.

The BRI has evolved considerably in the six years of its existence. As Xi's agenda became increasingly nationalistic, so did the BRI. While the BRI is still cast in terms of expanding the scale and scope of globalisation, it is now much more of a China-centric version of that aspiration, especially in Southeast, Central and West Asia. Concordantly, in the past two years, there have been growing concerns along populist and nationalist lines within several BRI countries – that the terms of their deals with China provide too many of the benefits to China while the recipients bear the brunt of the risks. Several countries pushed back against the terms of BRI projects, while more broadly issues were being raised about debt sustainability.

The myths about the BRI

Two competing myths have framed the perception of the BRI. China tends to portray the initiative with an overarching triumphant tone. Extolled by Xi as the 'project of the century', the BRI marks both the culmination of China's reform-era achievements and the beginning of a more proactive approach to global affairs.[4] In the official Chinese narrative, the BRI is envisioned as a purely economic project for enhanced connectivity and an extensive web of future trade routes.[5] Chinese officials are eager to emphasise the 'win–win' philosophy as the upholding pillar in the BRI's conception.[6] In doing so, China intends to present its strategic arrival to the global stage as non-threatening and an opportunity for the developing world.

As a transcontinental infrastructure programme, the BRI attempts to universalise the success of China's own development experience. Beijing positions the BRI in stark contrast to the United States' current 'America First' posture. The Chinese leadership has labelled the initiative as an extension of the 'Chinese Dream' and as an integral part of China's 'national rejuvenation', both of which provide legitimacy to Xi's incumbent administration.[7] Internationally, China advocates the BRI as the antithesis of populist-driven politics; as its abjuration of zero-sum competition; and, in Xi's own words, as an initiative that 'delivered benefits well beyond [China's] borders'.[8]

Against China's narrative, Western critics – those who are already suspicious of China's new assertive foreign-policy direction – see China's overseas infrastructure push as a manifestation of Beijing's ever-expanding global ambitions under the Xi administration. Many have sounded the alarm about the BRI being an economic scheme that would ultimately enable China to gain strategic assets. Serving as the linchpin for BRI criticisms is the notion of 'debt-trap

diplomacy', a phrase coined by the Indian scholar Brahma Chellaney.[9] Through purposefully extending loans to debt-ridden states, Beijing would convert economic and financial dominance into political leverage, forcing vulnerable partners to hand over strategically valuable concessions such as land, ports and natural resources. The transfer to Chinese ownership of the Hambantota port, after the Sri Lankan government was overburdened by Chinese debts, has been widely considered by BRI critics as a cautionary tale of the BRI's damage to the sovereignty of recipient countries, and of Beijing's geopolitical ambition that thrives on other states' financial distress.

For the US and some of its key allies, the BRI also embodies China's desire to alter the security status quo in strategically important regions. The potential for China to turn dual-use strategic ports – primarily the facilities at Hambantota, Gwadar (Pakistan) and Kyaukpyu (Myanmar) – into military assets has given rise to the concern over an expansion of Chinese military capacity in the Indian Ocean and the South China Sea.[10] Six years into the BRI's development, China's geopolitical contenders have held onto the belief that under the guise of a win–win framework and infrastructure connectivity, China seeks to establish its own economic and strategic spheres of influence that will stealthily undermine the world system built and maintained by the US since the Second World War. Echoing this critical standpoint, US Vice President Mike Pence characterised the BRI as a 'constricting belt or a one-way road'.[11] There has also been an increasing focus in Washington on the vulnerabilities that both countries and companies might face should China be able to turn its Digital Silk Road activities into a dominating influence over the information and communications technology sectors in recipient nations.[12] While other global financial powers were less outspokenly critical than Washington, they did develop a broad consensus that International Monetary Fund (IMF) resources should not be used to 'bail out' Chinese companies and investments in the context of failing BRI projects.[13]

With pressures building and uncertainties persisting on several fronts, data from official Chinese sources indicates that the pace of BRI project initiation slowed considerably in 2018, amid signs that Beijing was rethinking its approach to the BRI.[14] In response to these developments, at the Second Belt and Road Forum for International Cooperation in Beijing in April 2019, Xi himself dropped much of the triumphalist rhetoric that had marked the first summit in 2017 and has nevertheless continued to dominate domestic reporting on the BRI. Just two weeks before the second summit, China and Malaysia had agreed to restructure the financing of the East Coast Rail Link project that lowered its cost to Malaysia by roughly 30%.[15] This gave credibility to Xi's remarks at the summit emphasising greater flexibility, an increased focus on financial sustainability and the need to create more balance between China and recipient countries.

Were Xi's gestures intended primarily as damage control on the international stage, or did they signal a meaningful shift in Beijing's approach? This is the overarching question that this report hopes to illuminate. It begins with an exploration of the drivers behind the BRI, and how they have evolved, emphasising Beijing's efforts to recreate outside China the virtuous cycle centred on infrastructure investment, which has been at the core of China's extraordinary growth over the past three decades. The discussion then turns to the increasing concern with debt issues, but highlights China's vulnerability as a creditor as well as the concerns with debt sustainability in BRI recipient countries. Finally, it turns to the domestic politics that will shape Beijing's choices over the next several years.

1. China's Outbound Official Finance and the Virtuous Cycle of Infrastructure

Development finance and China's 'outward' policy

China's global development footprint has expanded significantly over the past decade. Between 2000 and 2014, official Chinese outbound investments reached US$354 billion, as indicated by AidData.[16] Since 2014, the implementation of key BRI projects has undoubtedly increased the flow of Chinese development finance to recipient countries. However, there has been a fog of opacity around these flows, and it is not clear that China has put in place a system to monitor the aggregation of BRI development finance, let alone its oversight and integration.

Three propositions – not necessarily mutually inconsistent – regarding the broad motives in China's overseas investments have emerged from the growing volume of research on this topic. The BRI seems to embody each of these. The first proposition is that China primarily focuses on economic benefits in the form of loan-induced interest payments, the extraction of natural resources and commercial exchanges.[17] At the same time, China needs overseas markets, in part to alleviate its domestic investment fatigue, which has led to declining capital productivity. To this end, China has sought public investments in countries with 'high-value market opportunities', especially in the rapidly developing Southeast Asia region. Through outbound investments and lending, China gains preferential treatment in the bilateral trade and commercial relationships with these countries.[18]

The second proposition argues that strategic interests can take precedence when China employs its concessional development finance to achieve its security and foreign-policy goals. In this regard, Beijing has a track record of exchanging financial generosity for votes in the United Nations. Meanwhile, state-backed financial instruments have been a crucial catalyst in gaining international support for Beijing's core interests, the prominent examples of which include endorsement for the 'One China' policy, turning a blind eye to China's expansion in the South China Sea, as well as the acceptance of China's policies on Tibet and Xinjiang.[19]

The third proposition maintains that China uses its financial assistance to give impetus to its overseas public diplomacy or 'soft power' campaigns, with the goal of fostering an international profile that is strong, yet benign and unthreatening. Although China's international image has shifted towards one of increasing assertiveness and strength since Xi came to power, Beijing's financial assistance remains central to its efforts in shaping a positive global perception of China. Ongoing Chinese investment programmes in foreign countries are interwoven with the building of a 'community of shared future for mankind', a concept coined and advocated by the Chinese government.[20]

Specific rationales behind the Belt and Road Initiative

Big infrastructure-investment programmes have generally had a strategic as well as an economic and financial purpose and impact. The Marshall Plan of the late 1940s and early 1950s, of course, is paradigmatic in this regard. China has assiduously avoided describing the BRI in strategic terms, beyond setting out a very substantial marker on the world stage. It has especially objected to any comparisons of the BRI with the 'imperialistic' Marshall Plan.[21] Nevertheless, for Beijing, it appears that there were three particular strategic goals in initiating the BRI.

The first was domestically driven: to create a more energetic growth environment in South and Central Asia that would synergise with economic development and stability in western China, a long-standing challenge for Beijing. For this reason, Pakistan became the most important partner state in the BRI, by providing an alternative northern pathway linking China's west and its western neighbours to key global sea lanes, especially through the port facilities at Gwadar.

The second was to create a mechanism that would facilitate China's global economic footprint expanding

beyond trade and direct investment, to international finance and global rule- and norm-setting. On the finance side, the aim has been to broaden the global role of China's currency, the renminbi (RMB). While China is a manufacturing and trade leviathan, it continues to punch below its weight as a global financial force, despite symbolic gains such as the RMB being included within the IMF's basket of currencies that comprise the Special Drawing Right, a global reserve asset. On the rule- and norm-setting side is the newest element of the BRI — the Digital Silk Road — which aims to construct communication networks across the developing world. China is looking to both build digital infrastructure and export e-commerce models to countries participating in the BRI.[22] These technologies are designed to supplement the Belt and Road's physical infrastructure while introducing common technical standards in participating nations, most of which lack rudimentary internet facilities.[23]

The third was to rebalance China's regional footprint – which had been focused eastward and southward – to include a substantial western dimension. This 'Go West' element was partially in response to the US 'tilt to Asia', initiated by then-president Barack Obama. The original geopolitics of the BRI was not designed to confront the United States, but to build up China's economic strength and strategic influence without generating conflict with Washington, by focusing opportunistically on areas perceived as of limited or declining importance to the US. This key strategic notion was famously elucidated by Professor Wang Jisi of Peking University in 2012, in an article that called for China's 'marching west,' in the face of the United States' 'rebalance' towards Asia.[24] In expanding its strategic focus to include continental Eurasia, China would be in a good position to increase its influence in resource-rich Central Asia; strengthen political stability in its western region; and cultivate good relationships with neighbouring countries that would, in turn, be naturally more aligned with China's core national interests.

As stated above, the BRI embodies each of the three general themes present in Chinese overseas investments. With regard to economic benefits, at the heart of the BRI is a continuation of the Going Out policy introduced in the late 1990s, when Beijing started to stockpile a massive current-account surplus and extensive foreign-exchange reserves, and sought effective strategies to spend its newly acquired capital.[25] The BRI follows the guiding principles of the Going Out policy, which encouraged Chinese companies to expand their presence in overseas markets, establish brand names, secure access to valuable resources and export practices that have proved successful in China's own development.[26]

Through building overseas hard infrastructure, the BRI would in theory help create new market demand for heavy industries in China – sectors that have long been dominated by state-owned enterprises (SOEs) and are struggling with excess capacity.[27] Some analysts have thus characterised the BRI as a 'new stimulus package in disguise', because the initiative allows the Chinese leadership to continue with its investment-driven development model and to postpone meaningful efforts of economic restructuring.[28]

The original geopolitics of the BRI was not to confront the United States

The BRI is also envisaged as helping Beijing circumvent the 'middle-income trap' without having to relinquish its control over state capitalism.[29] With the goal of moving up the global supply chain, Beijing is trying to generate a BRI-based economic network that is more dependent on China's input. If successful, the BRI – with its focus on critical infrastructure and enhanced trade flow – could kick-start the establishment of a China-centric supply system that fosters Chinese 'national champions', which would be competitive in industries now dominated by developed countries.[30] Moreover, the predominance of commercial and semi-commercial terms in the BRI's lending packages reflects Beijing's expectation that it would secure economic returns from its BRI investments. Unlike the financing of the Marshall Plan, which was at least 90% grant, BRI financial flows are largely based on interest-bearing loans.

In terms of leverage for achieving security goals, China has sought to link said BRI loans to the acceptance of Beijing's position in the South China Sea.[31] The Chinese ambassador to Vanuatu once openly expressed that BRI partners in the Pacific region were expected to stand with Beijing in the UN's collective

decision-making process.[32] This approach has had mixed results, and China has been much less ambitious around such transactional diplomacy with larger countries such as Malaysia and Indonesia. China has even had some success with Europe, with Greece having blocked European Union joint statements that would criticise Beijing's policies.[33]

The BRI is also valuable as a 'soft power' instrument. In this regard, the Chinese government has been employing the initiative to promote a positive image for its increased role in global governance, particularly as a successful model of economic development. Current public-diplomacy efforts around the BRI are consistent with China's earlier focus on nurturing the notion of a peaceful rise. With the BRI, China intends to present its economic prowess as a source of growth that is compatible with global development needs, while lessening the perceived threats resulting from tensions in the military and security domains. Beijing seeks to utilise the BRI platform to expand its engagement in global governance, through the concept of a 'community of shared future for mankind', with which China presents its own vision of future globalisation and offers a solution to today's transnational challenges.[34] Meanwhile, Beijing's BRI rhetoric emphasises features such as people-to-people ties and cultural exchanges as a way of winning the hearts and minds of foreign societies.[35]

A virtuous cycle built on infrastructure

At the core of the BRI as a strategy to promote accelerated economic development is an effort by China to replicate the role that infrastructure investment played domestically in recent decades. Chinese leaders subscribe to a virtuous cycle view of infrastructure development: the notion that progress made in infrastructure generates positive multiplier effects on economic growth and social stability. In this view, China's enormous investments in roads, bridges, railways, telecommunications and, more broadly, urbanisation were decisive in the country's economic success in recent decades, enabling higher productivity and the ability to provide basic social services.

With continued government support, China's investment in domestic infrastructure accounted for close to 30% of the country's total investment in 2017, even though the pace of urbanisation had begun to slow substantially.[36] On average, the country has spent 8.5% of its annual GDP on infrastructure since 1992.[37] As China deepened its connection with the global economy, deliberate spending on infrastructure served to anchor China's growth during financial crises and times of looming uncertainty. Examples of targeted infrastructure investments include the stimulus packages injected in the aftermaths of the 1997–98 Asian financial crisis[38] and the 2008 global financial crisis, respectively. The current trade war with the US and projected economic downturn has prompted Chinese leaders to turn back to infrastructure spending, hoping that the sector can help boost domestic demand for commodities, create new jobs and ultimately strengthen the economic outlook.[39]

Considering China's meteoric transformation into an economic powerhouse and its growth model driven by infrastructure investment, the Chinese leadership's inclination to apply its infrastructure-centric model externally should come as no surprise. There have been numerous virtuous-cycle theories in international development since the end of the Second World War. Ironically, perhaps the most similar to Chinese thinking in the BRI was the model found in Walt Rostow's *Stages of Economic Growth*, a 1960s US version that highlighted the need for extensive foreign aid in the 'take-off stage' in order for countries to achieve 'self-sustaining growth'.[40]

In the early 2000s, a growing number of African countries became disenchanted with their relations with the world's principal development-finance agencies who, under pressure from environmentalists and proponents of health- and education-based development strategies, had shifted away from infrastructure. Amid the retreat of traditional development players, China chose the continent to test its Going Out policy with a focus on infrastructure.[41] Starting with Africa, this policy enabled Chinese companies to engage in outbound investments with explicit official endorsement, at a time when Beijing's current-account surplus and foreign-exchange reserves grew rapidly at home. It was during this period that Chinese lending became increasingly less concessional, as the state sought to employ a number of financial instruments to secure increased economic returns from the assistance it provided to the developing world.[42]

Figure 1.1: **The Theory of the Infrastructure Virtuous Cycle**

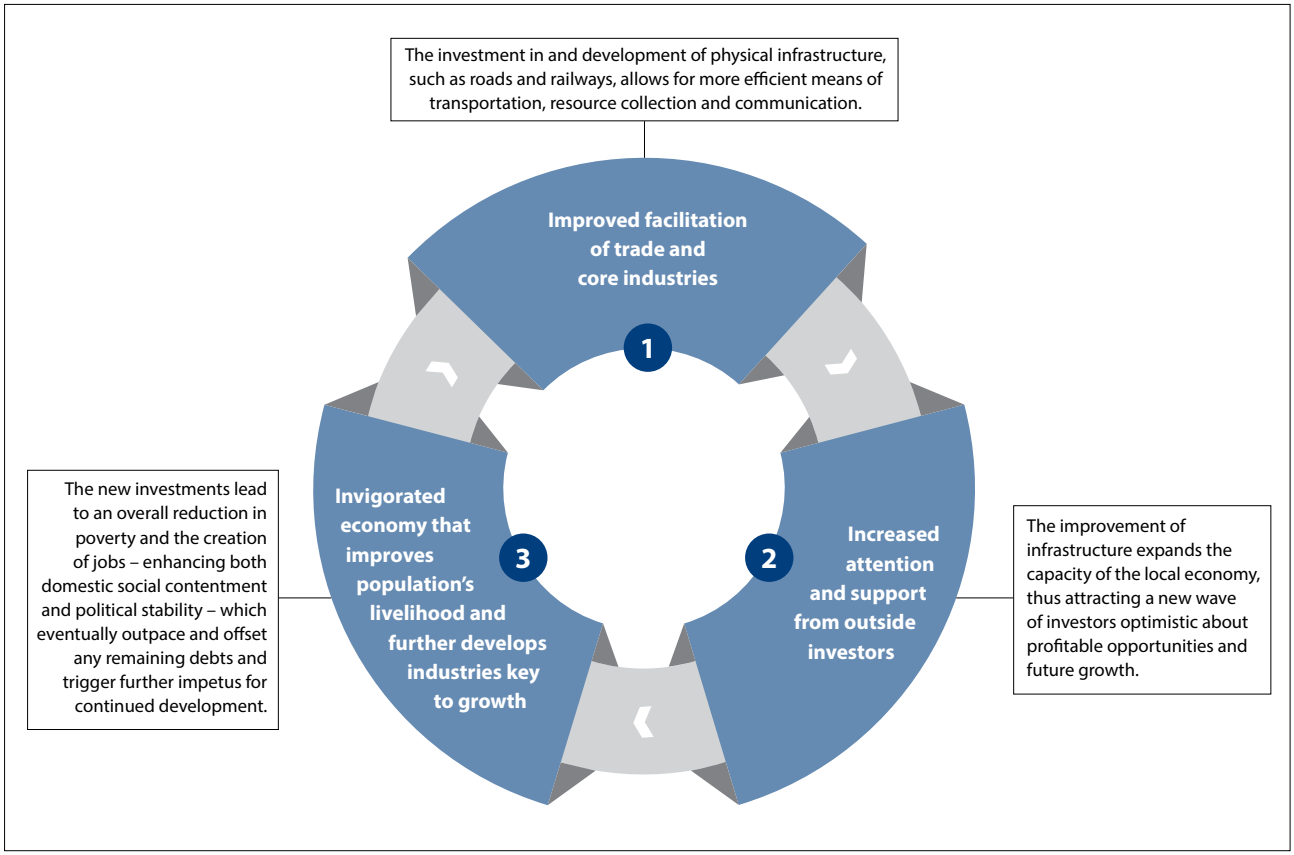


Figure 1.2: **China's Doctrine of the Virtuous Cycle in a Domestic Context**

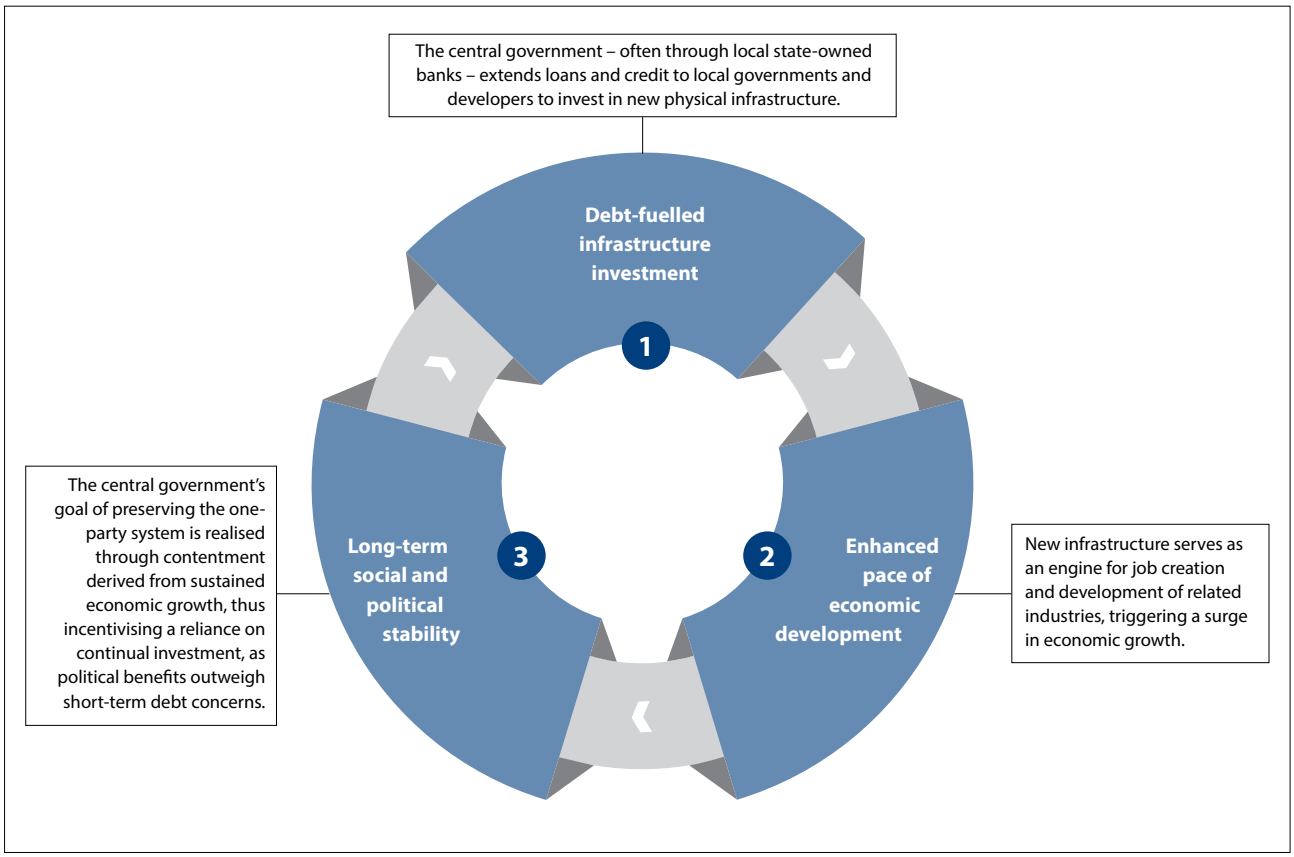
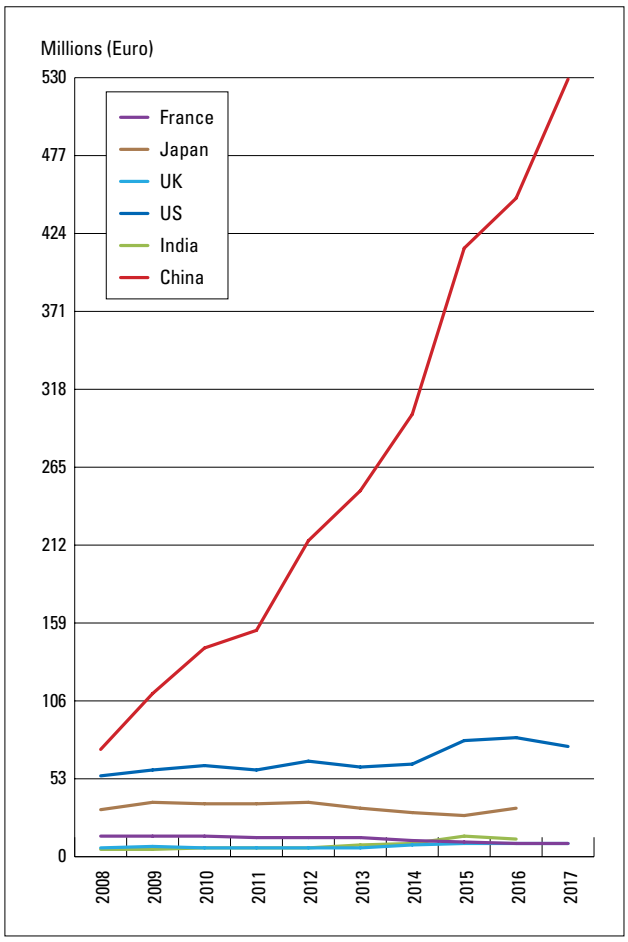
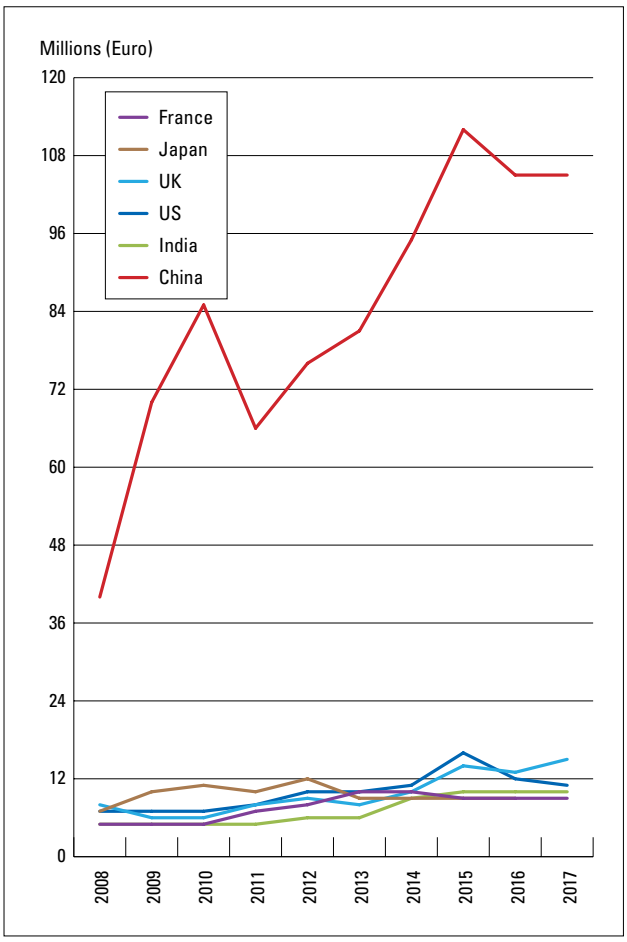


Figure 1.3: **Six-Country Comparison of Domestic Road-Infrastructure Investment, 2008–17**



Source: Organisation for Economic Co-operation and Development

Figure 1.4: **Six-Country Comparison of Domestic Rail-Infrastructure Investment, 2008–17**



Source: Organisation for Economic Co-operation and Development

In formulating its approach to early outbound investments, China took a leaf from the books of Japan and of Western countries who actively lent to China and received natural resources as payment in the 1980s.[43] These early deals highlighted targeted investments in infrastructure and resource-extraction projects. As the recipient country, China agreed to deferred-payment arrangements, frequently in the form of natural resources and goods manufactured using newly acquired equipment and skills.[44] For Beijing, early experiences as an aid recipient shed light on how mutual benefits can be achieved among countries at different developmental stages.[45]

The 2008 global financial crisis left the world without sufficient and viable funding for infrastructure development. At the same time, the domestic demand for China's now extensive private enterprises and SOEs involved in infrastructure was plateauing and soon to decline. In this context, capital provided through the BRI fits squarely into the developing world's demands for 'patient' long-term financing, while at the same time creating an outlet for utilising China's extensive industrial base in infrastructure. Moreover, Chinese lending without governance conditionality appeals strongly to the leaders of developing countries.

2. New BRI Debt Dynamics

Beijing's lack of serious concern for debt

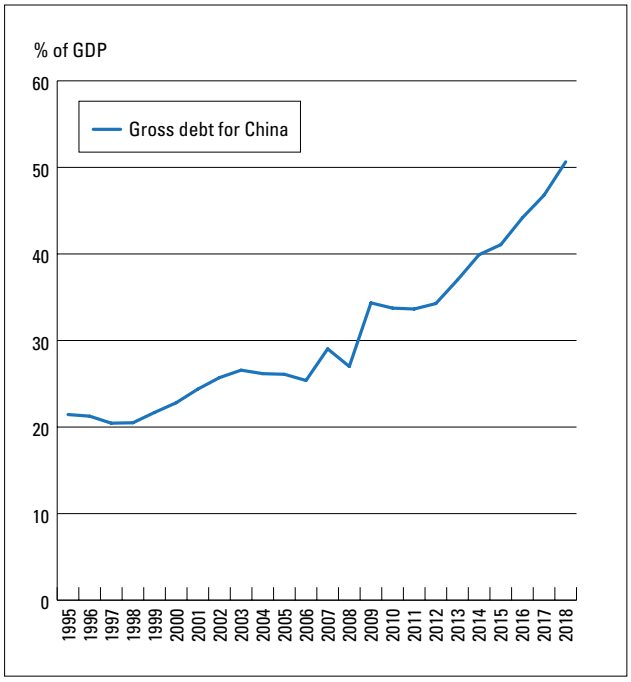
In filling the infrastructure gap, the Chinese government has emerged as the largest official creditor to the developing world, holding more debt than all other leading government creditors combined.[46] By 2018, the amount of debt owed by the entire world to China had amounted to more than US$5trn, a number that was about 6% of the world's combined GDP and had ballooned from around US$500bn in the early 2000s.[47]

While China's own positive experience with domestic-infrastructure development informed its approach to the BRI, implementing the initiative in an ambitiously diverse set of international contexts has proven to be a difficult task. Unlike the domestic context, where strong political incentives to deliver sustained economic growth prevail at all levels, international contexts are often rife with unpredictable factors that leave limited flexibility for China and BRI projects to manoeuvre. The BRI has increasingly found itself being subject to changing local politics; the current leaders in Malaysia, the Maldives and Pakistan all secured election victories with campaign rhetoric that either acknowledged or criticised BRI-induced mounting debt.[48]

When Beijing endorsed heavy investments in domestic infrastructure, debt was not a priority cause for concern. The central government believed – as the virtuous cycle indicates – that in due course the positive multiplier effects of infrastructure investments would eventually outgrow short-term deficits. When China implemented its stimulus package in response to the 2008 financial crisis, a high tolerance of excessive lending was a sign of the government's confidence in its ability to service debt.[49] Nevertheless, from the perspective of 2019, with China suffering from an extraordinarily high debt-to-GDP ratio and the consequent ongoing years-long struggle to re-establish financial stability, the lack of concern over domestic debt looks ill considered.

Not surprisingly, a similar lack of serious attention to debt was evident in the conceptualisation of the BRI. Six years into the initiative, debt unsustainability has

Figure 2.1: **China's Government Debt as a Percentage of GDP, 1995–2018**



Source: Federal Reserve Bank of St. Louis

resulted in a systemic payment challenge looming on the horizon. Only this time, the risks would affect a wide array of different countries, including China itself, and they are situated in contexts that have attracted greater international scrutiny. The reality is that infrastructure development in countries with weak institutions and substantial corruption is difficult, and demands greater planning and longer timelines. The emergence of difficult debt dynamics in at least eight BRI countries has substantial parallels to the African debt crisis in the 1980s, which was a function of the unintended consequences of a sharp increase in lending in difficult development circumstances, rather than an intentional effort by creditors to weaken debtors.

The financing of BRI projects was virtually destined to become a source of debt distress. In contrast to the norms established by the wealthier countries in the Organisation for Economic Co-operation and Development (OECD) – which seeks to ensure that public lending for investments in poor countries

predominantly takes the form of foreign aid grants or highly concessional loans whose terms are transparent – China has retained a model of commercial or semi-commercial public lending, in which the terms are not made public and are significantly less concessional in nature. In the BRI and in general, the vast majority of outgoing Chinese capital is issued in the form of loans by state-run policy banks.[50] The bulk of the BRI loans features terms that are typical of commercial lending deals made with Beijing.[51] Statistics suggest that between 2000 and 2017, more than half of Chinese public development-finance lending was on fully commercial terms, while only 15% of the lending contained genuinely concessional terms.[52]

Rising debt distress in BRI countries

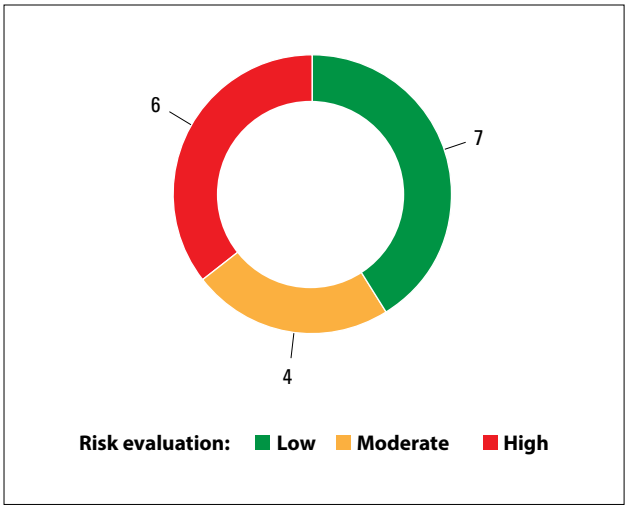
A particularly worrisome aspect of Beijing's growing role as a global creditor is its extensive lending to low-income countries that are already facing debt distress to varying degrees. Eventually, serious debt concerns could threaten to limit BRI recipient countries' capacity to keep absorbing Chinese lending, even if it is at much more concessional terms. China could face the alternatives of being forced to either accept substantial write-offs of debt owed to it, or face the need for extensive and extended 'defensive' lending to enable repayment.

Based on sovereign-debt portfolios, a 2018 study by the Center for Global Development on the BRI's debt problem identifies 23 countries to be at a high risk of debt distress.[53] If the projected growth impact of the BRI is taken into account, the analysis concludes that eight countries – Djibouti, Kyrgyzstan, Laos, the Maldives, Mongolia, Montenegro, Pakistan and Tajikistan – have displayed severe vulnerability to continued Chinese lending.[54] Further country-level analyses reveal that a large proportion of global external debt is owed to China, a pattern shared by all of the eight countries. Developments since the arrival of the BRI are particularly concerning – in just a few years, the pronounced debt surge seen in the eight countries has surpassed a sustainable degree both in terms of rate and scale, predominantly as a result of the financing of incoming Chinese projects.[55]

The Kunming–Vientiane Railway in Laos illustrates these risks. To date, the US$5.95bn project has resulted in a financial burden of more than US$700 million for the Laotian government. According to the joint-venture arrangement, Laos is responsible for 30% of the project financing – a US$1.78bn financing obligation for which the government thus far has resourced less than half, and as much as US$465m of that sum was financed through concessional loans from China.[56] The situation leaves Laos US$1.1bn short of fulfilling its part in this bilateral railway deal, a gap that is equivalent to 6% of the country's overall GDP, and with accruing external debt owed to China as the project proceeds.[57]

While, in theory, enhanced economic growth could potentially ameliorate existing debt risks, a recent World Bank study has pointed to the often exaggerated estimate of such growth benefits.[58] By factoring in expected economic pay-offs into the equation, the bank's analysis seeks to understand whether BRI-induced debt would be balanced out as growth starts to accelerate in recipient countries as a result of improved infrastructure conditions. Findings distilled from the study's economic and fiscal models suggest that, over the medium term, debt vulnerability is nonetheless expected to worsen in 12 of the 43 examined recipient countries – indicating a 28% deterioration rate.[59] Of the 30 BRI recipient countries considered under the long-term metric, 11 are expected to experience more severe indebtedness, even if the BRI's forecasted economic growth is achieved.[60] It is questionable, therefore, that the BRI's promised inclusive economic growth will deliver sufficient

Figure 2.2: **Debt Risks in Selected Low-Income Countries, Pre-BRI Investments**



Source: World Bank

Figure 2.3: **External Debt to China (Debt Stock as Share of GDP) – Top 50 Recipients**

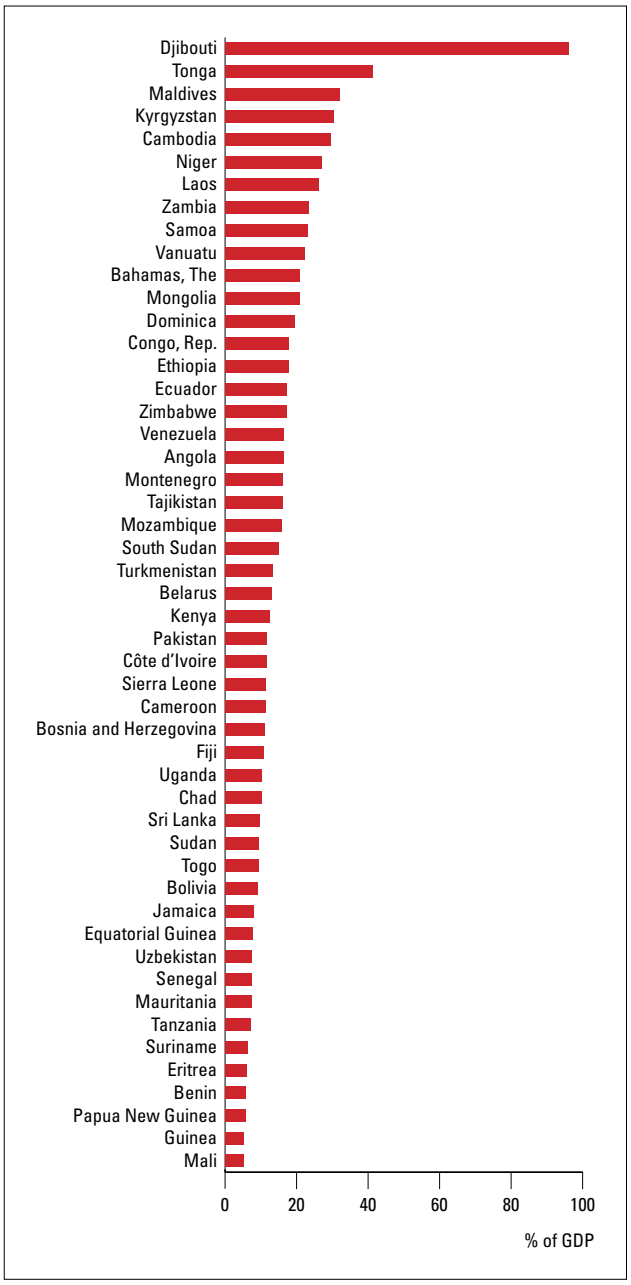
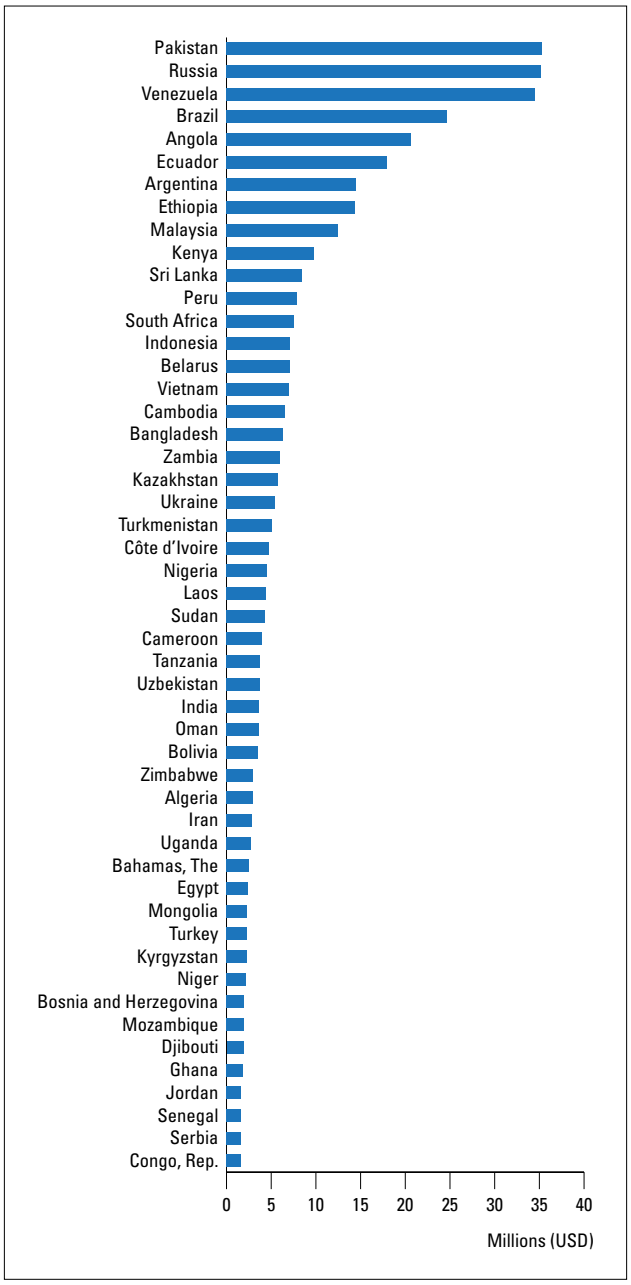


Figure 2.4: **Absolute Value of Debt to China – Top 50 Recipients**



Source: Kiel Institute

benefits to offset pronounced debt vulnerabilities that have emerged in some of the world's poorest countries.

The study suggests that as many as one-third of the low-income developing countries receiving BRI investments were already struggling with high risks of debt distress, even before obtaining loans issued by China.[61] Over the past decade, numerous low-income developing countries have increased their exposure to non-concessional loans. On a global scale, the percentage share of low-income developing countries at high risk of debt have doubled since 2013.[62] This is principally because without sufficient official development aid from traditional donors, these countries have deepened their reliance on bonds and financing provided by 'non-Paris Club official creditors', especially China.[63]

Should the economic benefits generated by the BRI not outpace the initiative's cost to recipient countries, over time the BRI could very well exacerbate existing debt vulnerabilities more broadly. In this case, the potential economic and political costs for both China and the BRI countries to retain the financing arrangements in the BRI agreements would be too exorbitant

to bear. The scenarios derived from the World Bank study call into question the fundamental feasibility of the BRI being able to re-enact China's virtuous cycle, and its related impact on stability in different overseas settings.

A recent study from the Kiel Institute argues that the actual debt dynamics born of China's aggressive official lending are substantially worse than has previously been recognised.[64] Widespread under-reporting on lending and the scarcity of official information have obscured the degree of debt vulnerability (to both creditors and debtors) linked to Chinese loans. In an effort to enhance the understanding of the world's aggregate indebtedness to China, the study suggests that as much as 50% of Chinese lending is absent from the World Bank's officially reported debt statistics.[65] Additionally, the total debt burden accrued among the top 50 recipient countries of Chinese financing is equivalent to 16–17% of their GDP in 2016, with close to half of the debt being under-reported.[66] In aggregate, China owns more than 40% of these 50 countries' external debt, and the amount of 'hidden' Chinese financing to developing countries has amounted to over US$200bn, in 2016, and possibly more since.

As much as 50% of Chinese lending is absent from officially reported debt statistics

The authors of the Kiel Institute study argue that the surge of China's overseas lending over the past decade bears a resemblance to the global syndicated loan boom in the 1970s, which created heavy debt loads on low-income developing countries and resulted in a flurry of financial crises accompanied by substantial sovereign defaults.[67] In that earlier lending boom, major recipients were the developing and resource-rich countries that previously had limited access to international capital. Similar to the motives behind the BRI, a key underlying rationale for the rise in sovereign-debt service in the 1970s was developing countries' need to build infrastructure. If the Kiel Institute's findings hold, the current debt loads resulting from China's overseas lending spree would coincide with the debt level that had led up to the last global debt crisis.

Facing debt: a more flexible Beijing on the defensive

After a period of mounting pushback against the BRI, there is evidence suggesting that Beijing is increasingly attuned to recipient countries' debt concerns and the long-term financial viability of the BRI as a whole. China has demonstrated considerable flexibility in a series of new negotiations focused on modifying financing terms to lessen the debt burdens on BRI recipient countries. Beijing's willingness to revise BRI contracts is manifest in the high-profile renegotiation of the 644 km East Coast Rail Link, a centrepiece of China's infrastructure push in Malaysia. Having cast himself as a vigorous critic of the BRI deals established under his predecessor's mandate, Prime Minister Mahathir Mohamad vowed to repeal what he referred to as 'unequal treaties' signed with Beijing, stating that the BRI could develop into 'a new version of colonialism'.[68] Mahathir's government terminated some minor oil- and gas-pipeline projects, and threatened to cancel the flagship railway project that could bring an insurmountable level of sovereign debt.[69]

As Malaysia's resistance to the BRI gained traction, China formulated offerings characterised by more generous financing terms in order to break the stalemate. Just two weeks before the second BRI forum, Beijing accommodated Kuala Lumpur through the very public signing of a supplementary agreement, 'which covers the engineering, procurement, construction and commissioning … aspects' of the East Coast Rail Link project.[70] According to details on Beijing's new concessions, the cost of the railway's first two phases would be reduced from US$15.9bn to US$10.6bn.[71] Rather than monopolising the project's implementation, the state-owned China Communications Construction Company would work alongside Malaysia Rail Link under a 50–50 joint-venture framework, and local workers would account for 70% of the jobs created by the project.[72] Furthermore, China would undertake a greater responsibility in financing the project in the form of an advance payment, which significantly curtails the number of loans extended by China's Export–Import (Exim) Bank.[73] With these new concessional terms in place, the debt burden on Malaysia is substantially reduced.

Three messages have been delivered to BRI stakeholders from Beijing's open acknowledgement of the bilateral talks centred on the East Coast Rail Link project. Firstly, the intentional publicity signalled Beijing's flexibility with regard to adjusting existing BRI projects. Although China has a track record of agreeing to refinancing, deferred payment and outright debt forgiveness, the Chinese government had not allowed prior setbacks to be even implicitly acknowledged in the public domain.[74] In contrast, the resumption of the railway project is being highlighted by China's state media as an exemplar of 'hardships and challenges overcome by the positive mindset and constructive vision in a BRI partnership'.[75] Secondly, the announcement of the renegotiation in the days leading up to the second Belt and Road Forum (BRF) revealed Beijing's worry that the conference might not be successful. Eventually, Mahathir at the conference pledged full support for the BRI and highlighted the rail project's successful renegotiation as vital progress for both China and Malaysia. Finally, it is clear that Beijing hopes to use a successful renegotiation with a key BRI recipient country to renew the positive expectations for the BRI.

Thus far, China has not been able to deliver the BRI's original vision – a genuinely multilateral endeavour that is not driven solely by Beijing's ambition – and this has damaged the initiative's reputation. In demonstrating its flexibility, Beijing intends to reinvigorate enthusiasm for the BRI and give momentum to the initiative's next phase of development. For President Xi, however, flexibility with China's debtors in the name of debt sustainability clashes with the goal of domestic financial sustainability.

3. Tensions at Home: Domestic Factors and their Potential Impact on the BRI's Financial Sustainability

The domestic politics of BRI finance

Central to Beijing's 2019 successful renegotiation with Malaysia was its financial flexibility to lighten Kuala Lumpur's debt burden. However, generalising this approach would create greater financial pressure on China, since the lender is expected to give more and receive less. Therefore, it is questionable as to whether Beijing would be able to apply the strategy used in the Malaysia case on a consistent basis in the revamping of the BRI. Several factors in China's domestic settings – persistent risks in the financial system, an economic slowdown and the potential dollar deficit – could severely constrain China's ability to engage in extensive renegotiations with a growing number of BRI countries. Each of these factors could introduce a new focus on China's own profitability and sustainability into Beijing's BRI calculation, effectively limiting future spending options, and creating complicated trade-offs between domestic expenditure, restructuring loans and new project investments.

In this context, there would be a direct trade-off between debt sustainability for recipients and financial sustainability for Beijing's approach to the BRI, which envisions multiple decades of continuing supply of capital under a mutually viable framework. At the same time, two other factors – industrial overcapacity and the overreach of the state sector in the BRI – counterbalance Beijing's incentives to spend more selectively and, if strong enough, would diminish the sustainability trade-off between the debtors and the creditor.

Risks in the domestic financial sector

The strength and stability in China's financial system are critical for, and in turn subject to, successful outcomes for the BRI. As discussed, the lion's share of the BRI's financing has been sourced from a consortium of Chinese state-owned financial institutions. The group includes four powerful state-owned commercial banks, China's two policy banks – the Export–Import Bank of China and China Development Bank – and the US$40bn Silk Road Fund.[76] World Bank statistics show that, through 2018, Beijing had made a cumulative commitment of no less than US$575bn to overseas-infrastructure investment in the BRI.[77] This massive volume of outbound investments makes the BRI vulnerable to risks existing within China's domestic financial sector.

The surge in China's overseas lending was coincident with increasing instability in the Chinese financial system. In less than 20 years, the Chinese banking system's total asset value increased from a meagre US$1.7trn to US$38.4trn, far surpassing the US$17.4trn asset value of US commercial banks.[78] But the legacy of Beijing's RMB4trn (around US$586bn) stimulus package introduced after the 2008 financial crisis has created far-reaching repercussions: extensive credit creation and lending during the recession incurred a dangerous level of financial liabilities that have proved difficult to resolve. In the banking system, the proliferation of non-deposit funding, shadow finance and regulatory arbitrage have resulted in a growing array of underlying risks that, if left unchecked, may eventually threaten to deeply impair China's economy.[79]

Chinese financial regulators have started to rein in these risks by embarking on a deleveraging campaign. Their efforts to tighten regulations often generate considerable fluctuations in the market, and come in conflict with entrenched interests and China's long-standing bias towards short-term growth maximisation. In 2019, the government's high-profile takeover of Baoshang Bank over the latter's misappropriation of funds, and the subsequent partial acquisition of the Bank of Jinzhou, which struggled with liquidity issues, led to concerns over the future of small financial institutions and exposed the fragility of China's financial sector.[80] Most observers believe that China has entered a prolonged period of financial stress and uncertainty

following years of unbridled lending in the interest of boosting the economy.

Financial instability in the domestic setting is a factor that constrains China's ability to fund the BRI in the same open-handed manner that it has for the past six years. In this context, leading financial institutions in China are likely incentivised to focus more on the domestic-sustainability and debt-payment issues in the BRI and to curtail the amount of overall outbound investments as a whole. Meanwhile, Beijing would be expected to direct greater attention to keeping capital onshore, while ensuring that the BRI would not develop into a white-elephant programme that might overdraw China's financial capacity.

China's economic slowdown

Related to unrelieved financial tensions, the prospect of persistent economic stagnation could be another factor that inhibits Beijing's appetite for BRI financing. China is amid a structural transition to less rapid economic growth, as rural-to-urban migration slows and the population ages at a rapid rate. In the second quarter of 2019, China's official year-on-year GDP growth slumped to 6.2% – a record low number since the data was first released in 1992.[81] Many observers believe that the actual growth rate is substantially lower. Moreover, it is not truly known what a new equilibrium growth rate might be. A worsening economic slowdown, either as a result of these broad demographic drivers or deriving from a trade war or internal financial stress, would increase the need to keep more capital onshore in order to stimulate investment at home.

The trade war with the US has taken a heavy toll on a Chinese economy struggling with inadequate consumer-driven growth. Overall, Chinese exports declined by 1.3% in June 2019 while imports experienced a more significant drop of 7.3%.[82] Official data on industrial profits indicates a decline from a 25% growth to a 2% deficit in 2019, with much of the downturn attributable to state-owned enterprises' continued inefficiency. In an effort to stabilise the economy through infrastructure investments, the central government has begun allowing credit expansion to resurface at the local level, resulting in renewed debt build-up and fiscal deficits.

A more alarming scenario would be a sharp economic downturn, which appears to be increasingly possible given continued stress in the financial sector and the pressure to maintain growth at a politically acceptable threshold. A Brookings study has concluded that, since the 2008 financial crisis and until 2016, China's annual GDP growth may have been overestimated by 1.7 percentage points on average.[83] This suggests greater economic instability and a far more tenuous grip on growth by Beijing. The IMF has warned about a possible nosedive in the Chinese economy. If China's economy took a sharper downward turn in the years to come, the focus on financial sustainability and debt repayment in BRI projects would become still more urgent.

Beijing's deficit of US dollars

A shortage of available US dollars may further compromise China's ability to sustain the extensive lending required for the BRI. China's access to US dollars has declined progressively in recent years. A notable slump in exports due to the trade war has reduced the amount of US currency flowing into the Chinese market. Concurrently, lack of confidence in the overall outlook for the Chinese economy has led to a consistent flight of dollars from the country.

The potential dollar deficit is a particularly concerning issue for China, considering that the financing of the BRI has been heavily dependent on the US currency. BRI recipient countries have shown limited interest in receiving RMB-denominated financing given the diminished demand for the Chinese currency as Beijing's push to internationalise the RMB stalled. In 2018, China's global trade conducted using the RMB declined to only 13%, plummeting from a 30% peak in 2015. In addition, in Hong Kong RMB-denominated international bonds and deposits have rapidly shrunk.[84] Beijing's recent decision to allow its currency to depreciate to more than RMB7 per US dollar will further reinforce investors' interests in reducing RMB holdings, and in seeking protection in such forms as overseas assets. If the weakening of the RMB continues for an extended period, pressure on China's foreign-exchange reserves will increase and the authorities of China's financial institutions will face opposition to lending these reserves to overseas projects.

Overcapacity and stalled SOE reform

In contrast to the preceding factors that contribute to a more cautious approach to the BRI, remaining overcapacity problems in China's manufacturing sectors could incentivise Beijing to brush aside domestic-debt concerns, and push on with still more outbound financing in search of new markets to export excess industrial capacity.

Much of Beijing's stimulus package in the wake of the 2008 global financial crisis was spent on domestic infrastructure and real estate, causing a dramatic rise in fixed-asset investments. In consequence, several heavy-manufacturing sectors – aluminium, glass and steel – experienced vigorous growth as the demand for industrial products soared. High profitability in these industries led to an expansion in production capacity. However, starting in 2014, as the stimulus package lost momentum and Beijing sought to avoid a real-estate bubble, demand for heavy-manufactured goods fell, resulting in a sharp decrease in industrial profits and pronounced overcapacity issues, which have lingered since.

Despite Beijing's policy of supply-side structural reform – which was initiated in late 2015 to reduce production growth and alleviate debt risks in heavy manufacturing – the government has not been fully successful in addressing challenges stemming from industrial overcapacity. While the reform plan has helped balance the relationship between supply and demand in the domestic context, the current economic slowdown, along with limited stimulus options given the stress in the financial system, could again cause demand for industrial products to shrink. Therefore, the persistence of industrial overcapacity could motivate Beijing to sustain its overseas demand creation through continued robust financing of BRI projects.

Another factor that may reduce Beijing's interest in consolidating the BRI is the weighty role of SOEs in both the BRI and in China's economy more broadly. Despite early expectations that Xi would downgrade the role of SOEs and improve these large conglomerates' efficiency, Beijing has in practice delayed and backtracked on deep SOE reform. Rather, in revitalising the party's role in the Chinese economy, Xi is relying on SOEs to reinforce party dominance and ensure that the state sector of the economy is not overshadowed by private entrepreneurship. As a result, in 2018 the state sector's share of total industrial assets grew for the first time in over two decades, while the private sector was squeezed despite it being more profitable and efficient.

As discussed, Chinese SOEs continue to dominate the implementation of BRI projects on the ground. According to China's official data, centrally controlled SOEs account for 70% of the BRI's total contract value.[85] Given the prominent role of SOEs in the BRI, genuine efforts to enhance SOE competitiveness in the initiative would lead to the SOEs bearing the financial costs of failed projects. However, should Beijing continue to prioritise political incentives over productivity and efficiency, SOEs will continue to be primarily employed as instruments to advance state-driven mandates at the expense of domestic financial prudence.

4. Mitigating Risks and Multilateralising the BRI

The quest for new partnerships

China's economic growth is sinking to a three-decade low and domestic pressures to maintain growth and employment continue to rise amidst seemingly endless trade tensions with Washington.[86] Accordingly, Beijing is finding itself increasingly dependent on the BRI to provide indisputable and sustainable domestic returns. Since being enshrined in the CCP's charter and irreversibly entangled with Xi's reputation, the BRI has become too big, and too important, to fail.

As discussed, the BRI was envisioned to be commercially viable because of the inherent growth-generating impact of infrastructure development. As the surge of international backlash against the BRI gained momentum, Chinese government officials – even as they vigorously rejected the accusation that the BRI was a 'debt trap' – began to realise that the early assumption that China's own developmental virtuous-cycle experience could be replicated in overseas contexts might be misplaced. Once Chinese leaders became aware that they had underestimated the significant difficulty, uncertainty and nuance involved in attempting to export China's development model, they realised that they would need to find ways to curtail losses and recalibrate the BRI's positioning.

By mid-2018, calls for a more careful, risk-cognisant approach to BRI project financing and security implementation were becoming frequent throughout Chinese state media.[87] In August 2018, at an internal symposium marking the fifth anniversary of the BRI, Xi urged for a directional shift in the policy's execution – away from the 'high-level', broad-sweeping, imprecise directives of the past and towards 'meticulous implementation, so as to realize high-quality development, bring benefits to local people, and build a global community of shared future'.[88] Also in 2018, the Politburo Standing Committee of the CCP set up its own BRI think tank – the Center of One Belt and One Road Security Studies in Shanghai – to better understand the risks involved in the initiative. The official 2019 report, 'The Belt and Road Initiative Progress, Contributions and Prospects', recognises that 'the Belt and Road Initiative is in urgent need of finance' from new models of international investment and funding due to its massive scale.[89]

One potentially attractive method to minimise losses and improve sustainability is the incorporation of more international partners across public and private sectors. China has called for increased multilateral involvement in the BRI before, at both the time of its founding and at the first BRF in 2017, but these earlier efforts seemed to be little more than rhetoric.[90] Along with other stated commitments – like ensuring high-quality projects; securing increasingly balanced outcomes between China and its partner countries; and preventing the spread of corruption – forging new partnerships with outside investors was a key component emphasised by President Xi at the second BRF in April 2019.[91] This time, Xi cast his push for partnerships as an effort to multilateralise the BRI, and to expand the range of stakeholders benefiting from the 'win–win' dynamics of the programme.

Beijing cannot easily maintain its current course as the BRI's only creditor

Yet this is only part of the motivation behind the push for partnerships. Consistent with growing concerns about the BRI's debt sustainability, Xi's ample calls for co-financing reflect a recognition by Beijing that it cannot easily maintain its current course as the BRI's only creditor to many of the world's poorest countries. The debt dynamics discussed above highlight how the financial burden to China of shouldering the 'new Silk Road' are becoming increasingly difficult to handle. With the dangerous overextension of finance by policy banks that are politically incentivised to lend, and the continuous outward investment by SOEs pressured to meet the regime's national agendas, the domestic financial costs of the BRI are escalating to a point where they will force Beijing to face a wave of new challenges

head-on – from expensive economic trade-offs to possibly infectious domestic political problems.

A shift away from the BRI's unilateral past would allow Beijing to address some key domestic and international concerns regarding the initiative. Domestically, cultivating partnerships would enable the leadership to demonstrate that they are easing the financial burden of the BRI, which would free up resources for domestic use. Internationally, working with bilateral and multilateral partners to shape, finance and implement BRI projects could boost confidence and transparency, while also shrinking the windows for corruption.

Thus, engaging credible and trusted banks, companies and countries as part of the BRI provides an appealing solution to many of Beijing's current challenges with the initiative. However, such a redirection will not be easy. In its initial phase, the BRI became effectively closed to potential outside partners, despite being thoroughly articulated by Beijing as 'open and inclusive' and welcoming to the 'active participation of all countries and international and regional organizations'.[92] In practice, Chinese state policy banks were given the responsibility of project design and negotiations with recipient countries, while Chinese SOEs and some private companies monopolised labour markets and project implementation on the ground. This initial pattern – though likely at least partially an unintentional by-product of Chinese domestic stakeholders dominating the BRI's earliest opportunities – has resulted in a path-dependence problem that China will need to overcome.

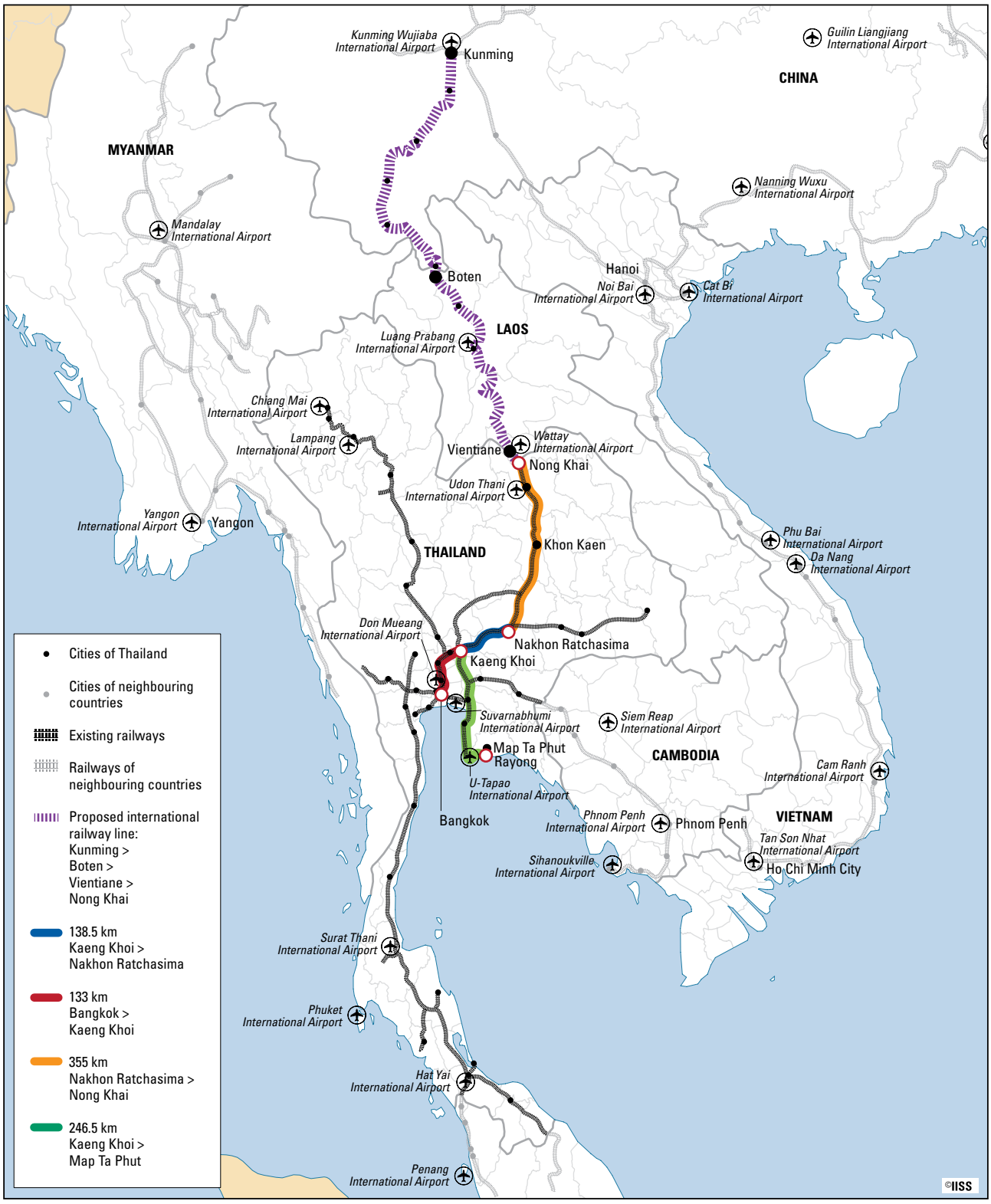
Xi has recently attempted to address this stigma by emphasising the inclusive and apolitical nature of the BRI's processes, but erasing the perception of the BRI as a 'China club' remains a work in progress.[93] Given the lack of international investment partnerships in the BRI so far, it will prove difficult for China's leadership to entice the most desirable partners into funding future projects.

China has taken some procedural steps to establish new means of partnership, both multilateral and bilateral. In March 2019, the Ministry of Finance (MoF) signed a memorandum of understanding (MOU) with eight major multilateral development banks (MDBs), including the Asian Infrastructure Investment Bank, the Asian Development Bank, the Development Bank of Latin America (Corporación Andina de Fomento), the European Bank for Reconstruction and Development, the European Investment Bank, the Inter-American Development Bank, the International Fund for Agricultural Development and the World Bank Group. The MOU established the Multilateral Cooperation Center for Development Finance (MCDF) to foster collaboration and communication on investment and infrastructure initiatives throughout BRI recipient countries. The MCDF attempts to answer many of the international critiques of the BRI by offering a platform for signatories to improve transparent and sustainable capacity-building, information sharing and project preparation.[94]

In addition to the MCDF, China has been advocating for the BRI's vision within international institutions including the UN, G20 and the Asia-Pacific Economic Cooperation (APEC).[95] China has also made efforts to cultivate bilateral partnerships within the BRI's purview. According to the 2019 report on the BRI's progress, the Chinese government 'signed third-party market cooperation agreements with France, Italy, Spain, Japan, and Portugal', reflecting Beijing's ongoing desire to court potential financiers and implementers for BRI projects.[96] Perhaps the most important move on bilateral partnerships occurred during Japanese Prime Minister Shinzo Abe's visit to China in late 2018, during which major MOUs were signed between Chinese state-owned policy banks and their Japanese counterparts on future infrastructure cooperation.[97] Upon their meeting, Xi and Abe reaffirmed both sides' commitment to 'Japan-China Business Cooperation in Third Countries', signalling a positive direction for future collaboration on BRI project implementation.[98] In addition to improved relations with Japan, China's recent efforts to increase ties with the wealthy Gulf monarchies are at least partially motivated by the potential for Gulf sovereign wealth funds to become financial partners in the BRI.

Despite obtaining the official support of several foreign governments, the BRI continues to struggle with a sceptical reception from the foreign private sector. Thailand's high-speed rail project reveals the limitations of China's progress on cooperation with Japan, for example. Just a month prior to the Xi–Abe summit, Chinese media touted the construction of Thailand's high-speed rail, a high-priority project that China and Japan were separately investing in, as the ideal flagship project for China–Japan

Map 4.1: **Concept Map of Thailand's High-Speed Railway System**



Source: Thailand Ministry of Transport

cooperation in a third country.[99] But following the summit, it was reported that cooperation between the two countries had run into an immense roadblock – the lack of enthusiasm among the Japanese private sector. Immediately following the 2019 BRF, Chinese state-owned news organisation CGTN published an opinion piece that explored the trouble of securing foreign private-sector involvement, emphasising that 'it would be better and more productive if governments and companies in third-party market countries were also engaged', potentially

alluding to the friction between China and Japan on joint ventures.[100] In July 2019, *China Daily* published an article that directly claimed that 'boosting third-party market cooperation remains a common challenge for China and Japan', citing a lack of mutual political trust and a win–win system as primary issues.[101]

It transpired that the Thai rail project had been dropped from the MOUs signed between the two parties, perhaps because Japanese corporations did not consider the investment viable.[102] Yet in March 2019, the Japan Bank for International Cooperation announced its commitment to provide guarantees for the project, thus renewing Japan's intent to work with China, at least on a rhetorical level.[103] A few months later, Xinhua posted an interview from the head of Japan's Mitsui & Co., designed to raise private-sector excitement about cooperation between China and Japan.[104] As of September 2019, it appears that the first phase of the high-speed rail is set to begin operation in 2023, thanks to financing by Thai companies and support from China.[105] It remains unclear whether Japanese companies will attempt to assert a concrete role in the latest development, or if they will decide to continue investing in separate lines of the rail as they have in the past.[106]

Nurturing relationships with reliable partners would provide China with some much-needed room to readjust the BRI towards burden-sharing. At present, Chinese state-owned banks and enterprises are on the frontlines of the BRI's risky investments, and it is they who will be most exposed in the likely event that some BRI recipient countries run into payment difficulties. As the Thai railway example highlights, the pathway to establishing such burden-sharing partnerships in the BRI remains challenging.

The AIIB as a potential vehicle for a more multilateral BRI

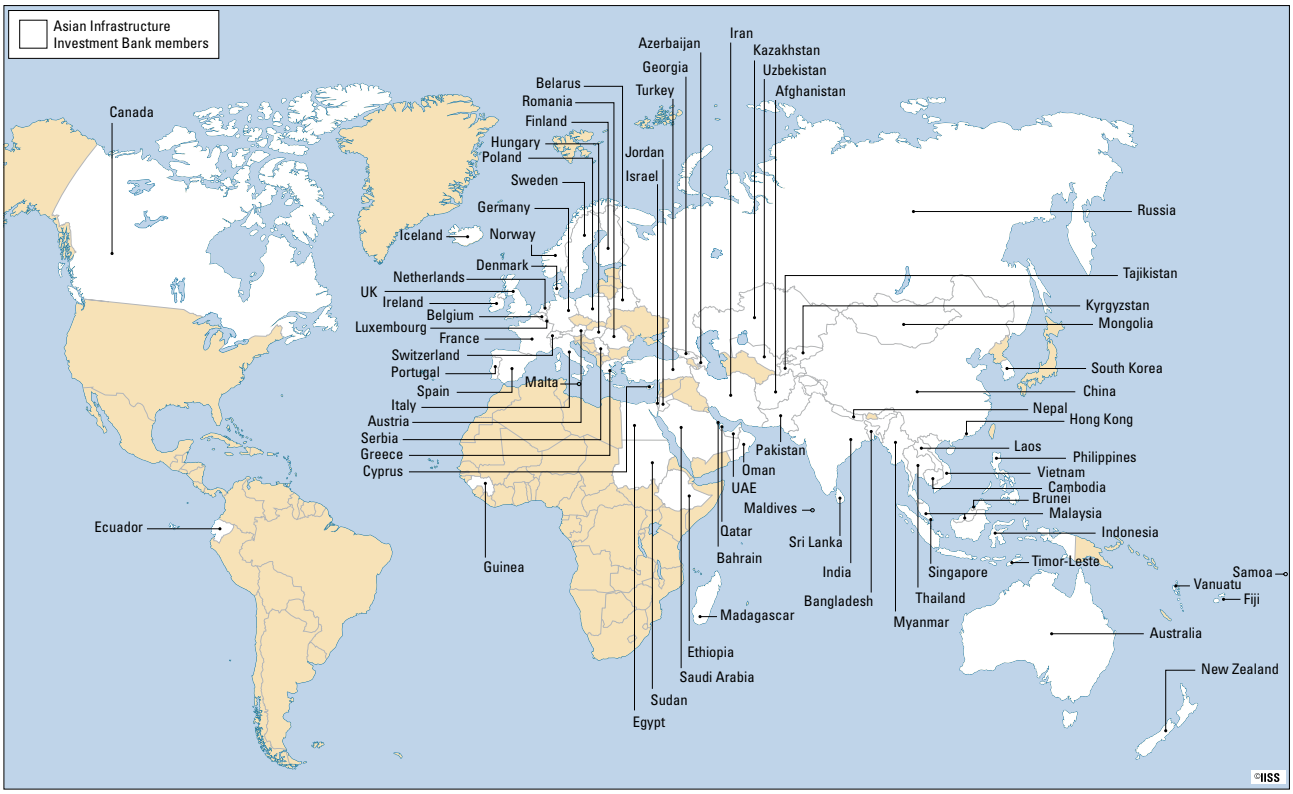
Having recognised the BRI's imminent need for international partnership, Beijing began intensifying its efforts to engage with various MDBs. In addition to easing some of the reputational issues that surround the BRI, working with capable MDBs would relieve the domestic pressures that Chinese leaders are facing in the absence of a more diverse financial-support network. Paradoxically, in its engagement with MDBs, China has thus far steered away from focusing on the Asian Infrastructure Investment Bank (AIIB). The AIIB and the BRI have parallel origins and mandates that suggest a potential for a much deeper partnership than currently exists. Despite this, their initial trajectories have taken them in very different directions. These critical differences between the BRI and the AIIB, however, might make the AIIB a natural 'bridge institution' for increasing the BRI's engagement with other international financial institutions and the foreign private sector.

In 2013, Xi unveiled the concepts for both the BRI and the AIIB to the world. Both were meant to support and implement the virtuous-cycle idea of stimulating economic development through investment in local infrastructure, with the AIIB having a stronger focus on Asia. Due to this conceptual overlap, it was assumed by many that the AIIB would be a principal financing mechanism for the BRI. Yet Beijing went in an alternative direction, desiring complete control of the financing dimension of the BRI, while supporting the AIIB's emergence as a serious MDB seeking credibility within the international finance arena via formal, transparent and globally recognised procedures.

In January 2014, Beijing launched a series of multilateral consultation meetings with countries interested in the AIIB, which culminated in the signing of the bank's 'Articles of Agreement' in late 2015 by 57 countries spanning the globe.[107] By the beginning of 2016, the AIIB was ready to formally open its doors. The AIIB's breadth of membership (numbering 100 as of late 2019)[108] demonstrates the widespread acceptance and support the organisation has received from the international community since its founding.[109] Meanwhile, the BRI has grown into the centrepiece of China's global strategy, yet with a much less concrete structure and focus, and characterised by an increasingly nationalist tone.

The AIIB and the BRI differ dramatically in structure and scope. The AIIB operates in accordance with international MDB standards, adhering to firm policies to ensure fairness and openness in proceedings and operations. This contrasts sharply with the negative perception of the BRI among other creditors, as it has not followed international lending guidelines and practices. Geographically, while the BRI stretches its reach into Europe, Africa and even Latin America, AIIB operations are limited to Asia. Notably, the AIIB does not offer any concessional loans, which suggests that the institution

Map 4.2: **Members of the Asian Infrastructure Investment Bank**



has adopted a different approach to investment financing compared to the BRI's mixed financing structures.

Consequently, despite the early assumption by many critics outside China that the AIIB and the BRI would both be dominated by top-down directives dictated by Beijing, the AIIB has developed into a globally accepted, trusted and independent MDB. AIIB projects are funded from two primary sources – capital subscriptions and borrowings; the former is made up of shares that are allocated by relative economic weight measured by GDP. China accounts for 30% of the subscription allocation, and 26.5% of the voting weight in the AIIB. Like other MDBs, the AIIB is moving to an investment-financing model based more on borrowed funds rather than on shareholder equity, as evidenced by its first successful bond issue of US$2.5bn in May 2019, and its intention to list its Euro Medium Term Note programme on the Luxembourg Stock Exchange.[110]

With its 26.5% voting share, China is the leading voice in the AIIB decision-making process. This enables China to block decisions that require a 75% supermajority, such as capital increases, individual members' subscription increases, changes in the board of directors and other issues of key institutional importance. However, investment approvals and strategy decisions, such as the decision to invest in BRI projects, remain attainable by a 50% majority, which China does not have on its own. In terms of contracts for projects, the AIIB employs well-defined, open and competitive bidding processes to obtain goods, works and services for all its investments.[111] Additionally, AIIB projects do not follow China's development policies. Comparable to those of other MDBs, the AIIB's operations and policies are constructed using a combination of frameworks and processes that reflect international norms broadly utilised by the global financial community. Providing technical and economic impact analyses; ensuring sustainable environmental and social compliance; and safeguarding anti-corruption and grievance processes are just a small sample of the development values that the AIIB is entrusted by its stakeholders to uphold.

In retrospect, China's leadership in proposing the AIIB likely sought to generate a credible institution within the confines of the existing global financial network precisely due to the strategic value of holding influence in an 'establishment' MDB within its own neighbourhood. As the AIIB continues to garner respect, so too has mainstream Chinese media come to appreciate the progress of the young MDB, especially as Chinese-founded entities are typically subject to intense

Table 4.1: **AIIB vs BRI Comparison Chart**		
	The Asian Infrastructure Investment Bank	**The Belt and Road Initiative**
Founder	China	China
Founding year	2013; first year of formal operation: 2016	2013
Participating countries	100	125
Primary source of project financing	Capital subscriptions of members and borrowings from international capital markets	Chinese state-owned commercial banks, policy banks and US$40bn Silk Road Fund
Geographic scope	Asia, based on UN classification, including: West Asia, Central Asia, East Asia, South Asia, Southeast Asia and Oceania	Broad focus, with preference for Asia (Southeast, Central, South), the Middle East, and Europe (Eastern, Central)
Approver of investments and strategic decisions	Simple majority (over 50%) of member votes	Top Chinese leadership, with exact decision-makers varying depending on the project or strategy
Structure	Strictly and legally defined, and modelled after other major MDBs such as the World Bank, the Asian Development Bank and the European Bank for Reconstruction and Development	Loose conglomeration of countries with a multifaceted set of projects, programmes and initiatives
Project-procurement process	Handled via a competitive, open and well-defined procurement policy for goods, civil works and services	Handled via a closed, hidden process that heavily favours Chinese entities as project implementers

scrutiny and international distrust amid the backdrop of a deterioration in US–China relations, and rising protectionism in the global tech industry.[112]

Though the AIIB's participation in the Belt and Road Initiative thus far has been marginal, it is increasing. By the end of 2016, the AIIB's funding amounted to less than 1% of the BRI's total investment. In 2017, the AIIB contributed US$2.5bn in loans to the BRI; a large increase from the US$1.7bn provided in 2016, but still a small portion of both the AIIB's lending potential and the BRI's received investments.[113] The AIIB was one of the MDBs that signed the recent memorandum of understanding with China's finance ministry on establishing the MCDF, to better coordinate MDB activities alongside the BRI. The signing of the MOU creates an institutional nexus between the Chinese MoF and the AIIB on matters related to the BRI, suggesting the potential for an expansion of the relationship between the two.

As the AIIB continues to mature and the BRI's debt pressures continue to mount, Beijing could come to recognise the AIIB as a well-positioned vehicle for shifting towards a new and internationalised BRI. At present, the BRI continues to suffer from a lack of credibility – not just in its financing, but also in its tendering. As the previously discussed Thai railway example has indicated, private-sector firms doubt their ability to both get contracts and the viability of the projects themselves. Co-financing projects with the AIIB would bring with it the AIIB's robust regulations and guidelines. This would provide much needed credibility to the BRI's tendering process, in a way that would appeal to potential partners who have been reluctant to invest in the past. The AIIB represents a critical bridge for fostering and facilitating the BRI's most coveted partnerships.

China's considerable influence within the AIIB could provide confidence to Beijing, which it would not necessarily have with other MDBs. China's voting share would allow it a comfortable, though not dominating, amount of sway over the project-selection process, which might be the ideal balance for China's leaders in terms of not threatening much of a loss of authority over the BRI's direction or facilitation.

Table 4.2: **Voting share distribution in the AIIB**	
Voting power of the top 12 members in the AIIB	
Member	**Voting power %***
China	26.5
India	7.6
Russia	6.0
Germany	4.2
South Korea	3.5
Australia	3.5
France	3.2
Indonesia	3.2
United Kingdom	2.9
Turkey	2.5
Italy	2.5
Saudi Arabia	2.5

*Note: Total voting-share percentage is calculated by considering basic votes, founding-member votes and shareholder votes. Although China has 30% shareholding in the AIIB, in combination with the equalising effect of basic votes and founding votes, its actual voting power comes out to around 26.5%.

5. Going Forward: A Dilemma for Beijing

The Chinese leadership finds itself caught between the twin pressures of the imperative to deliver tangible benefits of the BRI to domestic stakeholders, and the intensified international demands that more financial burdens be shouldered by China. Though rarely erupting into plain view, internal suspicions and even outright criticisms against the BRI are hardly new. Increasingly, the Chinese public questions the rationales behind Beijing's profligate overseas expenditure when enormous development challenges remain at home, and the country's own poverty-stricken regions perennially struggle with insufficient budgets.

These sentiments usually become visible following announcements of newly committed international spending. For example, a wave of disgruntled public opinion about Beijing's US$60bn loans to Africa surfaced on Chinese social media after the 2018 Forum on China–Africa Cooperation.[114] Criticism of the BRI from the academic sphere generally falls in line with disapproving public opinion. A recent report by a Peking University think tank said that unbridled overseas lending in the BRI has resulted in substantial pressure on China's foreign-exchange reserves and could eventually overstretch China's financial capacity.[115]

How Beijing responds to what is likely to be increased domestic pushback will have important implications for the future of the BRI. As China's economy experiences its slowest growth in 30 years, the government must demonstrate to the public that the BRI is not merely the flashy diplomacy favoured by the leadership, but make the case that its push for overseas infrastructure projects presents a concrete opportunity to address domestic needs. In order to do this, it is imperative for Beijing to translate overseas spending into reasonable dividends at home, especially in economic terms. In this context, Chinese policymakers will likely face strong pressure to continuously frame the initiative as an endeavour driven and dominated by China, so as to provide major benefits such as job creation and to export overcapacity, while insisting on issuing loans on or near commercial terms. In other words, domestic pressures could motivate Beijing to prevent the BRI from transforming into a truly multilateral programme, which would in turn almost certainly lead to it becoming progressively less ambitious. When analysts claim that we are at 'peak BRI', this is the scenario they have in mind.

At the same time, China faces growing pressure from BRI recipient countries, many of which now demand and expect that more generous financing be extended from Beijing as a condition to keep the partnership alive. For borrowing countries, heightened debt distress and the perception of overpriced projects that mostly serve China's interests provide a context for reassessing their own participation in the programme. In countries where there have been leadership changes, it is increasingly common to see incoming politicians riding on anti-BRI momentum and portraying BRI projects as 'bad deals' signed by the previous administration. Corruption and nepotism in BRI investments have entangled China with the twists and turns of local politics. Key BRI countries such as Malaysia, Myanmar, Pakistan and Sri Lanka have all engaged in renegotiations with China after suspending or cancelling projects undertaken by previous leaderships.[116] Meanwhile, recipient countries have used alternative financing sources as leverage in negotiations with Beijing, as in the case of the Uzbek government when it gained access to the Eurobond market. Nevertheless, growing criticism of the BRI is hardly the equivalent of categorical rejection of China's global infrastructure push. In fact, virtually all BRI recipient countries have managed to retain their participation in the Chinese initiative, which has, to varying degrees, become leverage for smaller states that seek to extract more returns from the broader bilateral relationship with China.

Beijing must translate overseas spending into dividends at home

In responding to the international pushback, Beijing has signalled that it is committed to flexibility in addressing the sustainability, concessionality and transparency of the BRI. At the second BRF in 2019, Xi promised to deliver a more multilateral BRI that creates benefits for all participating countries. At the core of Beijing's strategies to solve existing challenges is the extension of more financial largesse. To alleviate debt risks and satisfy criticisms emerging from recipient countries, Beijing has a history of engaging in renegotiations that eventually lead to favourable outcomes for the borrowers, including more concessional loans and debt forgiveness.[117] In this regard, the high-profile renegotiation between China and Malaysia is likely not an anomaly, but a prelude to more financing adjustments that will take place in the BRI. The fact that Beijing has effectively demonstrated its flexibility to offer more concessions prior to the second BRF will motivate more countries to seek better terms. However, as discussed, whether Beijing has the financial capacity to consistently fulfil recipient countries' demands remains debatable for the present, as does the sustainability of this strategy itself.

Beijing will need to create a delicate balance to reconcile these competing pressures. Six years since the BRI was unveiled to the world, it has become clear that China does not enjoy unchallenged authority as the main driver of this transnational infrastructure programme. Recipient countries, through a variety of means, could keep Beijing's ambition in check, and debt distress incurred in overseas investments could raise deep implications for China's broader strategic interests as well. At the same time, the overseas-investment fatigue brewing in Chinese society means that embedding the BRI into the triumphant nationalist state propaganda does not offer guaranteed approval from the Chinese public. During three decades of adherence to Deng Xiaoping's cautious foreign-policy dogma, never had China tied its domestic interests so deeply and intricately with an outward-looking initiative on par with the ambitious BRI. In this sense, Xi has led China into uncharted territory. The outcome of China's ability to manoeuvre with increasingly limited resources in its toolkit is destined to lead to far-reaching consequences for both the developing world and China itself.

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