Analyzing the Risks of China’s ‘One Belt, One Road’ Initiative

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Conference Report

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1. Political and Geopolitical Risks

Political risks include political factors such as political stability, government effectiveness, rule of law (law and order), democratic accountability, control of corruption, civil disturbance, and nationalization of military. As most researchers have pointed out that political risks of many countries along the OBOR (especially in the Middle East and Central Asia) are high, if we refer to the Regional Political Risk Index, Marsh Political Risk Index Map, New Coface Political Risk Index in 159 countries, Corruption Perceptions Index, and Asia Political Risk Index.

1.1 Nationalization, Expropriation and Other Takings

The government of the host country may implement nationalization or privatization in public infrastructure. Nationalization occurs more common in developing countries. Infrastructure investment is an area short of transparency and contains severe corruptions, especially in developing countries. In a host country with weak regimes for investor protection, confiscation and expropriation of funds occur frequently. Creeping expropriations such as discriminatory taxes, price controls and license cancellation harm the returns of infrastructure investment as well. There are also risks of other takings. Investment returns may suffer from sovereign risk and transfer risk, when capital is locked up or frozen by foreign government action or new policies.

1.2 Geopolitical Risks

Infrastructure Investment may be disrupted by geopolitical events such as regional conflicts or international tensions, change of political power, changes in public policy, political instability, social unrest, and political intervention. Political turmoil in some countries such as Syria, Afghanistan, Saudi Arabia and Lebanon directly or indirectly affect FDI. Political risks are magnified especially in politically instable countries. The Belt and Road program has not developed an investment insurance facility like the Multilateral Investment Guarantee Agency (MIGA) to mitigate political risks in developing countries. For example, MIGA provides political risk insurance against losses caused by currency inconvertibility and transfer restriction in the host country.

The political risk is illustrated by the case of the Myitsone Dam in Myanmar, the first dam planned to be developed by the State Power Investment Corporation (SPIC) - one of China’s largest electricity manufacturers [1]. The contract value of this hydropower project is USD 3.6 billion. Asia World, which is subject to sanction due to involve in drug dealings, owns 5% of the project.
Myanmar would get 10% electricity for free in 50 concessional periods and the full ownership through build-operate-transfer (BOT) 50 years later. This project, however, was suspended in mid-2012 by Myanmar’s former military government, due to public opposition and environmental issues. China insisted that the contract was valid and pushed the Burma government to resume the project. Now, the decision may be a dilemma for the committee led by Daw Aung San Suu Kyi, the leader of Myanmar’s civilian government. If the commission resumes this project, she will upset those who protested this project and NGOs. If the commission makes a decision to cancel the Myitsone Dam, Myanmar has to repay USD 800 million (as claimed by the SPIC) and losses caused by the stalled project (claimed as CNY 300 million each year) to the Chinese developer and risks angering China - Myanmar’s largest trade partner, though there are compromised options such as offering smaller hydropower projects with less environmental threat [2].

The case of Myitsone Dam reminds Chinese decision makers that political risks can be a major issue for BRI projects. As a long-term investment consideration to attract private investors, it is necessary to develop a political risk insurance system to cover (or partially cover) possibilities such as sovereign debt default, political violence, expropriation, terrorism events and other political turbulence.

2. Economic Risks

Like in any other transactions, investors should consider the following economic risks: (i) Inflation risk; (ii) commodity price risk (e.g. fluctuation of asset pricing); (iii) cash flow risk (long-term and steady cash flow is required); (iv) construction risks, such as construction delay and various accidents; (v) tax policy risk; (vi) operational risks, such as design, construction and maintenance risk, completion risk, cost and schedule overruns; (vii) exit strategy risk; (viii) traffic demand risk; (ix) bankruptcy or closure risk (e.g. the contractor or sub-contractor private company may go bankrupted before the work is done); and (x) emerging market risks. There parameters should be well calculated in the project’s costs.

Regarding projects of BOO (Build Own Operate), BOOT (Build-Own-Operate-Transfer), DBFO (design–build–finance–operate), and PFI (Private Finance Initiative), an infrastructure project (e.g. BOT, BOO, BOOT, DBFO) normally is proceeded in three phases: build/construction, operation and transfer. The Economist Intelligence Unit (EIU)’s risk assessment report provides an assessment for the operational, security credit, and sovereign risks of a project in a host country [3].
In addition, skills of operation, maintenance and management may affect the project’s returns. Generally, costs on operation and maintenance account for half the expenses of infrastructure construction. Particularly, inadequate managing and maintenance in developing countries results in quick deterioration of railways, bridges and highways. For example, the deteriorating railways and roads in Bangladesh have become a serious problem for local transportation; thus the Asian Development Bank (ADB) worked out a road master plan and long-term railway investment programs for this country [4].

3. Financial Risks: Black Swan and Gray Rhino?

Today, financial risks may directly or indirectly threaten the completion of a project. Many OBOR countries adopt foreign exchange control or capital control policies. Aside from the risk of currency depreciation, foreign investors will have to avoid losses from inability to convert local currency into foreign exchange or transfer constraints of outbound funds in the host country. Such factors as illiquidity premium, greenfield risk premium, and emerging market risk premium also have impacts on returns of an infrastructure project. In particular, some counterparty developing countries may suffer from heavy debt burden and financial risks. For instance, the $15 billion China-Uzbekistan investment transaction agreed by both parties is almost equal to 25% of Uzbekistan's gross domestic product (GDP). In another example, the $24 billion China-Bangladesh agreement signed in October 2016 is around 20% of Bangladesh's GDP [5].

Another issue is the credit enhancement. As the BRI requires over USD 1 trillion investment annually in infrastructure, a credit enhancement mechanism against credit risks or debt defaults like the Multilateral Investment Guarantee Agency (MIGA) can help promote foreign direct investment and reduce funding gaps.

It is noted that China’s financial market have accumulated internal financial risks. Recently, Mr. ZHOU Xiaochuan, China’s Central Bank Governor, issued an article on China’s potentially “sudden, contagious and hazardous” financial risks and appealed for stricter regulation [6]. Although he pointed that China needed to reform and open up financial markets, Zhou highlighted high leverage ratio, liquidity risk, credit risk, cross-sector and cross-market shadow banking. For example, the overall leverage ratio was 247% and the corporate sector leverage reached 165% at the end of 2016 [7]. He also warned to avoid not only “black swan” but also “gray rhino” events [8].
In mid-2017, the Chinese government took action to investigate large scale overseas acquisitions. Some debt-heavy large companies, including Dalian Wanda Group, Fosun International, Anbang Insurance Group, and HNA Group, were found to abuse the cheap lending provided by state-owned banks to build their commercial empires or engage in overseas takeovers. Such cases include: Wanda paid $3.5 billion for Legendary Entertainment in 2016; Anbang paid $2 billion for the Waldorf Astoria in New York in 2016; HNA Group bought $6.5 billion stakes in Hilton Hotels and 9.9% stakes in Deutsche Bank [9]. Thus the financial regulators required banks to scrutinize the lending to companies with heavy debts and a lot of deals. It turns out that the corporate debt quickly increased to 166% in July 2017, compared with nonfinancial companies’ debt rate of 120% of economic output in 2011 [10]. These investigations and the reduction of China’s foreign reserves in 2015-16 may affect capital invested in the OBOR program.

4. Legal and Regulatory Risks

Legal risk concerns the fairness, speediness and effectiveness of the judicial system, enforceability of contracts, non-discrimination against foreign companies, anti-trust and unfair competitive practices, protection of intellectual property and other properties, and integrity of accounting standards. Regulatory risk refers to a change in laws and regulations affecting a certain industry or market. Delays in acquiring necessary license or government permits, or stalled transfer of ownership stake, difficulties in acquiring land, contractual risk, and transparency of procurement procedures may result in infrastructure disruption.

In particular, corruption has been a serious challenge for infrastructure governance. Corruption may occur in any stage of infrastructure project, from design, construction, operation, to transfer or privatization of infrastructure. The OECD’s survey indicates that about 40% foreign bribery cases occurred in three sectors: 15% in construction, 15% in transportation and storage, and 10% in information and communication [11]. In the anti-corruption movement led by President Xi, 1.34 million officials, including 200 government officials of vice-ministerial rank and above, had been punished by the commencement of the 19th nation party congress in October; and the Chinese government announced to continue this graft fight until a “complete victory” was achieved [12].

Lack of effective dispute resolution mechanism can be another risk. Probably, it is hard for Asian commercial arbitration organizations to arbitrate conflicting interests between countries and the enforcement of arbitration award can be another problem. Therefore, whether to develop an organization like the International Centre for Settlement of Investment Disputes (ICSID) to solve regional settlement of disputes should be on the agenda of BRI.
5. Social and Environmental Risks

Assessing and managing social and environmental issues can be critical in infrastructure and energy projects. These issues include but not limited to labor and working conditions, labor strikes, pollution prevention and abatement, demolition and relocation, biodiversity conservation and ecological protection, indigenous people and cultural heritage.

As sustainable infrastructural development has become a trend, the Paris Climate Agreement came into force on November 4, 2016 and 170 parties have rectified it [13]. There are other rules, such as the UN Global Compact, UNEP Responsible Investment Principles, IFC Social and Environmental Sustainability Performance Standards, OECD Guidelines for Transnational Corporations, and the Extractive Industries Transparency Initiative Plan, to follow. This may challenge environmental practices in developing countries.

In summary, the major risks among the above-mentioned barriers to investment are (a) sovereign and credit risk, (b) political and corruption risks; (c) foreign exchange risk; (d) limited product offerings and liquidity constraints; and (e) deal implementation risks.

References

1. The State Power Investment Corporation, founded in December 2002, was one of the big five largest state-owned electricity producers in the P. R. China. The other four state-owned electricity producers are China Huaneng, Datang, Huadian and China Guodian Corporation.


8. “Gray rhino” here refers to highly probable but neglected economic problems.


10. Ibid

