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The Financing Mechanism for the Belt and Road Initiative

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In recent years, China has been actively building a mechanism to finance the Belt and Road Initiative (BRI), favoring a multilateral approach. This includes policy-oriented, developmental and commercial loans supplemented by investment funds and securities issuance, private–public partnerships (PPPs), mutually beneficial cooperation between China and the countries along the Belt and Road, and international financial institutions. However, BRI financing is confronted with the challenges such as high default risks, lack of standardization in financing practices, excessive risks assumed by Chinese state-owned financial institutions, and inadequate participation of international financial institutions and private capital.

China needs to pursue open, green, and clean cooperation, step up the assessment and monitoring of financing risks, standardize the practices of Chinese financial institutions, welcome funds from host countries and third-party international financial institutions, properly control the increasing speed in financing scale, and promote RMB-denominated lending under the BRI.

Current situation and features of the financing mechanism

So far, in addition to traditional approaches like loans from Chinese banks and investment funds, the financing of the BRI has made impressive progress in multilateral financial cooperation and capital market development.

Cooperation with foreign commercial banks has been enhanced remarkably

The China Development Bank (CDB) and the Export–Import (Exim) Bank of China are the main traditional funding sources for BRI projects. By the end of 2018, outstanding of international businesses of the CDB in those countries along the Belt and Road were USD105.9 billion, and the CDB provided financing of over USD190 billion for more than 600 BRI projects, and set up special lending schemes worth RMB260.7 billion to support BRI cooperation. As of April 2019, the Exim Bank of China had

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supported 1800-plus BRI projects, with loan balances exceeding RMB1 trillion, half of which were invested in infrastructure. State-owned commercial banks followed them closely. For instance, the Bank of China (BOC) had supported 600-plus BRI projects with credit extension loans totaling over USD130 billion.

Meanwhile, foreign banks have started to cooperate closely with Chinese banks. Citibank of the US, Standard Chartered Bank (SCB) of the UK, Hong Kong and Shanghai Banking Corporation, Oversea-Chinese Banking Corp of the Singapore, Commerzbank of the Germany, Banco Santander of the Spain, and other foreign commercial banks, have shown interests for the BRI. In April 2018, Citibank signed memorandum of understandings with BOC and China Merchants Bank (CMB) to strengthen cooperation and partnership in supporting clients' BRI investments and projects. SCB successively signed memorandum of understandings or strategic cooperation agreements with CMB, CDB, Shanghai Pudong Development Bank, and the Exim Bank of China under the BRI. Germany's Commerzbank signed a memorandum of understanding with the Industrial and Commercial Bank of China to work together on BRI projects, marking it the first German bank to join the Belt and Road Inter-Bank Regular Cooperation Mechanism.

Multilateral intergovernmental financial cooperation is widely utilized

In addition to partnerships with international multilateral development institutions in financing BRI projects, interbank association is becoming an important form of multilateral financial cooperation. The Asian Infrastructure Investment Bank (AIIB) plays a crucial role in the implementation of BRI projects. As of April 2019, the AIIB was comprised of 97 member states. It had approved loans of USD7.5 billion and leveraged other investments totaling almost USD40 billion. Its 35 approved projects are distributed over 13 countries, including India and Turkey. The AIIB also successively signed cooperation agreements with the World Bank, Asian Development Bank, European Bank for Reconstruction and Development (EBRD), and European Investment Bank, to jointly support the BRI via innovative financing mechanisms. The People's Bank of China has established joint financing programs with the International Finance Corporation under the World Bank Group, Inter-American Development Bank, African Development Bank, EBRD and other multilateral development institutions. By the end of 2018, these institutions had invested in more than 100 projects in over 70 countries and regions.

China also actively establishes multilateral interbank associations with other countries to promote multilateral financial cooperation. The China-Central and Eastern European Countries Inter-Bank Association was established in November 2017, with 14 member banks in China, Hungary, the Czech Republic, the Slovak Republic, and Croatia, among others. The China-Arab Countries Interbank Association, and China-Africa Interbank Association, were respectively established in July and September 2018, becoming the first multilateral financial cooperation mechanism between the respective sets of countries. Proposed by CDB, a China-Latin America multilateral financial cooperation mechanism was established in April 2019, the first of its kind for China and Latin American countries. This mechanism involves eight financial institutions, including the Bank of Investment and Foreign Trade in Argentina and the BBVA Bancomer in Mexico.

Different types of equity investment funds led by the Silk Road Fund and sovereign wealth funds are increasingly important in financing BRI projects

The advantage of the Silk Road Fund lies in its being backed by medium- to long-term equity investments, which not only provides capital for projects but also meets the diverse BRI fund demands by using various investment and financing tools, including equity financing, debt financing, and funds. Since it was established in 2014, Silk Road Fund investments have covered Russia, South Asia, Central Asia, West Asia and North Africa, Southeast Asia, Central and Eastern Europe, and have supported 30-plus projects with the investment fund exceeding USD11 billion. The Pakistan Karot Hydropower Project, Dubai Hassyan Clean Coal Power Project, and Dubai Concentrated Solar Power Project, all adopt PPP funding models. Meanwhile, the Chinese government continues to boost BRI projects through bilateral and multilateral investment funds. The Russia-China Regional Development Investment Fund, with an initial scale of RMB10 billion, was created to promote cooperation between China's Northeast and Russia's Far East. The China-EU Co-Investment Fund, with a total commitment of EUR500 million, was jointly invested by the Silk Road Fund and the European Investment Fund, and began operating in July 2018 for the purpose of developing synergies between the BRI and the Investment Plan for Europe. It is worth mentioning that sovereign wealth funds have started to increase investments in BRI projects. The scale of investment in major BRI countries by Abu Dhabi Investment Authority, China Investment Corporation, and other sovereign wealth funds, has substantially increased.

Stepping up building the capital market to lay a solid foundation for directly financing BRI projects through issuance of bonds and *stock*

The China Interbank Bond Market is expanding globally. By the end of 2018, Panda Bonds worth up to nearly RMB200 billion had been issued, including the first Green Financial Bond issuance by the BRICS New Development Bank in July 2016, worth RMB3 billion and with a five-year term, as well as the first public offering of Belt and Road Bonds, sold by China Merchants Port Holdings and Global Logistic Properties, on the Shenzhen Stock Exchange in February 2018. These offerings will fund the acquisition of Sri Lanka's Hambantota port, and acquire logistics infrastructure assets along the Belt and Road in Europe. The Bond Connect launched in 2017 has also started to facilitate BRI financing. In December 2017, the Exim Bank of China issued a Green Financial Bond of RMB2 billion to domestic and overseas Bond Connect investors for the development of clean energy industries in BRI-related countries. Chinese financial institutions and enterprises are increasing the financing scale of BRI projects through overseas bond markets. As of April 2019, five bonds had been issued overseas by 13 branch institutions of the BOC under the Belt and Road theme, totaled about USD15 billion in seven currencies, including the RMB, the Hong Kong dollar, the Euro, and the US dollar. Besides, equity, business, and technical cooperation between securities and futures exchanges from China and other countries is also underway. In 2015, the China Europe International Exchange was established as a joint venture by the Shanghai Stock Exchange (SSE), Deutsche Börse Group, and China Financial Futures Exchange. The SSE and Kazakhstan's Astana International Financial Centre authority signed cooperation agreements to co-invest and build the Astana International Exchange.

Risks and challenges facing the financing mechanism for the BRI

Currently, the major risks and challenges facing the financing mechanism for the BRI include heavy debt burdens of the countries along the BRI area, high risks of credit default, below-standard financing practices of some Chinese financial institutions, lack of openness and transparency, and low participation of international financial institutions and domestic private enterprises.

High default risks in financing the BRI may lead to host countries' debt risks and China's credit assets risks

The Belt and Road regions are confronted with relatively low levels of socioeconomic development, poor governmental management of their economies, lack of high-caliber people who meet industrial requirements, difficulty of earning foreign exchange through exports, heavy debt burdens, political and social instability, and high financing risks. If governments and enterprises of host countries fail to allocate China's credit funds efficiently, the level of external debt and unsustainable debt risks will rise, and the BRI will be labeled a "debt trap," increasing the risks of defaulting on BRI credit assets of Chinese financial institutions.

Lack of openness, transparency, and standardization in the financing mechanism

Currently, during infrastructure investment and financing in the Belt and Road regions, issuance of loans to infrastructure projects by Chinese-funded financial institutions largely depends on whether the project is carried out by Chinese enterprises. In fact, this practice was not invented by China. In the 1980s, Japan had frequently adopted a similar practice in investing and financing overseas. Under this mechanism, the quoted interest rate of Chinese financial institutions and quoted construction price of project contracting enterprises are both below market averages. In the absence of this mechanism, and taking into consideration the high risks of investment in BRI countries, Chinese financial institutions would act like international financial institutions and claim higher lending rates or even be unwilling to grant loans. Correspondingly, Chinese project contracting enterprises would raise their quoted prices to offset high project risks. From this point of view, the mechanism is obviously a win-win arrangement for both China and host countries.

For China, it can expand overseas project contracting markets with international credit, and reduce operating costs and investment risks through cooperation between financial enterprises and project contracting enterprises. For host countries, high construction quality of Chinese project contracting enterprises, lower construction costs, and low financing costs, help them considerably reduce the infrastructure's fiscal costs without affecting infrastructure quality. In contrast, huge costs put Western project contracting enterprises at a great disadvantage in the project contracting market in BRI countries. It is beneficial in the long run to reduce investment risks, improve openness and transparency, and welcome third-party international financial institutions and project contracting enterprises to participate.

China alone copes with great financing pressure and risks due to low levels of funding support from foreign governments and financial institutions

The majority of BRI projects are funded mainly or solely by Chinese financial institutions. This is because some BRI countries are heavily in debt and at high financing risk; after the global financial crisis, international financial institutions greatly cut their financing support for big public projects and are more cautiously when extending credit to developing countries.

China's financing support for BRI projects mainly comes from official capital

Bank loans and investment funds led by official capital may easily trigger security concerns and moral hazards in the BRI regions. Governments and citizens in some countries may doubt China's financing support, and oppose the BRI. Some countries may regard such official capital as aid funds, and the lax regulation in the process of financing risky projects and using the funds after they are obtained, will put Chinese-funded capital at significant risk.

Recommendations to improve the financing mechanism for the BRI

In response to the risks and challenges facing BRI financing, China needs to step up assessment and monitoring of financing risks, stick to the principle of openness, conform to international rules, regulate the conduct of Chinese financial institutions, and welcome the capital of host countries and third-party international financial institutions. In the view of declining trade surplus and foreign exchange reserve, China also needs to control rationally the growth of financing scale and promote RMB-denominated Belt and Road lending.

First, it should step up assessment and monitoring of financing risks from BRI projects, control the growth of credit scale, and promote RMB-denominated lending. Chinese financial institutions should abide by the Guiding Principles on Financing the Development of the Belt and Road, and A Framework to Assess Debt Sustainability and Fiscal Risks under the BRI, and step up assessment and monitoring of financing risks before, during, and after the implementation of BRI projects to decrease the likelihood of loan defaults. In view of the fierce competition between China and the other countries in politics, economy, science, and technology, declining trade surplus, and loss of momentum for growth of foreign exchange reserve, China needs to carefully maintain the scale of its financial support for BRI projects to prevent fast growth from affecting the asset quality of foreign exchange funds. Meanwhile, integration of BRI financing with RMB internationalization will broaden RMB backflow channels, and promote RMB-denominated lending, to avoid the negative impact on China's financial support for future BRI projects brought by decreased capital inflow of current account.

Second, it should stick to the principle of openness, conform to international rules, and strengthen cooperation with governments of host countries and third-party international financial institutions. Chinese financial institutions should standardize their financing practices, stick to open, green and clean cooperation, adopt agreed rules and standards, and ensure that infrastructure investment and financing abides by commonly accepted international rules and standards. To mitigate its financing pressure and risks, China should advocate cooperation with developmental financial institutions in countries along the BRI area and big international multilateral development banks, and actively leverage existing bilateral and multilateral government financial cooperation mechanisms. This will help inject external funds into BRI projects and increase the willingness of international commercial financial institutions to participate in financing BRI projects through syndicated loans, co-financing, guarantees, and other risk-sharing mechanisms.

Third, it should promote the PPP model. To avoid concerns from countries along the BRI area about export of China's official capital and abuse of the capital, participation of private capital in financing should be encouraged and supported. In this regard, the PPP financing model needs to be advocated. China should speed up establishing the framework of relevant laws and regulations, issue ordinances that specify the application scope, establishment and bidding process of the PPP model; additionally, it can provide more tax incentives and financial support for enterprises' participation in cross-border PPP projects, such as replacing business taxes with value-added taxes, implementing preferential tax policies aimed at facilitating exports, and adhering to relevant multilateral and bilateral treaties to avoid double taxation. Additionally, private financial institutions should play a larger role under the Belt and Road financial cooperation framework. China should encourage state-owned financial institutions to stay more open in promoting cooperation with private financial institutions, including co-establishing private equity funds to make investments, extending lines of credit with private commercial banks to encourage lending of the latter, and providing guarantees for private financial institutions to encourage their participation in more investing and financing activities.

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