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SECTOR IN-DEPTH
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Sovereigns – APAC and the CIS

China's Belt and Road supports growth potential, but increases macrostability risks for weakest sovereigns

Since unveiling its Belt and Road Initiative (BRI) in late 2013, China (A1 stable) has significantly increased its financing of infrastructure projects in Asia Pacific (APAC) and the Commonwealth of Independent States (CIS) to expand and integrate its trade routes. In this report, we examine the credit implications for 12 APAC and CIS sovereigns,[1] focusing on potential long-run economic gains and near- to medium-term macrostability risks.

» **Large infrastructure projects address investment needs and support long-term growth potential.** By investing in large transportation and energy projects that close critical infrastructure gaps, the BRI helps to expand productive capacity and contributes to both near-term growth and long-run growth potential in recipient countries. We see the greatest potential economic gains for Pakistan (B3 negative), Mongolia (B3 stable), Kazakhstan (Baa3 stable) and Cambodia (B2 stable). However, inefficient project implementation, and the absence of macroeconomic and structural reform requirements in many Chinese loans can lessen longer-term credit benefits for some sovereigns.

» **Scale and terms of BRI investment amplify macrostability risks for sovereigns with weaker economic fundamentals and limited policy effectiveness.** Bilateral lending from China comprises much of the financing for BRI projects. The scale relative to the size of the host economy, the terms of lending, and the recipient – whether government or private sector entity – vary considerably among sovereigns. For countries with weaker fiscal and external positions and large volumes of non-concessional funding, BRI project financing tends to exacerbate debt sustainability and balance of payments pressures. We see the Maldives (B2 negative), Pakistan and Sri Lanka (B2 stable) as the sovereigns at greatest risk from rising debt and widening external imbalances in part related to the BRI. Conversely, Kazakhstan, Vietnam (Ba3 stable) and Thailand (Baa1 stable) are not significantly exposed to potential BRI-related macrostability risks, due to generally stronger sovereign credit profiles or the smaller relative scale of their projects. If applied effectively, China's recently published debt sustainability analysis framework may mitigate financial stability risks that some borrowing countries face from BRI lending. However, the framework's effectiveness will ultimately depend on how widely it is applied, since it is not a mandatory tool.

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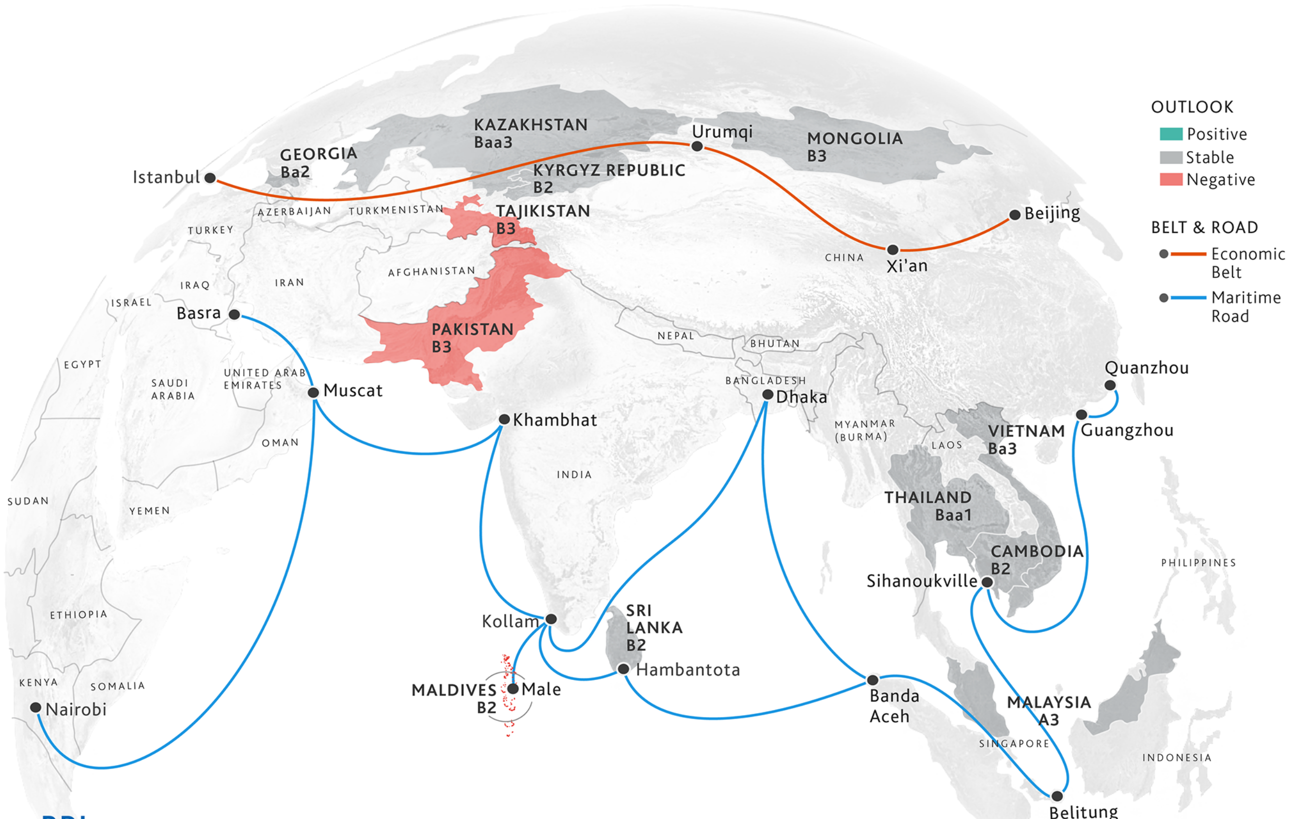
Overview

In previous reports, we have focused on the BRI's implications for sovereign issuers in Sub-Saharan Africa[2] and how BRI relationships will become increasingly important for China.[3] While the BRI covers about 130 countries globally, this report focuses on emerging and frontier countries in South Asia [Pakistan, Sri Lanka and the Maldives], Southeast Asia [Cambodia, Vietnam, Thailand and Malaysia (A3 stable)] and Central Asia/ CIS [Mongolia, Kazakhstan, Tajikistan (B3 negative), the Kyrgyz Republic (B2 stable) and Georgia (Ba2 stable)].



BRI in APAC & CIS

	(I) GROWTH	(II) FISCAL		(III) EXTERNAL	
	GDP Growth	Terms of Lending	Debt Dynamics	Trade Balance	EVI*
	Less More } Supportive	Less More } Concessional	Less More } Sustainable	Higher Lower } Deficit	Higher Lower } Risks
Maldives	—	▼	▼	▼	▼
Sri Lanka	—	▼	▼	▼	▼
Pakistan	▲	▼	▼	▼	▼
Tajikistan	—	—	▼	—	—
Kyrgyz Republic	—	—	▼	—	—
Cambodia	▲	▼	—	▼	▼
Mongolia	▲	▼	—	▲	▼
Malaysia	—	—	—	—	—
Georgia	—	—	—	—	—
Thailand	—	—	—	—	—
Vietnam	—	—	—	—	—
Kazakhstan	▲	—	—	—	—

*(Arrows indicate direction of pressures on sovereign credit profile. Further quantitative analysis of these variables is provided in report.)

**Note: External Vulnerability Indicator = (Short-Term External Debt + Currently Maturing Long-Term External Debt + Total Nonresident Deposits Over One Year)/ Official Foreign Exchange Reserves

Source: Moody's Investors Service

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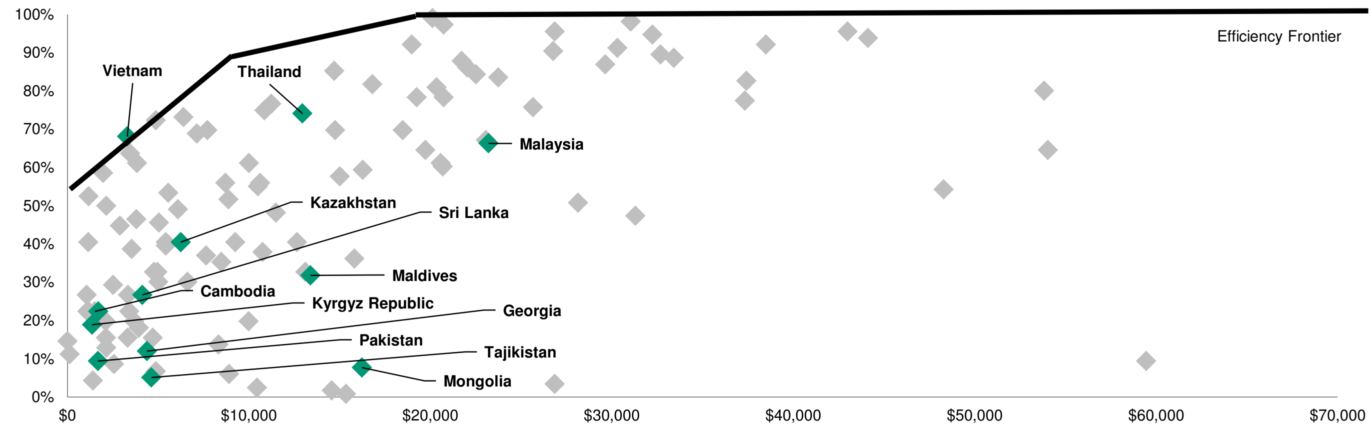
Large infrastructure projects address investment needs and support long-term growth potential

BRI infrastructure investment bolsters growth potential, economic linkages with China

Many BRI countries possess weak physical infrastructure and have relatively low levels of economic development,[4] which constrain competitiveness and growth potential. Many of these sovereigns also demonstrate low efficiency in public investment, which further limits potential economic growth from incremental infrastructure investment (see Exhibit 1).

Exhibit 1

Weak efficiency in public investment constrains economic growth
(Public capital stock per capita in PPP dollars - x axis; percentile rank* of infrastructure quality - y axis)

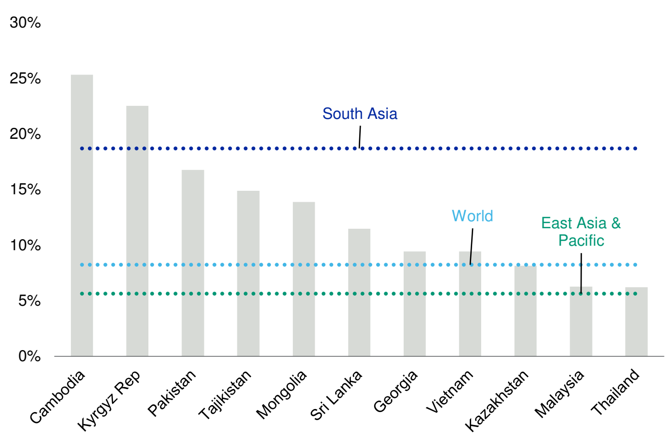


*Note: Percentile rank based on rated sovereigns and data availability
Sources: IMF, World Bank, Moody's Investors Service

The BRI's focus on basic infrastructure investment, particularly in the transportation and energy sectors, helps to address key bottlenecks to growth. Investment in these sectors should help to strengthen business environments and cost competitiveness, supporting trade viability and foreign direct investment (FDI) and, in turn, higher productivity. For example, BRI investment in energy infrastructure develops grid networks and lessens power losses and outages, resulting in productivity gains and, in some cases, reduced balance of payments risks through lower energy imports (see Exhibits 2 and 3).

Exhibit 2

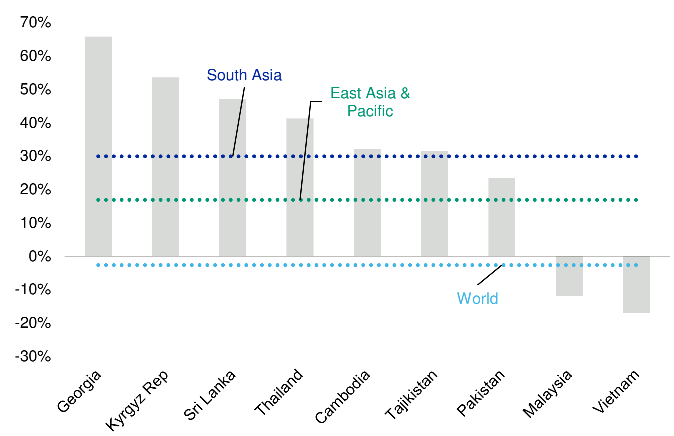
Some economies suffer significant losses in power transmission...
(Power transmission and distribution losses as % of output)



Note: Data is five-year average of latest available data. No data is available for the Maldives.
Sources: World Bank, Moody's Investors Service

Exhibit 3

...contribute to lower productivity losses, higher energy imports
(Net energy imports as % of energy use)



Note: Data is five-year average of latest available figures. No data is available for the Maldives. Kazakhstan and Mongolia are omitted due to substantial net exports.
Sources: World Bank, Moody's Investors Service

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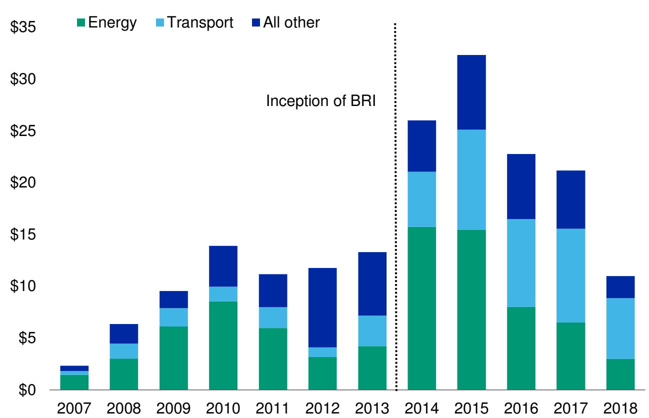
For many of the 12 sovereigns covered in this report, the value of Chinese direct investment and Chinese-led construction contracts has picked up considerably since 2013 (see Exhibit 4), following the official launch of the BRI. We view Chinese construction contracts as a close proxy for bilateral lending from official Chinese institutions, as it is highly common for China to lend money to foreign governments through state-owned financial institutions, in exchange for guaranteed contacts with Chinese construction companies.[5]

Since 2014, over three-fourths of Chinese investment has targeted the transportation and energy sectors. Overall, Pakistan, Malaysia, Kazakhstan, Sri Lanka and Cambodia have received the largest investment flows. However, the relative scale of investment compared to the size of the host economy differs materially, resulting in substantial variation in the potential impact of BRI projects on economic growth. For example, although Pakistan has received the largest absolute volume of Chinese investment, relative to GDP, investment is significantly higher in the Kyrgyz Republic, Mongolia, the Maldives and Cambodia (see Exhibit 5).

Exhibit 4

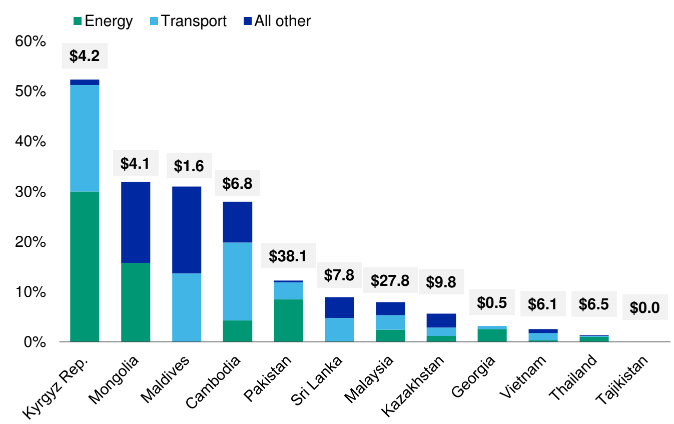
BRI projects in APAC and the CIS have focused mainly on the energy and transport sectors...
($ billions)



Note: Sum of total for 12 sovereigns.
Sources: China Global Investment Tracker, Moody's Investors Service

Exhibit 5

...with varying scale relative to the size of host economies
(Cumulative flows 2014-18, % of GDP)



Note: Data label is nominal amount in $ billions
Sources: China Global Investment Tracker, Moody's Investors Service

Project efficiency and absence of loan conditionality may limit longer-term benefits of BRI

Despite the large scale of BRI infrastructure investment, there are a number of factors that constrain the potential economic growth benefits in host countries by reducing the efficiency of project implementation and the extent to which such projects produce positive cash flow. For example, as with infrastructure projects in many emerging and frontier markets, BRI projects must navigate often difficult operating environments involving weak economic, legal and institutional frameworks that result in delays and other hurdles to implementation. These operating challenges reduce the efficiency of investment and limit long-run macroeconomic benefits.[6]

Meanwhile, although BRI-related public investment raises GDP, lower output gains as a result of less efficient investment can also lead to unsustainably higher debt-to-GDP ratios.[7] Chinese lenders often do not attach conditions requiring policy reforms that would mitigate such risks. This difference in approach can lessen the long-term economic benefits relative to financing from international financial institutions (IFIs) that require such conditionality. For example, the conditionality of multilateral development bank (MDB) loans tends to promote structural reforms aimed at strengthening macroeconomic and institutional frameworks that support sovereign credit profiles.

Relative to projects funded by MDBs and OECD Development Assistance Committee members, the positive economic impact of Chinese project financing tends to be more muted and shorter-lived. This is in part due to weaker loan conditionality and less expertise in project approval and appraisal processes and execution, and less rigorous cost benefit analyses. In addition, empirical, project-level analysis[8] of Chinese official development assistance (ODA), which is development oriented and usually provided on highly concessional

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terms, reveals that the more commercial (i.e., less concessional) the terms of Chinese infrastructure financing, the more muted the short-term growth benefits tend to be.

After considering these various factors, based on the scale of BRI investments and efficiency of public investment, we believe that Pakistan, Mongolia, Cambodia and Kazakhstan have the greatest potential to reap the long-run economic benefits from BRI investments.

As a benchmark, IMF staff have estimated in the past that raising infrastructure investment by 2% of GDP annually over a five-year period can increase annual real GDP growth by 1.5 percentage points in the near term and 0.3 percentage points over the long term.[9]

However, realizing such potential will depend on: project-specific investment efficiencies and completion time horizons; whether investments are additive or replace existing physical capital stock; the overall import intensity of investment; and the increased value-add for the economy.

Considering these factors, we expect BRI investments in the Maldives and the Kyrgyz Republic, despite their large scale relative to the size of the economies, to have a more limited overall impact on growth. Meanwhile, although BRI investments will complement ongoing domestic infrastructure plans in Vietnam and Thailand, their relatively small scale compared to the size of the economies will limit their impact on growth and the overall sovereign credit profile.

The following, more-detailed considerations on the country-specific economic impact of the BRI contributes to our overall assessment of economic strength in the respective sovereign credit profiles.

In **Pakistan**, the China-Pakistan Economic Corridor (CPEC), investment related to which totals around $18 billion (6% of fiscal 2018 GDP) to date, comprises $11.5 billion in private sector power projects under the independent power producers (IPP) scheme, and $6.5 billion in public sector infrastructure projects. These early-harvest investments are helping to eliminate chronic power shortages and we believe they will continue to gradually reduce supply-side bottlenecks. Additionally, we expect investments in the Port of Gwadar and new Gwadar airport, along with numerous rail and highway expansions, to shorten travel times along the western CPEC route, and facilitate the transport of goods to domestic and foreign markets. As part of the CPEC's second phase, we expect special economic zones to spur FDI, such as in the auto sector, that will durably increase Pakistan's manufacturing capacity.

In **Mongolia**, BRI investments focus mainly on rail transport and mining. The China-Mongolia-Russia Economic Corridor is a significant opportunity, given the country's strong diplomatic ties with and proximity to China. We expect two free trade zones – one each along the borders with China and Russia (Baa3 stable) – to boost Mongolia's export competitiveness by increasing rail capacity that will reduce bottlenecks and delays. As a landlocked country with abundant natural resources, Mongolia's growth prospects hinge on the development of the Tavan Tolgoi coal mine, the largest and mostly untapped metallurgical coal deposit in the world, and Oyu Tolgoi, one of the world's largest high-grade copper deposits. We expect that both can materially strengthen Mongolia's export competitiveness, given low-cost production and ongoing growth in demand from China.

For **Cambodia**, BRI investment is predominantly focused on the energy sector – both hydropower and coal power plants – and transportation projects. Overall, China's cumulative investments in Cambodia's energy sector total more than $11.5 billion (90% of 2018 GDP),[10] with approximately $5.3 billion of that occurring since 2013. We envisage that these power sector projects will help to reduce supply-side bottlenecks. Additionally, several transportation projects are underway, including the $2 billion Phnom Penh-Sihanoukville expressway, which will reduce transportation time and cost for goods traveling to Cambodia's sole deep-water port. Overall, we believe these infrastructure investments will help to raise Cambodia's growth potential.

Kazakhstan's strategic location within Central Asia along the old Silk Road is complemented by China's development of transportation networks with European trade partners. BRI investment focuses on development of Kazakhstan's rail network through the Khorgos Gateway, the world's largest dry port, which will expand capacity and dramatically increase shipping volumes through Kazakhstan.[11] Overall, we expect that the development of the transport logistics sector will allow Kazakhstan to benefit from any increase in trade between China and Europe, which will contribute to economic diversification away from hydrocarbon production.

BRI investments in **Vietnam** and **Thailand** are smaller in relation to the size of their economies, and both countries are incorporating these investments into existing government-led infrastructure plans. This is in part due to better physical infrastructure and project

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financing options than in many other BRI countries, which contribute to higher investment efficiency. Vietnam's current investment plans address most of its major infrastructure concerns, implying less of a need for Chinese project financing. The same is true for Thailand, where the Eastern Economic Corridor (EEC) – the government's five-year, $50 billion (10% of 2018 GDP) infrastructure plan – is significantly less reliant on construction and financing from China. Nonetheless, as with other members of the Association of Southeast Asian Nations,[12] BRI investments complement long-standing trade and investment relationships with China, along with select domestic infrastructure programs, which will help to further develop trade capacity and support future growth.

While the scale of BRI and overall infrastructure investment is large in the **Maldives**, there are two major challenges in capturing potential benefits: a large efficiency gap in public investment, and the economy's significant dependence on tourism and high exposure to climate change risk.[13] Even if large investment spending raises near-term demand-side growth, investment efficiency leakages and a significant buildup in leverage may limit the small island nation's ability to better withstand economic, external and climate shocks.

Similarly, while the **Kyrgyz Republic** has experienced the largest BRI investment as a share of GDP since 2014, inefficiencies in the investment process, the economy's limited ability to absorb such a large quantum of investment, and the high import content of major projects mean that the investment is not materially increasing real GDP growth. The surge in borrowing has limited fiscal space and is challenging the authorities' ability to prioritize growth-enhancing policies that diversify the economy away from low-productivity trade and agriculture.

Scale and terms of BRI investment amplify macrostability risks for sovereigns with weaker economic fundamentals and limited policy effectiveness

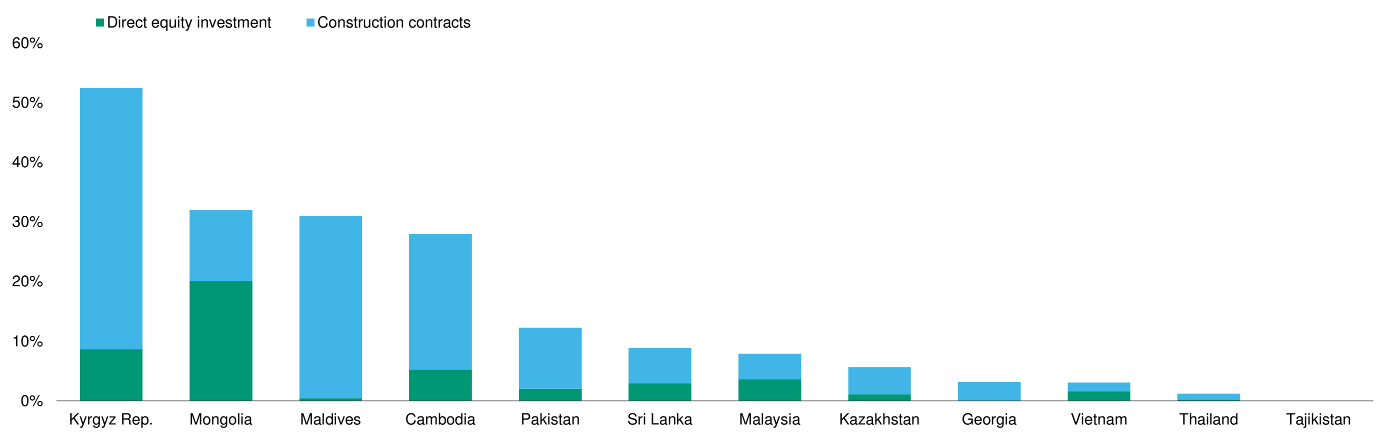
While BRI investments can boost economic growth, in some cases they also exacerbate fiscal and external vulnerability risk which limits potential long-term economic gains.

BRI investments are mainly financed by debt and pose the greatest credit risks to sovereigns that (i) are receiving large volumes of non-concessional financing, and (ii) already have elevated – particularly external – debt burdens, low foreign exchange reserves, large or widening current account deficits, and relatively weak institutions.

Debt is the primary source of funding for BRI investments

With the exception of Mongolia, most BRI project financing for the 12 sovereigns covered by this report is comprised of debt in the form of direct bilateral loans from China, rather than direct equity investment, that backs construction contracts with Chinese firms (see Exhibit 6). The resulting rise in debt, if not accompanied by commensurately faster economic growth, reduces debt sustainability and increases credit risks, particularly as these sovereigns face higher external debt servicing requirements.

Exhibit 6
Loans play a larger role than direct investment in BRI projects
(Cumulative flows 2014-18, % of GDP)



Sources: China Global Investment Tracker, Moody's Investors Service

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Higher non-concessional lending reduces debt sustainability and increases external vulnerability risk

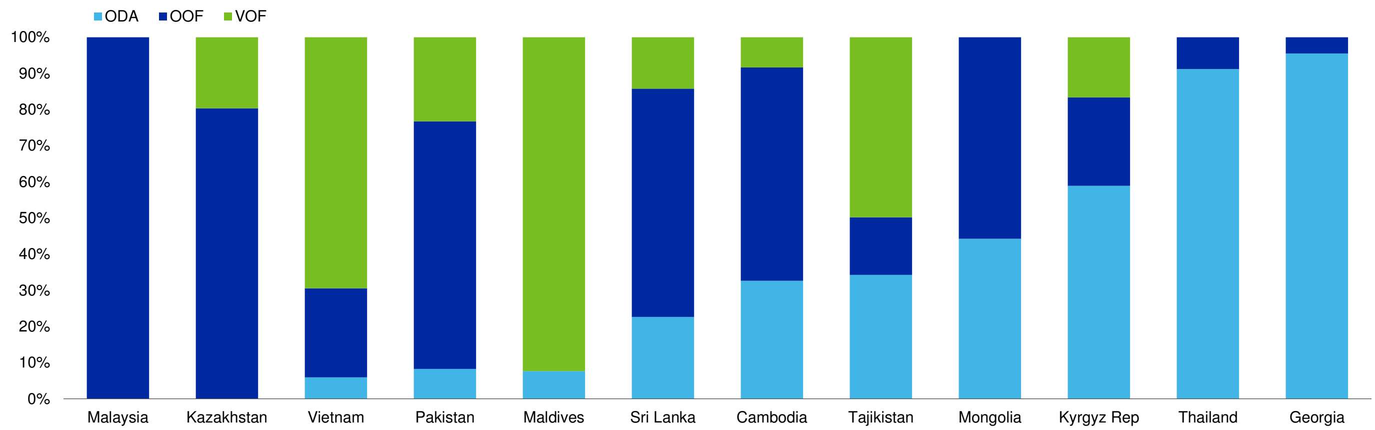
A key risk for BRI sovereigns is the fact that most project funding is non-concessional. All else equal, more commercial terms increase debt obligations and reduce debt affordability relative to concessional borrowing, which weighs on a government's fiscal strength. The lending terms can therefore mitigate or amplify risks to sovereign credit profiles.

To gauge the terms of BRI lending in the region, we rely on a combination of official host country and third-party sources, predominantly from the College of William & Mary/AidData's Global Chinese Official Finance Dataset.[14] While data are only available until 2014, AidData provides the greatest level of detail on lending terms.

Chinese lending falls into three categories defined by the OECD: (i) ODA – projects with a development focus and at least 25% concessionality; (ii) other official flows (OOF) – projects not primarily focused on development and with a grant element below 25%, often in countries that are not eligible for ODA; and (iii) vague official finance (VOF) – projects for which there is insufficient information and/or criteria to determine whether the lending is ODA or OOF.

Based on these categories, the terms of lending have varied widely across APAC and the CIS. Of the 12 sovereigns, Pakistan and Vietnam received the smallest share of concessional ODA loans, while Malaysia and Kazakhstan received no concessional financing. Conversely, one-third or more of cumulative lending to Tajikistan, Mongolia, the Kyrgyz Republic, Thailand and Georgia fell under ODA (see Exhibit 7).

Exhibit 7
Terms of past lending to BRI participants has varied widely
(Share of total lending by type, cumulative 2000-14)



Sources: AidData, Moody's Investors Service

BRI borrowing has raised debt burdens, weakened debt affordability for some sovereigns

With already elevated debt burdens and in some cases weak debt affordability, additional borrowing for large BRI projects exacerbates pressures on fiscal strength for the **Maldives, Sri Lanka, Pakistan, Tajikistan** and the **Kyrgyz Republic** (see Exhibit 8), heightening potential debt sustainability risks. In addition, the often opaque, non-concessional terms of Chinese lending obfuscates government liquidity assessments, particularly given the large scale of many BRI projects for some of these sovereigns.

When accounting for both outstanding debt owed to China and future lending pipelines from China,[15] the fiscal outlook deteriorates further for some sovereigns – the **Kyrgyz Republic, Tajikistan, Mongolia, Cambodia** and the **Maldives** each would have total estimated liabilities of close to 50% of GDP and above owed to China. For all of these countries, except Mongolia, potential future projects would more than double outstanding debt owed to China, which would increase funding source concentration risk and likely pressure government liquidity risk (see Exhibit 9).

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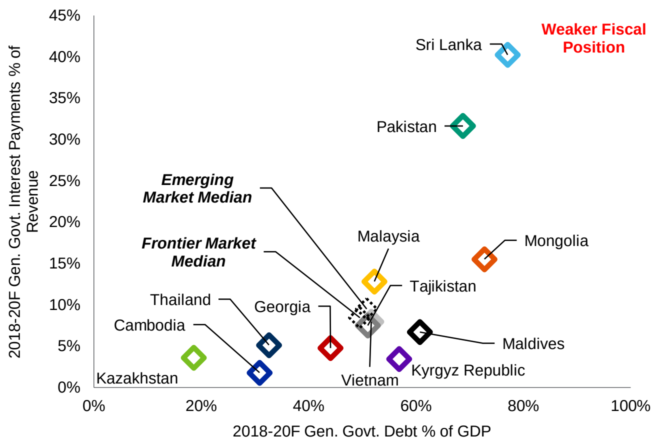
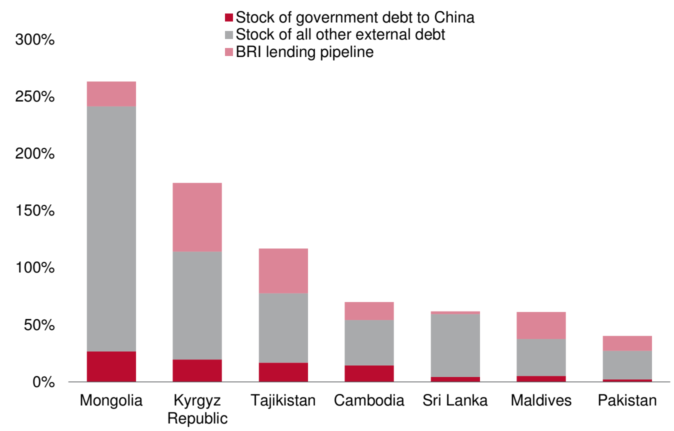
Exhibit 8
Many BRI countries already have elevated debt burdens and weak debt affordability...
(%)



Source: Moody's Investors Service

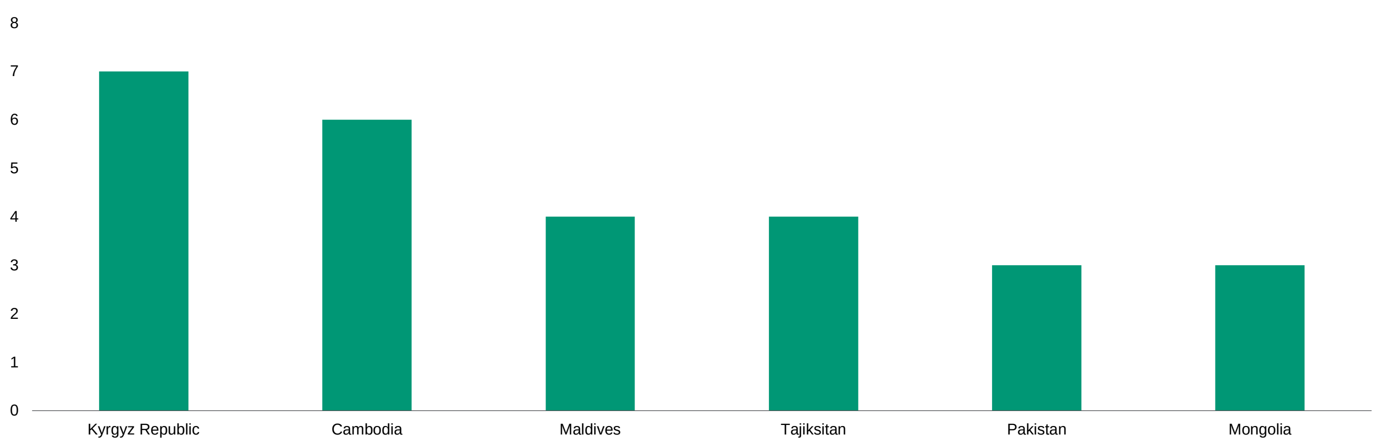
Exhibit 9
...and Chinese lending is set to increase further for some of the most externally indebted
(% of GDP, 2016*)



Note: Debt owed to China is as of the end of 2016, while BRI lending pipeline is projects announced through May 2018 since 2016.
Sources: Center for Global Development, Moody's Investors Service

For these sovereigns, the ability to "grow out" of additional government borrowing depends in part on nominal GDP growth rates. For example, it would take Cambodia and Kyrgyz Republic around an additional six and seven years, respectively, to stabilize their debt-to-GDP ratios back to end 2018 levels, based on a set of reasonable assumptions (see Exhibit 10).[16]

Exhibit 10
Given variation in growth rates, trajectory of debt burdens would vary significantly among countries with largest BRI lending pipelines
(Number of years required to stabilize debt-to-GDP ratios back to end 2018 levels)



Note: Assuming historical levels of nominal GDP growth, constant exchange rates, the full BRI lending pipeline as direct government debt taken on over a five-year period (with no added growth benefits from these investments), relative to a scenario in which these sovereigns' achieve a debt-stabilizing primary deficit
Sources: Center for Global Development, Moodys Investors Service

Put differently, all of these sovereigns would be able to stabilize their debt burdens within at most 15 years if nominal GDP were to grow at historical rates in dollar terms. However, the pace of debt accumulation for pipeline BRI investments and potentially larger debt burdens from accumulating primary deficits would be added fiscal risks for those slower-growing economies, coming on top of likely currency depreciation from balance of payments pressures that would weigh on debt affordability.

Of the 12 sovereigns, significant borrowing from China, or indirect fiscal costs as a result of such large BRI investments, is weighing most heavily on the fiscal strength of the following sovereigns:

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For the **Maldives**, **Tajikistan** and the **Kyrgyz Republic**, which have all amassed a large stock of debt to China, a lack of diverse funding sources stokes government liquidity and refinancing risk. The Maldives has accumulated a large amount of bilateral debt with China that it has used to finance several projects, including the upgrade of Malé's international airport and construction of the Sinamalé Bridge, originally known as the China-Maldives Friendship Bridge, which connects the islands of Malé and Hulhulé. Total debt to China is around $1.5 billion (roughly 70% of gross external debt), including guaranteed debt and debt owed directly to China. Meanwhile, Tajikistan's approximately $1.3 billion owed to the Export-Import Bank of China (CEXIM, A1 stable) comprises approximately 40% of the country's total external debt, which is worth around 39% of GDP. In the Kyrgyz Republic, CEXIM is similarly the sovereign's single largest creditor – its approximately $1.5 billion in outstanding loans comprise approximately 40% of the total external debt burden, which totaled over 100% of GDP at the end of 2018. For the Kyrgyz Republic, we expect that single-name creditor limits for the government's borrowing will limit further growth in this concentration.

In part owing to CPEC-related infrastructure projects, **Pakistan's** fiscal deficit widened to 5.6% of GDP in the year ending June 2017 and 6.4% in fiscal 2018 from an average of 4.7% over fiscal 2014-16. We project the fiscal deficit to be 5.9% of GDP in fiscal 2019 despite cuts to development spending, which includes infrastructure projects, given still weak revenue performance. Furthermore, a rising share of foreign currency borrowing for infrastructure projects and financing of the balance of payments deficit continue to pressure Pakistan's fiscal position.

Sri Lanka's indebtedness and external payment obligations were already substantial before the government began borrowing from China, and BRI has exacerbated these challenges. Of the approximately $10.3 billion (12% of 2018 GDP) of BRI investment in Sri Lanka, most projects are financed through debt. As of February 2019, Chinese loans were about 12% of Sri Lanka's total outstanding government foreign debt. The Hambantota Port and Mattala International Airport, together financed through $1.2 billion of borrowing, have proved to be commercially unviable. The onerous debt servicing burden was not covered by project cash flow, which led the government to restructure its loan in July 2017, in exchange for a 99-year lease on the port. While the restructuring provided a temporary respite to reserve adequacy, we expect the government's fiscal position to remain highly vulnerable to tightening in external and domestic financing conditions, given relatively large borrowing needs, reliance on external funding, and still low reserve adequacy.

Conversely, for **Kazakhstan** and **Thailand**, stronger fiscal starting positions, combined with sturdier macroeconomic fundamentals, mean there has been little or no risk to fiscal strength from BRI engagement. Kazakhstan's strong fiscal position affords it greater funding choices than other BRI sovereigns for which Chinese financing may be the only option. Although $26 billion (15% of estimated 2018 GDP) of infrastructure projects have been announced between Kazakhstan and China, they have not directly impacted the government's balance sheet. Total general government external debt was only 9.1% of GDP as of the end of 2017.[17] Similarly, for Thailand, financing for the EEC comes from a diverse mix of sources, not entirely through external government borrowing. For example, 80% of the financing for the $9.9 billion (2.0% of estimated 2018 GDP) Bangkok-Nong Khai rail project, which will facilitate further trade, is planned to be sourced from domestic borrowing, with the remainder raised externally. Unlike in many other BRI projects, China is providing design and supervision of the contract, not full-scale construction and financing.

BRI is contributing to elevated external vulnerability risks in some sovereigns

BRI investments are also adding to increased external vulnerability risks for some governments, particularly where export competitiveness has been slow to rise, Chinese imports have increased, and external debt repayments have weighed on foreign exchange reserves. This is most evident in the **Maldives, Pakistan** and **Sri Lanka**.

One of the main contributors to the deteriorating external positions of these countries is a substantial rise in imports from China for BRI projects, without offsetting exports, resulting in wider trade imbalances. This is of greatest significance for BRI projects that are designed to rely on both imported capital goods and labor from China, and that include significant external debt repayments in hard currency. The high import intensity and large external debt repayments of some BRI projects have raised external and price pressures, prompting tighter monetary and fiscal responses from policymakers, which weigh on economic growth.

Since 2013, trade balances have deteriorated the most in **Pakistan** and **Cambodia**, due to a surge in imported capital goods used in the construction of the CPEC and two large energy sector projects, the Kemchay Dam and Lower Sesan II Hydropower Plant (see Exhibit 11). There has not been any substantial pickup in exports to offset these imports. Conversely, **Mongolia** has seen a near doubling of its trade surplus with China.

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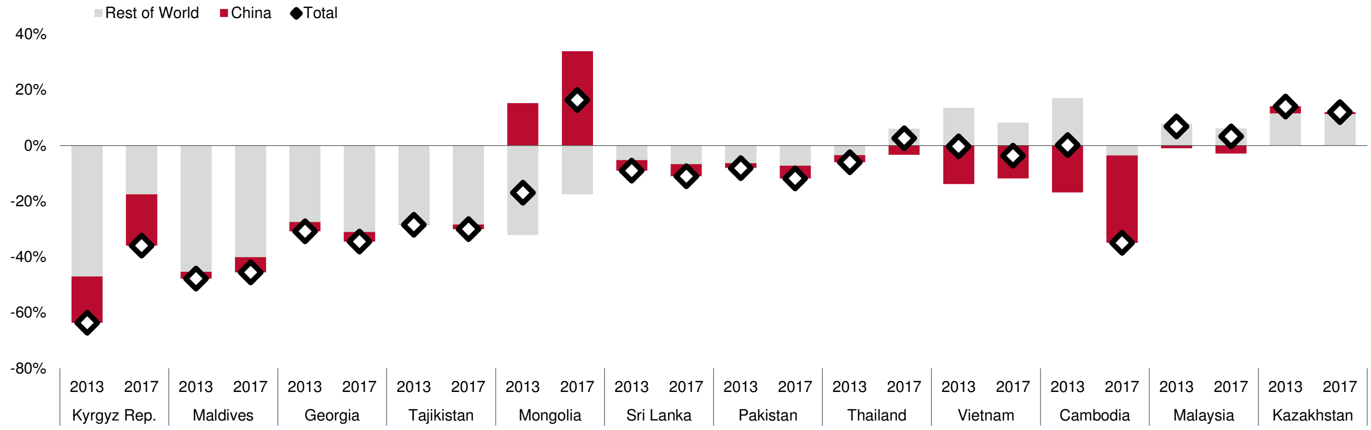
Exhibit 11

Trade deficits have widened the most in Pakistan and Cambodia, driven by imports from China
(% of GDP)



Sources: IMF Direction of Trade, Moody's Investors Service

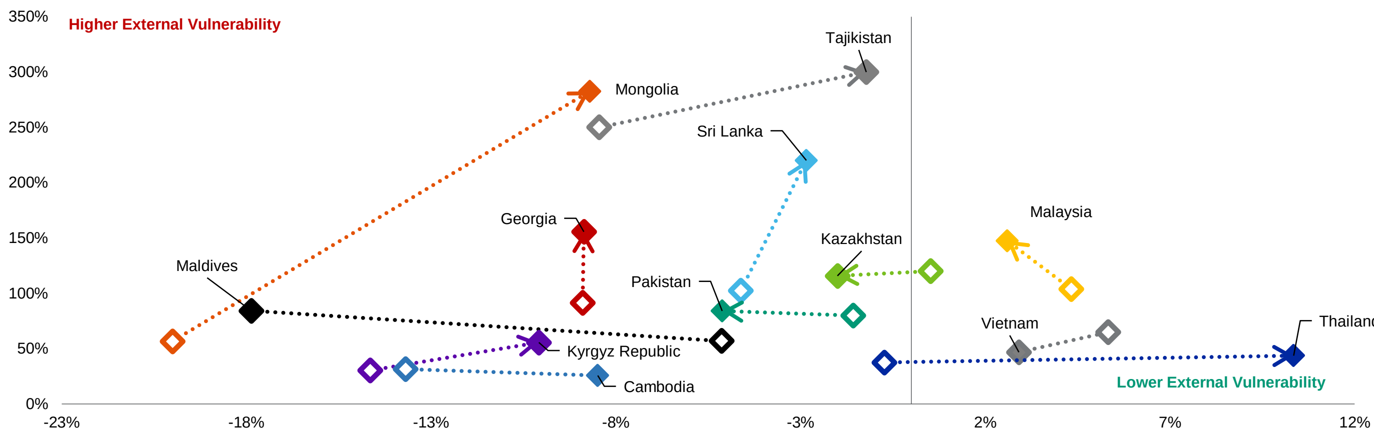
According to the Reconnecting Asia database, which tracks Asian infrastructure at the project level, 89% of BRI projects are run by Chinese companies, with only 7.6% led by local companies, and 3.4% by other foreign companies. This imbalance contributes to higher foreign currency outflows from the import of raw materials, capital goods and labor, and loan repayments on external financing.

Comparatively, for projects financed by the World Bank (IBRD, Aaa stable) and Asian Development Bank (ADB, Aaa stable), 29% of contractors are Chinese, 40.8% local, and 30.2% foreign.[18]

For **Cambodia, Sri Lanka** and the **Maldives**, substantial tourism receipts play a key role in offsetting sizable goods deficits with China. However, for the latter two, this has had limited impact in mitigating material balance of payments risks. Meanwhile, for **Pakistan** and the **Maldives**, adverse trade dynamics and external payment requirements have contributed to wider current account deficits and low foreign exchange reserve adequacy (see Exhibit 12).

Exhibit 12

External pressures have built up in many BRI sovereigns
(Current account balance, % of GDP - x axis; external vulnerability indicator, % - y axis)



Note: Outlined marker is 2012-13 average; full-colored marker is 2017-18E average
Source: Moody's Investors Service

Without a concomitant pickup in FDI, wider current account deficits have driven declines in the Maldives' and Pakistan's basic balances, while despite narrower current account deficits, the Kyrgyz Republic and Sri Lanka have retained negative basic balances due to

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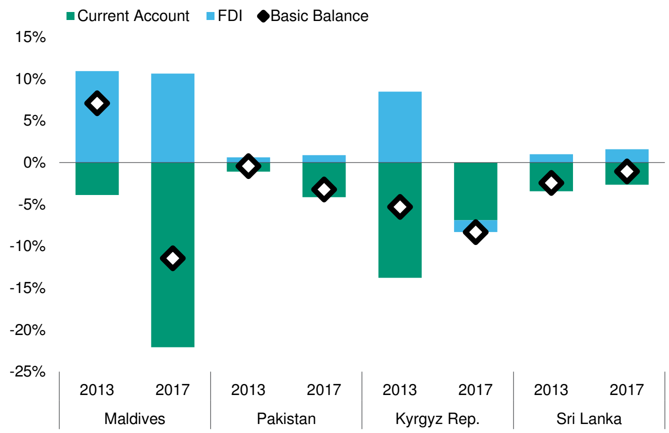
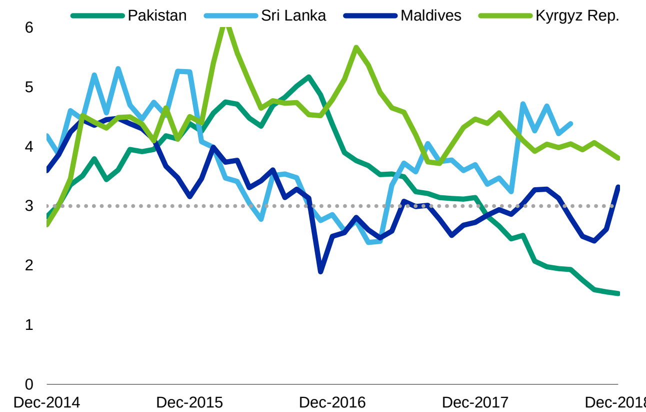
relatively weak FDI (see Exhibit 13). In addition, extended balance of payments pressures have reduced foreign reserves adequacy from already low levels in both the Maldives and Pakistan (see Exhibit 14).

Exhibit 13
Current account deficits and weak FDI inflows weigh on basic balances...
(% of GDP)



Source: Moody's Investors Service

Exhibit 14
...and have diminished foreign reserve adequacy
(Months of import cover)

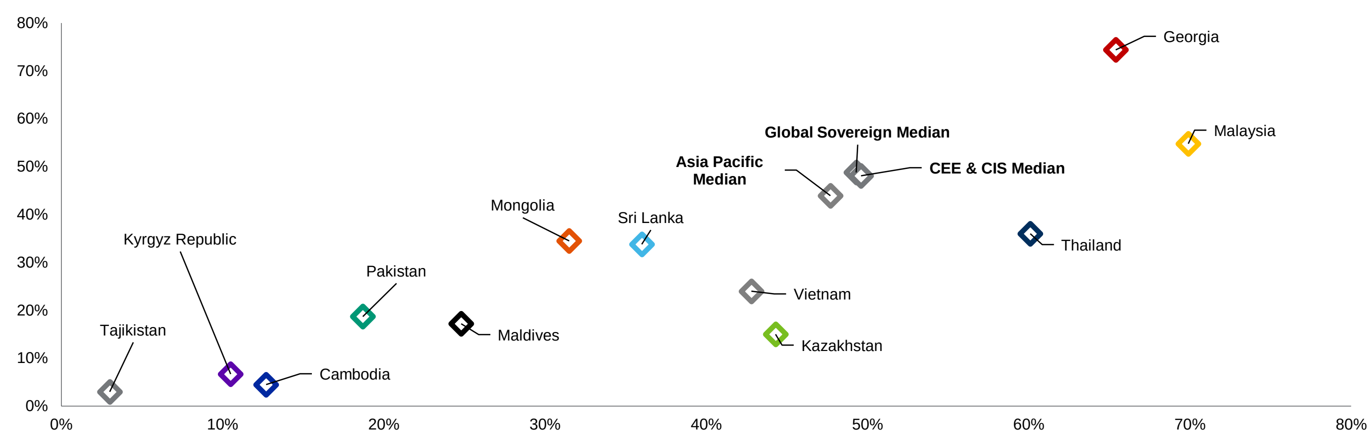


Import cover = exchange reserves excluding gold divided by a three-month moving average of goods imports
Sources: National authorities, Moody's Investors Service

Weak institutional frameworks can increase risks from BRI investments and limit policy effectiveness

Given relatively weak institutional frameworks and limited policy effectiveness in many of the sovereigns covered, macrostability challenges have become more pronounced, constraining the potential economic gains from BRI projects. For example, nine of the 12 rank below regional and global medians on international surveys of government effectiveness and control of corruption, which are some of the variables we consider when assessing a sovereign's overall institutional strength (see Exhibit 15).

Exhibit 15
Many BRI sovereigns have low rankings on surveys of institutional strength
(% rank* of government effectiveness, x-axis; control of corruption, y-axis)



*Among rated sovereigns
Sources: Worldwide Governance Indicators, Moody's Investors Service

Pakistan is an example of a country where institutional weaknesses combined with sizable Chinese investment have led to increased external vulnerability risks, given limited policy effectiveness in responding to those risks. While the CPEC is contributing to infrastructure improvements and increased aggregate demand, it has also resulted in substantial economic imbalances, as

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discussed above. The pickup in Pakistan's GDP growth was significant – to 5.8% in fiscal 2018, from 5.4% in fiscal 2017 – but resulted in imbalances, as it led to a material pickup in imports, including those not related to CPEC, and balance of payment pressures. Policymakers did not tackle this buildup of risks until foreign exchange reserves had fallen significantly.

To address these external imbalances, the State Bank of Pakistan has tightened domestic monetary conditions by allowing the Pakistani rupee to depreciate by over 30% since the beginning of December 2017 and raising policy rates by 500 basis points. Additionally, the government tightened fiscal policy and imposed regulatory duties on imports of nonessential goods. We expect these measures to temporarily slow economic growth below 4% this year and to narrow the current account deficit to around 4.5% of GDP.

In **Sri Lanka**, multiple feasibility studies questioned the economic viability of constructing a port in Hambantota, yet construction nonetheless went forward with the government and CEXIM signing a $307 million, 15-year loan agreement in 2007. The port opened in 2010.[19] According to data from the Sri Lankan Port Authority, traffic at the Hambantota port through 2018, measured in both vessels arrived and cargo handled, has been subdued since its opening, highlighting its limited economic viability and lack of positive impact for the Sri Lankan economy.

Potential future renegotiation of loan terms could mitigate some risks

The potential for restructuring loans to more concessionary terms could prevent crystallization of BRI-related risks for some sovereigns. For example, there have been several renegotiations in Sub-Saharan Africa,[20] demonstrating that Chinese debt relief is a possibility. However, China's presence as a major lender, often with significant opacity on lending terms, can be an obstacle to other lenders and impede more comprehensive debt restructurings, including from the Paris Club. This has been the case in the Republic of the Congo's (Caa2 stable) request for financial assistance from the IMF.

Unlike many of the world's largest advanced economies, China is not a member of the Paris Club, a group of advanced economy official creditors that provides debt restructuring for countries that have demonstrated commitment to restoring economic and financial conditions. As such, Chinese policy banks – which have provided approximately half of the funding for the BRI – have greater flexibility to provide liquidity relief by extending maturities on existing loans, on a bilateral basis, without adhering to the terms and conditions of a Paris Club restructuring.

Moving forward, the extent to which China works with BRI host countries to limit the buildup of unsustainable debt burdens and external risks, including through the restructuring of non-concessional loans, from BRI project investments will influence the net credit implications for the host sovereigns. The new Debt Sustainability Framework that was presented at the second BRI forum in Beijing on 25 April 2019 is a step in this direction.[21] The framework is comprehensive and based on similar principles about what drives debt sustainability as the frameworks defined by other institutions. If applied effectively, it may mitigate financial stability risks that some borrowing countries face from BRI lending. However, the framework's effectiveness will ultimately depend on how widely it is applied, since it is not a mandatory tool.

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Moody's related publications

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Endnotes

1 Cambodia, Georgia, Kazakhstan, Kyrgyz Republic, Malaysia, the Maldives, Mongolia, Pakistan, Sri Lanka, Tajikistan, Thailand and Vietnam

2 See Sovereigns – Africa: China's lending supports growth, exacerbates fiscal and external pressures in Sub-Saharan Africa, November 2018

3 See China's Belt and Road Initiative: BRI report card – deeper linkages, greater caution, January 2019

4 Proxied by GDP per capita in purchasing power parity (PPP) terms

5 For the purposes of this paper, we sum FDI and construction contracts to approximate total investments made by China in both equity and debt, based on data provided in the China Global Investment Tracker database from the AEI/Heritage Foundation.

6 See "Is it time for an infrastructure push? The macroeconomic effects of public investment", IMF World Economic Outlook Chapter 3, October 2014

7 Among the qualitative factors that the IMF notes could impede the efficiency of infrastructure investment, in no particular order, are weak project appraisal and approval processes, the rigor of cost-benefit analyses, lack of zero-based budgeting principles, and weak project execution.

8 See "Aid, China, and Growth: Evidence from a New Global Development Finance Dataset", Dreher et. al., AIDDATA Working Paper 46, October 2017

9 See "How Will China's Rebalancing Affect – Regional Economic Outlook: Middle East and Central Asia," IMF, October 2016

10 See "Are China's gifts a blessing or a curse for Cambodia," Heng, East Asia Forum, August 2018

11 See "The Rise of China-Europe Railways," Hillman, Center for Strategic & International Studies, March 2018

12 The Association of Southeast Asian Nations includes Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand and Vietnam.

13 See Environmental Risks – Sovereigns: Credit profiles of small, agriculture-reliant sovereigns most susceptible to climate change risk, May 2018, and "Maldives: 2017 Article IV Consultation, Country Report No. 17/357," IMF, December 2017

14 AidData, a research lab at the College of William & Mary, has developed a data set of over $350 billion in projects, both with Chinese aid and non-concessional official financing, spanning 138 countries between 2000-14. While this time span does not ideally overlap with the BRI, it provides context on Chinese regional financing, and can serve as a proxy for gauging further Chinese investment as the BRI matures.

15 See "Examining the Debt Implications of the Belt and Road Initiative from a Policy Perspective," Hurley et. al, Center for Global Development Policy Paper 121, March 2018

16 Assuming historical levels of nominal GDP growth, constant exchange rates, the full BRI lending pipeline as direct government debt taken on over a five-year period (with no added growth benefits from these investments), relative to a scenario in which these sovereigns' achieve a debt-stabilizing primary deficit.

17 See "China's Belt and Road Initiative and its Impact in Central Asia," Laruelle, The George Washington University: Central Asia Program, 2018

18 See "The Belt and Road's Barriers to Participation," Hillman, Reconnecting Asia, February 2018

19 While initial construction occurred before the official date of the BRI, further development of the Hambantota port became enveloped under the auspices of the BRI.

20 See Sovereigns – Africa: China's lending supports growth, exacerbates fiscal and external pressures in Sub-Saharan Africa, November 2018

21 See "Debt Sustainability Framework for Participating Countries of the Belt and Road Initiative," Ministry of Finance of People's Republic of China, April 2019

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