The challenges and the opportunities of the Belt and Road initiative for participating countries: the case of Timor-Leste[1]

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Abstract:

One of the main cornerstones of all infrastructure programs is always their financing. This is certainly the case of the Belt and Road Initiative (BRI). The initiative is estimated to be supported by nearly US$1 trillion in financing from Chinese state-owned Banks to serve projects implemented by Chinese state-owned enterprises along the Belt and Road. It is a clear example of China's financial statecraft. In this paper, a case study of the potential impact of the BRI on a small insular developing state like Timor-Leste is assessed. The country is an interesting example of both the attractive features and the potentially negative effects of the BRI for a participating country. We conclude that the risks are sufficiently mitigated and that the potential benefits outweigh the risks, particularly if the country maintains a diversified pool of development partners, and if, as a consequence, sizable private sector financing for infrastructure starts flowing into the country.

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Keywords:

Belt and Road Initiative, financing for development, financial statecraft, China, Timor-Leste.

Introduction:

Nearly five years have passed since the announcement of the Belt and Road Initiative (BRI) in 2013 by Chinese President Xi Jinping, an initiative estimated at around US$1 trillion that claims to increase connectivity, trade and economic growth across Asia and beyond. As its strategic document mentions (National Development and Reform Commission, hereafter NDRC, 2015), the initiative 'intends to strengthen hard infrastructure with new roads and railways, soft infrastructure with trade and

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transportation agreements, and even cultural ties with university scholarships and other people-to-people exchanges'. It currently covers more than 90 countries and over two-thirds of the world's population.

These five years have proved the Chinese political and economic commitment to the initiative. The BRI has become the cornerstone of President Xi's foreign economic policy and one of the pillars underpinning his political appeal domestically. The initiative was included in the Chinese Communist Party's constitution in 2017. It is difficult to think of any other recent global venture that has generated such a mixture of optimism and debate. An editorial of the Financial Times argued that the BRI 'exports the worst aspects of the Chinese economy, while increasing the strains on its already stressed financial system' ("One Belt, one Road and many questions" 2017). In addition, most of the questions raised when the BRI was launched remain unanswered, namely: (i) its specific geographical scope; (ii) its financing sources and tools; (iii) the real objectives of the Chinese government; and (iv) the BRI's impact, first, in the countries participating in the initiative; second, in non-participating countries; and, finally, in China itself.

In this paper, we will assess both the opportunities and the challenges of what benefitting from BRI financing would mean for Timor-Leste. Although a very limited number of authors have produced partial studies about the impact of the BRI in certain regions or countries (Blanchard, 2017, for South Asia; Kohli, 2018, for Central Asia), no study has yet assessed the potential of BRI financing for the development of one specific country. We will assess the case study of Timor-Leste, a post-conflict small, insular developing state located outside the main BRI corridors, as an example of the potential of the BRI for expansion.

This paper is divided into three sections. The first section presents the origin and discusses the specific geographical, conceptual and financial boundaries of the BRI. The second section discusses the areas where the initiative could potentially have positive (opportunities) or negative (challenges) impact for Timor-Leste. This section also evaluates mitigating measures that could be applied to minimize the associated risks. The final section sums up.

The boundaries of the Belt and Road Initiative

In 2013, President Xi first announced his vision of and proposal for a BRI in a phased manner. He proposed the launching of the Silk Road Economic Belt (the Belt: by land) on September 7 during an official visit to Kazakhstan. Later, he complemented the Belt with a proposal to create the twenty-first-century Maritime Silk Road (the Road: counterintuitively, by sea) on October 3 during an official visit to Indonesia for a meeting with the Association of Southeast Asian Nations (ASEAN). The third plenary session of the 18th Central Committee of the Communist Party of China officially adopted President Xi's vision as a national strategy on November 12, 2013 and several Chinese agencies started preparing for it in more detail. Finally, on March 25, 2015, the NDRC, the Chinese planning agency that reports directly to the Chinese State Council issued the 'Vision and actions on jointly building the Silk Road Economic Belt and the 21st century Maritime Silk Road' (NDRC, 2015). According to this document, the BRI is a systematic project aiming at integrating the development strategies of the countries along the routes; connecting Asia, Europe and Africa more closely; and promoting mutually beneficial cooperation. The areas of action of the initiative are '(i) policy coordination, (ii) facilities connectivity, (iii) unimpeded trade, (iv) financial integration, and (v) people-to-people exchange' (Ministry of Finance, 2017).

A. The geographical boundaries

Although geographically the BRI aims at improving connections between Asia, Europe and Africa, no geographical delimitation was initially presented other than the historical reference to the trade routes, including the lucrative silk trade that has connected Europe and Asia since the Han dynasty. The first geographical presentation of the BRI was initially made in a map published by China's state-owned Xinhua News Agency on May 8, 2014 ("How can the world be win-win?" 2014). According to this map, the Silk Road Economic Belt would begin in Xi'an, continue through Gansu and Xinjiang provinces, cross Kazakhstan, Uzbekistan, Turkmenistan, Iran and Turkey, and from Istanbul head northwest through Bulgaria, Romania, the Czech Republic and Germany to the port of Rotterdam in the Netherlands. From Rotterdam, the planned route would continue southeast back to Venice, where it would meet the Maritime Silk Road. The latter would start in China in the harbor of Quanzhou in Fujin Province, would include the harbors of Guangzhou, Beihai and Haikou before heading to Singapore and the Malacca Strait, Kolkata in India, and then through the Indian Ocean to Nairobi, Kenya. It would continue north through the Red Sea into the Mediterranean Sea, first to Athens and finally to Venice.

The BRI now comprises six land routes (see Xinhua, 2017a), namely (i) the China-Mongolia-Russia Economic Corridor (CMREC), proposed by President Xi in September 2014 during the first trilateral meeting of heads of state of those three countries, held in Dushanbe, Tajikistan, and honored in a trilateral development plan signed in June 2016; (ii) the New Eurasian Land Bridge (NELB), linking the Pacific and the Atlantic oceans by rail (plus the associated highways and power transmission lines) and, by definition, linking China to Europe, from the Chinese coastal cities of Lianyungang and Rizhao to the ports of Rotterdam in the Netherlands and Antwerp in Belgium, crossing Kazakhstan, Russia, Belarus, Poland, and Germany;[3] (iii) the China-Central Asia-West Asia Economic Corridor (CCWAEC), linking China to the Middle East, from Xinjiang to the Persian Gulf and the Mediterranean Sea, through countries including Kazakhstan, Kyrgyz Republic, Uzbekistan, Iran, Saudi Arabia and Turkey (closely resembling the ancient Silk Road); (iv) the China-Indochina Peninsula Economic Corridor (CIPEC), linking China to Southeast Asia, from the Pearl River Delta in China to both Hanoi and Singapore, crossing Vietnam, the Lao People's Democratic Republic (PDR), Cambodia, Thailand, Myanmar and Malaysia; (v) the China-Pakistan Economic Corridor (CPEC), proposed by Premier Li Keqiang in May 2013 during a visit to Pakistan, from Kashgar to the strategic port of Gwadar, where the land and the sea silk routes connect in the Indian Ocean;[4] and, finally, (vi) the Bangladesh-China-India-Myanmar Economic Corridor (BCIMEC), linking China to South Asia, from Kunming in the Chinese province of Yunnan to the Indian state of West Bengal, jointly presented by the Premiers of China and India during a visit of Premier Li Keqiang to India in May 2013 and formalized in a development plan signed by the governments of the four countries in December 2013. The six economic corridors are shown in Figure 1.

In addition, the twenty-first-century Maritime Silk Road envisioned by President Xi, connecting several Chinese ports, first, to Europe and Africa through the South China Sea and the Indian Ocean, and, second, to Southeast Asia and Oceania through the Southeast Asian seas and the South Pacific Ocean, was delineated in a document named "Vision for Maritime Cooperation" released on June 20, 2017, by both the NDRC and the State Oceanic Administration (SOA) (Xinhua, 2017b). According to this document, the BRI comprises three sea routes, or blue economic passages, namely (i) the China-Indian Ocean-Africa Mediterranean Sea Blue Economic Passage, linking the CIPEC, CPEC and the BCIMEC; (ii) the China-Oceania-South Pacific Blue Economic Passage; and (iii) the China-North Europe Blue Economic Passage (also called the Northern Sea Route, or Silk Road on Ice), through the Arctic Ocean.

[3] Xinhua also mentions other transcontinental rail routes that have recently been inaugurated between China and Europe, namely between (i) Chongqing and Duisburg, in Germany; (ii) Chengu and Poland; and (ii) Yiwu and Madrid, in Spain. These show the potential of the BRI, according to China's state-owned News Agency (see "Backgrounder," 2017).

[4] The CPEC, estimated at a total of US$60 billion, was described as the 'fastest and most effective' of all the BRI projects by the Chinese Ambassador to Islamabad (Voice of America News, 2017).

A third passage, the China-Arctic Ocean-Europe passage, was initially proposed by Russia, and recently President Xi and the Russian Prime Minister Dmitry Medvedev committed to make joint efforts to develop and implement the route (Xinhua, 2017c). The three passages can be seen in Figure 1..

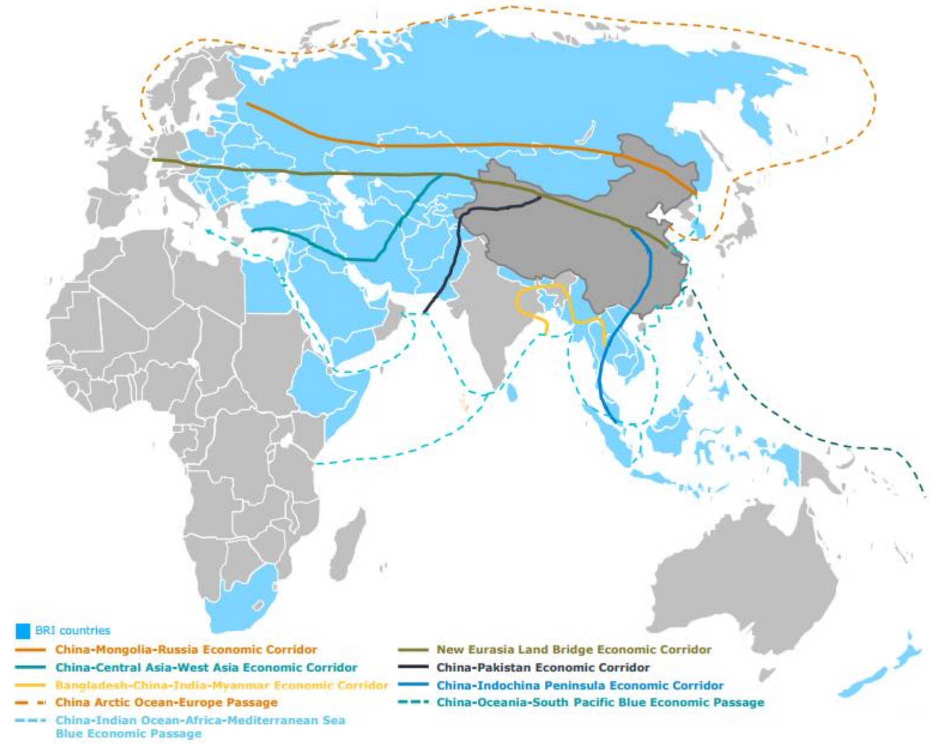

Figure 1: The Belt and Road Initiative: Six Economic Corridors spanning Asia, Europe and Africa

Source: Wang (2017).

All in all, the potential and aim of the BRI is virtually global, by covering 91 countries in all continents as of today (see Hong Kong Trade Development Council, 2018, for a list of countries with Memorandums of Understanding for collaboration with China under the BRI, illustrated in Figure 2) representing 70% of the world's population and 40% of the global gross domestic product (GDP) (measured in current US dollars) (World Bank, 2018a). It is interesting to note that some of these 90 countries, such as Bolivia, Nigeria, Senegal and Uruguay actually lie outside the economic corridors mentioned earlier.

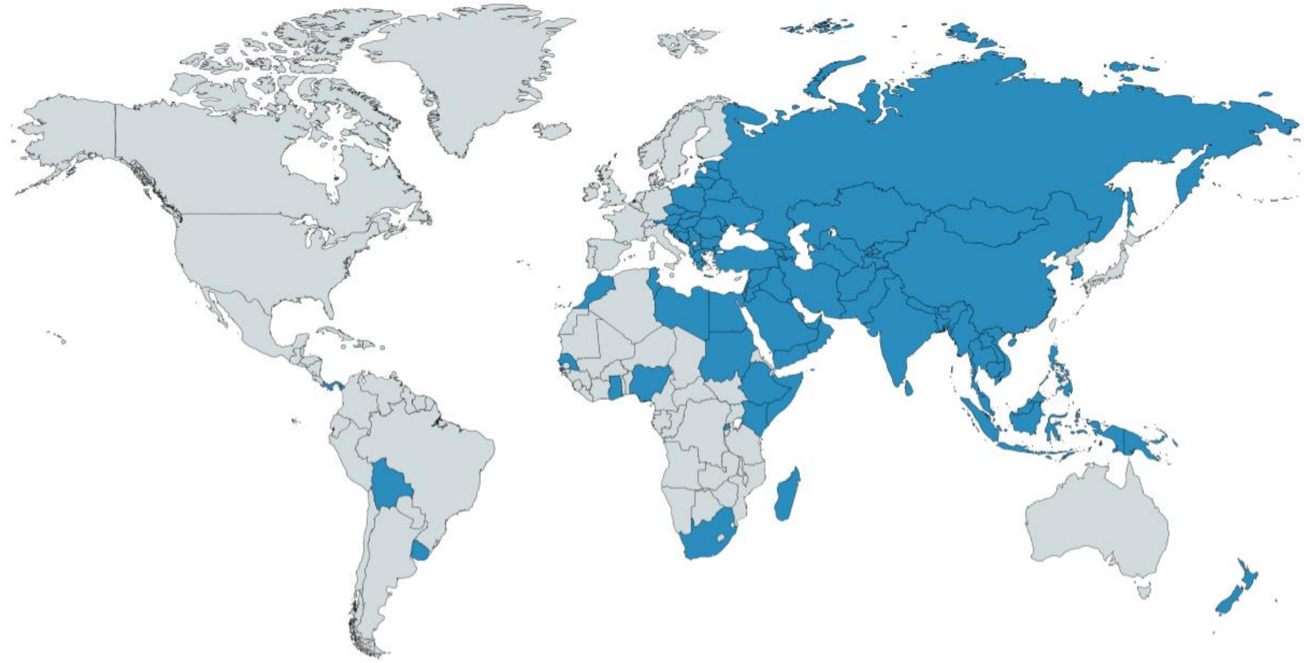

Figure 2: The Belt and Road member countries

Source: Author, based on Hong Kong Trade Development Council (2018).

B. The conceptual boundaries

Conceptually, Chinese government thinking is normally associated with patience, strategy and long-term objectives. The meaning of the BRI needs then to be placed within a long-term historical perspective.

In October 2017, the two-five-year-mandate limit for Chinese presidents was eliminated, giving President Xi the ability to continue ruling the country without time constraints. Xi also became the third Chinese leader to have his political program (thought, theory or philosophy in Beijing's political jargon) inscribed in the Chinese Communist Party's constitution, after Mao Zedong and Deng Xiaoping. In fact, President Xi's thought represents a departure from Deng Xiaoping's. Although President Xi's 'socialism with Chinese characteristics for a new era' (2017) seems to affix just an additional characteristic, the new era, to Deng's 'socialism with Chinese characteristics' (1978), the change in philosophy is more profound than that. The 'new era' component represents a critical step forward in assuming the country's global ambitions as an emerging superpower. While the project of Deng Xiaoping was inward-looking, focused on domestic economic development, President Xi does not want China to take a back seat in the world. The proposal for the BRI was one the main pillars contributing to the formulation of this new thought. In fact, the 19th National Congress of the Communist Party of China not only added President Xi's thought to the Party's Constitution, but it also made an additional amendment that read: 'following the principle of achieving shared growth through discussion and collaboration, and pursuing the Belt and Road Initiative.'

C. The financing boundaries

The financial dimension of the BRI should be assessed from both the demand and supply sides. In terms of demand, infrastructure needs in Asia are vast. The Asian Development Bank (hereafter ADB) estimates that developing Asia alone will require US$26 trillion in infrastructure investment between

2016 and 2030 to maintain its growth momentum, eradicate poverty, and respond to climate change (ADB, 2017). This amount is equivalent to nearly US$1.7 trillion annually. Nearly two-thirds of that amount are needed for energy and transport infrastructure. In addition, one should also bear in mind that this amount is estimated for the ADB's definition of Developing Asia, meaning that countries such as Russia, developed Asian countries, Middle Eastern countries and Turkey are not included in the figures. All in all, the financing needs are enormous, and the BRI can play a significant role in helping to meet them. In terms of supply, Chinese banks held more than US$22.6 billion in deposits in 2016 (Statista, 2018) and foreign exchange reserves in China exceeded US$3.1 trillion in August 2018, nearly 9% of the world's total (Trading Economics, 2018). Liquidity is therefore rapidly available for the financing of BRI projects.

The concept of the BRI is an ambiguous one, as previously mentioned, so the financial boundaries of the initiative are not easily estimated. Estimations of the BRI's size vary between the US$1 trillion committed by the Chinese in its first stage (Perlez & Huang, 2017; Hillman, 2018a) and the US$8 trillion estimated in total investment if the full scope of projects in BRI participant countries materializes (Balding, 2017; Moser, 2017; Wo-lap, 2016). Even in the most conservative case, the initiative would be seven times larger than the US Marshall Plan, which amounted to US$130 billion in current prices (The Economist, 2016).

The financing of the BRI is based on two main sources, namely: (i) the main financing, estimated around US$900 billion; and (ii) the Silk Road Fund (SRF), estimated at around US$40 billion. By March 2016, the Bank of China had transferred US$82 billion to three policy banks supporting BRI projects: US$32 billion to the China Development Bank, US$30 billion to the Export-Import Bank of China, and US$20 billion to the Agricultural Bank of China. By the same time, the SRF had received the first capital installment, which amounted to US$10 billion. In May 2017, President Xi announced a further US$124 billion for the BRI, including (i) US$14.5 billion for the SRF; (ii) special lending schemes for the China Development Bank and the Export-Import Bank of China worth around US$36 billion and US$19 billion, respectively; and (iii) a request for state-owned banks to establish a BRI Fund worth US$43 billion (Deloitte, 2018).

President Xi described the funding bottleneck in the region as 'a prominent challenge' to the BRI (cited by Zhang & Miller, 2017) during the Belt and Road Forum for International Cooperation held in Beijing on May 14-15, 2017, which was attended by 30 heads of state and government of BRI countries and representatives of 100 other countries and 70 international organizations.

BRI financing flows mainly from Chinese banks, which benefit from large economies of scale and from generous state subsidies, to Chinese state-owned enterprises (SOEs). In fact, the BRI financing model fits perfectly into the conceptual framework of 'financial statecraft' following the definition of Armijo & Katada (2015) as 'the intentional use, by national governments, of domestic or international monetary or financial capabilities for the purpose of achieving foreign policy goals, whether political, economic or financial.' According to this framework, the ultimate step in financial statecraft for an emerging power is to seek a systemic and offensive approach. In the systemic approach, the emerging power seeks a 'greater voice in global financial and monetary governance' through financial tools—the diversification of foreign capital sources, promotion of public banks, capital controls, multilateral banks–and monetary tools such as reserve accumulation, regional monetary funds, and promotion of multiple reserve currencies. In the offensive approach, the emerging power seeks also to 'construct institutions of global governance, giving oneself ongoing hegemonic or disproportionate influence' by resorting to financial means that 'promote home financial markets as a source of global influence' and monetary means that 'promote one's currency as a global reserve or transactions currency.'

Regarding state-owned banks, Deloitte (2018) estimated that the Big Four (Industrial and Commercial Bank of China, Bank of China, China Construction Bank, and Agricultural Bank of China) were responsible for 51% of total BRI financing by December 2016 in terms of outstanding loans and equity investment. In addition, the China Development Bank and the Export-Import Bank of China accounted for 38% and 8%, respectively. In total, these six institutions provided 97% of the financing of the BRI. Financing by the SRF amounted to an additional 1%. These Chinese banks enjoy low borrowing costs, because their bonds are treated like virtual sovereign debt by the markets[5] and they have access to direct lending from the People's Bank of China. However, the attractiveness of the Chinese financing is surprising if we take into account that nearly three-quarters of their lending was offered on commercial, non-concessional, terms, which is more expensive than the financing offered by multilateral development banks (hereafter MDB). Interest rates for sovereign long-term lending offered by Chinese state-owned banks range from 2%-3% (soft loans) to 6%-7%, with standard maturity of 20 years and a standard grace period of between 2 to 5 years.[6] These financing parameters are less attractive than those offered by MDBs, which ranged between zero and 1.5% in 2015 (see Faure, Prizzon, & Rogerson., 2015). Borrowers commonly state that the attractiveness of the Chinese funding emerges from it having 'fewer strings attached' and from the 'higher risks taken' comparative to other lenders. In addition, China seeks to offer the borrowing country a full turnkey solution for project finance in infrastructure investment, covering financing, insurance, and implementation.

Finally, regarding SOEs, it is important to note that their size and capacity to implement projects match both the magnitude of the financing amounts made available by the state-owned banks and the magnitude of the needs of the BRI participating countries. Hillman (2018b) showed that the number of Chinese firms included in Fortune's Global 500 list of the world's largest companies by revenue increased from ten in 2000 (9 SOEs) to one hundred and twenty firms as of July 2018 (81 STEs). The trend was especially evident in the construction industry. In 2017, seven of the ten largest construction firms, by revenue, were Chinese.

The Asian Infrastructure Investment Bank (AIIB) and the New Development Bank (NDB, formerly known as BRICS Bank) are often described in the literature as institutions that will 'support the efforts of governments of the countries along the Belt and Road and their companies and financial institutions with good credit rating' (NDRC, 2015). We will briefly focus on the case of the AIIB, since Timor-Leste became one of its shareholders in March 2017.[7] The AIIB differs from the other financing sources mentioned in this text by the fact that it is a multilateral financial institution (with 86 current and prospective shareholders as of May 2018, according to AIIB, 2018). Moreover, the AIIB claims that it has world-class policies for safeguards, transparency, anti-corruption measures, universal procurement and universal recruitment, among others. It has certainly put a great deal of effort into assessing the best practices of its peer institutions and in hiring experts highly versed in such policies. In any case, it is undeniable that the overarching mission of the AIIB, promoting the connectivity and the economic development of Asia, largely overlaps with the BRI, both strategically and geographically. The most interesting feature of the AIIB is that it leverages the financial credibility and reputations of developed nations (such as Canada, Germany, France and the United Kingdom) to contribute indirectly, in practical terms, to the BRI.

[5] China's sovereign credit rating is A+ according to Standard & Poor's and Fitch and A1 according to Moody's.

[6] Let's take the examples of the Jakarta-Bandung Railway, Indonesia's first high-speed railway; the Lao PDR section of the Kunming-Singapore railway; and Sri Lanka's Hambantota port. First, in Indonesia, the China Development Bank offered a 40-year concessionary loan, without asking for government debt guarantees, to finance 75% of the US$5.3 billion railway. The loans carried a 10-year grace period. A 60% portion was denominated in US dollars carrying a 2% interest rate, and the remaining 40% calculated in Chinese yuan, carrying a 3.4% rate. Second, in Lao PDR, the Export-Import Bank of China offered a concessionary loan with an interest rate set slightly below 3%. Finally, in Sri Lanka, for phase I of the port the Export-Import Bank of China offered an 11-year commercial loan to finance US$306 million at 6.3% with a one-year grace period (see Sirimanna (2011) and Zhang & Miller, (2017) for further details and examples).

[7] Timor Leste's membership in the AIIB was approved by the Bank's Governors in March 23, 2017 (Government of Timor-Leste, 2017) and they delivered the Instrument of Ratification on November 22, 2017.

Challenges and opportunities for Timor-Leste

This section will discuss both the challenges and the opportunities that the BRI brings to Timor-Leste. We will first present the background of the relationship between the initiative and Timor-Leste. We will then present Timor-Leste's main financing sources for its projects, as well as its corresponding needs. We will finally assess how the pervasive effects of the BRI mentioned in the previous section could potentially affect Timor-Leste if it were to be actively enrolled in the BRI.

A. Timor-Leste in the BRI

China was one of the few countries to recognize Timor-Leste as an independent state when independence was first declared on November 28, 1975, and ties between the two countries have remained positive in tone since its de facto independence on May 20, 2002. Ties remain limited in scope because of the latter's small economy.

Geographically speaking, Timor-Leste would seem an unlikely BRI member, being south of both the Initiative's main sea passages, namely the China-Indian Ocean-Africa Mediterranean Sea Blue Economic Passage and the China-Oceania-South Pacific Blue Economic Passage (see Figure 1). Nonetheless, Timor-Leste is considered a BRI country, based on the criteria that it has a Memorandum of Understanding for collaboration with China under the BRI (Hong Kong Trade Development Council, 2018).

In fact, during the Belt and Road Forum on International Cooperation hosted by President Xi in May 14-15, 2017, both governments signed the standard Memorandum of Understanding on Belt and Road Cooperation, as did the other BRI countries. The document officially qualifies Timor-Leste for the BRI. Moreover, the country is currently the only Portuguese-speaking member country of the BRI. Previously, on April 14, 2014, the Chinese and Timorese governments had signed a joint statement on 'establishing a comprehensive partnership of good neighborly friendship, mutual trust and mutual benefit.' The statement mentioned that the 'Timor-Leste government appreciated and supported the proposals made by the Chinese government to build a 21st-century Maritime Silk Road and an AIIB, and would actively participate in these processes' (Ministry of Foreign Affairs, 2014).

The relationship between Timor-Leste and China is currently strong. Observers claim that there has been a gradual realignment of Timor-Leste, from traditional aid providers such as Japan, the United States, and Australia (the last-named in the context of the disagreement on the exploration of offshore oil), to China (Suzuki, 2017). Two of the most influential figures in the country, namely Xanana Gusmão, former president of the Republic, president of one of the two largest political parties and still actively politically engaged and influential; and José Ramos Horta, a Nobel Peace awardee, welcome Chinese assistance, and refer to China as an old friend and today's alternative to Japan and the United States (Suzuki, 2017).

B. The opportunities represented by the BRI for Timor-Leste

Timor-Leste depends on oil and gas for nearly 90% of its national revenue. The Petroleum Fund, the country's sovereign wealth fund, endowed with nearly US$16 billion, supports the national state budget on an annual basis with around US$1.3 billion (see ADB, 2016a). The ADB (2106a) considers that 'Timor-Leste is one of the world's most oil-dependent countries. Production from current oil and gas fields began in 2004 and is forecast to end in 2021.… Prospects for new developments are uncertain.' Therefore, Timor-Leste has a limited opportunity to use its petroleum wealth to establish a pattern of sustainable growth. Currently, the petroleum sector operates as an enclave. Its only link to the onshore (real) economy is through public spending of the 'Petroleum Fund's taxes and royalties. By law, the government is entitled to withdraw the estimated sustainable income from the fund each year to finance infrastructure investment and public spending. This income is defined as the maximum annual withdrawal that could be sustained indefinitely in real terms and is calculated at 3% of the estimated petroleum wealth.

The oil revenues come from the Bayu-Undan oil and gas field, which is expected to stop producing in the next five to ten years. The recent signing, in March 2018, of a treaty drawing the maritime boundary between Australia and Timor-Leste (Gloystein & Paul, 2018) could help resolve the long-standing maritime dispute between the two countries, paving the way for the development of the estimated US$65 billion Greater Sunrise field oil and gas project. In the meantime, facing the exhaustion of the Bayu-Undan field, the country is stepping up efforts to diversify financing and industries, including meaningful tax incentives for foreign investors.[8]

The damaged and underdeveloped infrastructure in Timor-Leste, caused by underinvestment in maintenance and construction of new roads under Indonesian rule of the country and by years of conflict from the country's declaration of independence until the restoration of independence in 2002, is one of the major challenges facing the country in recent years. The Timor-Leste government created and released a Strategic Development Plan to transform the country into a medium-to-high income economy by 2030, including an entire section on developing national infrastructure (see table 1 below, retrieved from Government of Timor-Leste, 2011). Other main projects currently in preparation/implementation include the Oecusse Special Economic Zone,[9] in which a US$80 million international airport, yet to be open, and a US$17 million bridge are located.

Table 1 - Selected infrastructure projects in the pipeline in Timor-Leste (2011-2030)

Roads and bridges	• Dili-Manatuto-Baucau Road (US$100 million) • Manatuto-Natarbora Road (US$60 million) • Dili-Liquiça-Bobonaro Road (US$82 million) • Dili-Aileu-Maubisse-Aituto-Ainaro-Cassa Road (US$82 million) Ongoing, financed by the World Bank and the Asian Development Bank
Seaports	• New deepwater seaport of Tibar (north, located about 10 kilometers west of Dili) (US$490 million, operating by 2020): construction started on 14 June 2017, after six years of planning and procurement, under a public-private partnership led by the British Bolloré Group (construction, financing and 30-year concession for operations). The government of Timor-Leste contributed US$130 million. • New seaport of Suai (south) (US$720 million; abandoned)
Airports	• Dili's Presidente Nicolau Lobato International Airport upgraded from 80,000 to one million passengers per year (planned) • Baucau National Airport, as an alternative to Dili's • Network of eight national airports operating (second airport: Suai airport opened on June 20, 2017)

Source: Government of Timor-Leste (2011), Global Construction Review (2017). Does not include infrastructure for water and sanitation; energy; or telecommunications.

To implement the SPD, in 2011, the Timorese Government established the Infrastructure Fund,[10] a financial instrument to 'carefully target investment in major public projects essential to boost development and create a well-functioning economy' (Government of Timor-Leste, 2018). The Infrastructure Fund finances the implementation of infrastructure that requires major investment in multi-year and large projects worth more than US$1 million. From its inception in 2011 to December

[8] These include a 10% corporate tax; a "no profit no tax" promise; and five-, eight-, or ten-year tax holidays depending on the location and nature of the investment. Special Economic (Social Market) Zones have been created in Oecusse exclave and on Atauro Island. 3% annual spending has been frontloaded to 2022 in order to "improve capabilities" in government and "resolve bottlenecks" (Davidson, 2017).

[9] The development of the Special Economic Zone is managed by the former Prime-Minister, Mario Alkatiri, under the motto of a better governance, corruption-free area.

[10] By Decree of Law No. 8/2011, which is a subsidiary to Law No. 1/2011.

31, 2017 the Infrastructure Fund had financed projects amounting to a total of US$3.9 billion (Government of Timor-Leste, 2018).

According to the ADB (2016a), 'The process of state building is progressing well: key public sector institutions have been established, service delivery is improving, and the building blocks for an enabling business environment are coming into place. Timor-Leste remains fragile, however.… Infrastructure is improving, but additional investments are needed … Real progress has been made in restoring and upgrading a core network of national, district, and rural roads. Public investment has transformed the electricity sector while deregulation has delivered transformative gains in telecommunications. Improving access to clean water and sanitation has been slower. Many rural communities lack access to basic services, and urban water supply, sewerage, and solid waste management are in poor condition.'

Higher public spending has driven growth but threatens long-term fiscal sustainability. Public expenditure, excluding grants, rose from US$241 million in 2007 to US$1.37 billion in 2014, according to the ADB (2016a) as the government scaled up investment in infrastructure through the Infrastructure Fund and rolled out large social transfer programs. Withdrawals from the Petroleum Fund financed 85% of budgeted expenditures in 2015 and were almost double the estimated sustainable income. According to the ADB (2016a), 'continuation of recent spending growth will threaten the long-term sustainability of the Petroleum Fund. Withdrawals must return to sustainable levels in the medium term to avoid depleting the fund and reaching a fiscal cliff, which would require a large and abrupt reduction in public spending.'

So far, Chinese actors have been very active in project finance in Timor-Leste. Since Timorese independence, China has funded (through grants) and constructed the country's presidential palace, ministry of foreign affairs and army barracks (Economist Intelligence Unit, 2016). However, Timor-Leste has been very reluctant to take on debt in the past, prioritizing grant financing (such as that from the World Bank and ADB, both under the status of fragile-and-conflict-affected country). A US$50 million concessional loan agreement[11] to construct and upgrade the Dili drainage system (Government of Timor-Leste, 2015) was negotiated in 2015 between the government of Timor-Leste and the Export-Import Bank of China (the only one so far with any of China's state-owned banks). However, the loan agreement was never signed and the Timorese Court of Auditors vetoed it.

The potential of the BRI, as well as that of multilateral development banks, such as the ADB, the AIIB and the World Bank Group, to facilitate trade, accelerate growth, and increase regional cooperation and integration within Asia through infrastructure investment is sizeable. The World Bank points out three major opportunities of the BRI, namely (i) its tremendous size and scope; (ii) the large unexploited potential existing in the region; and (iii) its impact in improving connectivity (World Bank, 2018b). When charged with the negative impact of BRI lending in some borrowing countries, the Chinese Ministry of Foreign Affairs denied that China had caused any debt crisis in those countries, stating that 'The Belt and Road initiative follows the golden rule of shared benefits through consultation and contribution, and has delivered US$2.2 billion tax revenue and more than 200,000 jobs for cooperation partners' (Li, 2018).

The BRI could be a convenient window of opportunity for Timor-Leste to accelerate project financing and implementation within the country's vision for 2030. The first BRI project (if one considers it as such) will be financed under the soft part of the initiative, the 'cultural ties with university scholarships and other people-to-people exchanges,'[12] within the health sector. Macao will be launching a hospital

[11] An annual fixed interest rate of 2% over 20 years and a grace period of 5 years, representing a grant element of 28%, exceeding the 25% minimum grant element required by the OECD for a loan to be considered as concessional (OECD, 2018).

[12] The BRI 'intends to strengthen hard infrastructure with new roads and railways, soft infrastructure with trade and transportation agreements, and even cultural ties with university scholarships and other people-to-people exchanges' (NDRC, 2015).

twinning program focused on deploying health professionals in countries included in the BRI and Timor-Leste will receive health support, especially for the development of primary health care (Moura, 2018).

C. The challenges of the BRI for Timor-Leste

BRI critics often assume that China will reap the largest part of the initiative's benefits. China's role in BRI countries is already increasing. *The Economist* (2016) showed that, in 2015, China's foreign direct investment (FDI) in BRI countries rose twice as fast as the increase in its total FDI and that 44% of China's new engineering projects were signed in BRI countries (52% in the first five months of 2016).

In addition, the BRI presents risks and potentially negative impacts for the countries participating in the initiative. We will focus our assessment on the four main factors in our view, namely: (i) excessive political interference by China in the selection of projects, that could fail to ensure minimum commercial return and maximum bearable risk; (ii) the increasing indebtedness of borrowing countries; (iii) permissive (or nonexistent) environmental, social, transparent and anti-corruption standards for projects; (iv) the lack of a level playing field for procurement for non-Chinese suppliers of public works, goods and services; and (iv) the use of BRI projects to exercise undue influence in other areas, such as military.

First, regarding the inclusion of non-economically viable but politically or militarily useful projects in the BRI, the Chinese government claims that SOEs make their investment decisions based on commercial and economic returns. However, some observers question that claim. The governor of China's Central Bank warned that 'the reliance on cheap loans raises risks and problems, starting with moral hazard and unsustainability' (Zhang & Miller, 2017). The credit rating agency Fitch (cited by Wells & Weinland, 2017) stated that 'Chinese banks do not have a track record of allocating resources efficiently at home, especially in relation to infrastructure projects, so they are unlikely to have more success overseas' and that, consequently, 'the lack of commercial imperatives behind BRI projects means that it is highly uncertain whether future project returns will be sufficient to fully cover repayments to Chinese creditors.' Indeed, Fitch (2018) indicated that 'some China-backed infrastructure projects along the BRI were previously written off as financially unfeasible by traditional lenders or private investors.'

As mitigating measures, among other initiatives proposed by Deloitte (2018), China should also diversify the number of borrowers and decrease the size of projects. In addition, it is expected that China will increase its efforts to minimize the potential reputational losses associated with the projects that do not deliver properly during implementation. RWR Advisory Group, cited by Kynge (2018), found that 14% of 1,674 BRI projects since 2013 had encountered problems, such as public opposition to projects, objections over labor policies, delays caused by land acquisition, financial irregularities and concerns about national security. The Chinese government claims that this percentage is relatively low and that it is mostly due to the lack of experience of the Chinese promoters in operating in sometimes challenging countries. The same government claims that these problems are expected to be further minimized in time, when a sufficient stock of relevant experience is built. In fact, Chinese government scrutiny of prospective deals has increased and managers of state-owned enterprises and banks are now held responsible for bad investments (including pay cuts, disciplinary action and judicial hearings), following a 2016 ruling by China's State Council, as pointed out by Thomas & Price (2016).

Second, regarding the potentially increasing indebtedness of some borrowing countries, it is a fact that the financing required for BRI projects may expand debt to unsustainable levels. For example, first, the construction of the Lao PDR section of the Kunming-Singapore railway has an estimated cost of US$6 billion, nearly 40% of the country's GDP in 2016[13] (World Bank, 2018b), and, second, Vanuatu, with

[13] The Laotian Government, in an attempt to control the impact of the project in its public finances, has limited their participation to around US$700 million and financed the remaining amount through a Public-Private-Partnership. Nonetheless, US$500 million of the Laotian contribution will be financed through a loan of the Export-Import Bank of China.

only 270,000 inhabitants, has taken US$270 million in Chinese loans in the past decade, worth 35% of its GDP (Parker & Chefitz, 2018). It is not clear that the increase in trade and the economic development brought about by the BRI will generate and secure sufficient revenues to service the participating countries' carrying costs of projects. At a project level, limited financing alternatives for many borrowing countries puts them in an unfavorable position to negotiate good terms. A good example is the 2010 negotiation for the financing of phase I of the US$8 billion Hambantota port in Sri Lanka, which concluded with a significantly high interest rate of 6.3% for a US$306 million loan from the Export-Import Bank of China (see Sirimanna, 2011). With nearly all its revenue going toward debt repayment, the Sri Lankan government had to consent to sell (for US$1.12 billion) an 85% stake and a 99-year lease to the China Merchants Port Group (Panda, 2017).

In the case of Timor-Leste, one should bear in mind that its government debt level was just 13.0% of its GDP in 2016 (internal database of the ADB), largely boosted by the revenues of the Petroleum Fund. In fact, so far, Timorese governments have been extremely reluctant to borrow, historically limiting loan contracting to a very few key infrastructure projects (roads exclusively in practical terms[14]), all of them endowed with high concessionality levels and complemented by technical assistance and capacity development in the form of grants. In addition, the cost of borrowing of any loan taken by the government is limited, according to the Public Debt Law, to a ceiling marked by the average return of the Petroleum Fund. Therefore, we do not expect BRI financing to Timor-Leste to put sovereign public debt into stress in the short and medium run.

Third, regarding the risks associated with permissive or nonexistent minimum environmental, social, transparent and anti-corruption standards for projects, this could result in serious biodiversity loss, environmental degradation, forced displacement of population, and the capture of disproportionate economic benefits by Timor-Leste's leading economic classes. This is particularly worrying in countries with relatively poor governance, as observed in many BRI participant countries.

In the case of Timor-Leste, the use of forced eviction in development projects implemented by the Timorese government has been documented (Davidson, 2017). In addition, where transparent and anti-corruption standards are concerned, both international and Timorese watchdog groups have openly criticized the lack of transparency and accountability in development projects in Timor-Leste, particularly the lack of public cost-benefit and risk analyses at the project level (see Davidson, 2017, for detailed references). In 2012, the Timorese government inaugurated a so-called 'Transparency Portal',[15] but this does nothing more than present macro figures for financing pledged and received. Therefore, we note that neither the Chinese SOEs nor the Timorese executing agencies have good historical records of implementation of environmental and social safeguards and anti-corruption standards, so we are concerned that BRI financing in Timor-Leste could raise problems in these areas.

One mitigating measure would be the increasing participation of developed countries and of MDBs in the BRI. They could bring their long-term development experience to the initiative, with particular gains in environmental and social standards, transparency and anti-corruption measures, but also the diversification of financing sources and terms, the leveraging of additional financial resources, and technology transfer. In the same vein, Deloitte (2018) projects that by 2030 at least half of BRI funding will be met by a combination of private capital, multilateral banks, and foreign governments. However, so far, only 100 out of 941 BRI projects have involved the World Bank, the IMF or the ADB (Fitch, 2018).

Fourth, regarding the lack of a level playing field for procurement for non-Chinese suppliers of public works, goods and services, the numbers show that the BRI is mainly benefitting China's SOEs and

[14] On 2 May 2012, the Timorese Finance Minister and the ADB President signed Timor-Leste's first multilateral loan agreement in Manila, for US$40 million, to fund the costs of upgrading the 29-km Dili-Liquica and 32-km Tibar-Gleno roads. These projects were completed by the end of 2015.
[15] See http://www.transparency.gov.tl/english.html.

contractors. In fact, Hillman (2018b) found that Chinese projects are less open to local and international participation than those financed by MDBs. Within a sample of 2,200 transportation projects in Asia, approved from 2006 to 2017, the author found that 89% of all contractors participating in Chinese-funded projects were Chinese firms, 8% were local companies; and 3% were from third countries. In comparison, of the contractors participating in projects funded by the World Bank and the ADB, 29% were Chinese, 41% were local, and 30 % were from third countries.

This is of particular importance for Timor-Leste. In fact, the projects financed so far by China in Timor-Leste have made no use of the local labor force, as pointed out by Davidson (2017). The lack of involvement of the Timorese labor force was one of the main reasons invoked by the Timorese Court of Auditors to veto the US$50 million concessional loan offered by the Export-Import Bank of China to construct and upgrade the Dili drainage system mentioned earlier. Nevertheless, this limitation appears more on the supply than on the demand side. In fact, the most important constraint for project implementation in Timor-Leste is arguably the lack of capacity in executing agencies, and not the financing per se. The ADB estimates that Timor-Leste ranks among the Asian countries with the lowest capacities in 'public sector management and institutions' and in 'structural policies'. In 2016, Timor-Leste only presented better indicators than Afghanistan, Myanmar and Papua New Guinea (ADB, 2016b). Capacity development is of paramount importance, and this should involve all development partners operating in Timor-Leste, including China. Capacity building, on-the-job training and educational and vocational training should be incorporated into BRI projects in weak-performing countries such as Timor-Leste.

Finally, regarding the use of BRI projects to exercise critical Chinese influence in other areas, such as military, one might suggest that Tibar deepwater port could follow the same route as Doraleh port in Djibouti (Thorne & Spevack, 2017) or Gwardar port in Pakistan (Chan, 2018), potentially serving as a military platform supporting the global presence of the Chinese navy worldwide. In fact, in early 2016, a Chinese naval task force comprising three vessels made a five-day official stopover in Dili en route to a naval escort mission in the Gulf of Aden (Economist Intelligence Unit, 2016; Suzuki 2017). The visit occurred in the context of previous military cooperation between the two countries. In 2008, the Timorese Navypurchased two Shanghai-class patrol boats from a Chinese promoter. They were manned by Chinese sailors while the Timorese sailors were trained to guard the Timorese coasts (Murdoch, 2010). In 2010, the Chinese Government funded the new headquarters for the Timorese Army costing US$9 million (Everingham, 2010). However, there has been no further public reference to Chinese military presence in Timor-Leste since 2016. Therefore, we see no concrete intention so far by China to use Timor-Leste for military purposes.

All in all, we conclude that Timor-Leste has to attract investment, which so far has been insignificant. BRI financing could have a significant impact in the quantity and quality of infrastructure in the country, if considered as part of a diversified pool of lenders. The BRI could also attract additional private investment to Timor-Leste. However, increasing infrastructure financing by multilateral development banks, including the AIIB, is also needed. It is good news, for instance, that ADB allocated resources to Timor-Leste will increase from US$137 million between 2015 and 2017 to US$301 million between 2019 and 2021, according to the ADB (2018). As shown in Table 2, Timor-Leste is not in a particularly vulnerable position for receiving BRI financing. The potentially negative effects associated with the BRI are less severe than many critics suggest, partly because they are underpinned by strong bilateral relationships; partly because both China and Timor-Leste have introduced sufficient measures to mitigate associated risks; and partly because developed countries and MDBs are expected to become more involved. The areas that are most exposed to the potentially negative effects of BRI financing are related to (i) environmental and social safeguards, and transparency and anti-corruption policies, due to the relatively poor experience of both Chinese SOEs and Timorese executing agencies in dealing with these aspects of development projects; and (ii) the lack of a local labor force used in the projects, due mostly to the lack of skills domestically.

Table 2 – Main risks and associated mitigating measures identified for BRI financing in Timor-Leste

Main risk	Associated mitigating measures
Excessive political, noncommercial, interference in the selection of the projects	- Increasing involvement of other development partners - Ensuring that projects present a minimum commercial return and a maximum bearable risk - Closer scrutiny of prospective deals by the Chinese Ggvernment, holding state-owned enterprise and bank managers responsible for bad investments
Increasing indebtedness of borrowing countries	- Increasing involvement of other development partners - Ensuring that projects present a minimum commercial return and a maximum bearable risk - The Timorese Public Debt Law, as well as the main political parties, strongly limit the readiness of the Timorese government to take on public debt
Permissive (or nonexisting) environmental, social, transparent and anti-corruption standards in projects	- Increasing involvement of other development partners
Lack of a level playing field for procurement for non-Chinese suppliers of public works, goods and services	- Increasing involvement of other development partners - Strengthening capacity building of the Timorese executing agencies and Ministries, - Strengthening on-the-job training and educational and vocational training of the Timorese population
Use of BRI projects for critically exercising influence in other areas, such as military	- Increasing involvement of other development partners

Source: Author.

Concluding remarks

The BRI will clearly improve connectivity and, consequently, trade and economic growth are expected to follow. Infrastructure financing will be further leveraged, and project funding sources will be diversified. However, some authors and political observers argue that the long-term costs could be greater than the benefits, particularly in certain countries and/or in certain locations associated with specific projects.

These long-term costs are associated with some potentially negative effects of the BRI and could be divided into five main groups: (i) excessive political interference by China in the selection of the projects, as a consequence of which could fail to ensure the minimum commercial return and the maximum bearable risk; (ii) increasing indebtedness of borrowing countries; (iii) permissive (or nonexistent) environmental, social, transparent and anti-corruption standards for projects; (iv) lack of a level playing field for procurement for non-Chinese suppliers of public works, goods and services; and (iv) use of BRI projects for critically exercising influence in other areas, such as military.

We argue that most of the risks identified are less severe than some critics suggest and that these risks are being mitigated, partly because they are underpinned by strong bilateral relationships, partly because both China and Timor-Leste have introduced sufficient measures to mitigate associated risks; and partly because developed countries and MDBs are expected to become more involved. Timor-Leste is not in a particularly vulnerable position as a recipient of BRI financing.

All in all, the case study of a small insular developing economy such as Timor-Leste that, although participating in the BRI, is not located on any of the main corridors of the initiative, presents a stimulating example of how the BRI could expand. With a US$16 billion wealth fund, Timor-Leste could invest without borrowing. However, the country lacks the capacity to implement BRI infrastructural projects. It should use its past, present and future revenues from natural resources, as well as critical support from other development partners, including China. The country should develop its social and economic infrastructures and work on economic reforms to ensure that it has a strong revenue base before its natural resources are depleted. Timor-Leste could benefit from actively participating in the BRI, both from the soft and hard components of the initiative. Better connectivity could help generate significant revenues in sectors such as tourism. Timor-Leste should carefully assess and prioritize these investments.

Avenues for further research include assessing the potential challenges and opportunities brought by the BRI to other participating countries, apart from Timor-Leste. More globally, a conceptual framework could be built for (i) evaluating BRI risks for the participating and nonparticipating countries, and China, and (ii) proposing potential solutions and measures that mitigate those risks. There are many fruitful avenues for further research ahead.

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