China’s Silk Road Strategy

By Chi Lo

China’s “New Silk Road” strategy, also dubbed the “One Belt, One Road” project, is a political and economic strategy conceived to kill three birds with one stone by achieving long-term international, domestic, and political objectives. Internationally, implementation of the New Silk Road strategy will unleash a regional infrastructure boom by connecting China with Asia, Europe, and Africa by land and sea, and boost renminbi internationalization by encouraging its use in both trade and financial transactions. Domestically, it will help export China’s excess capacity, which should enhance investment returns and stabilize growth. Rather than a means of reviving China’s excess investment, it is a medium-term step to help rebalance China’s economy via consumption-led growth. Politically, Beijing is using the OBOR project to secure foreign trade relationships in response to some major trade pacts that have excluded China.

It is also evident that through the New Silk Road strategy, Beijing is developing a coherent set of policies to realize President Xi Jinping’s “Chinese Dream,” in which he seeks to combine national and personal aspirations to “reclaim national pride and enhance personal well-being.” In economic terms, this amounts to creating incentive compatibility between the state and the people to maximize national and individual interests. However, the potential risks to China associated with the New Silk Road strategy are not negligible.

Chi Lo is Senior Economist with BNPP IP (Asia) Ltd., and author of China’s Impossible Trinity: The Structural Challenges to the “Chinese Dream” (Palgrave Macmillan, 2015). Opinions here are the author’s and do not necessarily reflect those of BNPP IP.
China’s New Silk Road strategy borrows the concept of the historical Silk Road connecting Chang’an (now Xi’an) in the east to the Mediterranean in the west. It is President Xi’s strategic plan to connect Asia and Europe by investing in infrastructure projects to enhance trade and cultural relations, supported by vast financial resources, including a US$40 billion Silk Road Fund, the US$100 billion Asian Infrastructure Investment Bank, and the US$50 billion New Development Bank.

There are two elements in the OBOR project. “One Belt” refers to the “Silk Road Economic Belt,” which starts from Xi’an and passes through major cities including Almaty, Samarkand, Tehran, and Moscow before ending in Venice. It plans to build roads, railways, and gas pipelines across central Asia to Europe. “One Road” refers to the “21st Century Maritime Silk Road,” which begins in Fuzhou and links major coastal cities including Hanoi, Jakarta, Kuala Lumpur, Kolkata (formerly Calcutta) and Nairobi before joining the Silk Road Economic Belt in Venice. It will build ports and maritime facilities from the Pacific Ocean to the Baltic Sea.

OBOR has three pillars: first, spreading economic development around the world through infrastructure investment and new trade routes; second, creating interdependence between China and other countries and regions via global partnership networks; and third, focusing on Asia as part of a new “neighborhood diplomacy.” By building closer economic ties with the regional economies along the New Silk Road, Beijing is aiming to tie these regions’ prosperity to their relationship with China, hence laying the foundation of an economic empire centered in China.

Greater financial cooperation between China and the New Silk Road countries should encourage deeper integration of markets, backed by the increased use of the renminbi for trade and financial transactions. These opportunities will also create a major role for China-dominated multilateral organizations, such as the AIIB, the NDB, the Shanghai Cooperation Organisation, and the ASEAN +1.

OBOR is the next step in China’s strategic development after its “bring in” policy (to attract foreign investment and technology) and “go out” policy (to encourage Chinese companies to expand abroad) strategies. It is also an extension of the “go west” policy, initiated in 2000, to boost the underdeveloped western provinces.

OBOR will also have a significant impact on China’s domestic economy by providing an investment platform for boosting national infrastructure spending, urbanization, and trade. The OBOR strategic framework comprises five domestic development zones with infrastructure plans connecting each to the other and to neighboring countries. In the northwest zone, Xinjiang will serve as the transportation, trade, and logistics hub for linking central, south, and west Asian countries. In the southwest zone, Guangxi will develop economic ties with ASEAN, the Pearl River-Xizang (Tibet), and the Beibu Gulf, and Yunnan will build an international transport corridor linking China with the Greater Mekong sub-region.

For the northeast zone, Inner Mongolia will build railway links with Heilongjiang and Russia. A Eurasian high-speed rail transport will also be built linking Beijing and Moscow. Chongqing, for the inland zone, will serve

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These initiatives will unleash a regional and domestic infrastructure boom, helping to stabilize China’s growth while structural reforms are being implemented. China’s large state companies will likely lead most of the OBOR projects, paving the way for the small (including private) companies to follow.

It would be wrong to view OBOR as an escape route for China to revive its investment-led growth model. The expenditure-switching from investment to consumption in the Chinese economy is inherently liable to contraction because the multiplier effect of a decline in investment on the economy kicks in faster and larger than the multiplier effect of an increase in consumption. So investment cannot be allowed fall too quickly, otherwise the negative shock will crush growth before consumption can catch up to become a growth driver. OBOR can help rebalance China toward consumption-led growth by preventing investment from falling too fast during China’s structural reforms.

Arguably, OBOR is also an effort by China to counter U.S.-driven trade agreements, such as the
Trans-Pacific Partnership and the Transatlantic Trade and Investment Partnership, both of which exclude China. These new trade pacts are seen by many analysts as part of the United States’ effort to contain China due to concerns about China’s ulterior motives for naval expansion and energy security. From China’s perspective, however, economic growth is key to its national security, as it legitimizes the Communist Party’s rule, and OBOR is part of its survival tactics.

Since 2010, the United States has been working closely with South Korea, Japan, Taiwan, the Philippines, Australia, and India in its “pivot to Asia” policy initiative. This has made it hard for China to expand its influence over regions to its east, and prompted Beijing to rethink its strategy of concentrating investment in the eastern coast. Through the New Silk Road, Beijing is trying to find an alternative by targeting the western and southern parts of the country and expanding internationally to the west.

The real question is not whether China can be contained, but through which channels it will exercise its influence as a new international player. Economic expansion is one possibility; military confrontation is another. China’s former leaders pursued a “peaceful rise.” The current generation of leaders may not necessarily take the same reserved approach.

In my view, Beijing still sees its geopolitical and security interests as best served by tying other countries into ever-closer trade and investment relationships. It is a strategic vision based on economic power. Granted, the OBOR project under the New Silk Road strategy will enhance China’s economic and political clout, which would imply an expansion of its military influence. But as China builds closer economic ties with the world, it will also have a lot to lose if it upsets international relations. It is not in Beijing’s best interest to instigate international instability.

However, OBOR also carries some potentially big risks for China. Some of the countries participating in the OBOR scheme have poor economic fundamentals, including large fiscal and current account deficits. Beijing will be taking on greater default risk by investing in them or by providing them with capital. A wider use of the renminbi may also expose China to foreign exchange risk.

For example, suppose China swaps renminbi for country X’s currency at the current exchange rate. If country X uses the funds to buy Chinese machinery but China does not spend currency X at once to buy goods from country X, it would be exposed to foreign exchange risk if currency X depreciates.

The politics may also backfire on China. Given China’s poor track record operating in foreign countries, including clashes in work ethics and the lack of human rights in labor treatment, a major increase in the scale of China’s external activities could increase the risk of damaging Beijing’s political image or creating instability in the host countries. Expansion of Chinese influence throughout central and south Asia will also create tensions with major players in those regions.

Nevertheless, if China encourages free trade and abides by international norms and market rules, OBOR would be positive for global markets by fostering new trade networks and better allocation of capital. The economic benefit will outweigh the risk.

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