CHINA’S ONE BELT, ONE ROAD
What is it? Why now? What does it mean for investors?

What exactly is One Belt, One Road?

Over 2000 years ago, Zhang Qian, China’s imperial envoy, helped to establish a network of trade routes that facilitated the export of Chinese goods to Central Asia and the Arabian Peninsula. At the time, one of China’s key exports was silk, and in 1877 the name “Silk Road” was coined by German explorer Ferdinand von Richthofen. The road itself influenced the development of the entire region for centuries and the resulting trade led to the rise of Imperial China and its economic and cultural dominance of Asia.

This network of trade routes disintegrated after the fragmentation of the Mongol Empire led to increased conflict and instability in the region. Eventually, the original Silk Road was replaced by more secure sea trade routes established by the European maritime nations, and became known as the “Maritime Silk Road”.

In 2013, China’s president, Xi Jinping, proposed re-establishing the ancient land-based trade routes and modernising the sea-based trade routes by creating a network of railways, roads, ports and pipelines that would link China with Central Asia, West Asia, and parts of South Asia. This infrastructure initiative consists of the Silk Road Economic Belt (SREB) and the 21st-century Maritime Silk Road (MSR), more commonly known as the “The Belt and Road” (B&R), or “One Belt, One Road” (OBOR).

In 2015, China’s State Council formally authorised the OBOR initiative and provided more detail on these two key components. The intention is that the Silk Road Economic Belt will comprise three routes connecting China to Europe (via Central Asia), the Persian Gulf, the Mediterranean (through West Asia), and the Indian Ocean (via South Asia). The 21st Century Maritime Silk Road will create connections via regional waterways.

The initiative is extremely large, even by Chinese standards. In its current form it involves an area that covers 55% of world GNP, 70% of the global population, and 75% of known energy reserves.

To date, more than 60 countries, with a combined GDP of USD21 tn, have expressed an interest in participating in the OBOR initiative.

Exhibit 1: Proposed Silk Road and Maritime Silk Road

Source: Xinhua
Why China? Why Now?

The OBOR initiative forms the most important part of President Xi’s foreign policy platform, and given his personal endorsement of the initiative, his political success or failure is now inextricably linked to the outcome of the project. President Xi was the first to announce the OBOR initiative in 2013 and has personally visited 37 countries to advocate its merits. So why is the normally risk-averse president staking his reputation on what is ostensibly just a grandiose infrastructure plan?

The OBOR initiative helps to address a number of significant issues for China. These can be broken down into two broad categories: economic and political.

Economic

China’s mercantilist economic model and closed capital account over the last 20 years resulted in a considerable surplus of domestic savings. Using its large, state-owned and policy banks, the Chinese government redirected this surplus capital towards domestic infrastructure, in particular transport infrastructure.

The result was gross investment of over USD10tn in infrastructure during the last decade which, in turn, led to significant increases in production capacity in a number of related industries. These infrastructure-driven industries, such as steel, aluminium, glass, coal, cement, power and transportation manufacturing are now suffering from a significant oversupply because infrastructure investment within China has started to slow. Overcapacity peaked in 2014 with estimates of excess supply ranging from 10% to over 50%, depending on the industry (Exhibit 2).

The Chinese economy is rapidly transitioning from investment-led growth to consumption-led growth. The government is well aware, however, that a significant slow-down in the infrastructure-driven industrial part of the economy would undermine this transition due to resulting economic instability. Added to this, these industries tend to be highly labour-intensive meaning a rapid shutdown of surplus capacity would result in widespread job losses and risk social unrest, something the Chinese government is always keen to avoid. China’s infrastructure boom in the last decade means that it now leads the world in a number of areas including high-speed trains, bridge & tunnel building and port construction. OBOR-related infrastructure projects therefore present potentially lucrative opportunities for Chinese companies involved in these industries.

In short, what President Xi is trying to achieve with this strategy in the next few years is to export excess production and infrastructure expertise to developing countries that are part of the OBOR initiative. It is hoped that this will support the part of the economy dependent on investment, while the consumption-driven economy becomes strong enough to support China’s overall economy.

In the longer-term the goal is to facilitate Chinese exports to the fast-growing economies of South East Asia, Central Asia and Africa. In a world where China’s largest export markets, the U.S. and Europe, face economic stagnation and increasing protectionism, developing low-cost, efficient trade routes on land and by sea, where “all roads lead to China”, makes strategic economic sense.

Exhibit 2: Average Overcapacity Reached c20% in China in 2014

![Graph showing average overcapacity in various industries in China in 2014.](Image)

Source: Bloomberg, Barclays Research estimates
Political

The Chinese government is well aware that no superpower has ever emerged without a conflict or significant geo-political tension. As such, it has repeatedly asserted that the aim of the OBOR initiative is to facilitate trade for the promotion of peaceful development. As motivation for pursuing this policy, China has cited lessons learned from the overcapacity crisis of the 1930s which afflicted the West and precipitated the Second World War.

It has also rejected descriptions of the OBOR initiative as “China’s Marshall Plan”, in reference to the US development aid programme in Western Europe after World War II. The Marshall Plan was designed to redevelop the shattered economies of Western Europe but excluded communist countries in order to prevent the spread of communism. China argues that the OBOR initiative is open to all countries regardless of ideology, governmental system or geopolitical affiliation.

Given the size of the OBOR initiative, however, and the number of countries it involves, any amount of co-operation between the governments of these countries will inevitably have political implications. Indeed, many historians liken the current geo-political paradigm in Central and East Asia to the regional scenario in Europe between the end of the nineteenth century and the years before the First World War, when strong nations competed with one another for economic and military dominance.

From this perspective, and given the geography of the countries involved and the focus on both maritime and land-based trade routes, the OBOR initiative fits both the Mahan and Mackinder doctrines of geopolitics. In 1890, US Admiral Alfred Thayer Mahan published “The Influence of Sea Power Upon History”, which advocated the importance of maritime supremacy. It argued that nations that dominate the seas, as Britain did at the time, would dominate the world. In his 1919 article “Democratic Ideals and Reality: A Study in the Politics of Reconstruction”, English geographer Halford John Mackinder proposed that a strong power which integrated the transportation and trading channels of Europe, Asia, and Africa into a single “World-Island”, would be in a position to dominate the globe economically and politically.

If China is successful in linking all the contiguous land areas of Eurasia together, this will undermine the strategic advantage of the U.S.’s maritime dominance and bypass the Malacca Straits maritime trade route. It is no surprise that the first large project to be completed under the OBOR banner was the 2,400km oil and gas pipelines from the port of Kyaukpyu in Myanmar to Kunming in Yunnan province in Southeast China. These pipelines bypass the Malacca Straits through which 80% of all China’s imported hydrocarbons currently flow, thereby making them subject to U.S. control.

In summary, President Xi signs onto his predecessors’ opinion that China will enjoy a “period of strategic opportunity” lasting until 2020. He believes that it should take advantage of a mostly benign security environment, and the U.S.’s geopolitical retrenchment under President Trump, to strengthen its regional political influence whilst avoiding direct conflict. The OBOR initiative is a way of packaging such a strategy. It also fits with President Xi’s “Chinese Dream” of ensuring that China reclaims what it sees as its rightful place as a regional superpower, harking back to the early Qing dynasty.

Exhibit 3: Notable Countries That Have Expressed an Interest in Joining the OBOR Initiative

Source: Secondary research, PwC analysis (tentative listing)
What does it mean for investors?

Progress to-date

Like all large political programmes, a healthy dose of scepticism is required when trying to work out the investment implications of the OBOR initiative. That said, it is already too big for investors to ignore, despite the fact that there are very different estimates of the total amount of capital the OBOR initiative will require. China’s State Council has estimated that it would cost as much as USD8tn for it to be fully implemented as envisaged by President Xi. In another announcement, China has said it will invest a total of USD4tn in OBOR countries, although it has not specified how this will be financed and over what period.

As anyone who has travelled extensively in Asia knows, there is no doubt that the region needs new infrastructure. According to the Asian Development Bank, it needs investment worth approximately USD770bn a year until 2020. To put this in context, the Marshall Plan amounted to USD130bn in today’s money and President Trump’s infrastructure plan envisages spending USD1tn over 10 years.

Politically, the OBOR initiative has already achieved momentum. China has signed agreements with Mongolia, Tajikistan, Russia, Turkey, and Hungary. Current projects already include a rail link between eastern China and Iran, which may be extended to Europe, as well as rail links with Laos and Thailand and high-speed rail projects in Indonesia. Furthermore, to date, more than 200 enterprises have signed co-operation agreements for projects along OBOR routes.

A financial structure to support these projects is also starting to materialise. In 2015, China’s central bank transferred USD82bn to three state-owned policy banks for OBOR projects. China’s sovereign wealth fund backed a new Silk Road Fund worth USD40bn and the government set up the Asia Infrastructure Investment Bank with USD100bn of initial capital. The bank is not formally part of the OBOR initiative, but the loans approved at its first general meeting were all related to infrastructure projects in countries that have signed up.

Even within China, however, there is concern that the government is overreaching. Although details of individual deals are not publicly disclosed, it is clear from a number of sources within China that the financing already provided by China for OBOR-related projects in Kenya, Pakistan and Myanmar are at well below market rates. There is also criticism within China that the OBOR initiative will result in “mángmù fâzhânh”, a Chinese term which means “blind development”. Some Chinese analysts have questioned whether it is sensible to commit such large amounts of capital to low-return projects in high-risk countries.

Investment implications

The first round effect of a successful OBOR implementation is that the chance of a Chinese ‘hard-landing’ is greatly reduced. At the National People’s Congress in March 2017, the government set a growth target for the year of 6.5%. In order to achieve this, it needs to replace slowing domestic demand with regional demand. In short, China is seeking to export the investment-led part of its economy in order to buy itself time to restructure and shut down its overbuilt heavy industries without triggering an economic crisis. If it can manage this balancing act, this would be supportive of global commodity prices and would be positive for investors, especially Emerging Markets investors.

The longer-term, second order effects are likely to be two-fold. First, a successful implementation of the OBOR initiative would accelerate the process of economic decoupling of Emerging Markets from Developed Markets. 63 of the 65 countries highlighted in Exhibit 3 can be classified as developing. Emerging Markets have long been viewed as a high beta play on global growth and commodities prices, however, as intra-emerging markets trade continues to grow more quickly than global trade, the dependence of Emerging Markets on Developed Markets’ demand and capital will continue to diminish. A successful implementation of the OBOR initiative would only accelerate this trend.

The other main second order effect is the increase of China’s ‘soft power’ given the geo-political implications of the OBOR initiative described above. This has already caused considerable concern in Washington and other Western capitals. It is telling that it was Singapore’s Lee Kuan Yew who, recognising the threat to Singapore’s control of the Strait of Malacca, first advised the U.S. on its diplomatic “pivot” to Asia and the Pacific, and opened up military ports to assist with new U.S. military deployment within the South East Asian region. Indeed Australia has so far refused to sign up to the OBOR initiative, seeing it as a threat to its relationship with the U.S., and has also been lobbying the U.S. to do more in the Asia-Pacific region. In short, investors need to be aware that one consequence of a successful implementation of the OBOR initiative may be increased geopolitical tension in the Asia-Pacific region.

What does it mean for investors?
Final thoughts

One key concern for investors is the fact that the OBOR initiative extends the policy of economic development in Western China over the last decade which has resulted in the overcapacity problem China is experiencing today. Indeed, some economic historians argue that planning more state-led development projects that will not generate an economic return represents a backward step. In the 1950s, Mao’s attempt to move growth away from the coast using state-directed investment projects in inland areas had devastating economic consequences.

Long-term investors therefore need to ask themselves a number of questions. Can China replicate its success in domestic infrastructure development abroad given that geographical and geopolitical conditions differ widely outside of China? Is this increase in state-directed infrastructure development in Western China and abroad compatible with China’s aim of rebalancing the economy towards consumption-driven growth? Is the OBOR initiative even necessary given the significant integration of coastal China into the global economy? Can China attract private capital into OBOR-related projects or will this be another example where too much depends upon public financing and state-owned enterprises?

The answers to these questions are, as yet, unknown.
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