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The «One Belt One Road» Project: an Investment Driven Growth Strategy.
Background, Potential, Problems

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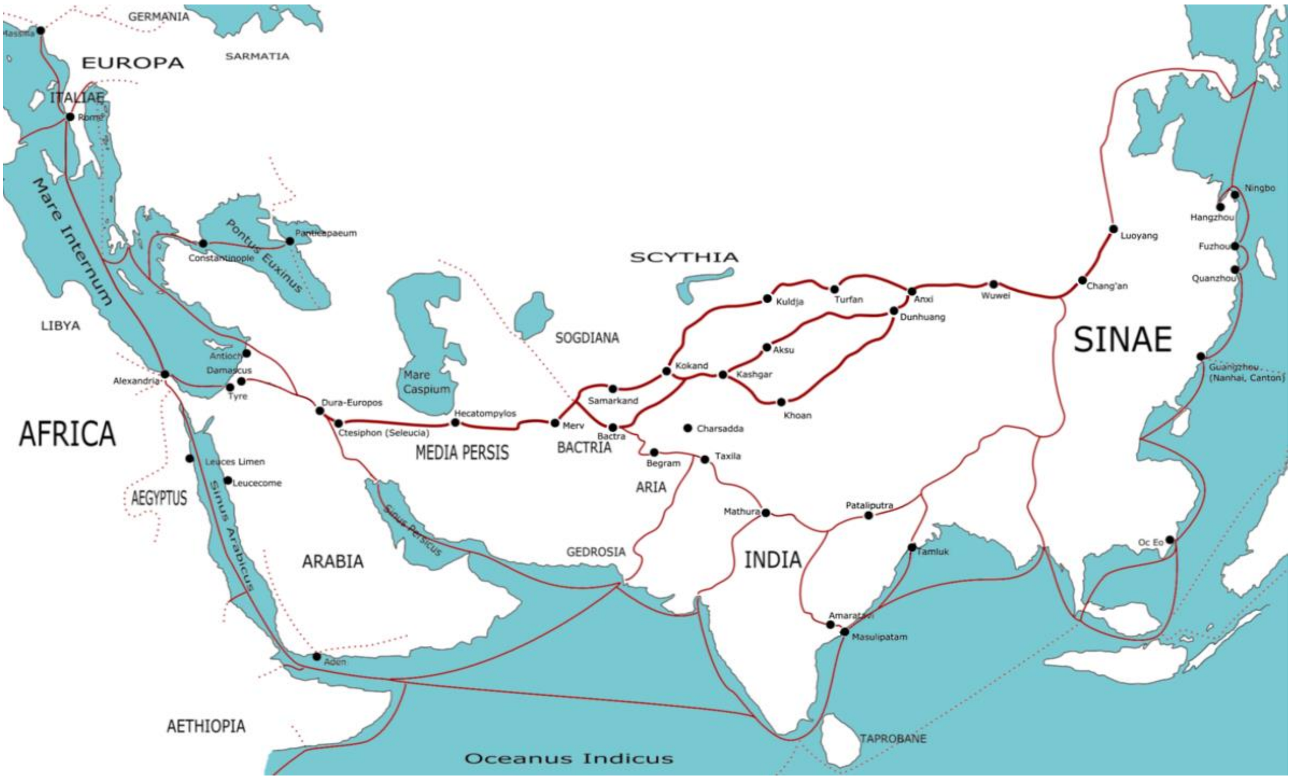
<u>1. Background</u>

1.1. Historical Background: The Ancient Forerunner



"The original Silk Road came into being during the westward expansion of China's Han Dynasty (206 BC–220 AD), which forged trade networks throughout what are today the Central Asian countries of Kyrgyzstan, Tajikistan, Kazakhstan, Uzbekistan, Turkmenistan, and Afghanistan, as well as modern-day Pakistan and India to the south. Those routes eventually extended over four thousand miles to Europe.

Central Asia was thus the epicenter of one of the first waves of globalization, connecting eastern and western markets, spurring immense wealth, and intermixing cultural and religious traditions.

Valuable Chinese silk, spices, jade, and other goods moved west while China received gold and other precious metals, ivory, and glass products.

The route peaked during the first millennium, under the leadership of first the Roman and then Byzantine Empires, and the Tang dynasty (618–907) in China.

But the Crusades, as well as advances by the Mongols in Central Asia, dampened trade. By the sixteenth century, Asian commerce with Europe had largely shifted to maritime trade routes, which were cheaper and faster.

Today, Central Asian countries are economically isolated, with intra-regional trade making up just 6.2 percent of all cross-border commerce. They are also heavily dependent on Russia, particularly remittances—which dropped 15 percent in 2014 due to Russia's economic woes" (McBride, *Building the New Silk Road*, Council of Foreign Relations, May 22, 2015; https://www.cfr.org/backgrounder/building-new-silk-road)

1.2. The Ancient Route: a poetical picture… or a polemical comparison?

Those ancient times are remembered so in a chinese brochure on the New Silk Road:

„As a miracle in human history, the ancient Silk Road boosted trade and cultural exchanges in the Eurasian region. In ancient times, different nationalities, different cultures and different religions slowly communicated and spread along the Silk Road amidst the tinkle of camel bells. At the time, the regions through which the Silk Road ran were relatively peaceful, without the problems of ‚geopolitics', ‚geo-economics', ‚military threats', or the problem of terrorism that haunts Central Asia, Afghanistan and other places today, let along the concept of ‚international terrorism'"
(*New Silk Road: The Legend of Land and Sea,* Beijing, Foreign Languages Press, 2014, p. 2)

There were actually already in those ancient times both the land Silk Road and the Maritime Silk Road.

The Maritime Silk Road, starting from the southeast coast of China, ran through Southeast Asia, Africa, and finally into Europe. (New Silk Road 2014)

1.3. The New Silk Road: 2 Definitions

And now to the New Silk Road.
The project of *Silk Road Economic Belt* and of *Maritime Silk Road,* mainly abbreviated as "One Belt One Road", and most recently as "B&R" Initiative, was first launched by Chinese President Xi Jinping in a speech in Astana (Kazakhstan) in 2013.

Chinese government offered two definitions for this New Silk Road:

- *"The new Silk Road is a modern 3-D sea, land and air transportation network, covering a wider geographical area, richer cultural connotation and wider field of economic ties,*

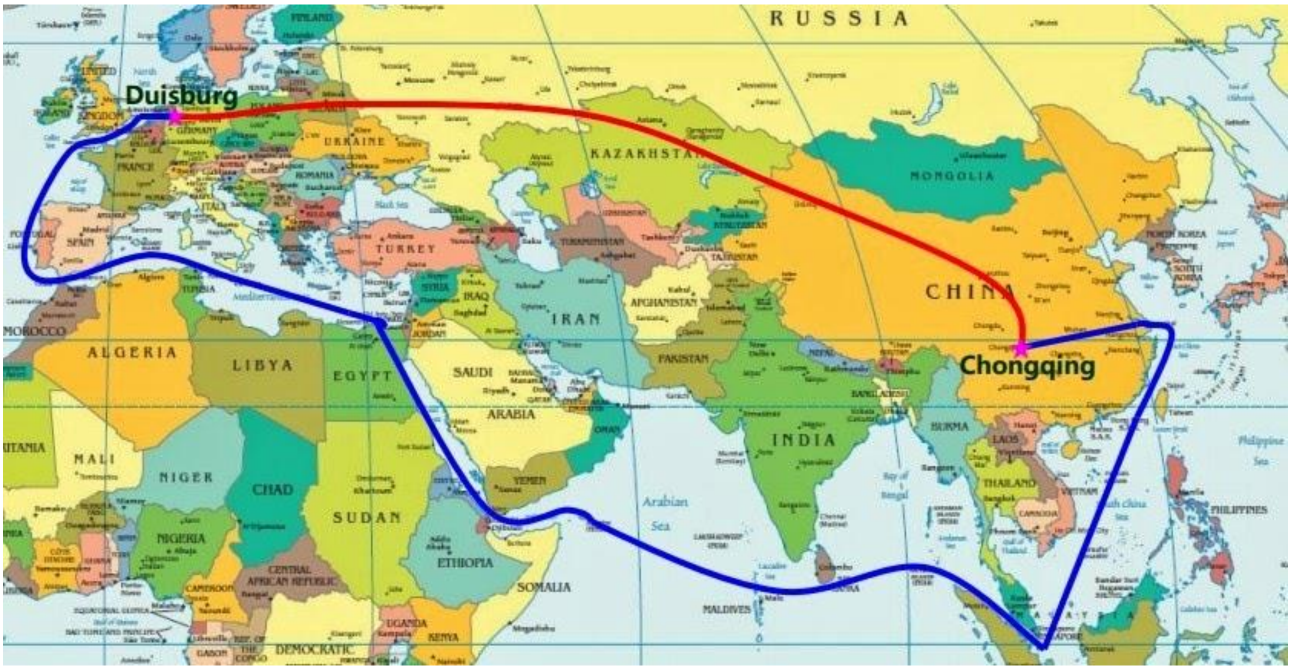
- *[The new Silk Road is] a multi-dimensional and multi-directional connectivity network of roads, information and energy“* (New Silk Road 2014: 8, 11)

1.4. The New Routes (plenty of them actually)

A closer look to the Routes can be somehow confusing.
Let’s have a look at the first slide.

In geographical terms:
China will be connected with Europe not only through the Pacific Sea but also by means of 2 new ways: the Silk Road Economic Belt (green line) and the 21st Century Maritime Silk Road (blue line). We can see also China-Pakistan Economic Corridor (red line)

But a partly different route can be seen in the following picture, which shows the Chongqing-Duisburg railway, through Kazakhstan and Russia.
(And also a partly different Maritime Silk Road).



Moreover, the already quoted brochure on New Silk Road mentioned an "open transportation corridor from the Pacific to the Baltic", too (New Silk Road 2014: 11).
Such a corridor is different from both the routes we looked at.

Routes even partly different from the former ones are to be seen here.

And finally this is another one (a not so nice one for Italy…).

Which is the true map? More than one.

1.5. State of the art as of May 2017: 5 routes

The truth was unveiled only recently: in the book published by the Chinese Foreign Languages Press in May 2017, on the eve of the International B&R Forum: the routes are 5.

The Silk Road Economic Belt has three routes:
1) one from Northwest China and Northeast China to Europe and the Baltic Sea via Central Asia and Russia (orange);
2) one from Northwest China to the Persian Gulf and the Mediterranean Sea, passing through Central Asia and West Asia (red);
3) and one from Southwest China through the Indochina Peninsula to the Indian Ocean (yellow).

The 21st-Century Maritime Silk Road has two major routes:

4) one starts from coastal ports of China, crosses the South China Sea, passes through the Malacca Strait, and reaches the Indian Ocean, extending to Europe (aquamarine);
5) the other starts from coastal ports of China, crosses the South China Sea, and extends to the South Pacific (blu)

(*Building the Belt and Road: Concept, Practice and China's Contribution*, Beijing, Foreign Languages Press, May 2017, pp. 9-10)

It makes sense

All of this can sound a little bit strange.
But cannot be judged inconsistent with the original idea of OBOR, which is closer to a network and a grid than to straight lines.

No definite plan, flexible approach…

There is also another remark we can make. As noted by Robert Berke, OBOR „*is not a formal plan in any sense, but merely a broad outline of goals, a work in progress, being filled in, opportunistically, with projects as they are* *developed, and as negotiations with target countries allow. The Road is also not a ‚start'up' from scratch, but builds upon and extends a number of projects that have been ongoing with China's partners"* (R. Berke, Could The New Silk Road End Old Geopolitical Tensions?, oilprice.com, May 26, 2015 ; my underlines).

This is very much the Chinese way of dealing with business opportunities
There is nothing like a previously definite/closed plan.
There is instead something that is built underway.

…but a strong strategy

But, on the other hand, there is a strong strategy behind the B&R Initiative.

The B&R project has a quite strong theoretical background.
This background was provided by Justin Yifu Lin, a Chinese economist who served as Chief economist at the World Bank between 2008 and 2012.
In 2013 he wrote a book on the Great Financial Crisis and its aftermath:
"Against the Consensus. Reflections on the Great Recession", Cambridge, Cambridge University Press, 2013 (here cited as ATC 2013).

The book deals with a few interesting issues
(among them, a proposal for a New World Monetary System).
But the key issue is another one:
a close examination of the different strategies put in place in order to restore growth after the Great Recession.
He enumerates three different approaches/strategies, eventually combined:

1) **Structural reforms to enhance competitiveness [= Austerity].**

   "The problem is that structural reform is contractionary and may cut more deeply into jobs, economic growth, and government revenues, at least in the short run. Thus structural reforms are not politically feasible in many countries. And, even if implemented, such reforms may not reduce the fiscal deficit, because social spending generally increases in response to rising unemployment and fiscal revenue shrinks when growth slows" (ATC 2013: 65)

2) **Currency devaluation [+QE]**

   Devaluation + Expansionary monetary policies to counterbalance the side effects of structural reform
   "The standard recommendation has long been to offset the contractionary effects of structural reforms by devaluing the currency to increase demand for a country's exports. But any attempt at currency devaluation in the Eurozone, Japan, or the US could trigger a currency war and competitive devaluations".

   So this way is wrong, too:
   "Instead, high-income countries need to stimulate demand to create space for structural reforms. Public or private debt restructuring and fiscal consolidation should not be the priority" (ATC 2013: 65).

3) Deficit spending

"Raising government spending instead could boost demand and reduce unemployment, but concerns about debt levels would likely dictate that the spending be matched by revenue gains" (ATC 2013: 69)
That is: financing consumption it's not a good idea.
One should finance investments instead, because the multiplier is higher, particularly in one case: that of specific bottleneck-releasing infrastructure investments (ATC 72-3).

Here the problem is not *if*, but: *where*?

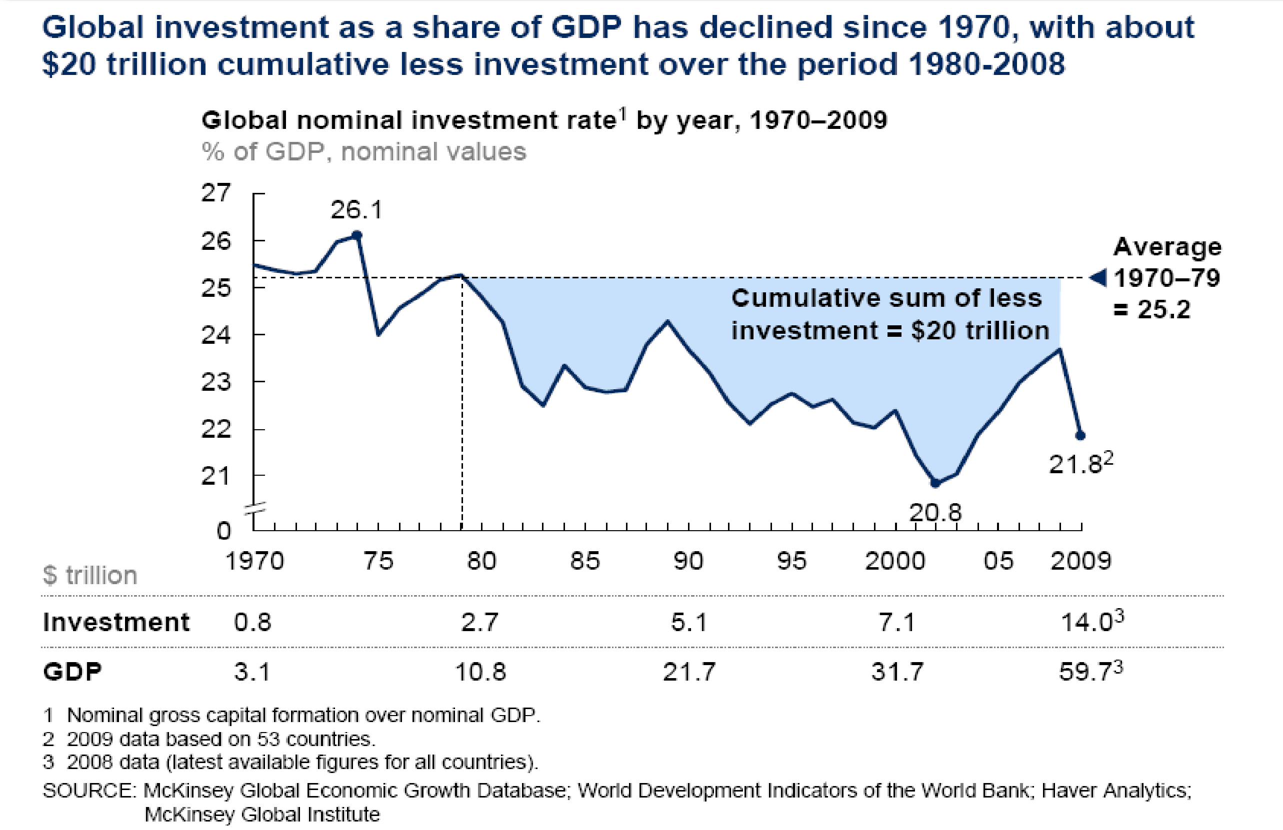
1.6. Theoretical Background for B&R

4) Bottleneck-releasing infrastructure investments in developing countries

"Opportunities for bottleneck-releasing infrastructure investments are likely to be comparatively limited in advanced economies, since their infrastructure capital stock is already well developed.
Moreover, <u>since growth in the global economy is increasingly driven by developing countries, any infrastructure initiatives should include them. Infrastructure investments in developing countries can be transformative</u>. (…) <u>A global infrastructure initiative to finance bottleneck-releasing infrastructure projects would create much-needed jobs in developed and developing countries</u>. It would generate demand boost and create space for implementing necessarily structural reforms in Eurozone and other high-income countries"
(ATC 2013: 74, 78)

Justin Yifu Lin has a point here, as it can be shown by

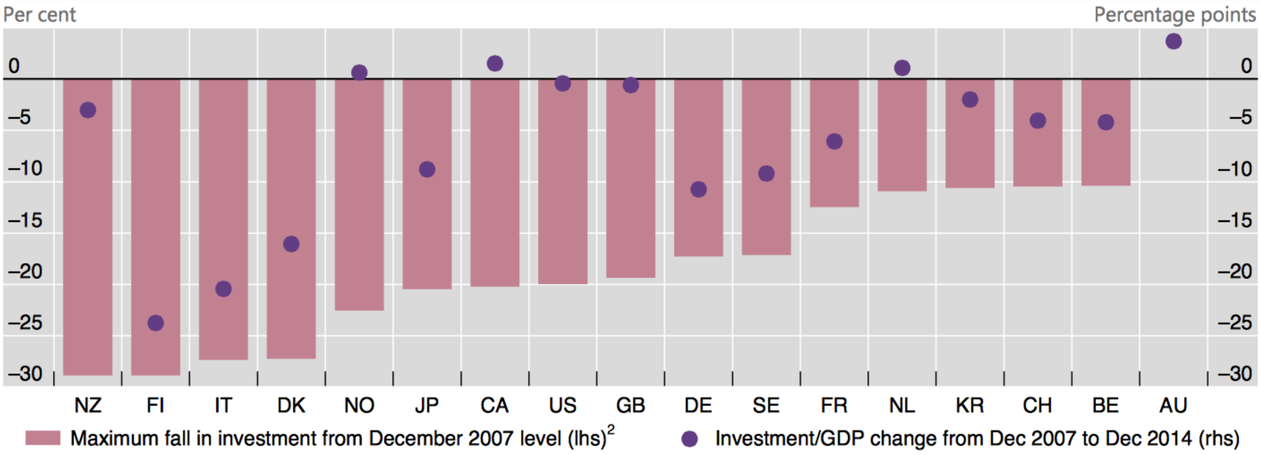
- The Long-term Decline in Global Investment driven by a strong decline in the advanced countries…



- ...and Collapsed Investment in many countries since 2008.

Investment collapsed in the recession and has not recovered in many countries

Real private non-residential gross fixed capital formation[1] Graph 1



AU = Australia; BE = Belgium; CA = Canada; CH = Switzerland; DE = Germany; DK = Denmark; FI = Finland; FR = France; GB = United Kingdom; IT = Italy; JP = Japan; KR = Korea; NL = Netherlands; NO = Norway; NZ = New Zealand; SE = Sweden; US = United States.

[1] For Italy and Switzerland, government real non-residential capital formation is included. [2] Data up to December 2014.

Sources: OECD; BIS calculations.

Uncertainty about returns is key
in my opinion in both cases.
But let's take a closer look to the recent collapse in investment.

As a research by BIS pointed out:
"Despite the easy financial conditions globally, business investment in recent years has been rather weak in advanced economies. Two leading hypotheses have been proposed to account for weak investment: one that the cost and availability of finance remain restrictive, and another that the expected return
is not sufficient to justify the risk of irreversible physical investment.
A lack of funding does not seem to have been sufficient to explain weak investment. <u>It seems more plausible that uncertainty about returns on new capital could have played some role in depressing business investment</u>"

(R. Banerjee, J. Kearns, M. Lombardi, *(Why) is Investment Weak?,* "BIS Quarterly Review", March 2015, pp. 67-82, here p. 76; italics are mine. In the following I will cite the paper as Banerjee/Kearns/Lombardi 2015).

This is true for advanced economies.

But where the infrastructure capital stock is underdeveloped,
much higher returns can be expected:
in this case investment unleash growth in developing countries,
while the advanced ones can build the road today, and sell consumer products tomorrow.

Following OECD estimates,
"Closing the infrastructure gap in developing countries could create between 1,1 and 2,9 million jobs in advanced economies" (ATC 2013: 79)

"Thus, if carried out properly, a global infrastructure initiative could raise exports and reduce unemployment in high-income countries while reducing poverty and boosting growth in developing countries…

Ultimately, this could create a virtuous cycle of global growth, with surplus global savings flowing to support investment and growth in developing countries, generating more import demand, supporting recovery form the global crisis, and helping the world economy become more inclusive and stable" (ATC 2013: 84)

A call for a global infrastructure initiative

Justin Yifu Lin theories are basically a call for
designing a global infrastructure initiative:

that is, the initiative Xi launched in September 2013 with his speech in Astana. In a later speech he claimed the necessity of infrastructure investments that could *"break the bottleneck in Asian connectivity"* (cited in *China to establish $40 billion Silk Road infrastructure fund*, Reuters, 8 November 2014, italics are mine)

Beyond every theoretical assumption, there is a good reason for a Chinese to assume that an investment driven growth model can be successful:
China's development since the late Seventies.

"China's experience demonstrates the benefits of infrastructure investments" ($600bn spent between 1990 and 2005 only to upgrade China's road system: cfr. ATC 2013: 77).

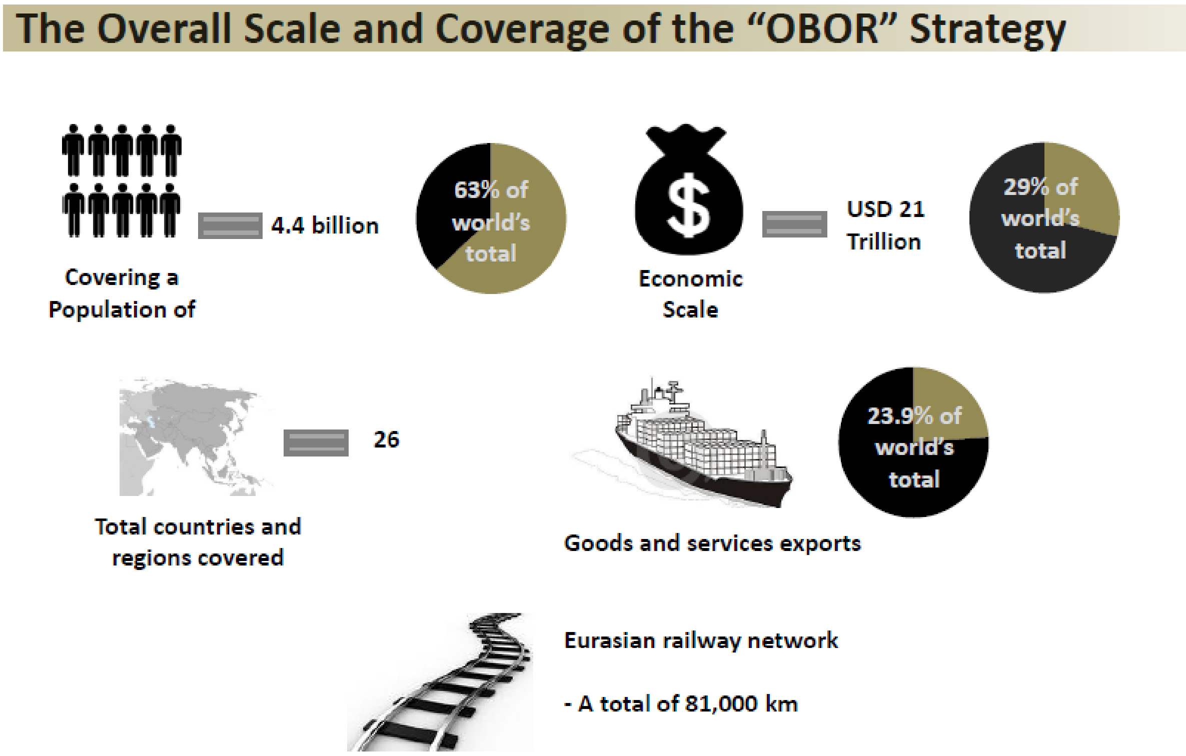
"China's development model… is based on massive state-led investments in infrastructure – roads, ports, electricity, railways and airports – that facilitate industrial development" (F. Fukujama, *Exporting the Chinese Model*, "Project Syndicate, 12 January 2016).

So, no wonder that a similar model has been proposed for boosting growth on a world scale, too.

2. Potential

The project is quite ambitious indeed:

It involves 65 countries (26 of which directly crossed by the Roads),
around 63% of world population,
29% of world GDP
and 24% of goods and services exchanged worldwide.

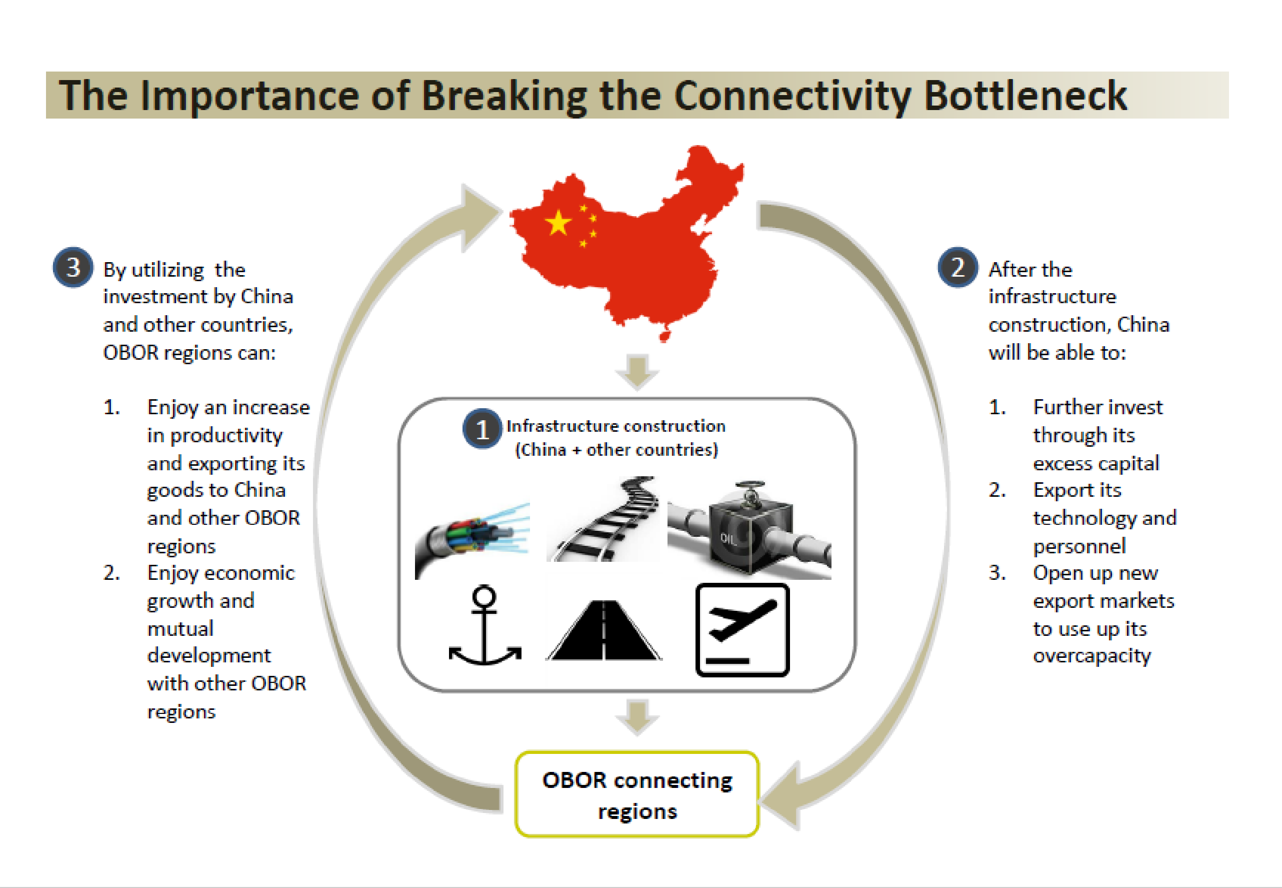


2.1. Potential for Chinese Economy

Of course, this strategy is also designed to resolve some problems China is currently facing.
The B&R Initiative enables China

- to import natural resources such as oil & gas, and minerals from neighboring countries more efficiently;
- to overcome China's overcapacity issue in a number of sectors – such as steel, aluminum, solar panels, cement, coal, ship-building, etc.;
- to use excess capital now reaching USD 4 trillion of foreign reserves;
- to fight underdevelopment in China's central and western regions (Xinjiang's development and stabilization is an important issue for China)

Through a number of infrastructure construction, financial cooperation and capital investment, China hopes to solve these problems while helping the economic growth of the partner countries along the way.



Through the B&R Initiative China can also:

- Strengthening bilateral ties with the countries on the Route:

  free-trade agreements that mainly involve the use of renminbi as transaction currency, so paving the road for a future role as an international reserve currency.
- Creating a good-neighborly relationship zone at China's West borders:

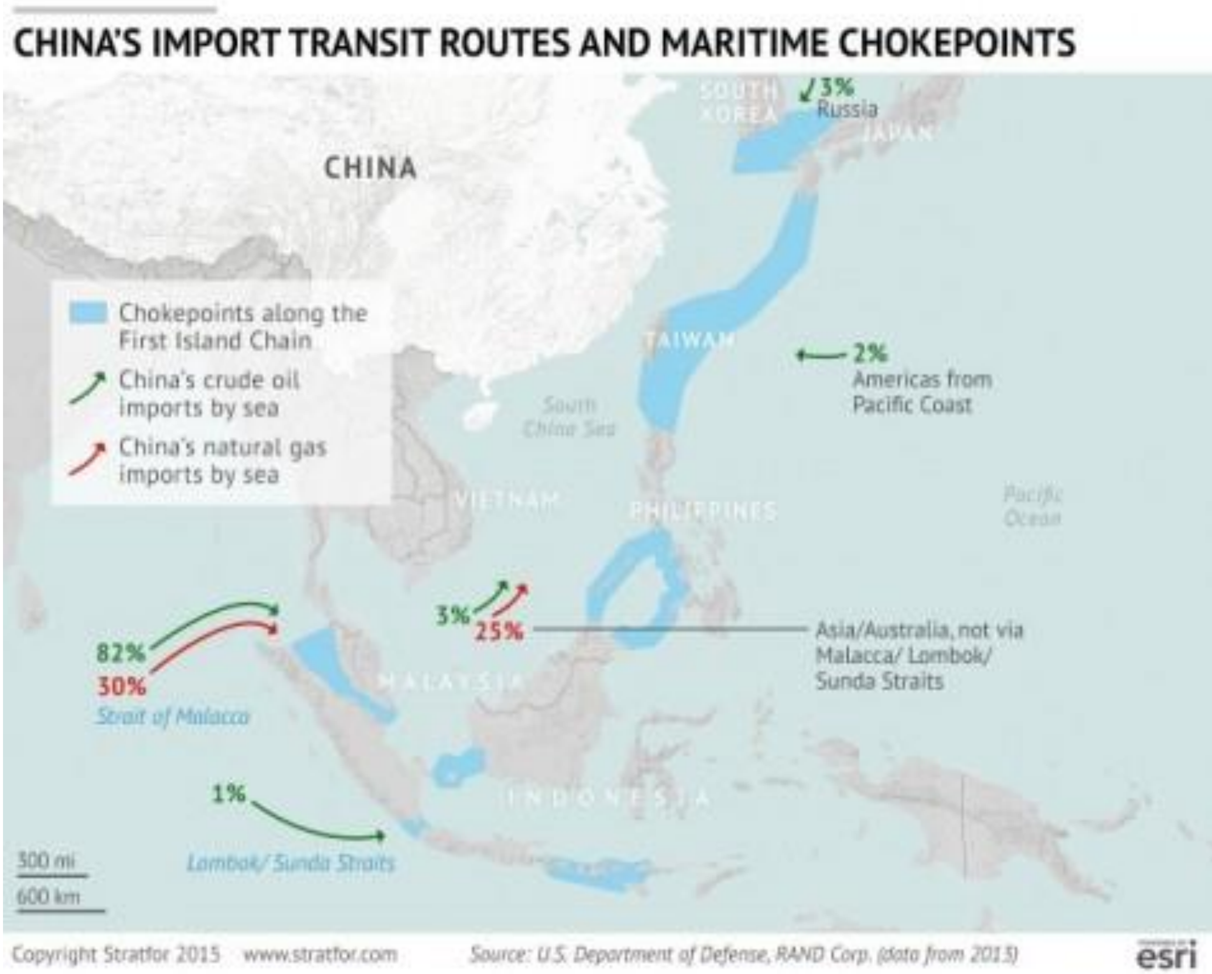
Chinese government insists that this is in no way a “strategic buffer zone”, and that it is intended to be a “strategic stability zone” instead – but the distinction is actually thin.

2.2. Three other important strategic consequences are finally to be considered:

1) **A better control over the trade lanes**, that is over the channels through which business travels.

More precisely: through the land Belt, China can override American-dominated SLOCs (sea lanes of communication), by building competing land lanes.
(A. Bhardwaj, *“Silk Routes versus Sea Lanes. The Return of Landlubbers”, Economic & Political Weekly*, 30 May 2015)

What’s at stake here is easy to understand if you mind that currently 80% of Chinese oil imports are shipped by sea through Malacca Strait.



The *Belt and Road* Initiative aims to mitigate the risk of maritime interdiction by constructing transit routes along **six economic corridors**:

1. The China-Mongolia-Russia corridor, anchored by the Trans-Siberian railway.

2. The New Eurasian Land Bridge, anchored by a set of railways running from central China (Wuhan, Chongqing and Chengdu) to Europe via Kazakhstan, Russia and Belarus.
3. The China-Central Asia-Western Asia Corridor, speculated to follow the overland Silk Road Economic Belt as depicted in maps released last year by the state-owned Xinhua News Agency, passing through Central Asia, Iran and Turkey to reach Europe.
4. The China-Pakistan Corridor, which would extend the Karakoram Highway, which already crosses the mountains between China and Pakistan, and build highway and rail links all the way through Pakistan to the port of Gwadar.
5. The Indochina Peninsula Corridor.
6. The Bangladesh-China-India-Myanmar Corridor.

These six economic corridors are to be seen here:

2) OBOR's land route is **a Land Bridge between Asia and Europe**. Eurasia is still far, but important geopolitical consequences of strengthened ties between China, Russia and Europe can be envisaged.

(And an acceleration to this process could be an unintended consequence of thetensions with Russia over Ukraine).

3) Finally, OBOR contributes substantially to **enhance China's international role**, already moving "from free-rider and rule-taker to ever more influential rule-maker" (J. Bremmer, C. Kupchan, Top Risks 2016, Eurasia group , p. 8).

3. <u>Problems</u>

The problems are matched with the opportunities.
The Infrastructural gap to be filled in Asia has been estimated at 8 trillion $ through 2020 (J. Stokes, *China's Road Rules. Beijing Looks West Toward Eurasian Integration*, "Foreign Affairs", 19 April 2015). And this gap is huge in Central Asia. That is huge growth opportunity but also huge capital amount needed.

The B&R initiative could need public and private investments roughly 12 times the size of the Marshall Plan that helped rebuild Europe after World War II.

It is well known that "the multilateral lending institutions are severely undercapitalised and have nowhere near enough resources to meet the enormous infrastructure needs across Asia, Africa and Latin America"
(John Kemp, Reuters market analyst, 10 November 2014)

3.1. Two new Multilateral Development Institutions and other banks/funds

In order to face the problem China built 2 new multilateral financial institutions, AIIB and NDB.
They cannot substitute the other development banks (and they're not intended to), but their creation is an important move.

Source: Development banks company reports

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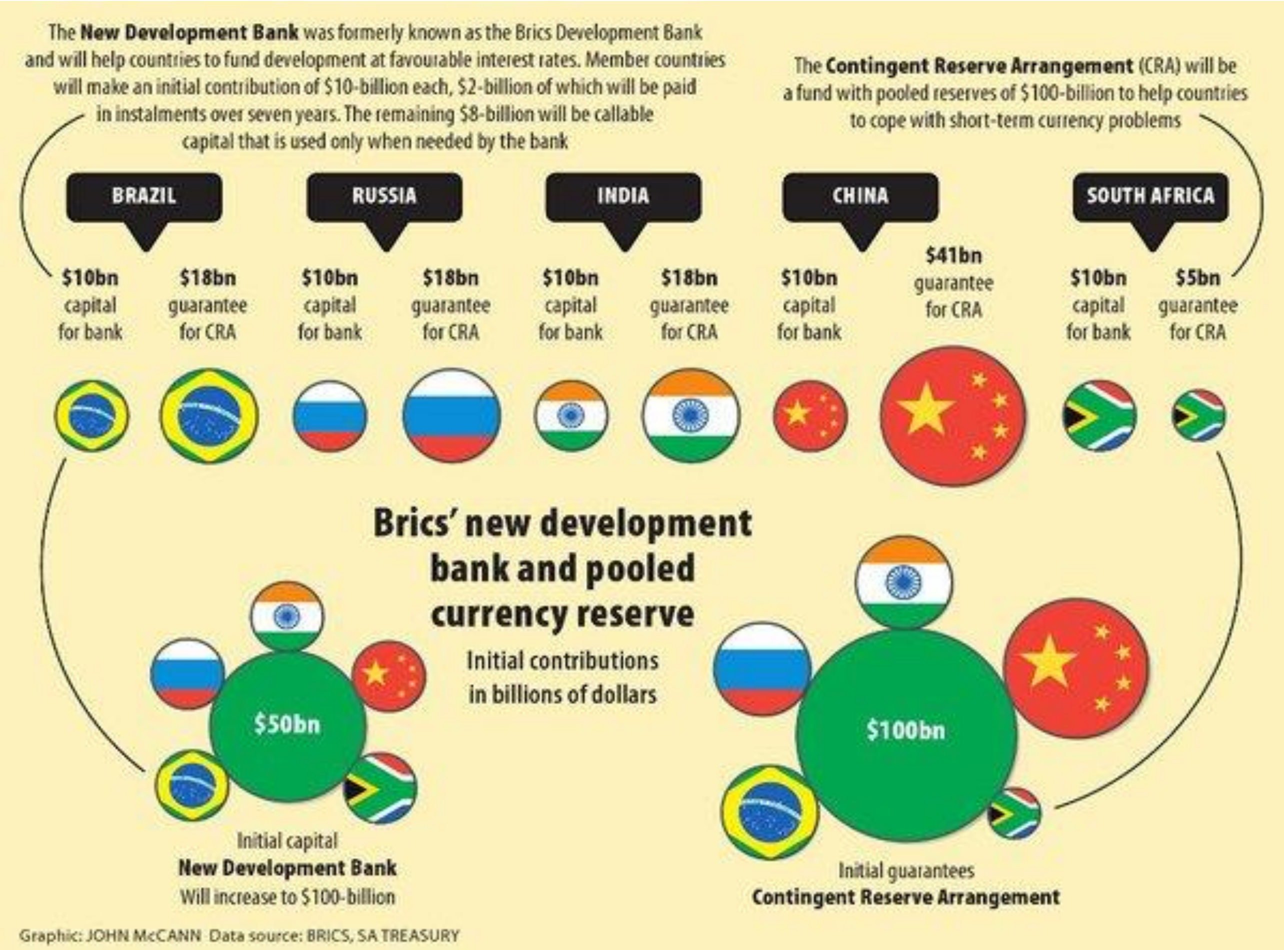
- The Asian Infrastructure Investment Bank
The AIIB, funded with $ 100 billion, is an alternative to the old Asian Development Bank (founded in 1966 and led by Japan). Despite the hostility by the US and Japan, several Western countries (among them Germany, France, UK and Italy) joined the AIIB or applied for membership.
By the end of 2016 $1.7 bn in loans to 9 projects

- The New Development Bank
The New Development Bank (formerly known as the BRICS Development Bank) was announced in the BRICS Meeting in Fortaleza (Brasil, Juli 2014).
It's both an answer to the needs for development funds
and, through the pooled reserves, a sort of assurance against destabilizing capital outflows that could create short-term currency problems.



Others:

China Development Bank
By the end of 2016 signed more than 100 projects in B&R countries:
$30 bn in loans, valued more than $40 bn

Silk Road Fund
Starting capital of $40 bn
By the end of 2016 signed 15 project with an estimated value of $6 bn

Export-Import Bank of China
By the end of 2016 signed 1,100 projects in B&R countries, valued at $100 bn, issuing $80 bn in loans

Agricultural Development Bank of China is also involved

Chinese Membership in EBRD since January 2016 is another useful tool.

ICBC
took the lead in founding China/CEE Financial Holdings, which launched the china/CEE fund project (aimed at Financial support for Central and Eastern Europe)

3.2. A huge financial commitment already in place…

Public funding for the effort has already raised hundreds of billions of dollars in pledges.

To sum up, the Asian Infrastructure Investment Bank, funded largely by China, has about US$100 billion available for the program. The Silk Road Fund, also set up by China, has about US$40 billion, and the New Development Bank, which focuses on projects in Brazil, Russia, India, and China, has already another US$100 billion.

These commitments show the seriousness China and other countries along the route are giving the B&R initiative.

While this committed US$240 billion is roughly the annual GDP of Finland, it is still less than an eighth of what is needed annually to finance the infrastructure needs of the emerging economies along the land and sea routes. Further commitments will be needed, not only from developing markets that would be the direct beneficiaries of the infrastructure improvements, but also from European governments that would benefit from improved trade connections as well as from private investors.

3.3. …but complete funding is uncertain

Question marks:

Alternative investments could be more promising (Fintech etc.)

What rate of return on investment could we bet on?

There is a lot of uncertainty here.
The reason is quite simple:
All calculations about the economic feasibility change profoundly if, along the way, one builds a belt of cities or not.

This is the real bet. So investment on OBOR is a bet on a (not so close) future

That said, the lesson of the past is quite sobering:
Railways investment in the XIXth Century promoted growth, but it wasn't profitable in itself.

What could go wrong?

- Financial troubles in China

It is widely accepted that Chinese authorities are currently facing a credit (shadow banking) & real estate bubble

There is an ongoing monetary tighteting.
Things could get worse

- A large scale financial crisis as in 2007

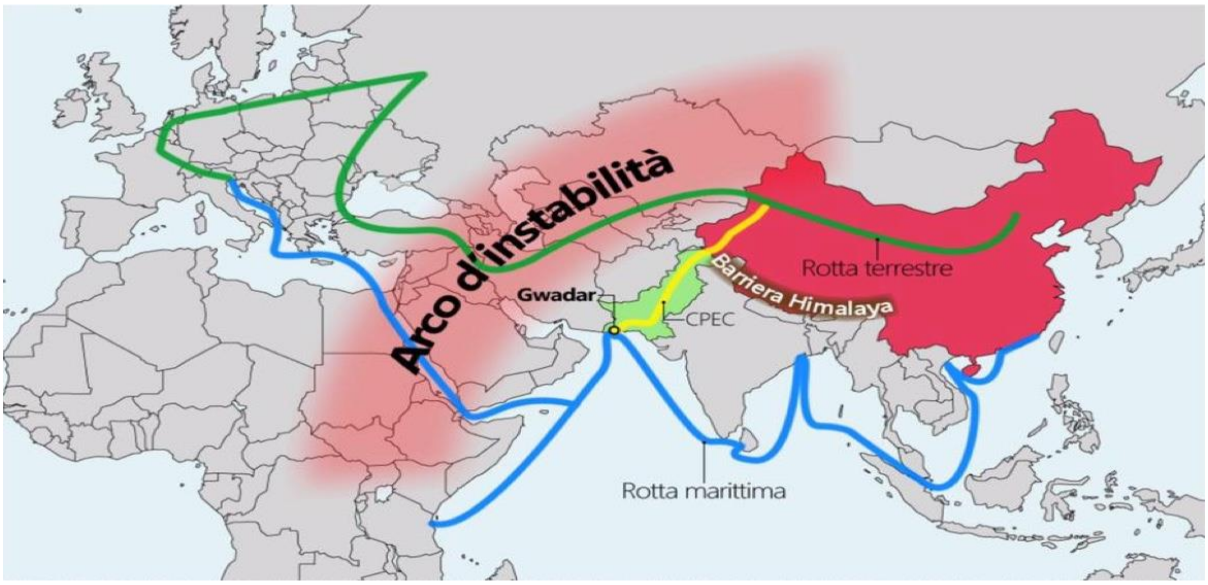
could have devastating effects on B&R Initiative as well.

3.4. The main problem on the road

But the main problem isn't a financial one.

It has a completely different nature: It is political risk.

There is an important geopolitical issue, that undermines Silk Road Economic Belt, Century Maritime Silk Road and also China-Pakistan Economic Corridor: The so-called Arc of Instability.



The political instability in North Africa and Middle East is today more of an issue in terms of hurdle to Asian-European traffic route than in terms of price of energy

Many States created after WWI and the fall of the Ottoman Empire,
then frozen by the Cold War, were put into motion after 1990.

The stabilization of the area is not an easy task

For China, the necessity of military projection could raise the costs of the project.

Already 10,000 Chinese soldiers are currently protecting the building process of the China/Pakistan corridor.

But a real military involvement in these crisis areas is different / and also very complicated (China has no military basis over there)

The regional political risk I mentioned can be more dangerous if we mind the strategical issues that OBOR poses to other powers

3.5. Strategical/geopolitical issues with other powers

1) USA

A) competition with the US-sponsored New Silk Road Initiative for Central Asia (this is done: nobody even remembers it)

B) problems for transatlantic relationship posed by the possibility of closer ties between EU and China

C) loss of US dominance in the seas
(better: decreased importance of this dominance)

2) Russia

Russia traditionally sees Central Asian countries as its backyard
In 2014, its answer to the free trade zone proposed by China for the members a Shanghai Cooperation Organization
(China, Russia, Kazakhstan, Uzbekistan, Kyrgyzstan, Tajikistan)
was the establishment of Eurasian Economic Union
(among Russia, Belarus, Kazakhstan, Armenia, Kyrgyzstan).
Now the situation has improved (thanks to US-led western policies toward Russia).

3) India

China/Pakistan Economic Corridor crosses the contended region of Kashmir.
So India opposes this $64 bn project.

4) EU

The situation is more complex here.
The B&R initiative is a bridge between Asia and Europe, insofar beneficial for both parts involved.
On the other hand, the B&R Initiative is becoming the framework in which China puts bilateral relations; moreover, China is signing related bilateral agreements with some EU countries and not with EU as a whole.
All this is seen somehow with suspect by Germany, that would prefer a more manageable "coordination at EU level". So, following a German research paper, "the main risk for European countries and the EU consists of the concentration in particular mechanisms or even projects in the realm of OBOR. This could strengthen Chinese actors in playing, for instance, individual European countries off against the European Union (EU), or the EU off against mechanisms such as the Central and Eastern European forum with China ("16+1")"
(N. Godehardt, *No End of History. A Chinese Alternative Concept of International Order?,* Stiftung Wissenschaft und Politik, RP2, January 2016, p. 6).

Another related issue is Central Asia: toward these countries Germany is showing an increasingly clear diplomatic activism, in order to avoid the establishing of preferential channels with China.

3.6. Conclusions

At the end of this journey we can come back to our first slide.
We cannot but hope that the Chinese bet (economic growth and peaceful trade against political instability and terrorism) results to be a successful one.
On the other hand, we should always keep in mind that
geopolitics isn't something which we have invented, but a hard fact.

Thank you for your kind attention.