

China's new silk route

The long and winding road

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Introduction

Over the past year China has increasingly made headlines in global news, creating a constant stream of articles, background reports and opinion pieces. Many of the events covered are having an impact well beyond the country and its own economy. Some of the main events that have dominated global news recently have included the ongoing slowdown of the Chinese economy, culminating in the slowest annual growth in 25 years, several severe stock market crashes, official recognition by the IMF of the Renminbi as a reserve currency and a significant devaluation while it slowly moves

towards a more market-determined exchange rate, as well as many other government interventions and policy easing. In the midst of all these developments, it may be challenging to keep an eye on China's long-term goals, ambitions and initiatives, most notably, the massive efforts China's leadership is putting into its 'going global' strategy. These efforts are shaped more and more by the so-called 'Belt and Road' (B&R) initiative, an initiative that is gaining wider recognition and momentum in public opinion in China, but not necessarily yet outside the country.

Belt and Road: a concept, a strategy, a slogan?

During various state visits in 2013, China's president Xi Jinping announced the Silk Route Economic Belt (SREB) and the 21st-century Maritime Silk Route (MSR). These two major initiatives were initially packaged and labelled under the overarching term 'One Belt, One Road' (一带一路) or, in short: 'Belt & Road'.¹ Those who are new to the term may struggle to understand what Belt & Road actually is. It is often communicated as a national vision and foreign strategy, sometimes resembling conceptual propaganda, but it is also mentioned in relation to concrete investments and projects.

'Belt and Road' (or 'B&R') as communicated by the Chinese government is a concept which aims to increase connectivity between the Asian, European and African continents. The intention is for this increased connectivity to enhance trade flows and spur long-term regional economic growth and development, benefiting all those involved.

The official information currently available, mostly provided by China's state news agency 'Xinhua', suggests that B&R comprises two physical routes, with numerous side-branches along the way. These two different routes ultimately connect China with Europe, Africa and Southeast Asia. This impression is further enhanced by a map published by the news agency, depicting both a land route running from inner China to Southern Europe (via the Netherlands) and a sea route connecting the port of Shanghai ultimately with the end point of the land-based route in Venice, via India and Africa.



Source: Xinhua

¹ In September 2015, China's National Development and Reform Commission (NDRC), Foreign Ministry and Ministry of Commerce (MOFCOM) announced that the scheme's official English name is 'The Belt and Road', or 'B&R'

However, it seems that this is more a symbolic portrayal than a factual interpretation. In reality, B&R is more of a large ‘umbrella’ type of initiative. It seems to be a potentially huge collective of current, planned and future infrastructure projects, accompanied by a host of bilateral and regional trade agreements. Ongoing and planned projects will focus on the development of a wide array of assets, including ports, roads, railways, airports, power plants, oil and gas pipelines and refineries, and Free Trade Zones, etc., as well as a supporting IT, telecom and financial infrastructure. To date, PwC has tracked the equivalent of c. US\$250 billion in projects that have either been built already, recently started construction or have been agreed on and signed in relation to B&R.

Some of the core elements of the B&R initiative (such as a focus on infrastructure investments in underdeveloped Western China and Central Asia) are far from new and long predate the public announcements in 2013. B&R, however, bundles all ongoing and planned efforts – such as the China-Pakistan Economic Corridor (CPEC) and the Bangladesh-China-India-Myanmar Corridor (BCIM) – under one unifying framework. The overarching B&R initiative is motivated by myriad macro long-term drivers, both political and economic. The idea of ‘connectivity’ along two main routes, and the investments that will go into it, is intended to be an effective and integrated way to stimulate trade and exports with China’s neighbours, increase export demand for Chinese capacity (e.g. construction and engineering capacity), help internationalise the Chinese currency Renminbi and create goodwill amongst its many neighbouring countries.

Initially covering only the development of Western China and specifically the interior state of Xinjiang, the B&R initiative in its full extent is now reflecting China’s outbound focus in three directions: West (West China, Central Asia, the Middle East and Europe), East (Southeast Asia), and South (South Asia and Africa). For various reasons, Eurasia (because of its proximity to Western China, abundance of natural resources and need for greater regional stability) and Southeast Asia (due to the importance of its trade with China) will be given priority. It is expected that the Maritime route will be developed later, in part because China has a limited comparative advantage in establishing sea routes and is facing opposition from many different countries due to the position it has taken in the South Chinese Sea over disputed areas.

After coming to power, Xi Jinping has clearly brought ownership to China’s outward focus. With the B&R concept, a clear and coherent outward direction has been established, which is being heavily pushed by the central government in Beijing. Under Jinping’s leadership, Belt and Road has been elevated to a powerful slogan meant to guide and direct the efforts of both the public (e.g. provincial governments, state-owned enterprises) and the private sector in China.

B&R is also very much a national strategy. The initiative is expected to be a critical driver for China’s long-term goals, ambitions and initiatives, and a key pillar of its ‘going global’ strategy. Underlying this overarching strategy is an action plan which was released in March last year. This plan was established in a joint effort between the Ministry of Foreign Affairs, the National Development and Reform Commission (NDRC) and the Ministry of Commerce. In its current shape, the plan is more a vision expressing China’s grand ambitions rather than a practical implementation plan and the concept seems to be deliberately kept both broad and vague. Though little is known yet about further details of B&R and what implementation may look like, China’s central government has created a dedicated group responsible for overseeing implementation of all B&R initiatives – an office directly situated under the NDRC.



While in theory much broader in nature, B&R initially manifests itself primarily as a massive infrastructure development programme. It is based on the logic of using China's huge economic leverage abroad and exporting its strong infrastructure development capabilities to other regions.

An enormous financing commitment and platform is supporting the B&R initiative. Based on analyses, PwC predicts that B&R will mobilise up to US\$1 trillion of outbound state financing from the Chinese government in the next 10 years. Most of this funding will come in the form of preferential debt funding, but some will be in equity. The government has created specific vehicles to help allocate this money to appropriate projects and initiatives. These include, amongst others, the recent establishment of a New Silk Road Fund (NSRF), the establishment of the Asian Infrastructure Investment Bank (AIIB) and the government directing large sums of its foreign exchange reserves and several of its largest state-owned banks to the initiatives.

If carried out at full scale, the implementation of B&R will cover a long time span of at least 30 to 40 years. 2049 is often referred to as a key milestone as it is the year when the 100th anniversary of the establishment of the People's Republic of China will be celebrated.

Belt and Road's significance to China

Although often described as a way to revitalise ancient trade routes, today's B&R initiative is much more comprehensive. Rather than a mere recreation of former connections and corridors throughout Central Asia and the Middle East to connect China and Europe, B&R intends to go far beyond that.

B&R can be regarded as the most important driver for China's long-term development strategy, foreign policy and – in the opinion of some – even a way to reform the structure of its own economy. It is meant to shape both China's national economic development strategy and international activities for the years to come and is expected to feature prominently in China's next five-year plan which will be released later this year.

Falling exports, sluggish economic growth, both globally and at home, and a persistent need for China to structurally transform its economy from being driven by government investments and exports to a more consumer-driven model are, in essence, all at the base of China's recent launch and acceleration of the B&R initiative. Due to the nature of its economic growth model, China has created a problem of serious overcapacity in many of its industries. China's enduring emphasis on heavy industries over the past two decades, as well as government being a decisive force in the country's economy are two of the key reasons for this overcapacity. By now, the government has identified well over a dozen industries for which it is taking specific measures to curb further production.

In the B&R initiative, the Chinese government sees a way to offset part of the existing domestic overcapacity by exporting its well-developed engineering and construction capabilities, materials and equipment and self-developed technology. Apart from China's experience in building world-class infrastructure, it will mostly export excess capacity with low opportunity cost and therefore there isn't necessarily a need to gain quick returns. At the same time, China hopes to spur further demand for its goods and services by enhancing connectivity and trade between regions across Asia, Europe and Africa, creating medium and long-term growth momentum and a boost to the country's GDP.

Within China, around 16 of the country's 27 provinces are covered by B&R and an even larger number has indicated a desire to participate. For many less developed regions, mostly in inland China, the initiative is a clear opportunity to catch up with the more advanced provinces on China's East coast. Central government also intends to bring more stability to the interior states (most notably Xinjiang) by establishing better connectivity with other regions.

In its current form, B&R is also China's grand strategy for developing a larger leadership role on the international stage and enhancing ties with neighbouring nations. With a strategy that seems largely based on loans and aid and therefore helping China to build financial power (including the wider international use of its currency) alongside its trade power, the country hopes to expand its influence in a geopolitical marketplace where global powers are competing for influence in emerging markets.

Involvement of other countries in the Belt and Road initiative

The geographical area that is potentially covered by the B&R initiative is vast. In its current shape, the initiative has close to 65 countries somehow connected, covering more than half of the world's population (c. 4.4 billion), around 30% of the global economy and a total infrastructure investment need of around US\$5 trillion.

Some commentators have coined the term 'Chinese Marshall Plan' to describe the B&R initiative, a reference to the Marshall Recovery Programme which focused on revitalising Western Europe after the end of the Second World War with the leadership and

funding of the US. However, the comparison is not an accurate one, in the sense that China is putting a very clear emphasis on the inclusiveness and 'win-win' character of its B&R initiative. Where the original Marshall plan deliberately excluded some countries from participation and put hefty conditions on others, China is making clear that all countries along the way are welcomed to join, without B&R attaching additional conditions.

According to China, B&R is not to be seen as an alliance and it stresses the fact that the initiative comes without any political strings attached. While this may be so, it is fair to believe that Chinese help and money will come with its own set of conditions, which may include high interest payments, a need to use Chinese labour, goods and technology and having to grant long-term access to natural resources.

Middle East and Europe (16 countries)

Key countries include

- Poland
- Romania
- Czech Republic
- Bulgaria
- Lithuania
- Slovenia

Commonwealth of Independent States (11 countries)

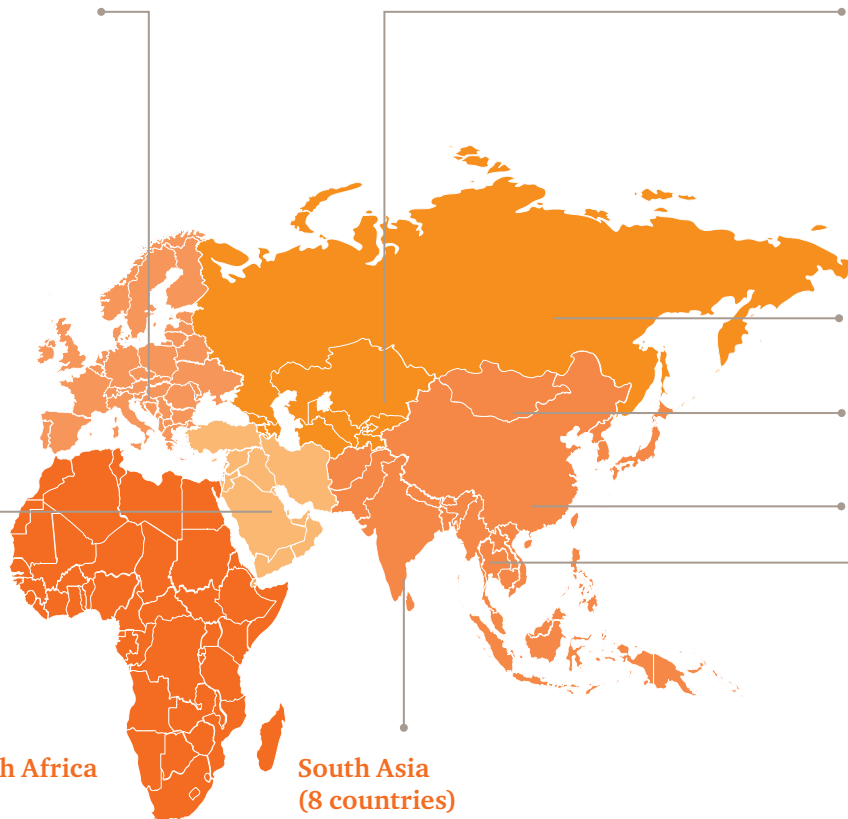
Key countries include

- Kazakhstan
- Uzbekistan
- Ukraine
- Kyrgyzstan

Russia

Mongolia

China



West Asia and North Africa (16 countries)

Key countries include

- Saudi Arabia
- United Arab Emirates
- Egypt
- Iran
- Turkey
- Israel

South Asia (8 countries)

Key countries include

- India
- Pakistan
- Bangladesh
- Nepal

Southeast Asia (11 countries)

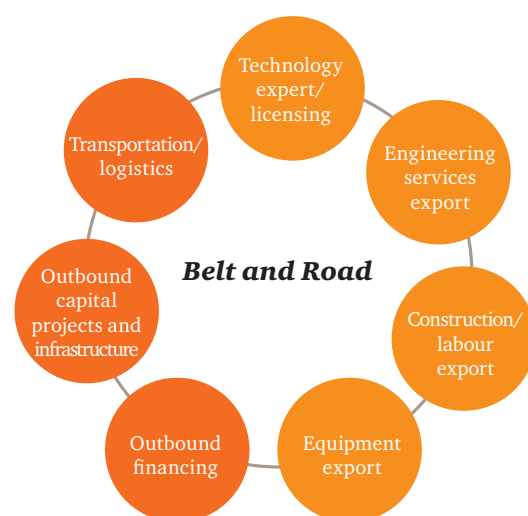
Key countries include

- Indonesia
- Thailand
- Malaysia
- Vietnam
- Singapore

Source: Secondary research, PwC analysis (Tentative listing)

Implications for international firms

Opportunities arising from the Belt and Road strategy



Key opportunities

- Outbound capital projects and infrastructure – especially in partnership with Chinese players
 - Supply equipment/technology/intellectual property
 - Joint or independent engineering, procurement and construction/project finance
 - Joint new client developments (e.g. developing market governments)
- Leverage Chinese partnerships abroad for accessing Chinese market itself
- Leverage Chinese funding for divestment, fundraising, etc.
- Outbound financing/private equity fund (e.g. joint AIIB, Silk Road Fund, etc.)
- Better trade with markets with improved infrastructure (Europe eastward)

While China has tremendous economic leverage which it intends to use abroad, even its pockets aren't deep enough to cover the huge investments required to fulfil the B&R initiative. It hopes to cooperate with different governments, companies and investment funds, potentially creating opportunities for many shared projects and public-private partnership (PPP) initiatives.

B&R is expected to have a significant impact on non-Chinese businesses in numerous ways. The figure above illustrates high-level opportunities brought by the first wave of B&R, especially for businesses that focus on infrastructure building, including suppliers of technology, equipment and components, raw materials and other elements to Chinese construction companies. They can partner with their Chinese customers outside China in much the same way as they have done inside China in the past. While technologies of Western firms complement China's advantages, these complementarities will exist outside China for the Chinese companies as well. B&R essentially expands the demands of their customers. Siemens, for example, has won a US\$1 billion order from China's Shandong Electric Power Construction 3rd Company (SEPCOIII) for the construction of a combined cycle power plant at the Ras Al-Khair Plant in Saudi Arabia. Secondly, foreign engineering, procurement and construction companies could partner with Chinese players in overseas markets, or conduct joint new market and customer development.

Furthermore, there are opportunities for foreign companies that have previously proved to be less successful in breaking into the Chinese market. These firms could partner with Chinese players overseas and subsequently leverage these customer relationships when re-entering the Chinese market itself. It's key to realise here that the majority of players reaping fruits from B&R funding so far have been China's mega-sized state-owned enterprises (SOEs). One or two successful project partnerships with these players can build goodwill and track record to gain an edge in their domestic bids. In the Siemens-SEPCOIII partnership case mentioned earlier, SEPCOIII recommended Siemens to other SEPCO subsidiaries in China based on their good experience.

As well as industry players, financial players such as private equity firms and other institutional investors could potentially discover investment opportunities. As Chinese companies are increasingly experimenting with PPP-type investments into infrastructure in emerging markets, they are aided by very substantial Chinese public sector financing and guarantee under the B&R banner. These de facto subsidies drastically improve the infrastructure projects' risk-return profile. Many of the SOE players are arguably 'too big to fail' and will receive Chinese government backing in negative case scenarios. Furthermore, China's state-owned policy insurer will cover certain projects during any political or social incidents.

In the longer term, there will be macro impacts for international firms. One of the primary objectives of the B&R initiative is to facilitate smoother trade flow within the connected regions; essentially building infrastructure to drive shorter lead times and reduced transportation costs. Improved linkage via railways and maritime connectivity is expected to further reduce the transit time between Europe and China. The land route will also emerge as an interesting option for the movement of goods, being significantly more cost effective than air-freight, and a possible alternative to sea transportation. This will greatly benefit organisations that rely on raw materials from the region as well as international players who are seeking to further penetrate large consumer markets like China and South Asia with their finished products.

The road ahead

Historical silk routes emerged organically more than 2,000 years ago, due to increasing foreign demand for Chinese silk. The development of the routes and corridors currently being envisioned is very much driven by China itself. Although details remain scarce at this stage, expectations surrounding the B&R initiative are high. Whether results from the concept will be as impressive as its set up ultimately depends on the speed and effectiveness of implementation.

There are many challenges for China and the other countries involved, of which rough terrain, persistent regional conflicts, thriving corruption, and scepticism amongst various countries towards China and its intentions are just some. The sheer amount and variation of challenges will make the realisation of the B&R initiative a very complex endeavour.

There is a long and winding road ahead before China, along with all the underdeveloped nations across Central Asia and the Middle East, can reach the position, influence and level of prosperity that they once held in the days of the ancient silk routes.

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