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No. 2/2016

Xi Jinping's long road to somewhere?

China's OBOR initiative and how Europe should respond

by Guy de Jonquières, Senior Fellow at ECIPE

THE MENTION OF China's One Belt One Road initiative, also known as Belt and Road, brings to mind the Indian fable of the three blind men and the elephant. The men have never seen an elephant, so have no idea what one looks like. One grasps its trunk and insists it is a tree. Another puts his arms round its leg and declares it to be the column of a statue. And the third grabs its tail, which he says is obviously a snake. Perceptions of what OBOR is really about – and how far it is feasible – diverge equally widely.

Some observers argue that the initiative, launched with a flourish by President Xi in 2013, is primarily about economics; others that it is principally about geo-politics. For some it is driven, like most Chinese foreign policy, by priorities and pressures close to home; for others, it is a visionary strategy for expanding China's sphere of international influence and establishing regional hegemony, while countering the US-led TransPacific Partnership. Some think it is really about promoting the development of backward inland provinces; others that it is about exporting China's massive excess capacity in steel, cement and other industries.

Then again, some think it is aimed at preventing instability in neighbouring Islamic states spilling over into the western province of Xinjiang, with its large and restive Muslim population. Still others see it as an extension of China's "Going Out" strategy, intended to promote outward investment, that will also safeguard the country's dependence on extended supply lines of

EXECUTIVE SUMMARY

The true nature and purpose of China's One Belt One Road (OBOR) initiative are subject to much speculation. The one certainty is that OBOR commands powerful high-level Chinese support and is backed by a large investment of political capital. It is no less than the personal signature initiative of President Xi, who has made clear that he regards it as central to his political legitimacy and as the tangible embodiment of his "China Dream" of rejuvenating the nation and its ruling Communist Party – which in his mind are probably the same thing.

However, the initiative faces formidable challenges. It remains unclear how much new

investment OBOR has generated, how far it makes economic or geo-political sense or, indeed, how far China can afford to support it, given its current economic and financial difficulties. There has been fierce competition to win government support for OBOR projects but its political nature risks leading to serious misallocation of resources.

OBOR should not be expected to provide a financial bonanza for Europe or to re-energise the region's flagging economic performance and loss of self-confidence. Nor does the EU need Chinese investment or other resources to achieve those objectives: the solutions to its problems lie mostly in its own hands. However, it should not turn its back on OBOR. It should, rather, view the initiative as one in a series of small steps aimed at fos-

tering deeper mutual understanding and engagement – and possibly even greater trust – between the EU and China. Though that could cause strains in its relations with the US, realistically, the EU has little option. It also has little to lose by trying to build bridges and make common cause with China in areas of mutual benefit, even though they may not pay off politically and economically in the longer term. Setting its face against China would not insulate Europe from the aftershocks if China suffered serious economic setbacks or entered a period of political and social turbulence. Whatever happens, China's economy is simply too big and too deeply integrated with the rest of the world, and the country's global impact too great, to be ignored.

imported energy and raw materials. And some observers view OBOR as little more than a slogan containing very little real substance to date.

Curiously, most or all of those different interpretations may well be true. OBOR, it seems, has achieved the rare feat of being all things to all men. At least for the moment. However, things that please everybody do not always amount to a lot. An outward appearance of coherence can fragment, as differing priorities and incompatible interests assert themselves. And that, too, may be true of OBOR.

The one certainty is that OBOR commands powerful high-level Chinese support and is backed by a large investment of political capital. It is no less than the personal signature initiative of President Xi, who has made clear that he regards it as central to his political legitimacy and as the tangible embodiment of his “China Dream” of rejuvenating the nation and its ruling Communist Party – which in his mind are probably the same thing. When Mr Xi issues orders, those further down the line of command jump to attention. And so great is his authority in China that the rest of world should pay attention, too.

Turning his dream into reality is not, however, proving easy. To generate momentum for OBOR, events, rallies and meetings have been staged across China, at both national and local level. That has doubtless raised the initiative’s profile and unleashed a wave of public enthusiasm and energy. But it has also complicated the task of co-ordination – always formidable in China – by involving a multiplicity of special interests, in addition to the plethora of different and often rival agencies and departments that habitually have a say in the country’s policy formulation processes. Some foreign diplomats say they have found it difficult to extract specifics about the initiative from Chinese officials and even to discover who, if anyone, is in overall control of it.

With so many fingers in the pie, there has inevitably been fierce competition to grab a bigger share of it and, above all of the government loans and subsidies required to fund it. It is far from clear how many viable new projects have emerged from this stampede. Indeed, there have been numerous reports of existing or shelved programmes being rebranded with the OBOR label in the hope of winning official favour or support. A lot of effort, it seems, may be going into pouring old wine into a new bottle.

One symptom is the claim earlier this year by Gao Hucheng, China’s commerce secretary, that since OBOR was launched, special economic zones along its route have created almost one million jobs in 35 countries and regions and generated more than \$100bn in tax revenues. If so, that is a truly remarkable achievement.

However, it may also be the reverse: an attempt to create the illusion of progress where there has actually been very little, by, as one Beijing observer puts it, “building Potemkin villages along the OBOR”. It is not easy to identify really significant developments that unarguably owe their genesis to the initiative. That may be because it is difficult to determine exactly where it begins and ends. Or perhaps it is because bankable projects that offer worthwhile economic returns just aren’t that easy to come up with.

For instance, analysts who have studied the proposed route between the Russian border and the former capital of Xian, OBOR’s Chinese hub, have concluded that it can never be economically viable because so few people live along it. Some other projects, beyond China’s borders, look even more dubious, indeed dangerous – so much so that even some of the Chinese state-owned enterprises charged with spearheading OBOR appear distinctly hesitant about getting involved. One senior executive of a leading energy group, fearing that participation in OBOR could expose it to heavy losses, refers to the plan disparagingly in private as “One Road, One Trap”.

One particularly questionable project is intended to transform Gwadar, a remote Pakistani promontory on the Indian Ocean, into a transportation hub for energy and raw materials and a humming port metropolis modelled on the thriving southern Chinese city of Shenzhen. Yet Gwadar is acutely short of fresh water and 400 miles from the nearest electricity grid or large city. It is also under threat from militant jihadists and separatists, requiring 2,000 Pakistani soldiers to guard a handful of Chinese workers. No wonder prospective Chinese investors are hardly rushing in.

Not all the links in the OBOR chain look as risky as Gwadar. Some independent economists believe the maritime section, confusingly named the Road, makes more commercial and economic sense than much of the land-based or Belt part.

STRATEGIC DILEMMAS

NONETHELESS, STRATEGIC DILEMMAS LIE AT the heart of the grand plan. On the one hand, it is intended in part to stabilise troubled neighbours such as Pakistan and Afghanistan in the aftermath of US military withdrawal by promoting their economic and industrial development. However, similar western policies in far-flung and unstable places have repeatedly failed. If OBOR is no more successful, China could find itself drawn into political and military quagmires that it is ill-equipped to navigate, creating serious challenges to its vaunted – though inconsistently implemented – doctrine of non-intervention in other countries' internal affairs.

If Beijing had a clearly articulated and overarching global geopolitical strategy, it might perhaps find such conundrums slightly less difficult to wrestle with. But, by the admission of its own senior policy makers, it does not. Indeed, Wang Jisi, a leading foreign policy expert who is often – though not entirely accurately – credited as OBOR's intellectual architect, warned in 2010 that without one, OBOR could lead China into dangerous international territory. Like much of the country's foreign policy, OBOR seems to be heavily influenced by a China-centric world view, driven chiefly by inward-looking impulses and intended first and foremost to meet pressing domestic priorities and needs.

Southeast Asia presents another challenge. For Beijing, OBOR is a way of strengthening and tightening regional relations. Yet it seems unlikely to dispel on its own the deep anxieties and ill-feeling generated across the region by China's aggressive expansionism and land grabs in the South China Sea. Indeed, OBOR may backfire if other Asian countries come to view it less as a positive gesture of co-operation than as an attempt to promote and extend China's supremacy in the region and to underpin other nations' dependence on it.

Another big question is how far China can afford the substantial investments, including heavy associated spending to boost its overseas military presence, that OBOR calls for. Though no firm figures have been given for its overall cost, some estimates put it at at least \$1 trillion. Most of that is expected to be financed by Chinese lenders, with the Asian Infrastructure Investment Bank and the \$40bn Silk Road Fund chipping in relatively small proportions of the total. China's policymakers expect that its investments will ultimately generate significant financial returns for the state and for corporate investors.

However, the initiative comes at a difficult and perilous moment for China's economy. Former double-digit growth is giving way to what looks likely to be an extended slowdown, as the authorities struggle to staunch sizeable capital outflows and to contain a massive credit explosion that has raised debt to vertiginous levels. Meanwhile the far-reaching and painful structural reforms that policymakers acknowledge are essential in order to re-balance the economy and place it on a sustainable footing have ground almost to a halt.

Just as slower growth spells lower tax revenues, potential claims on fiscal resources are mounting, notably in the form of rapidly rising levels of bad debt. Some independent analysts estimate that Chinese banks' non-performing loans are as much as 20 per cent of their total assets, far higher than the official figure of 1.67 per cent, and equivalent to around 60 per cent of Gross Domestic Product. Though all those assets might not have to be written off – some could probably be restructured or sold – the bill for cleaning up the mess could be large.

Indeed, much of the debate about China's economy today centres on whether these problems are set to create a full-blown financial crisis, or whether it will manage somehow to muddle through, but at the cost of an extended and bumpy period of under-performance. Meanwhile, other costly burdens loom that will weigh on growth and the public finances: notably undertaking a huge environmental clean-up operation, dealing with acute water shortages and coping with a shrinking and fast-ageing population that will eliminate the “demographic dividend” that has helped power the economy's rapid expansion since the early 1980s.

All this means that China is likely to have less scope in the future to deal with problems and promote initiatives simply by throwing money at them, as it has often done in the past. Whether OBOR will nonetheless prove to be the catalyst for a great national rejuvenation, as Mr Xi hopes, that will also help reinvigorate China's stuttering economy – or whether it will turn out to be hubristic overstretch – remains uncertain.

DOOMED TO SUCCEED?

IN ONE SENSE, THOUGH, THE INITIATIVE is doomed to succeed. Mr Xi has staked so much personal and political capital on it that it has become a key test of his leadership: failure would inflict severe loss of face and prestige and would risk seriously diminishing his stature and authority. Whatever happens, the party's propaganda machine will no doubt be working overtime to present it as a triumph at home, which is the one audience that China's rulers really care about.

OBOR is at least going with the flow. Asia is the world's economically most dynamic region – admittedly, in a world where growth remains generally weak – and it offers huge opportunities and promise for the future. To harness them, the region needs large amounts of investment – as much as \$8 trillion over a decade in infrastructure alone, according to the Asian Development Bank. If it is to keep on growing, many of those investments will happen with or without OBOR. The still unanswered question is how many of them Mr Xi and OBOR can plausibly take credit for.

The ambitions of OBOR's architects do not stop at Asia. They conceive of it as a truly global enterprise, extending to Europe and embracing Africa and Latin America as well. Indeed, the Chinese government has sought to sell the initiative to European policymakers, at both EU and national level, as a shot in the arm for the region's economy that could revive its growth and restore its flagging dynamism by increasing levels of investment.

Though some in Europe have reacted enthusiastically, such arguments appear optimistic and their economic foundations questionable. Europe undoubtedly does need more investment. Fixed capital formation in the EU suffered a collapse after the global financial and Euro crises, from which it has yet fully to recover. However, it is far from clear that China offers the solution – even if it had unlimited funds to invest.

The last thing Europe needs, from China or anywhere else, is more capital: it already has more than it knows what to do with. High savings levels in many countries, encouraged by the austerity policies imposed, voluntarily or involuntarily, on Eurozone members, have put substantial financial resources at their disposal. However, a sizeable proportion is not utilised at home but is exported. Last year, net lending to the rest of the world exceeded net borrowing in 23 of the EU's 28 members and the Euro area was a net international creditor to the tune of 2.9 per cent of aggregate GDP.

Nor is Europe short of the technology, knowledge, experience and engineering and management skills needed to undertake large-scale infrastructure projects and investment in a wide range of productive, wealth-creating activities. By most measures, it remains far ahead of China, which actually needs what Europe has to offer rather more than the other way round. Indeed, China's rulers view OBOR and the "Going Out" strategy as ways to catch up by acquiring abroad know-how and assets essential to economic and industrial development that the country lacks.

As a report by the European Investment Bank concluded in 2013, investment in Europe is being held back, not principally by financial constraints, but by weak demand, by over-capacity generated by the chronic misallocation of capital that triggered the Euro crisis and by a climate of acute political and economic uncertainty. Together, these have depressed prospective returns on investment and made owners and custodians of Europe's abundant pool of capital acutely cautious about committing it.

Solutions to this nexus of problems may not be easily found. But the keys lie firmly in Europe's hands, not in China's. Hopes that Chinese money and drive will provide the missing "Ingredient X" that will somehow make up for Europe's self-inflicted policy failures, power its economic revival and restore its flagging self-confidence and sense of purpose are not only exaggerated. They are largely misplaced.

That should temper expectations of how much OBOR can contribute. It does not, however, mean that Europe should turn its back on this or on other potentially constructive Chinese initiatives. It should, rather, remain ready to respond to them in a businesslike manner and to explore opportunities for co-operation that genuinely serve the interests of both sides, while remaining vigilant about possible pitfalls and attempts by Beijing to get its way by employing its well-practised divide-and-rule tactics among EU member states.

Europe should view OBOR, not as some giant leap forward – as it is often portrayed in

China – but as one in a series of small steps aimed at fostering steadily closer engagement with China. That is the spirit of the approach so far favoured, at senior levels at least, by the European Commission.

Steps taken to date include establishing a “connectivity platform”, a Sino-EU working group charged with identifying specific opportunities for co-operation on OBOR, initially in the field of transport; a modest proposed Chinese contribution of €5bn-€10bn to the planned €315bn European Fund for Strategic Investments, the so-called Juncker fund; and EU support for Chinese membership of the European Bank for Reconstruction and Development, which is studying possible joint projects and knowhow exchanges with the AIIB, to which 14 EU member states have signed up.

None of these developments is ground-breaking and some may never bear fruit at all. However, in parallel with the continuing negotiations on a bilateral investment treaty and the possible launch at some point of talks on an EU-China free trade agreement, they offer both sides opportunities to understand each other better and, perhaps, even to establish some level of mutual trust.

Some may ask whether this is a realistic or worthwhile approach, at a time when Mr Xi is displaying what many see as dictatorial tendencies, when China’s foreign policy is increasingly coloured by nationalism and when its economy is looking decidedly shaky. Such questions particularly preoccupy Washington, whose dealings with Beijing are subject to growing tensions that are likely to rise further if Donald Trump becomes the next US president. Those tensions risk, in turn, imposing strains on transatlantic relations if US and European policies towards China diverge sharply.

Realistically, however, the EU has little choice but to try to work with China. It lacks the superpower status, the strategic stake and the political and military influence in Asia that lead many in the US to view China as a threat. It also has little to lose by trying to engage more deeply with China. Seeking to build bridges and make common cause in areas of mutual benefit may or may not pay off politically and economically in the longer term. But setting its face against China would not insulate Europe from the aftershocks if the country suffered serious economic setbacks or entered a period of political and social turbulence. Whatever happens, China’s economy is simply too big and too deeply integrated with the rest of the world, and the country’s global impact too great, to be ignored. ■