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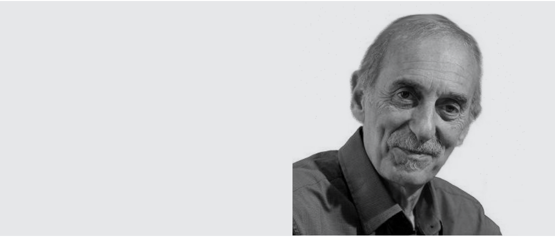

Thematic Report

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China: Back to a Silk Road Future

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- **Continued growth in China is coupled with a new 21st century financial diplomacy.**
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For investors, the big news out of China has been the doubling in the Shanghai Composite index since last summer, and, not unrelated, the monetary easing undertaken by the People's Bank of China in response to the secular slowdown in the economy in general, and the real estate sector in particular. Who knows where this is going to end? More easing is a given as the economic slowdown is set to continue, if erratically. More infrastructure stimulus has already been enacted and proposed. The Ministry of Finance recently announced, along with the PBC and the China Banking Regulatory Commission that banks will be required to carry on lending and rolling over loans to heavily indebted local government finance vehicles because the local government debt swap plan hasn't worked according to plan so far.

Nowcasting of the economy suggests that the tempo of economic growth in the second quarter may have been comparable to the 6% or annualised rate in the previous quarter. But the equity market marches on regardless in an orgy of speculative euphoria and will face its macro day of reckoning either when valuations get more stretched and/or when the authorities decide to get serious about tackling excessive credit creation.

But there is other big news out of China that goes far beyond cyclical forecasting and financial markets. For, out of the shadows of the years following the Western financial crisis, China is gradually carving out a new global financial diplomacy structured around a 21st century reconstruction of the old Silk Road that once defined the 'global system' when China ruled the world. This diplomacy brings with it new business opportunities for companies, new financial possibilities as the RMB becomes more widely used and quite possibly is included by the IMF in the SDR later this year, and new tensions with countries such as the US, Japan, India and Russia which all have strategic and national interests in those parts of the world that lie along the territory captured by OBOR – or One Belt One Road.

OBOR as the centre-piece of global strategy and economic policy

"Those of a more political bent... see these developments as the 'inevitable' turning back of the clock of world history, in which the period 1750-2000 can now be seen as a brief aberration."

For those who are curious historically, OBOR is throwback to the old Silk Road trading routes that dominated the global system, such as it was, from before the birth of Christ until the Middle Ages and in some continuing respects until the eighteenth century. Those of a more political bent, who haven't ever been comfortable with US footprint on the global system we have had since 1945, see these developments as the 'inevitable' turning back of the clock of world history, in which the period 1750-2000 can now be seen as a brief aberration. Analysts and strategists, salivating at the new business prospects from which they hope to benefit ooze words and phrases such as 'transformative', 'unprecedented', 'fountainhead', and 'epoch-changing'.

There is indeed a fascinating historical parallel, which is worth exploring both because there are similarities, and importantly because circumstances could not be more different. Whether or not the last 250 years of world history were a temporary deviation is a matter for conjecture and a few drinks, but the idea that you can extrapolate indefinitely the rise of China and other emerging markets over the last 20-25 years under the most extraordinarily benign conditions of globalisation seems far-fetched and undisciplined. This is not to argue that China and others won't deliver on more growth, a bigger middle class, bigger global presence and so on – but that's not quite in keeping with adjectives, words and phrases referred earlier. There's a quite plausible and more credible argument in fact that America's geography, and its technological and economic prowess will continue to be dominant, if not pre-eminent, in the global system for the foreseeable future.

Nevertheless, OBOR resonates strongly in Chinese history and in its consciousness. According to China, it will bind together 65 countries and 4.4 billion people from Xi'an in western China (the old imperial capital and start of the original Silk Road), across central Asia to the Middle East, Russia and Europe. The maritime road is designed to link the South China Sea to the Indian Ocean, East Africa, the Red Sea and then the Mediterranean. Inevitably, this will require China to project its growing naval power further afield. OBOR will be financed by China's development banks, the largest of which, China Development Bank, recently received over $60 billion in new capital to help fund new operations. China will doubtless see fit to allocate more of its near $4 trillion foreign exchange reserve pool to this end.

OBOR has sprung to life alongside other important initiatives in which China has sought to raise the profile of its global financial diplomacy. Externally, it has co-sponsored with others in the BRICS group the New Development Bank – a sort of IMF clone writ small – and created the Asian Infrastructure Investment Bank to which it will provide half the capital, a competitor to the Asian Development Bank, itself modeled on the World Bank. At home, it has acted incrementally and cautiously to open up its capital account, and encourage a wider use of the Renminbi (RMB) in world trade and in capital markets. This is important, because otherwise, China's new global financial diplomacy would be based on the US dollar, which is precisely what the government does not want.

"The idea that China will permit residents to export capital abroad without restriction is one that has never sat comfortably with the authorities..."

It is worth bearing in mind that capital account liberalisation has been a goal for the best part of 25 years but very little progress has actually been made – except perhaps with regard to inward capital flows. Witness, for example, the Hong Kong-Shanghai Connect scheme and the incremental changes in developing the Shanghai and other free trade zones. The idea that China will permit residents to export capital abroad without restriction is one that has never sat comfortably with the authorities, even though the capital account is porous for those that can exploit it. As we shall see later, an open capital account makes the world of difference to the development of the RMB as a global reserve currency, as opposed to its merely accounting for a higher proportion of global trade and capital transactions.

The original Silk Road didn't suddenly end with the Industrial Revolution

It is sometimes said that the original Silk Road, alleged to have started as a result of expeditions westwards out of China and towards India by an imperial envoy, Zhang Qian around 138-125 BC, was put out of commission by European explorers and merchants and then by the economic and military ascendancy in Europe following the Industrial Revolution. There's no doubt that the latter exploits and accomplishments of Europeans put China in the shade, but it is not correct to attribute the decline of the Silk Road to the Europeans.

What might once have been called 'Peak Silk Road' occurred during the Tang Dynasty (618-907) in the seventh century. By some accounts, the intensity of traffic along the Silk Roads – for there were several – subsided gradually thereafter. Others argue that the Golden Age was in the thirteenth century after the Mongols had intruded and subsequently established a sort of Pax Mongolica. In any event, after this period, the roads succumbed to wars, uprisings and the effects over time of evolving religious strife between Christians and Muslims. Under the Ming Dynasty (1368-1644), a slow and more significant transformation occurred moreover, as rising barriers to trade and the Ottomans' boycott of trade with the west on the land routes were accompanied by advances in maritime capabilities and the development of sea routes, championed in China by the legendary navigator Zheng He and in Europe by the Portuguese in the sixteenth century, then the Dutch and then the English.

The trials and tribulations of the Silk Road certainly didn't arrest Chinese economic development because by the start of the nineteenth century, China is thought to have had a GDP that remained larger than that of Europe. But by then, a long-standing decline in income per head going back to the fifteenth century was much more marked. It is indeed extraordinary why China – a unified free trade zone in its own space – regressed. It was the centre of a global trading system (of sorts), pioneered the printing press, inland waterways and canals, astronomical clocks, scientific instruments, libraries and large ocean-going ships long before Europe. It is also the subject of an age-old and still raging controversy. But by the time the Industrial Revolution was underway, the Silk Road wasn't the major thriving heart of the global system sometimes alleged. It had seen its best days.

From Silk Road to OBOR

It is understandable why China's revival of the idea under the OBOR banner has received such attention. It has achieved an economic size and significance that has put it back on the geopolitical and geoeconomic map. OBOR is also fortuitous and dovetails well with some contemporary developments of which we are well aware.

"A new focus is needed to channel China's excess savings abroad..."

China's voracious appetite for construction raw material in Africa, Asia and Latin America is lessening. The real estate and investment boom at home which the search for materials served has now ended. The secular fade in real estate and some other investment is leaving China with significant overcapacity in a swathe of industrial sectors and construction, plus a widespread deflation in industry and construction, and rising debt management problems in non-financial companies, especially in the state sector, property and local governments. A new focus is needed to channel China's excess savings abroad, and to offer local companies new export and sales markets.

China's past model rested partly on the accumulation of external surpluses, the proceeds of which were invested largely in foreign, especially US, bonds. But the country has tired of accumulating endless volumes of US Treasury and other government bonds as an offsetting export of capital to its current account surplus, and now prefers more direct investment overseas.

Moreover, China has long expressed opposition to the dominance of the US and the US dollar in the world's Bretton Woods institutions. It has become increasingly frustrated that IMF reform proposals have been stuck in the US Congress since 2010, and it has had little joy pushing other Bretton Woods institutions to be more active in infrastructure financing. In Asia alone, according to a well-reported Asia Development Bank report from 2010, there was (in that year) an infrastructure shortage relative to perceived needs of $8.2 trillion over the coming decade. It is now 2015, and that gap has not been eroded very much.

China's co-founding of the BRICS Bank – or more formally the New Development Bank – was a symbolic gesture to create a sort of IMF clone, and it remains to be seen whether this institution will do much more than issue reports, employ talented people, and offer liquidity support to member countries should they get into difficulty periodically.

As is well-known now, the creation of the AIIB – for which China will provide half the capital – is more important. It now has 57 members. The only major hold-outs are the US, Japan, Canada and Mexico, but Japan may relent before long. If financing, logistical and governance issues are addressed successfully, the AIIB could be lending $20 billion a year by 2020, not far off the $30 billion annual loan commitments of the World Bank today.

The inclusion of so many non-Asian members, including those drawn from the OECD, does add weight to the view that the AIIB will not be, as had been feared, a blatant agent of Chinese foreign policy in which deals of spurious commercial value would be pushed through. But if it were to function as a complementary institution to the Asian Development Bank, or even as a more effective clone, drawing in private capital and expertise, it would probably evolve cautiously. It would need to establish a reputation for sound governance and behave pretty much as the ADB does. And if it essentially raises capital and issues loans primarily denominated in US dollars, then we might wonder what the AIIB's purpose is in the first place? In any event, the AIIB is a complementary side-show to OBOR.

"Will OBOR succeed in transforming the global system as is sometimes argued?"

Will OBOR succeed in transforming the global system as is sometimes argued? Protagonists say that the beneficiaries of new investment and suppliers stand to gain from new infrastructure, energy pipelines, fibre optic and communications systems, and lower trade barriers. It is also argued that it suits China to a tee. It could offset the effects of a falling investment rate and rising overcapacity at home, offer commercial sweeteners to potential anti-corruption campaign targets to co-operate with reforms, improve internal economic integration between China's advanced coastal and the more backward western provinces, and importantly, spur greater financial integration including wider use of the RMB.

But not so fast: the narrative of reserve accumulation

Yet, this is to put the cart before the horse. New institutions and building projects may enhance the lives of people most immediately affected and benefit the companies doing the construction, but in and of themselves they don't change the way the global system works. In fact, OBOR and complementary agencies such as the AIIB cannot be transformative in the abstract, and could only be so if their success reflects China's successful pursuit of other economic and political goals. And as you can see from what follows, these goals may be difficult if not impossible to achieve.

China would have to have an economic model that could catapult China's income per head 12% of the level of the US to, say, 50% or more over the next 20 years or so. It would need to embrace open and transparent governance, succumbing perhaps to foreign influences including over its exchange rate and interest rates, and capital markets conduct. It would have to realise a reputation for trust in an independent judicial system, with neutral contract enforcement. It would have to secure a willingness of other nations, including India, Russia, Japan and many others across central, south and southeast Asia to buy into China's foreign policy, turning their back on the US in the process. It would have to have, in effect, carte blanche to determine outcomes across OBOR in a world that bears no resemblance to that in which the Silk Road evolved.

And last but not least, it would have to allow the development of the RMB as a reserve currency rather than just a more widely-used vehicle for transactions. This last condition isn't the only condition, of course, but it is central – also to many others. The narrative of reserve accumulation has nothing to do with the statements and articles often written about it. To build up a reserve currency – a phenomenon that has only happened twice in history – you have to allow foreign central banks to accumulate claims on you – that is, you have to incur liabilities in your own currency, which become same currency claims or assets abroad. The only two ways of doing this are by running a current account deficit on the balance of payments or by having a totally open capital account in which trillions of dollars' worth of RMB would flow freely into open and liquid capital markets in China, and out of the country at will.

The first of these conditions is not met today, nor does it seem likely to be met at any point we can predict for as long as savings exceed investment – which is precisely the direction of travel as China seeks to reduce its credit-fueled investment rate. The second is the subject of reform under the banner of capital account liberalisation, but as suggested above, an open capital account is not really compatible with the Party's designs on economic management and control.

Logic of war in the grammar of commerce

China's new global financial diplomacy aims, without question, to extend and deepen the country's global footprint. And there is also little question that it will invoke new commercial and business opportunities and heightened economic and political competition with its neighbours and with the US.

"China's westward pivot... can be seen as a commercial and truculent riposte to America's pivot to Asia."

China's westward pivot, so to speak, can be seen as a commercial and truculent riposte to America's pivot to Asia. Perhaps the US and China will be able to co-operate in the future and prevent intense regionalisation of trade and commercial arrangements. But equally, while we used to talk about the nineteenth and twentieth centuries as an era when trade followed the flag, today it's the other way round. The flag follows trade. The rules that characterised the Bretton Woods world are weaker or being flouted. New and competitive institutions are being set up, ostensibly to promote trade, economic cooperation and integration, but close behind is the political influence and leverage that the sponsors hope to capitalise upon.

As the US historian and father of geoeconomics, Edward Luttwak, says, this is 'the logic of war in the grammar of commerce'. The linkages to financial markets aren't immediately apparent, but as eggs are eggs, they carry profound implications for foreign exchange markets and risk premiums in other assets.

George Magnus

Biography

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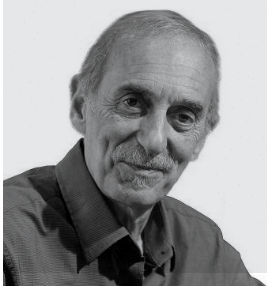
George Magnus
Chief Economic Adviser



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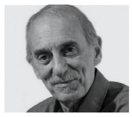

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