BNP PARIBAS
INVESTMENT PARTNERS | The asset manager for a changing world

Chi on China

China's "One Belt One Road": The Land and Sea Strategies (Part 2 of 2)

You have enemies? Good. That means you've stood up for something, sometime in your life.
Winston Churchill

SUMMARY

- The "One Belt One Road" (OBOR) strategy marks a major shift in China's diplomatic and financial strategies to revive its global influence by opening up new trade networks and investment opportunities that will reshape the global balance of economic power in the long-term.
- The land route of OBOR will strengthen China's ability to secure energy (especially oil) sources. The sea route will give it control over Asia's sea lanes, home to China's oil import routes, and establish a strategic naval base.
- The resulting geopolitical and financial liberalisation strategy will help restructure China's economic development process, deepen renminbi internationalisation, prompt a re-rating of Chinese asset values and open up investment and financial opportunities to private (global) investors.

In pursuit of the "Chinese Dream", Beijing seeks to play a more substantive role on the global stage. This is a marked change from the previous leadership's passive diplomacy. President Xi Jinping seeks to improve diplomatic relations with China's neighbours to achieve a strategic goal of achieving "the great rejuvenation of the Chinese people"[1] through the creation of new trade networks and infrastructure investment along the

[1] See "*Xi Jinping: China to further friendly relations with neighboring countries*", Xinhuanet, 2013-10-26
http://news.xinhuanet.com/english/china/2013-10/26/c_125601680.htm

"New Silk Road[2]", which includes a land route (the "Silk Road Economic Belt") and a sea route (the "21st Century Maritime Silk Road").

By financing railways, roads, ports and power lines, China will draw its neighbours closer to its economic embrace. At the same time, the strategy will create an investment and financial boom over the coming decades. China estimates that its companies will invest USD 1.25 trillion overseas in the coming decade[3], competing with Japan to become Asia's leading investor and financier.

The land-route strategy

The "Silk Road Economic Belt" will link China to Europe and South and Central Asia (Maps 1, 2 and 4) by creating a land-transport network that will cut thousands of miles off the traditional sea routes from China's east coast for transporting oil and gas and other natural resources imports.

Map 1: The land route: "Silk Road Economic Belt"

Sources: Wikipedia, BNPP IP (Asia)

The southwest province of Yunnan is designated as an economic bridgehead for expansion into the Mekong Basin (Map 2). Chinese companies are building power lines, roads and dams, and investing in property, agriculture and mines in the area. A USD 4 billion highway now runs from Kunming, Yunnan's provincial capital, to Bangkok. There are plans for building a USD7 billion high-speed railway between Jinhong in Yunnan and Vientiane of Laos, financed by China's Exim Bank.

---

[2] See Part 1 of this series.

[3] See "*China overseas investment to hit US$1.25 trln in next decade: Xi Jinping*", Secretariado Permanente Do Forum Para a Coopercao Economica e Comercial, 10-11-14 http://www.forumchinaplp.org.mo/china-overseas-investment-to-hit-us1-25-trln-in-next-decade-xi-jinping/

Map 2: Stretching into the Mekong Basin

Sources: Wikipedia, BNPP IP (Asia)

This land route may compete with Russia to gain influence in central Asia. Due to its vast network expansion, many central Asian countries may find China's "Silk Road Economic Belt" more attractive than Russia's Eurasian Economic Union[4], which is relatively less extensive (Map 3).

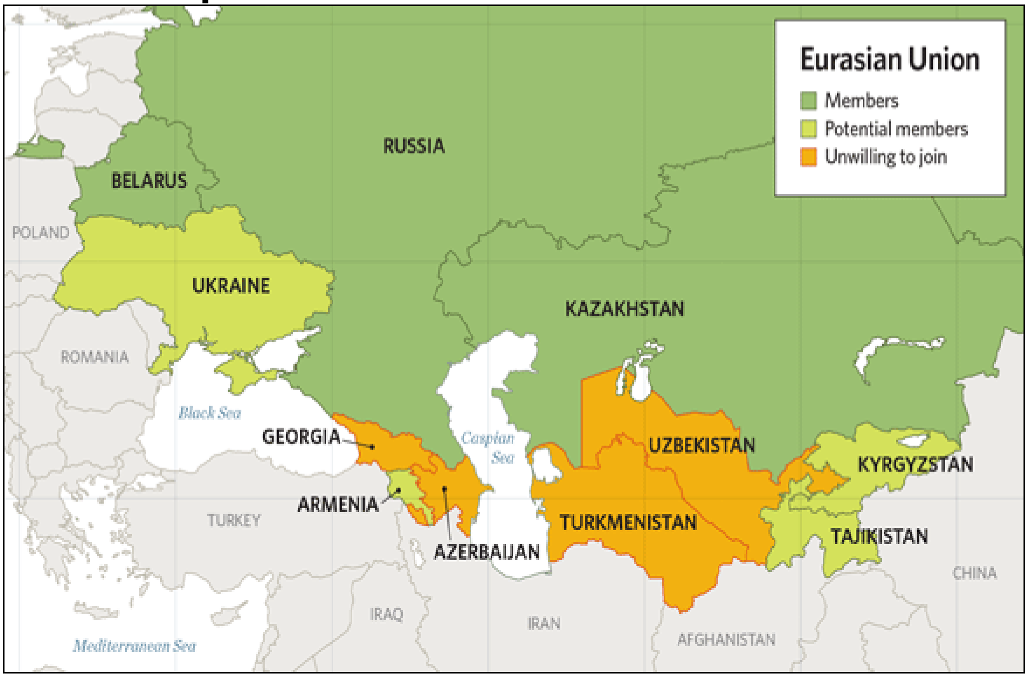
Domestically, Beijing hopes to use better economic connectivity to enrich its underdeveloped border regions through the creation of new trade zones so that it can keep ethnic tensions at bay, especially in the volatile region of Xinjiang. Funding from the USD 40 billion Silk Road Fund, the Asian Infrastructure Investment Banks (AIIB), the New Development Bank (NDB) and China's policy banks will support infrastructure construction along the route.

A proposed Bangladesh-China-India-Myanmar (BCIM) economic corridor will link Kunming of Yunnan and Kolkata[5] of India with highways and other infrastructure means, including oil and gas pipelines (Map 4). There are already oil and gas pipelines and highways running between Kunming and Kyaukphyu of Myanmar. Developing this section of the land route will enable Beijing to extend its influence into the Indian Ocean.

[4] The Eurasian Economic Union (EEU) is an economic union of states located primarily in northern Eurasia. A treaty for establishing the EEU was signed in 2014 by the leaders of Armenia, Belarus, Kazakhstan, Kyrgyzstan and Russia, and came into force on 1 January 2015.

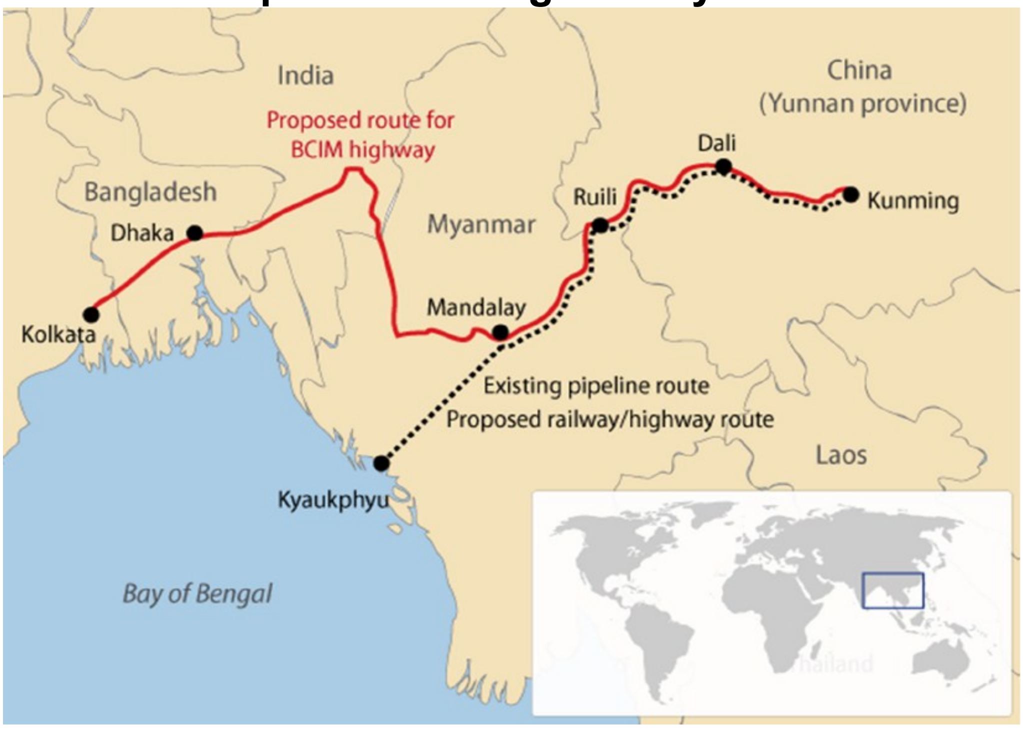
[5] Kolkata was formerly Calcutta, the capital of the Indian state of West Bengal.

Map 3: The Eurasian Economic Union



Sources: Wikipedia, BNPP IP (Asia)

Map 4: Extending into Myanmar

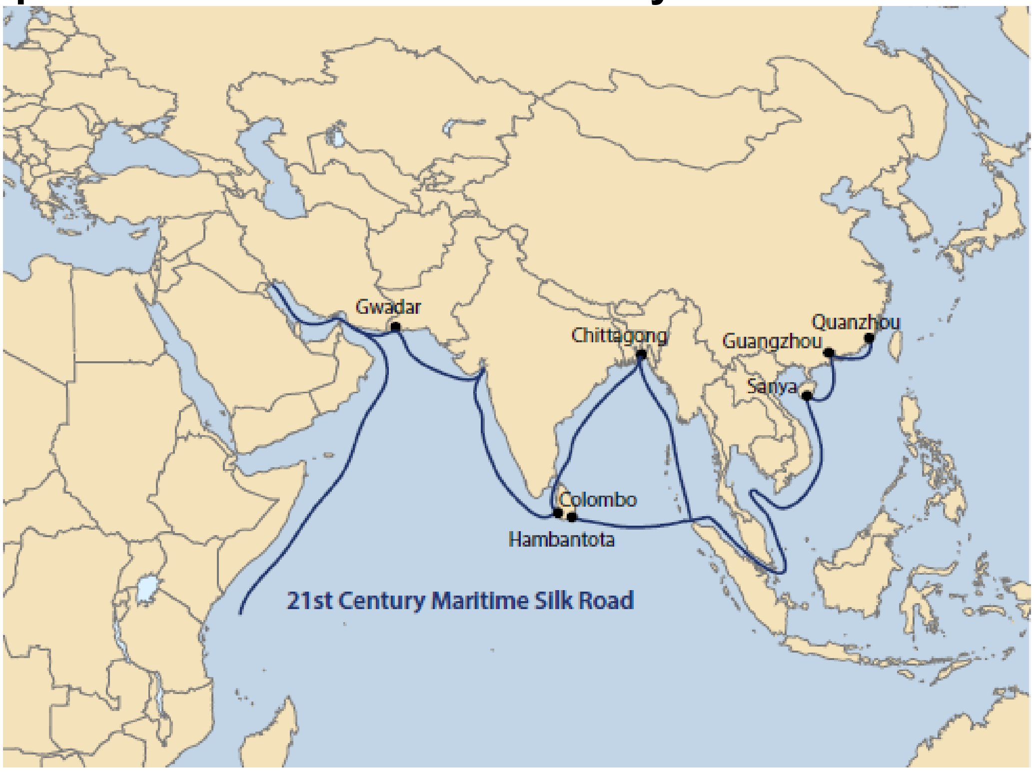


Sources: Wikipedia, BNPP IP (Asia)

The sea-route strategy

The "21st Century Maritime Silk Road" will enable China to boost trade and influence along Asia's sea transport lanes and, by extension, over the South China Sea (Map 5). It has financed new ports in the Indian Ocean in Bangladesh, Pakistan and Sri Lanka. While its primary focus is commercial, it is also building up naval power (running in parallel to the US Navy) to protect its trade routes.

Map 5: The sea route: "21st Century Maritime Silk Road"



Sources: Wikipedia, BNPP IP (Asia)

Strategically, this sea-route will enable China to exert control over the China Seas, many parts of which are also claimed by other South Eastern Asian nations. Weighing the costs against the benefits, Beijing seems to be focusing on economic expansion, while keeping "uneasy peace" by slowly changing its influence in the waters.

But this approach has created geopolitical tension, with some Asian countries suspecting China of pursuing a strategy of encircling Asia with a "string of pearls" – a network of ports connecting China's eastern coast to the Middle East that would boost its strategic clout and maritime access (Map 6). They see China designing the "New Silk Road" to make it the hub of a new order in Asia and the Indian Ocean, and worry that by establishing dominance along major trade routes, China is trying to redraw Asia's geopolitical map.

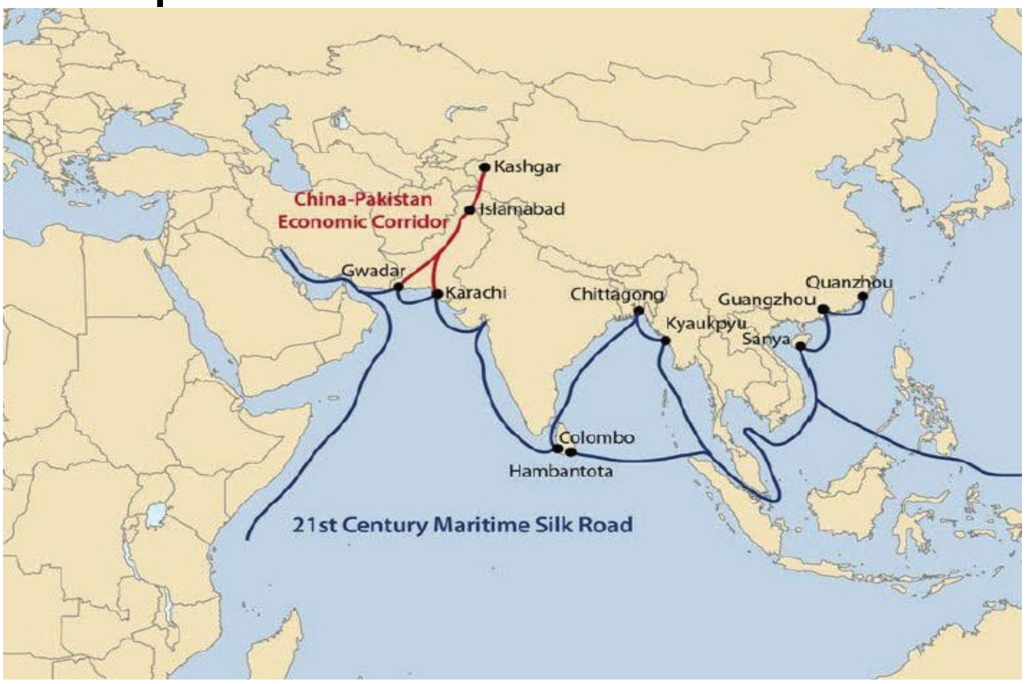
To allay the fears, China has invited India to join its sea route initiatives. Time will tell if this olive-branch will work, but China's economic forces have pushed on, and often to states that are not necessarily India's friends. It is financing a USD 46 billion investment scheme in Pakistan, the bulk of which will fund a 3,000 km "economic corridor" from the Arabian Sea to Xinjiang in northwest China (Map 7). The route will begin in Gwadar, a Chinese-run port near the Iran border and key shipping routes in and out of the Persian Gulf. It will improve connectivity between Asia and Europe, creating new trade routes and boosting regional growth.

BNP PARIBAS INVESTMENT PARTNERS | The asset manager for a changing world

Map 6: China's "String of Pearls" strategy

Sources: Wikipedia, BNPP IP (Asia)

Map 7: China-Pakistan Economic Corridor



Sources: Wikipedia, BNPP IP (Asia)

The grand vision of the "21st Century Silk Road" is to build new port infrastructure that links to inland transport networks, increase the number of international sea routes, improve logistics (including through enhanced usage of information technology), dismantle trade and investment barriers and deepen financial integration by greater usage of the renminbi.

The geopolitical-economic significance
Putting it all together, successfully developing OBOR will enable China to expand its influence to, and reap economic benefits in Asia, the Middle East, Europe, Africa, America and even Latin America. It will also go a long way to deepen renminbi internationalisation.

The Middle East is of particular strategic importance to China's game plan due to its connectivity with the major oil-consuming regions. Establishing a major influence in the Middle East will give China an edge in trading with the major energy consumers on the OBOR route and beyond (Map 8).

Meanwhile, China imports about 50% of its oil demand, and became the world's largest oil importer in 2013. The majority of its oil imports come from the Middle East and Africa, which are transported by sea with 80% of the imports passing through a 600-mile Malacca waterway that connects the Indian Ocean to the west and the Pacific Ocean to the east (Map 9). This makes the security of sea channels a strategic priority for China and has led to the speculation that it wants to build a "string of pearls" of ports around South and South East Asia to allow its navy to secure its sea lanes.

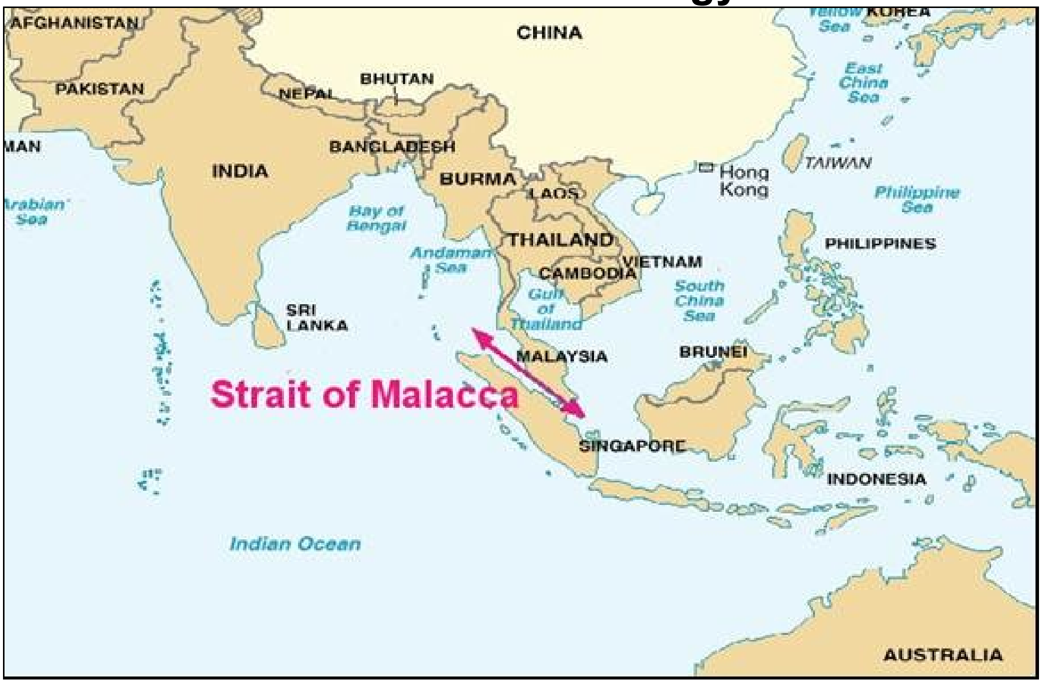
Implications
China's move from investment-led growth to consumption-led growth is inherently contractionary. The OBOR strategy, by rejuvenating an investment and trade boom in the medium-term, will help lessen this structural drag on domestic demand growth and improve investment returns, as we argued recently[6]. So it is instrumental to the remaking of China's growth model.

Map 8: Strategic importance of the Middle East in China's OBOR strategy

Sources: Wikipedia, BNPP IP (Asia)

[6] See *"Chi on China: The AIIB: Reviving China's Investment-led Growth or Rebalancing towards Consumption?"* 13 May 2015.

Map 9: Strategic importance of the Straits of Malacca in China's OBOR strategy



Sources: Wikipedia, BNPP IP (Asia)

The "New Silk Road" project will involve hundreds of billions of US dollars of investment in the coming decades, which will dwarf China's deep pockets that include a USD 40 billion Silk Road Fund and financial resources from the China-led AIIB, NDB and domestic policy banks. To make OBOR successful, Beijing needs to get the private sector, including foreign investors, involved.

OBOR will increase China's investment and financing activities overseas. This will increase the "export" of the renminbi, deepen renminbi internationalisation and speed up its move towards a global reserve currency status. Combined with the benefits delivered by the structural rebalancing of the growth model facilitated by OBOR, these forces will prompt a re-rating of Chinese assets by the financial markets, compressing China's risk premium and boosting its asset values.

In a nutshell, China's OBOR has the potential to transform China long-term growth model[7] and reshape the global balance of economic power with the renminbi becoming a major global currency in the coming years. So it is inadvisable for investors to underweight China. Tactically, one can consider entry/exit strategies at different points in time. But strategically, it is preferable to have a core investment exposure to the Middle Kingdom.

Chi Lo
Senior Economist, BNPP IP

[7] See reference in footnote 6.

DISCLAIMER