China's Belt and Road Policy: Issues and Suggestions

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China has embarked on an ambitious plan to create a new silk road but on a global scale. China's motivations are in question due to a number of empirical results including creating debt problems in several countries and appearing to favor Chinese firms over firms from other countries in rewarding project contracts. This paper looks at the empirical evidence and discusses the portfolio of possible motivations behind the program; Humanitarianism, economic gain to China, an addiction to infrastructure development, and political power. It also looks at the role the United States might play in improving the policy. Finally, we focus on how competition in finance can improve outcomes and offer an institutional structure, a Sovereign Wealth Fund mutual fund, that could help deliver that competition.

Keywords: Belt and Road, global economic development

INTRODUCTION

In somewhat of a quiet moment on September 7th, 2013, Chairman Xi Jinping in a speech at Nazarbayev University in Kazakhstan announced the advent of a new Chinese initiative to partner with countries along the old Silk Road to build infrastructure across and develop a Silk Road economic belt that would benefit every country along the path.[1] In his speech, he also promised that China would never interfere with the internal affairs of any of the nations and would not seek leadership in regional affairs nor would it attempt to operate spheres of influence. This initiative spread to include Southeast Asia, Africa, and Europe.

The Belt and Road Policy has the potential to be the most robust economic foreign policy initiative in history. While the major focus is on building global infrastructure, it appears to also include cultural and academic exchanges. Measuring its current size is difficult but it is estimated that China has already spent 200 billion dollars on the initiative.[2] It is estimated that by 2027, China will need to spend up to 1.3 Trillion additional dollars on this policy.[2] That contrasts with the Marshall Plan at the end of WWII that spent approximately 15 billion dollars, about 183 billion dollars in today's terms, to help rebuild Europe.[3,4]

In this paper, we look at where the initiative currently stands, what motivates China to undertake such a challenge, where is the United States in all of this, and would Belt and Road benefit from greater transparency, more competition, and the employment of other types of financial resources.

Where Do Things Stand?

The Greenberg Center for Geoeconomic Studies has created a Belt and Road Tracker.[5] Data indicates that China loaned over 120 billion dollars over the period running from 2014-2017.[5] However, in doing so these loans may have placed some countries in a severely difficult debt situation. For example, the tracker notes that Cambodia and Laos owe China debt in the amount of more or almost 20 percent of their GDP.[5]

Djibouti is far worse owing China almost 80 percent of GDP.[5] Ethiopia is another African country with a large percentage of debt with China (17 percent of GDP), and many of the former Soviet Republics from along the old silk road are in serious debt to China.[5] Kyrgyzstan is chief among these former Soviet states owing China 42.3 percent of its GDP.[5] As a comparison the United States owes China around 4.6 percent of GDP, but of course has a much deeper ability to sustain debt.[6,7,8] Where the danger mark is, is difficult to say, but Djibouti and Sri Lanka (who owes China just under 10 percent of their GDP) have already struggled to meet their debt obligations to China and have, arguably, given up either assets or the management of those assets in settlement. It is important to note that while the optics suggest ex post collateral issues, the protagonists all deny that assessment. They argue that the asset deals are separate from the loan obligations.

China's Motivations

What has motivated China to embark on the Belt and Road project? It is, of course, possible that China has entered the Belt and Road initiative as a humanitarian gesture. There are other possibilities as well. We will discuss the following reasons why China may have introduced this policy: humanitarian wants, Economic growth, an addiction to infrastructure development, and gaining political advantage.

Humanitarianism

China has grown at a rapid real economic pace and the fortunate of those who have benefitted from that growth may well feel that they should share their good fortune. Given the level of poverty in China, those benefits could also be spread internally across China. However, it is somewhat clear that there has been quite a bit of redundant capital already spread through China and expanding investment abroad might lead to greater growth than more investment at home. In short, there is an argument that excess capital should be allocated where it would create the most benefit for people irrespective of their citizenship. Many of the investments are in countries that suffer from extensive poverty. Infrastructure enhancement gives such countries a better chance of climbing out of poverty and reaching middle class status.

Economic Benefit to China

It is, however, more likely that China sees the program as a boost to China itself. That boost can be economic, political, or both. It is possible to marry together philanthropy and economic gain. Clearly, if successful, the new Silk Road and other tributaries will make it easier for China to access markets outside China. In many cases, new markets may be generated in locations that were, heretofore, too costly to get to. Of course, building a railroad line that changes the time it takes to get from one location to another from 3 days to 3 hours is only beneficial, economically, if enough entities want to move goods and services between those locations. One reason there may be little competition to China's Belt and Road initiative, is that market capitalists do not see a profit motive behind financing the necessary infrastructure. Since it does not have to satisfy shareholders' quarterly whims, China may feel it can build and then wait for markets to generate positive outcomes. It is likely that China's brand of state capitalism allows a longer-term view than does typical market capitalism. At this point it is unclear exactly how projects are prioritized, but given some "loud" failures already, it appears that economic outcomes have not been an overwhelmingly important variable.

Addiction to Infrastructure Development

China has a distinctive role through its infrastructure investing. That is, China is not dominated by a consumer economy the way is, say, the United States. It may be that China has a comparative advantage in the building trades, but it is quite likely that they are overcapitalized in that area. According to the CIA world Factbook, in 2017, private consumption made up only 39.1 percent of the Chinese economy as compared to 42.7 percent for fixed investment.[9] In contrast, in the first quarter of 2022, consumption made up 68.5 percent of U.S. GDP and total investment, both private and public, made up 27.4 percent.[7,10] Given redundant capital investment at home, it makes sense to employ its resources abroad. While it might be argued that China would be better off promoting more consumption and less investment, thus strengthening its local economy, and raising its relatively low median income, China appears to be struggling to implement, successfully, such a policy.

Already China faces steep competition from Vietnam, Cambodia, and other ASEAN countries in the production of components. Nevertheless, China's powerful surplus in foreign reserves, added to its strong advantage in the construction industries, makes it possible to find a home for investment abroad. It appears that in projects financed primarily by China, China's construction firms win a disproportionate share of the contracts compared to when there are other financing units.[2] That is, is this essentially a make work program for the Chinese construction industry?

Political Power

Finally, despite Mr. Xi's statement in September of 2013, the Belt and Road initiative could be all about raising China's economic and political power in the global community. The United States' "pivot" towards Asia was a difficult pill for China to swallow especially since they were not asked to join the team. However, the nationalistic foreign policy pursued by the Trump Administration, including exiting the TPP agreement, may well have opened the door to a greater role for China. Still, there was Japan to reckon with and despite the U.S. retreat in the Pacific, the animosity between China and Japan may have been enough to encourage more action from China.

If political gain is China's goal, an obvious technique is to over-lend to poor countries, (i.e., predatory lending). When these countries cannot make their payment obligations, China comes up with an ex post collateral scheme in which debt is forgiven in return for real assets or, we might think of it, as an equity stake. Both in Sri Lanka and in Djibouti this tactic may have been employed giving China management rights to an important Sri Lankan port and providing a naval base for China in Africa in the case of Djibouti. We cannot know whether this was part of the "scheme" or not. However, this would be a classic example of how to effectively work predatory lending to gain political influence and power. With the last United States Administration effectively turning it back on globalization, and with Europe suffering from economic aging and poor performance, the timing was ideal for China.

Summary of Motivations

We, at this writing, cannot know for sure what motivations lie behind China's Belt and Road initiative. It could be that all four elements are at play. My personal guess is that the key motivators are economic growth and the addiction or notion that China is living off its construction capital expertise. Better relations with other nations and political gains are more likely to be a side benefit as a type of "Smithian" hand plays out.[11] Whether or not there are political motivations behind the program's development, there is the reality that political power grows with global investing. Certainly, competing economies need to take notice.

United States Response

The Biden Administration will need to work hard to convince its allies that it is back to being a team player and may find it hard to assume the leadership role it had before the Trump Presidency. Of course, excluding China from any major economic policy group makes little economic sense. Politics can be a different matter. Clearly any new alliance must include a promise and real verification that all countries play by the rules.

At this writing, the Biden Administration is just beginning to fully develop its foreign policy goals. Given the new Administration's personnel choices, one expects the United States to attempt to return to the global leadership role abandoned by the Trump Administration. Partners may well be reticent given the radical departure from the traditional role of the United States by the former Administration. They may wonder, what might happen in 2024? Europe, ASEAN, Japan, South Korea, and Australia, for example, may all view the United States as a serendipity ally and choose to resist U.S. leadership.

Clearly, Russia was thrilled with the weakening of the traditional role of the United States in global matters, both politically and economically. China, on the other hand, has faced a mixed result. The trade wars weakened the global economy and global competition but had the benefit, to China, of the weakening political role played in the Pacific by the United States. If the United States was victorious in the trade war, it is hard to prove it from the data. In 2019, before the pandemic, export growth in the United States was zero.[7] The United States tends to export high skill level goods and services and the weakening export growth helps to explain the poor real growth rate of the economy in 2019 of only 2.3 percent despite fabulous unemployment numbers.[7,12] While conventional wisdom is that China was hoping that President Biden would win the election, it is unclear how a strengthening of the U. S. role in the pacific will sit with China.

At this writing we expect the United States to re-enter the TPP in some way. Of course, excluding China from any major project in the Pacific makes as little economic sense now as it did then. However, that does not mean that China should not be required to participate in good faith and play by all the rules established by the group. Further, we would argue that establishing a duopoly of power is also inappropriate. It is time to consider not only the economic growth of the powerful, but also global income distributions. While technically, any distribution of income can be consistent with a Pareto optimal economic outcome, any global outcome that does not result in a successful attack on poverty should be considered a failure. All of this means that the United States should take a good look at the Belt and Road Initiative. What role should the United States play if any? Are there financial and real roles for the U.S. to play to improve the Initiative? It is critical, for global leadership, that the United States shows, through real policy actions, concern for countries suffering from poverty, and that it strives to create opportunities for growth in such economies. Decreasing poverty globally is not only the obligation of leadership but will also benefit the United States through increased exports of its sophisticated goods and services.

Would the Belt and Road Initiative Benefit From Competition?

The Belt and Road policy has been in play now for approximately nine years. As we noted above, employing the Greenberg Center for Geoeconomic Studies Belt and Road Tracker, substantial investments have already been made though they are only the tip of the required 1.3 trillion dollar, by 2027, estimated price tag.[5,2] Below we have some suggestions for improving the more globally beneficial aspects of the policy.

We believe that the Belt and Road initiative would benefit from a variety of competitive changes. First, competition for contractual work. There should be more transparent bidding for work projects financed by China. The empirical evidence is that Chinese firms disproportionately win China financed projects, vis-à-vis projects financed by other sources such as development banks.[2] This leads to two possible conclusions. First that Chinese firms are chosen before the projects are fully ready for bid and second, is the implication that less-than-optimal efficiency results. To the extent that these projects are expected to generate financial benefits that will enable the host to pay back Chinese loans, the host country will benefit from employing the lowest cost, given a set quality, provider. This evidence also implies that China may have motivations beyond good business practices such as making work for their fixed investment resources and/or creating predatory lending opportunities.

Second, there should be more competition in financing. For example, I have argued elsewhere for the advent of a Sovereign Wealth Fund mutual fund. Such a fund would create competition in Belt and Road project finance both in terms of specific projects and in what projects should be initiated. A Sovereign Wealth Fund mutual fund would create several benefits to both the financiers and the hosts. Sovereign Wealth Funds, especially those that are natural resource based, would benefit from diversification. Most global investments by Sovereign Wealth Funds appear to be tied to advanced country outcomes. Diversifying into developing countries is likely to give them significant diversification benefits. Second, by employing a mutual fund no one Sovereign Wealth Fund is exposed to dramatic financial failure. Each Sovereign Wealth Fund participant would own a pro rata share of the Fund and therefore, get pro rata benefits and costs. The host country would have the benefit of the Fund's expertise and would be able to compare offers from China and the Fund. In addition, due to the nature of a purely financial relationship, any collateral issues would be made ex-ante. The likelihood of predatory financing would approximate zero.

Such a Fund would, of course, need to have infrastructure investing expertise but could draw from a wider group of candidates. The Fund could be of the debt, debt-equity, or equity type. It is my view that equity financing would be the best alternative.[13] When a project is financed by debt, the financier is most concerned with being paid back. While they will likely hope the project will be successful, their key focus is on getting their required return. As long as the host government pays the financier what is owed, it is a successful investment from the point of view of the Fund. However, equity financing requires the project being financed be successful. That outcome requires more exacting analysis and is likely to lead to deeper quality and cost considerations than would be required for a lending investment. While the host government will now have to share the residual claims of the investment, the relationship would be totally transparent and would benefit from equity analysis. Of course, an option that allows the host country to purchase the Sovereign Wealth Fund's equity position can be worked out ahead of time or negotiated later. In any case, the relationship should be totally transparent.

An aside to this argument is the reality that many of the largest Sovereign Wealth Funds are Chinese funds. Certainly, those Funds should be invited to join any Sovereign Wealth Fund mutual fund. Therefore, these two models are not totally exclusive of one another.

Other coalitions can also be formed to bring to bear greater competition to the Belt and Road project. These could range from a consortium of Development Banks to a coalition of private foundations. The benefit of a Sovereign Wealth Fund mutual fund as compared to the institutions just mentioned is that the Sovereign Wealth Funds are in business to earn a return on their investment. Some may see this as a net cost. However, Sovereign Wealth Funds tend to have a great advantage in their nature. Unlike most for profit financial institutions like private equity funds, hedge funds, and mutual funds, they are not pressured to show great quarterly results. They can make longer range investments. Unlike non-profits they have a greater need to be "right" in their allocation decisions. I believe that Sovereign Wealth Funds are in the best position to provide effective competition to China in the Belt and Road initiative.

Summary

China deserves credit for creating the Belt and Road concept. It has the potential to raise global living standards possibly beyond the benefits of the Marshall plan. As noted above, I believe that China's key motivations are honorable enough. Surely, successful investments not only create work for China's infrastructure industries but will also create better political relations. However, for the initiative to have full success, better financial and infrastructure investment competition is called for. The new U.S. Administration is likely to play a bigger role in global development and should take a good look at how they can enhance the Chinese initiative through financial and real contributions. We also provide another alternative player, a Sovereign Wealth Fund mutual fund. The view here is that a Sovereign Wealth Fund equity mutual fund would be uniquely positioned to provide a competitive financial environment for the Belt and Road program, and that competition will benefit the initiative. In making that point, I should point out that such a fund does not currently exist. In the meantime, other coalitions of investors may be formed to provide more expertise and competition to the current initiative. Additional expertise and financial investment can only improve this worthy program.

ENDNOTES

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