

BUILDING THE RIGHT SILK ROAD

CHINA AND THE 'ONE BELT, ONE ROAD' INITIATIVE

Dominic Barton

CHINA'S development in the last 30 years of the twentieth century was extraordinary. It is a tale of unparalleled growth, urbanization, and wealth creation—China has moved a staggering 300 million people from poverty into its middle class in the last 30 years alone.

However, in the twenty-first century, it is the most connected global economies that will be the ones best positioned to succeed—and, in this regard, China has room to grow. President Xi Jinping recognizes the importance of this. During his speech at the College of Europe in 2014, he noted that

history tells us that only by interacting with and learning from others can a civilization enjoy full vitality—if all civilizations can uphold inclusiveness, the so-called 'clash of civilizations' will be out of the question and the harmony of civilizations will become reality.

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This notion of 'common prosperity' through close international collaboration underpins China's vision to develop a 'New Silk Road by Land and Sea' through the 'One Belt, One Road' initiative (OBOR). Delivering on this vision will be crucial for China, whose leaders understand that 'opening up' is a prerequisite for the services-based, consumption economy to which they aspire. It will also be crucial for the development and prosperity of the entire OBOR region.

However, success will be difficult. Political differences, varying economic cultures, and other potential roadblocks, will complicate the effort, but this is the nature of bold ideas that transform the world. To ensure success, OBOR nations will need to quickly and decisively define the right targets, set the right priorities, and design the right operating model for working together.



The New Silk Road by Land and Sea

A (NOT SO) NEW ROAD

The Old Silk Road developed over about four hundred years from 200 BC to 200 AD under the Han Dynasty. During this period, the silk trade accounted for about five percent of China's economy—then the world's largest, as it has been for the vast majority of the last 2,000 years. Over time, the costs of trading over land rose, and the 'Maritime Silk Road,' through the South China Sea and Indian Ocean, grew in relevance. However, despite the economic potential of the Maritime Silk Road, China began turning inward after explorer Zheng He's expeditions in the early 1400s were stopped, leading to a progressive decline over several centuries. The prominence of the Silk Road thus began to wane, as

did the prominence of the Chinese economy—a trend accelerated by the colonial wars of the nineteenth century and the global wars of the twentieth century.

In the twenty-first century, China is participating in a global economy that is more connected than ever before. In a 2014 public study, the McKinsey Global Institute (MGI)—the economics and business research arm of McKinsey & Company—projected that global flows (including flows of goods, services, financial products, people, and data) account for 15 to 25 percent of global GDP growth each year, and that returns to the most connected countries are as much as 40 percent higher than returns to the least connected countries.

While China falls within this “more connected” bucket of nations, it ranks behind many of its economic peers in connectivity terms. According to the MGI Global Connectivity Index, which measures connectivity using a composite score along the five major flow types mentioned above, China ranks as the 25th most connected economy in the world.

The data suggests that China’s weakest areas fall where the world is shifting—to a more human capital and data-enabled service economy (China ranks 93rd in people flows, 33rd in data flows, and 21st in service flows). By comparison, the United States (the only comparably-sized global economy to China) ranks third overall on the index, and is in the top 10 on every type of flow. Mainland China also ranks behind Hong Kong SAR, which is measured separately and ranks second overall in the index, behind only Germany.

These themes around connectivity serve as important inputs into the rationale for the OBOR initiative, which was announced in 2013. The initiative has since become a foundation of China’s foreign policy, as well as an important pillar

of its internal economic and social development strategy. At a conceptual level, the vision for OBOR is to establish a platform for international economic development grounded in principles of collaboration and mutual benefit. At a practical level, there are a number of notions on how the initiative might work.

At the annual Stockholm China Forum in Guangzhou in late May 2015, ex-

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perts and policymakers “mull[ing] half a dozen descriptions and interpretations,” according to Philip Stephens of the *Financial Times*, without reaching one particular definition. What does seem clear is that many nations are interested in participating in the initiative—about 60 nations from Europe, the Middle East, Central Asia, and South Asia view the OBOR initiative as one way to increase economic activity and connectivity at their major ports, and through land routes within their nations.

Economic, social and cultural development in these nations will be crucial for the future prosperity of the world. The 60 nations currently “at the table” represent 60 percent of the world’s population, 30 percent of the world’s GDP, and about 25 percent of global

trade. Success in establishing a platform for international economic development in this region could result in a contribution of 80 percent of global GDP growth by 2050, and contribute significantly to lifting three billion people out of poverty.

However, initiatives that have the potential to transform the world in this way are, by their nature, difficult to undertake. Each of the 60 nations that have expressed interest in OBOR has a different economic, political, and social context—and different development needs as a result. Furthermore, no one nation or set of nations has a mandate on the direction of the OBOR initiative—while China can and should lead, all nations must work together for the effort to be effective. Nations must also build trust with each other if they are to work together effectively. Currently, some nations have expressed skepticism about China’s intentions, viewing OBOR as an attempt by China to establish itself as a global power or secure resources for its future. Other nations worry that Chinese investment is heavily influenced by government interests, as opposed to business interests.

To ensure success, OBOR nations will need to act decisively. First, success will require a clearly defined set of goals—what are OBOR nations trying to achieve, and how will they measure success? Second, it will require focusing on a small number of priorities—in

a sea of limitless development opportunities, where will OBOR nations focus their resources? Finally, it will require a clear operating model—for example, how will OBOR nations reach agreement and settle disputes? In short, to ensure success, OBOR nations must set the *right* goals, focus on the *right* priorities, and design the *right* operating model.

SETTING THE *RIGHT* GOALS

The vision for ‘One Belt, One Road’ at a conceptual level—to establish a platform for international economic development based on principles of inclusiveness and mutual benefit—is inspiring. Moving forward, OBOR nations will increase the probability of success by defining a set of objectives to measure their performance.

Several objectives flow naturally from the initiative’s vision. First, a clear emphasis can be placed on economic growth, which is a natural measure of economic development. Since the purpose of economic growth is not simply “growth for growth’s sake,” a second objective can be to meaningfully improve the lives of the people who live within an economic region. Finally, OBOR nations should aspire to do this over the longterm. As a result, the third “right” goal for the initiative could be to promote an economic system that consumes resources in a sustainable manner.

These objectives can be measured in many ways—in our experience, the most successful metrics are highly aspirational (yet achievable), specific, and simple. Following these guidelines, OBOR nations could measure success using three metrics:

- Achieving economic growth: the OBOR region could aspire to contribute 80 percent of global GDP growth per year by 2050.
- Promoting widespread affluence: the OBOR could aspire to lift three billion more of its people out of poverty and into the middle class by 2050.
- Encouraging sustainable utilization of resources: the OBOR region could aspire to increase non-fossil fuel usage to 25 percent of primary energy consumption.

These aspirational, specific, and simple targets—each reflective of the OBOR vision—can serve to measure whether the initiative is having a level of impact that is commensurate with its potential.

FOCUSING ON THE RIGHT PRIORITIES

Once they have defined the proper objectives and metrics to measure success, OBOR nations must focus on the right priority areas for development and investment.

While there are many possibilities here, we believe that three areas would have the highest potential benefit to nations in the OBOR region.

The first is infrastructure. The OBOR region should prioritize boosting infrastructure capacity and productivity among its members. Infrastructure is a key to economic development, due to its ability to unlock economic potential—it links people to one another, and links entire economies to new pools of demand and the supply chains they will need to meet them. In some cases, the right infrastructure can help entire economies “leapfrog” stages of development—as we are already beginning to see with mobile phone use and its impact on financial inclusion in Kenya, or the use of biometric identification systems and its impact on the provision of social services in India.

In this sense, the Chinese saying ‘build a road first if you want to get rich’ is spot on—data suggests that for every \$1 billion in infrastructure investment, 30,000 to 80,000 jobs are created, generating \$2.5 billion in new GDP.

Even though the economic potential of infrastructure investments is large, however, countries often run into two stumbling blocks on the ground. The first problem is that infrastructure has long-run, hard-to-measure returns that require large up-front costs. This

reality often leads to underinvestment in infrastructure—MGI finds that the infrastructure gap is an astounding \$57 trillion in terms of infrastructure investments that will be required simply to keep up with projected GDP growth by 2030.

The second stumbling block countries often face is building the “right” infrastructure. Many nations have faced criticism over funding what are perceived to be “unnecessary” projects that “front-run” demand.

While this strategy has been successful in some cases, in others it has resulted in large capital expenditures with little to no economic return. Nevertheless, boosting infrastructure capacity in proper areas will significantly help OBOR nations meet their goals of economic prosperity and widespread affluence.

To help overcome some of the barriers to infrastructure investments, OBOR nations can focus on boosting the productivity and efficiency of infrastructure projects. For example, MGI finds that taking a series of actions to boost infrastructure productivity could save countries up to 40 percent on their infrastructure investment

bills. The OBOR region is uniquely positioned—given its multilateral structure—to consider two actions in particular:

1. *Develop an open infrastructure platform:* the OBOR region should consider setting up an open data platform for infrastructure projects accessible to all participants. The aim of the platform would be to create a single information point that provides transparency at all stages of an infrastructure project (e.g., bidding, location selection, technical requirements, funding, tendering standards, demand forecasting). This would help productivity and encourage investment across a project’s lifecycle.
2. *Convene an OBOR Infrastructure Expo:* the OBOR region should consider convening a global infrastructure expo as a platform for facilitating communication and interaction between market participants. Its aspiration could be to do for infrastructure what the Great Exhibition in 1851 in England (the first international exhibition for manufactured goods) did for industrialization.

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The second area of potential benefit to nations in the OBOR region is industrial development. OBOR nations should focus on actions and initiatives that accelerate their industrial development, so that they can move away from depending on agriculture and natural resources as engines of economic growth. This is an area where China can, and should, lead. China's experiences have shown the effectiveness of economic development policies targeted at increasing industrialization; and China's expensive lessons (e.g., environmental issues) will help other OBOR nations understand (and perhaps counter) the effects of rapid industrialization.

Sharing best practices in two areas will be most helpful for developing economies in the region.

Encourage a scientific approach to industrial planning. China has developed a highly effective top-down economic and industrial planning system that provides usable guidance to regional development. One key element of this system is the identification of priority sectors for development.

In this vein, China can help lower-income countries focus on developing labor-intensive, industrial sectors to help 'up-skill' their labor forces and increase productivity (e.g., food processing, textiles, mining-product processing). In middle-income countries, for

which the key economic development issue is avoiding the "middle-income trap," China can focus its collaboration on technology and capital intensive industries (e.g., advanced manufacturing, electronics, and renewable energy). For high-income countries (including China, as its economy continues to evolve), developing service sectors (e.g., information technology, finance, education) would be the most prudent area of focus.

Support local governments in efforts to attract foreign companies and investment. China's experience in developing successful industrial parks and special economic zones to attract investment from state-owned, private, and public companies can be very valuable for other OBOR nations.

China should help OBOR nations design the key elements of these parks—including taxation codes, efficient administration, and financial services for companies—and introduce investments directly once the industrial parks and special economic zones have been established.

The third area of potential benefit to nations in the OBOR region is improving the quality of life for their citizens. Quality of life—particularly measured in terms of decent living conditions—is crucial to sustain long-run growth, and in its own right

is a responsibility governments have to their people. OBOR nations could benefit greatly from focusing on one of the pervasive issues facing the global poor—a lack of decent and affordable housing. This is another area where China has made extraordinary progress. Just last year in China, nearly five million affordable-housing units were completed, and construction began on another seven million.

OBOR leaders can help massively increase the number of affordable housing units for their people through three actions:

1. *Encourage private sector involvement in construction:* whether through public-private partnerships or requirements that private developers dedicate a percentage of their commercial residential developments to affordable housing units, OBOR nations should consider integrating private sector developers into affordable housing construction projects, in order to increase project productivity and help in best-practice and knowledge sharing.
2. *Promote integrated construction to reduce costs:* developers can experience significant savings by developing industry-chain management approaches to their housing developments. For ex-

ample, Country Garden in China uses integrated design, construction, and interior decoration in all of its housing projects. This facilitates high construction speeds and significant cost savings.

3. *Spread the use of provident funds:* where appropriate, OBOR nations can consider establishing provident funds to help lower-income households secure financing through low-interest loans. This could help stimulate growth in the real estate market by effectively providing subsidized loans to help low-income families improve their standard of living.

Each of these actions will require extraordinary leadership, dedication, focus, and talent—both at the senior policy level and in local city governments, large companies, and through the region's entrepreneurs.

DESIGNING THE RIGHT OPERATING MODEL

Finally, once OBOR has articulated a clear set of measurable goals and focused its efforts on the right priorities, it would benefit greatly from continuing to build its operating model to support the initiative on the ground.

This operating model would benefit from the inclusion of the following elements, among others.

First, it should be inclusive, equitable, and multilateral, as a matter of both principle and practice.

Second, the OBOR region would benefit from agreeing to a set of holistic objectives that balance GDP growth, income equality, and sustainability, both conceptually and through agreements and projects that will be set up between OBOR nations. Perhaps the relevant UN post-2015 Sustainable Development Goals could provide useful targeted input in moving forward.

Third, the OBOR region should seek to establish an economic ‘code of conduct’ to fulfill its vision of a vast and prosperous commercial region. This code of conduct is best-rooted in market principles, considering that it must operate across a large and politically disparate set of countries.

Fourth, a cross-border, stable, and transparent legal and regulatory system will be essential to create an attractive investment climate with lower entry barriers.

Finally, any central entities created by this operating model must develop a strong innovation culture—this is especially important in the context of a multi-decade program like OBOR, where the costs of failing to innovate could compound over time. The Asia

Infrastructure Investment Bank—another multilateral platform being led by China—is showing very promising signs in terms of innovation and agility. OBOR nations may be able to benefit from adopting similar characteristics when designing their operating model in the years ahead.

A healthy and dynamic operating model is also important to mitigate potential risks and deal with conflicts between member nations. There are several types of risk that should be of primary concern to OBOR nations. First and foremost is political risk—especially in less developed economies, where companies will likely demand downside protection for large projects.

In addition to political risk, OBOR leaders and their teams will have to wrestle with significant operational risks—and will be forced to constantly monitor and combat potential risks at a project level. Finally, projects will face steep financial risks, compounded by their expected scale (e.g., large infrastructure projects). One approach to handle this could be to develop consortiums to dilute investment risk.

These actions may reduce risks, but they will certainly not eliminate them. When conflicts do arise, OBOR nations would benefit greatly from instituting a conflict resolution mechanism.

In this regard, OBOR nations can look to other large multilateral organizations for guidance. For example, the North American Free Trade Agreement (NAFTA)—a multilateral trade agreement—helped ensure the vitality of its operating model by establishing a dispute settlement framework for conflicts between nations.

The framework has three major pillars. First, NAFTA allows claims to be filed with an international arbitration tribunal before the investor exhausts local remedies—this reinforces the international and multilateral principles of the trade agreement. Second, emphasis is placed on the right of the private investor, who is allowed to bring claims directly against governments or other NAFTA parties. This assurance helps promote private sector investment, and also plays a positive role in increasing public sector accountability. Third, the committee requires nations to outline in advance which industries are subject to any specific regulation—putting these rules in writing has reduced the likelihood of discrimination.

The NAFTA framework has arbitrated over one hundred disputes and has helped create a predictable, rules-based investment climate. A similar mecha-

nism, albeit on an even greater scale, could have similarly positive effects for OBOR nations.

LONG-TERM THINKING

China’s development over the past 30 years has been extraordinary. With the OBOR initiative, many nations have expressed a desire to work with China in the next phase of their development journeys. The potential impact of this partnership is enormous—for China, for nations in the OBOR economic region, and for the entire world. While it will take decades for this potential to be realized, this should come as no surprise—it takes time to fundamentally transform the global economy.

Luckily, China is no stranger to long-term thinking. For decades, China has simultaneously articulated its fifty-year strategy and executed successive five year plans—this balance has been one of the fundamental drivers of its success story—perhaps even the most fundamental one. In a world where short-term thinking is on the rise in both politics and business, this has been a refreshing and important reminder of the possibilities that come with taking a longterm approach. The entire world, and especially the OBOR region, will experience a better future if we remember this, and orient our actions for the long term. ●