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Assessment of the Economic Background of the OBOR

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ABSTRACT

Although there is a growing number concerning articles/papers on China's 'One Belt, One Road' (OBOR), it is difficult to find comprehensive research regarding the economic background in spite of the OBOR initiative involving multi-dimensional considerations. Although China targets to become a soft power leader by reviving the spirit of the old Silk Road, the OBOR is a large-scale investment project, whose rate of investment (ROI) is important for sustainability. Since new infrastructure in isolated regions is likely to be used less frequently, anticipated profitability is low. In spite of this risk, China promotes the OBOR for its economic and political purposes. China will promote the OBOR in spite of the U.S. withdrawal from TPP membership, since boosting aggregate demand is of critical importance for the country. This paper analyzes the economic background of the OBOR, which establishes China's own model of regional integration, eases unemployment, and internationalizes its currency. Finally, this paper discusses diverse risks for China in the process of implementing the OBOR.

1. Introduction

The One Belt and One Road (in short OBOR) initiative prepared by the State Council of the People's Republic of China (State Council of PRC, 2015) states that the old Silk Road served as trade routes and cultural exchanges linking the major civilizations of Asia, Middle East, Europe and Africa for several thousands of years. Chinese authorities interpret the OBOR initiative to follow in the spirit of the old Silk Road, including cooperation, openness and mutual benefit, and bringing prosperity and development to the region.

Chinese authorities propose revitalizing the spirit of the old Silk Road today in order to escape slow global economic growth, and to foster regional economic integration and global governance based on complex international political mechanisms.

The OBOR initiative aims to promote the physical connectivity of Asia, Europe and Africa by establishing and strengthening partnerships among the countries along the OBOR initiative. Providing infrastructure for isolated countries is akin to official development assistance (ODA) projects, which are perceived to be virtually free for receiving countries. However, the OBOR is an investment project financed by the China-initiated Asian Infrastructure Investment Bank (AIIB) with initial capital totaling \$50 billion. The investment costs will be recouped through revenue raised from the users of the newly built infrastructure for the transport of commodities and people across countries. Many countries subject to AIIB financial support are suffering from underdevelopment and sluggish economy, which suggests the return on investment (ROI) may be low, and many projects may be blocked during initial assessment.

Several questions face the OBOR, including its feasibility. China could secure funds via the AIIB, Chinese banks, and state-owned enterprises (SOEs), but the coordination of various interests under China's leadership is a challenge. In order to assess the feasibility of the initiative, the dynamism and trajectory of the OBOR should be examined. China's official rhetoric is 'win-win' arrangements: China supports developing countries in improving infrastructure, and in

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return, it will access new markets and create business opportunities. Considering the process of forming Chinese policy, the OBOR must be initiated and shaped by many economic and political factors. If the ‘win-win’ structure is excessively preferential toward China in terms of influence and economic gains, it will be difficult for China to induce participation from countries, and the OBOR will face external obstacles. This would make the road of the OBOR very bumpy for China.

The economic considerations of the OBOR include prioritizing Chinese interests (Ifri, 2017, p.17) and China’s regional/global diplomacy. The majority of the literature regarding the OBOR describes China’s good will for promoting regional prosperity and development in the continents of Asia, Middle East, Europe and Africa. If this is valid, the OBOR should have experienced substantial progress. The China-Pakistan Economic Corridor is in progress,^a but China could not extend its high-speed train internationally. This reveals the difficulties and complexities concerning the OBOR in coordinating transnational interests involving countries along the OBOR initiative. This paper aims to comprehensively analyze the trajectory and examine policy implications for the OBOR.



Source: McKinsey & Company (2016)

Figure 1. Several routes proposed for the ‘new Silk Road’

2. Literature on the OBOR

Prior to the official announcement of the OBOR in March 2015, China made two symbolic diplomatic activities in Kazakhstan and Indonesia. China’s President Xi Jinping made state visits to Kazakhstan in September 2013 and Indonesia one month later, proposing the joint project of building the Silk Road Economic Belt for Kazakhstan and the 21st-Century Maritime Silk Road for Indonesia, respectively. Kazakhstan and Indonesia are the biggest countries in Central Asia and Southeast Asia. This highlights China’s strategy to reduce anti-China sentiment in promoting the OBOR initiative and attract attention from the countries along the OBOR initiative. Based on the support of these two countries, China announced the promotion of an infrastructure network in isolated countries in Central Asia, South Asia and Africa in order to promote peace, prosperity and development. This reflects the merits of the new Chinese foreign policy.

While many papers and reports regarding the OBOR are similar in content and consistent with China’s intentions, some explore geographical coverage, issues and challenges for the future of the OBOR. McKinsey & Company (2016b) states, “One of the biggest stories in Asian business is China’s One Belt, One Road initiative, an economic and diplomatic program that could transform trade.” Since the OBOR contains creating massive infrastructure in foreign countries and operating mechanisms, success will depend on many factors including economic, financial, social and political issues.

One of the critical issues facing the OBOR is the lack of clarity and transparency, while trying to build infrastructure across countries. If the countries at stake trust the good faith China has claimed in the State Council of PRC (2015), they may anticipate the new infrastructure will be free. The East Asia Forum (2016) states that “there are significant risks associated with China’s OBOR strategy. China’s neomercantilism lacks sensitivity when addressing

^a The first freight train from Yiwu, China set off January 1, 2017 and arrived at to London, England after 18 days. This can be regarded as a symbolic event rather than commercial transportation.

Table 1. Recent studies on the OBOR

Authors	Major issues/conclusions
HKTDC (2017)	<ul style="list-style-type: none"> • Analysis of six economic corridors in the OBOR. • Key areas of co-operation are policy, finance and others.
McKinsey & Company (2016a,b)	<ul style="list-style-type: none"> • Assess the feasibility of the OBOR. The success of the OBOR initiative needs two parts: One will be that the funds are indeed available; and governments are willing to deploy them.
Dollar (2015)	<ul style="list-style-type: none"> • Because that a diverse group of nearly 60 countries have signed up, it would be difficult for China to use the AIIB to finance projects in favored countries over the exclusion of other members.
East Asia Forum (2016)	<ul style="list-style-type: none"> • The biggest driving factor for China's OBOR initiative is to solve the problem of over production capacity by exporting its products to neighboring countries along the OBOR geographical region.
State Council of PRC (2015)	<ul style="list-style-type: none"> • Official statement on action plan on the OROB initiative. China is promoting the OBOR to support building infrastructure for countries involved, reviving the spirit of old Silk Road.
Intelligence Unit (2016)	<ul style="list-style-type: none"> • The major infrastructure projects of the OBOR are summarized covering seven key regional spheres: Africa, Central Asia, Eastern Europe, the Middle East, Russia, South Asia and South-east Asia.
South China Morning Post (2017)	<ul style="list-style-type: none"> • Comparison of the OROB with the contents of the TPP. China's OBOR initiative is based upon projects, not rules, supporting that China has made connectivity and infrastructure as the top priorities.
Tsui et al. (2017)	<ul style="list-style-type: none"> • Analysis of the OBOR in the context of international politics, China's countermeasure against the U.S.'s TPP
Du (2016)	<ul style="list-style-type: none"> • Compare the OBOR with the TPP, claiming the former to be the Chinese version of globalization
Overholt (2015)	<ul style="list-style-type: none"> • OBOR is China's grand strategy encountering the U.S.'s TPP promotion or "rebalancing" in Asia.
Wang (2016)	<ul style="list-style-type: none"> • The OBOR may be China's reaction to the aftershock of the TPP by the U.S.
Lin et al. (2017)	<ul style="list-style-type: none"> • The OBOR would provide a great opportunity for the internationalization of the renminbi, since more trade and investment can be settled with renminbi.
International Monetary Institute (2015)	<ul style="list-style-type: none"> • The role of the renminbi as international money will be bigger as the OBOR progresses. For fast internationalization of the renminbi, the use of the renminbi should be guaranteed in trade and investment.

some issues in host countries, particularly regarding culture, environment and ethnicity. Beijing's authoritarian approach may also impede effective cooperation with democratic countries.^b Moreover, many countries along the OBOR have a poor capacity in dealing with international business negotiations. It will take substantial time in settling sensitive issues with governmental offices and non-governmental organizations. The HKTDC (2017) suggests that key areas of cooperation for the OBOR are policy and finance. While China proposed the OBOR in order to build new roads and bridges for supporting countries, it is time for China to finance projects and subsequently recover costs. Therefore, a significant amount of commercial and legal contracts should be signed in order to proceed.

New export markets became important for China since the U.S. promoted the Trans-Pacific Partnership (TPP) Agreement in 2012, although the U.S. has subsequently withdrawn its membership in early 2017. Since TPP contains 12 member countries in the Asia-Pacific region, China regarded this as "China containment" policy during the period of 2012-2013, and later changed its perception into the more favorable position that the TPP can be a vehicle for reforming its economy. At this time, China began to consider the OBOR in response to the TPP under the U.S. leadership, as discussed in Overholt (2015) and Wang (2016).

Various studies have identified that the OBOR can be a good channel for the internationalization of the renminbi. China complained about the mistreatment by the International Monetary Fund (IMF) led by the U.S. and the Asian Development Bank (ADB) by Japan regarding the economic power of China. Although China's renminbi joined the basket of the IMF Special Drawing Rights (SDR) with a weight of 10.92%, compared with the U.S. dollar comprising 41.73% and the Euro 30.93% as of October 1, 2016, China has promoted its currency as a major international currency. However, internationalization progress has been challenged by various factors such as weakening value of the currency, downturn in economic growth, financial stability of state-owned enterprises (SOEs) and capital outflows (Overholt 2017; Lin et al., 2017).

Although there is the growing number of articles/papers regarding the OBOR, most aim to introduce the blue print of the initiative and the goals of China's new foreign policy. It is difficult to find a paper exploring the practical economic background of China's OBOR. Few studies discuss the background of the initiative, with simple remarks

^b Du (2016) argues the opposite case by saying "China's preference to avoid if possible formal treaties with measurable compliance requirements in favor of less formal arrangements that give it flexibility and allow it to maximize its economic and political skills, as well as recognition of the difficulty of building its Belt and Road."

concerning various issues such as domestic politics, China's dream, China style diplomacy, SOEs, and the U.S.'s 'pivot to Asia' policy. This paper may be the first in conducting a comprehensive analysis of the background of the OBOR from economic perspectives. This paper tries to assess the economic background of the OBOR in the context of easing the unemployment problem originating from the SOE reforms and the internationalization of the Renminbi. This may be the first study which explores the backgrounds of the OBOR, linking China's economic problems and its external goals.

3. Analysis of China's OBOR Economics

The OBOR encompasses potentially 65 countries, accounting for 65% of the global population (totaling 4.4 billion), 60% of global trade, and 29% of global GDP. Many countries/regions along the OBOR are isolated and require infrastructure development and industrialization. China is a key trade partner for many countries, especially in Asia, and there is great opportunity for creating new trade/business with China, as trade facilitation progresses due to building new logistics infrastructure.

In theory, the OBOR could bring substantial economic benefits to China. However, there are many roadblocks originating from the transnational project. It is well known that China has set a diplomatic goal of becoming a soft power leader in reviving the spirit of the old Silk Road. However, the OBOR is a massive investment project, whose rate of investment (ROI) is important for sustainability. Since new infrastructure in isolated regions is likely to be used less frequently, the fees (revenues) collected from those facilities will be limited. This will be assessed in the initial evaluation of projects. The low chance of recovering costs will make the OBOR projects risky. In spite of this risk, China promotes the OBOR for its own economic and political considerations.

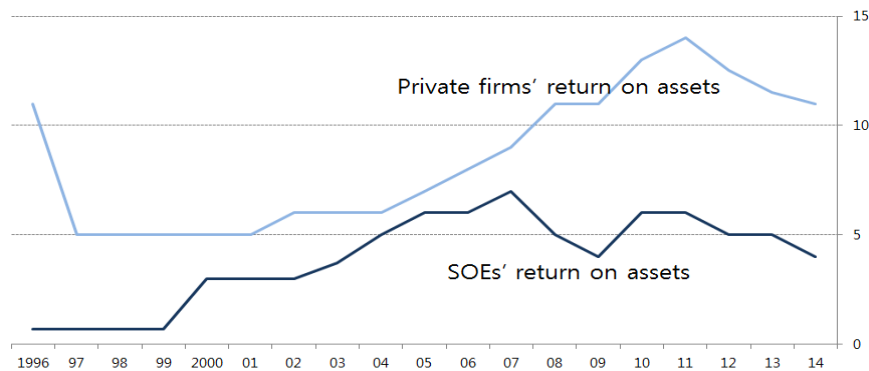
During the process that Eurasia is connected via the initiative, and all countries are integrated into an economic bloc in the long run, China's impact on the region will grow. China may use the OBOR in order to increase aggregate demand for its products in order to solve domestic economic problems, and may try to shift away from its current financial system. "China's domestic political economy has also been a major driving force. In particular, the growing problems with the old growth model, the changing relationship between the government and state-owned enterprises and banks.... Domestic politics has also shaped the way China promotes the international use of its currency." (CIGI 2016, p.1). When Chinese president Xi Jinping took power in 2013, the international environment was not favorable for China and the domestic economy was in a downturn. In particular, unemployment was rising due to slow economic growth. As the Obama administration in the U.S. promoted the TPP, it was natural for China to view its export markets narrowing. China has promoted the internationalization of the renminbi since 2009, but its progress has been slow due to interference from the U.S. and Japan. It needed a new approach for promoting the renminbi used in international transactions. These might be major driving forces behind China's OBOR initiative.

3.1 Easing unemployment risk by opening new markets

The World Economic Forum (2016) presented three risky trends observed in China's macro-economic indicators: (1) The increase in total social financing in spite of the decline in GDP growth; (2) The rapid decline in the private sector's fixed-asset investment; (3) The relatively stable unemployment rate. The article focuses on the third trend with minor discussion on the first and second trends. Although the stable unemployment rate despite economic growth slowdown seems positive, it points out that this implies long-term weakness in national productivity growth. China's productivity grew by 8% on average over the last decades, but currently is less than 6% annually. Stable unemployment could be possible due to the expansion of SOEs, and state banks propping up the SOEs, producing 'zombie' companies. As a result, workers' productivity has declined over time and SOEs tend to undermine national competitiveness.

This is the opposite phenomenon to the SOEs reforms that China announced in the Third Plenum of the 18th Central Committee of the Communist Party of China (CCP) in November 2013. In order to maintain jobs, China continues to subsidize stagnant SOEs, making the public sector grow and generating overcapacity. SOEs are key players in China in terms of business power, the number of companies and economic impacts. The number of SOEs in China totaled 144,700 enterprises in 2011, and SOEs' shares of business profit and taxes account for approximately 40% of the economy. Tam et al. (2015) reported that Chinese SOEs hire 17% of urban employment^c and represent 38 percent of China's industrial assets. According to Leutert (2016), SOEs account for 25%-30% of the manufacturing industry in terms of the number of companies, but their output share is higher than 90% in some sectors.

^c China has reduced its SOEs substantially over the years of its WTO accession from 70% of employment in manufacturing in 1980s to 26% in 2012.



Source: Financial Times (2016.3.1) based on National Bureau of Statistics

Figure 2. Widening profitability gap between private firms and SOEs

According to the US-China Economic and Security Review Commission (USCC) in 2016, although Beijing has repeatedly pledged to reform its SOEs to facilitate the invisible hand of markets to allocate resources, the country has increased its control over SOEs and expanded the share of SOEs in the national economy in recent years. In order to achieve social and economic goals, various financial subsidies (cheap financing) and direct/indirect incentives have been provided. There have been many warnings about the debt risk of China’s state corporate sector. Lipton (2015) asserts that China’s SOEs are “essentially on life support,” warning that the country could face an economic crisis unless the SOEs are reformed immediately. China needs to create aggregate demand with the OBOR to offset economic losses due to SOEs reforms. In this case, the OBOR will act as a buffer to the accompanying economic shock.

When China joined the World Trade Organization (WTO), it was supposed to automatically treat China as a market economy as of December 11, 2016, the 15th year anniversary of the WTO. However, the U.S., European countries and other advanced economies refused to confer the market economic status (MES) to China as a result of China not having developed its economic system for enabling markets to determine resource allocation. “To date, the CCP has not demonstrated a commitment to a free market economy as a matter of principle and practical considerations mitigate against reform efforts. SOEs in strategic sectors are the primary entities through which the CCP directs the economy towards the regime’s strategic ends; real reform in these sectors would mean giving up control and dramatically reducing the government’s ability to achieve the goals identified in the 13th Five-Year Plan (FYP).”(USCC, 2016, p.91).

Table 2. China’s overcapacity industries

Aluminum	Copper	Paper and Pulp
Chemicals	Cotton	Power Generation Equipment
Cement	Glass	Rubber
Ceramic	Iron	Solar Panels
Coal	Oil Refining	Steel

Source: USCC (2016, p.105)

It is not surprising that China faces an overcapacity problem and has become the source of global oversupply in traditional manufacturing sectors as suggested in Table 2. Currently the capacity utilization ratios in these sectors are approximately 35%~40%, which is about half of standard utilization ratios. In the case of steel, global overcapacity has originated from China during the last decade, and as this creates market distortions, the number of anti-dumping (AD) and counter-veiling duty (CVD) disputes have increased dramatically, as displayed in Figure 3.

China has been successful in developing its industrial structure through its national planning system and strong political leadership. The industrial plan for developing heavyweight industries was introduced in 2000. As displayed in Table 3, 7 industries including telecommunications and shipping were chosen for strategic industries in 2006, and 7 additional strategic emerging industries in 2010. In 2015, new initiatives were announced, referred to as ‘Made in China 2025’, which targeted 10 high-tech sectors such as robotics. Its aim is to be internationally competitive with products from advanced economies such as the U.S. and Germany. Most leading companies in strategic sectors are SOEs or under heavy state control. Industrial development via supporting strategic sectors is a key condition for realizing China’s dream of a “socialist modernized society” (shehuizhuyi xiandaihua shehui).

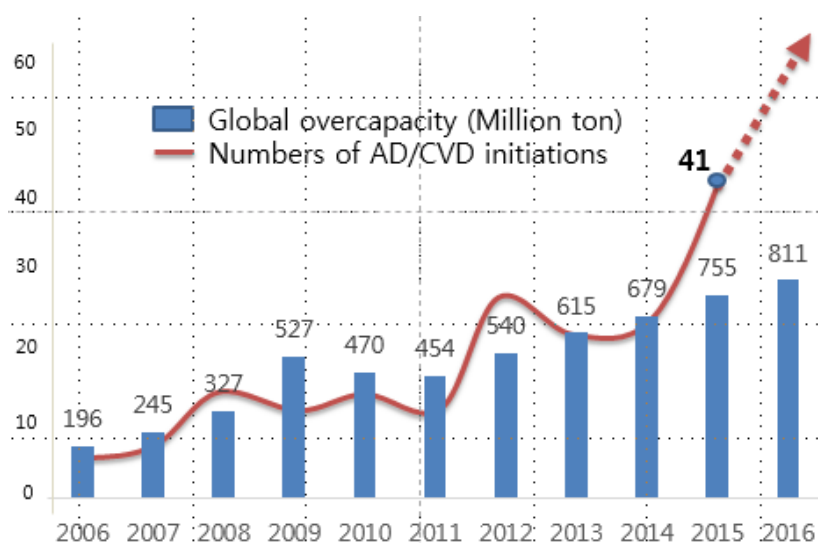
China needs to take aggressive measures for reducing “zombie” SOEs which rely on government supports for their survival.^d However, rising unemployment fueling social unrest does not create a politically acceptable environment for

^d “Zombies make up about 7.5 percent of industrial businesses, which are mostly state-owned enterprises in the northeast rust belt and the less-developed western regions” (Bloomberg News, 2016).

Table 3. Strategic sectors identified in China’s State Planning

Made in China 2025 (2015)	Strategic Emerging Industries (2010)	Strategic Industries (2006)	Heavyweight Industries (2000)
<ul style="list-style-type: none"> • Clean energy vehicles • Next generation IT • Biotechnology • New materials • Aerospace • Ocean engineering and high-tech ships • Railway • Robotics • Power equipment • Agricultural machinery 	<ul style="list-style-type: none"> • Clean energy technologies • Next-generation IT • Biotechnology • High-end equipment manufacturing • Alternative energy • New materials • Clean energy vehicles 	<ul style="list-style-type: none"> • Armaments • Power generation and distribution • Oil and petrochemicals • Telecommunications • Coal • Civil aviation • Shipping 	<ul style="list-style-type: none"> • Machinery • Automobiles • IT • Construction • Iron, steel • Non-ferrous metals

Source: USCC (2016, p.110) based on the data from the State Council of PRC



Source: Drawing based on the data from OECD Steel Committee

Figure 3. Trend of global overcapacity and numbers of AD/CVD

SEO reform in China, as identified by the World Economic Forum (2016). Wang (2017, p39) notes that reform programs prepared by the new government could not be implemented as scheduled due to the “resistance from state-owned enterprises and self-serving government bureaucrats.” In fact, the unemployment rate has increased from near zero in 2010 to more than 5 percent recently, and some estimate overcapacity in industries such as steel and coal at 10%. These companies tend to provide workers leave without payment rather than layoffs. In particular, “underemployment is especially rampant at state-owned companies” (Bloomberg News, 2016). It should be noted that China’s unemployment rate would be much higher than 4.1% (IMF 2016) if SOEs did not provide jobs funded by government subsidies.

China has placed a higher priority in mitigating social unrest compared with economic reforms. In order to promote employment in SOEs, government provided diverse supports for SOEs by delaying structural adjustment of overcapacity. Moreover, government sought ways of creating new export demand for SOEs in order to promote additional employment. This would reduce the financial burden for the SOEs and may be free from international blame regarding subsidies. The OBOR could be designed for promoting export markets under low capacity utilization, while promoting the ‘Made in China 2025’.

A key issue is why China is promoting the OBOR. According to the State Council of PRC (2015), the five major goals of the OBOR are policy coordination, the improvement of connectivity, facilitation of bilateral/regional trade, financial integration, and strengthening international ties. However, it is difficult to perceive the several trillion dollar project to be promoted entirely with good faith,^e although the OBOR is “Chinese version of globalization... nurturing shared interests, shared system and effective dispute settlement mechanism.”(Du, 2016, p.42). Prior research has presented the background of the OBOR, but comprehensive assessment has not been conducted. The East Asia Forum (2016) notes that China is promoting the OBOR in order to ease the problems of its overproduction, including

^e Asian Development Bank estimates that Asia needs 770 billion dollar per year for building infrastructure.

state-owned enterprises (SOEs), by accessing new export markets in the countries along the OBOR.

The OBOR intends to build a massive infrastructure network along the Silk Road across Central Asia to Europe, and along the 21st Century Maritime Silk Road into Southeast Asia and Africa. Building roads and rail lines, communication facility, energy pipelines, and coastal ports requires a lot of resources such as steel, cement, glass, aluminum, coal, and shipbuilding materials, which all face slumping global demand and sharp declines in profit. The Intelligence Unit (2016) shows that the major infrastructure projects of the OBOR could cover seven key regional spheres in the world: Africa, Central Asia, Eastern Europe, the Middle East, Russia, South Asia and South-east Asia. China's SOEs policy is linked with the OBOR in order to extend the life of companies that should have either closed or contracted if national subsidies were not provided. The East Asia Forum (2016) asserts that the biggest driving factor for China's OBOR initiative is to solve the problem of overproduction capacity by exporting products to neighboring countries in the OBOR geographical region. If the OBOR advances as planned, and China applies gradual measures for industrial restructuring, then the OBOR may be consistent with the national goal of easing unemployment while promoting strategic industries. Otherwise, extending 'zombie' SOEs would bear larger costs for the country due to further delaying structural reforms.

3.2 Countermeasure for the TPP

Japan and Korea finalized a bilateral FTA in 1999, and China proposed an FTA with ASEAN members in November 2000 as well as a China-Japan-Korea (CJK) FTA in 2002. While China was swift in taking countermeasures against the FTA promotion policy by rival countries such as Japan, progress has been slow. As of April 2017, China implemented 15 FTAs but most FTAs involve small and developing countries. The biggest FTA for China under negotiation is the Regional Comprehensive Economic Partnership (RCEP), which began in November 2011. The 17th round of negotiations held in Japan in February 2017 was completed, but the prospect for concluding the RCEP is not promising. The progress of the CJK FTA is similar to the RCEP, and no member countries are actively pursuing negotiations.

Table 4. China's FTA policy performance (as of April 2017)

Implemented/concluded	Under negotiation	Under discussion
Hong Kong, Macao, ASEAN, Thailand, Chile, Pakistan, New Zealand, Singapore, Peru, Costa Rica, Taiwan, Iceland, Switzerland, Korea, Australia, Georgia	GCC, Norway, CJK, RCEP, Sri Lanka	India, Colombia, Nepal, Mauritius

The expression of the U.S. to promote the TPP did not arouse serious attention from China in September 2008, since it was regarded as the expansion of the Pacific 4 (Brunei, Chile, New Zealand, and Singapore). However, China could not remain inactive, and began devising plans regarding the progress of the TPP when Japan, Canada and Mexico expressed interest in joining the TPP during 2011-2013.

The TPP has three implications for China: institutional building, market opening, and international alliance. The U.S. claimed the TPP to be '21st Century Trade Framework' which adopted most advanced trade rules in the world, adding stronger regulations across many fields such as the governance of SOEs and the protection of intellectual property rights (IPR). Though the Korea-US (KORUS) FTA was used as guidance for the TPP negotiations, the TPP has more comprehensive and broader market access regulations than the KORUS FTA. Although it is said that the TPP membership is open for new members, China is likely not able to meet the requirements for TPP membership. The TPP was interpreted as U.S. strategy for containing China. China containment policy can be found in President Obama's speech on the day of signing the TPP agreement by saying "TPP allows America – and not countries like China – to write the rules of the road in the 21st century, which is especially important in a region as dynamic as the Asia-Pacific." (The White House, 2016).

China's first response was to propose the FTA in Asia Pacific (FTAAP) at the Leaders' meeting of the Asia Pacific Economic Cooperation (APEC) and to speed up negotiations for the China-Korea FTA. Unlike mass media reports which indicated that China actively encouraged negotiations regarding the CJK FTA and the RCEP, this is not true as evident in the lack of progress of those FTAs. Another response was to initiate its own approach for regional economic integration, which is the OBOR strategy. Overholt (2015) asserted that the OBOR is China's strategy for countering the U.S. promotion of the TPP, or "rebalancing" Asia, and Wang (2016) states that the OBOR may be China's reaction to the TPP.

3.3 Renminbi internationalization

Currency internationalization can be interpreted as the performance of three monetary functions including a medium of exchange in economic transactions, a store of value, and a unit of account. These three functions can be performed at private and public levels. In regard to being a medium of exchange, private actors use currency to settle international transactions, and governments use foreign exchange for market intervention. Similarly, a unit of account functions at

the level of private international transactions, and at the governmental level for pegging exchange rates. Private actors use international currency as a store of value at the private level and governments as a means of storing national wealth. Cohen (1971; 2012) demonstrated that these six functions could be interrelated to some extent. He classified international currencies into ‘fully’ international currencies and ‘partial’ international currencies, in which ‘fully’ international currencies perform all six functional roles, while ‘partial’ international currencies perform a portion of the six.

Table 5. Roles of an international currency

Function of money	Governments	Private sectors
Store of value	International reserves	Currency substitution (private dollarization)
Medium of exchange	Vehicle currency for foreign exchange intervention	Invoicing trade and financial transactions
Unit of account	Anchor for pegging local currency	Denominating trade and financial transactions

Source: Chinn and Frankel (2005)

Strange (1971) raised two questions regarding currency internationalization: (1) What is the political background for choosing a foreign currency?; (2) What political consequences derive from using an international currency? Addressing the relationship between political factors and the internationalization of currencies, he divided international currencies into four categories of “neutral currencies,” “negotiated currencies,” “top currencies” and “master currencies.” A neutral currency is a currency that is internationally used due to pure economic strength of the issuing country, which does not promote internationalization intentionally. The Swiss franc is an example of a neutral currency. An issuing country can negotiate with other countries to use its currency by providing incentives, which is a negotiated currency. A negotiated currency is the British sterling following World War II. Market power induces people to use a specific currency. This is called a top currency, which tends to be the currency of the dominant country in the global economy. The U.S. dollar in the 1950s can be considered a top currency. Master currencies are those which were enforced for use by a hegemonic state. An example is the French franc used in the franc zone prior to World War II.

Several studies support the internationalization of the Chinese renminbi on account of China’s economic growth and China’s second largest economy in the world. However, many studies such as Chey (2013), Cohen (2012), Cooper (2010), Eichengreen (2009), and the IMF (2010) raise doubts regarding the prospect for renminbi internationalization, noting the underdevelopment of Chinese financial markets and the lack of economic reforms as critical economic factors that work against the internationalization of the renminbi. Chey (2013, p17) notes that “the authoritarian nature of the Chinese political regime has also been often indicated as a political factor inimical to financial market development and confidence in the Renminbi, as it may raise foreign doubts about the Chinese commitment to a market economy.” Recently, Kim (2017) argued that the vulnerability of the balance of payments could be another barrier for renminbi internationalization, observing the trend of China’s balance of payments over the last decade.

In spite of these barriers to the internationalization of the renminbi,^f China has promoted the internationalization of its currency, since the internationalization of the renminbi provides various benefits such as transaction cost reductions, the reduction in exchange rate risk, collection of international seigniorage, the development of financial markets, macroeconomic flexibility, political hegemony, and enhancement of national reputation as an issuing country of an international currency. According to Zhang and Tao (2014), the Chinese renminbi has become a ‘partial’ international currency, performing some functions of trade settlement, foreign direct investment, bond issuance, and bank deposits as international currency since 2009. Some developing economies use the renminbi as a reserve currency. China’s 12th Five-Year Plan (2011-15) defined the gradual realization of the Renminbi internationalization. In spite of the multi-dimensional efforts by the Chinese government, the renminbi has not experienced substantial progress. China has realized that the renminbi internationalization requires reforming its economic system, including its financial sector, and opening its markets with the adoption of a more flexible currency exchange system.

China requires a path for renminbi internationalization, overcoming its limitations in economic and political reforms. It is not feasible to promote a master currency these days, and it is hard to classify the renminbi as even a neutral currency since China is promoting the internationalization of the renminbi. However, the renminbi can be developed for a negotiated currency in that China has signed 28 agreements for bilateral currency swaps as of the end of 2015, and opened renminbi clearing banks in 14 countries. Moreover, the renminbi may be developed into a more internationalized currency rather than negotiated currency under certain conditions such economic dominance, economic assistance, trade relationships, and capital exports. These conditions can be met for countries participating in the OBOR projects. The Journal of Chinese Economics (2016) assesses that the role of Renminbi as international money will grow as the OBOR progresses. For fast internationalization of Renminbi, the use of Renminbi should be guaranteed in trade and investment.

^f Chey (2013, p17) argues that China’s economic scales should be much larger than that of the US in order to become an international currency, based on the fact that the US economy was more than two times of the UK in the early 1910s, when the US dollar was about to be an international currency, and it became larger than four times in the late 1920s, when its currency replaced British sterling, and gained the title of an international currency.

Regarding this, Lu (2016) assesses that the OBOR initiative “now offers fertile fields for Renminbi internationalization to grow deep roots...China is the biggest trading partner for most countries along the Belt and Road routes...With the implementation of the “Belt and Road” strategy and through the connectivity of infrastructure facilities, it could help promote deeper integration between cross-border Renminbi operations and the real economy of these countries, and will help further consolidate the foundation for steady progress of Renminbi internationalization.” The similar argument was raised in Kim (2017). He argues that China is promoting the OBOR initiative in order to “turbocharge Renminbi usage by emphasizing the Renminbi role as a vehicle to raise capital in overseas financial centers to fund numerous projects across Eurasia.” Lin et al. (2017) support the points raised by Lu (2016) in stating that the OBOR would be a locomotive for the renminbi internationalization, since the currency could be used for settlement in more trade and investment in the region.

4. Conclusion and policy implications

Although there has been little progress in creating new infrastructure regarding the OBOR initiative, China has already received diplomatic gains by arguing that China’s OBOR is a win-win plan and the Chinese version of the Marshall Plan, supporting the Asian countries in badly need of infrastructure. President Xi provided strong remarks that China will play a role of protecting global free trade, contrasting the protectionism of the Trump Administration in the U.S. in the 2017 World Economic Forum. At the OBOR Forum held in Beijing in May 2017, 28 political leaders participated. The OBOR has been an effective vehicle for publicizing China and President Xi Jinping’s leadership to the world.

This paper posits that China promoted the OBOR to solve domestic economic problems, including offsetting the shock from SEO reforms, as well as to take counter-measures for the U.S. promotion of the TPP and to advance the internationalization of the Chinese currency. Although China could feel relieved from the U.S. withdrawal from the TPP, the internationalization of the Yuan is still one of China’s top priorities in foreign policy. Thus, China maintains its position toward the OBOR, as evident at the OBOR summit held in Beijing in May 2017. President Xi Jinping stated at the summit that international organizations such as WTO, APEC, ASEAN and the EU should join the OBOR initiative to depress the spread of protectionism and to promote global economic growth.

It should be noted that the scale of the OBOR is sufficiently massive that no country other than China could initiate such an ambitious endeavor, and it should also be recognized that the OBOR encompasses multiple dimensions of economic and political factors. This paper focuses on these economic factors. While many economic aspects may be considered, this paper concludes three policies may be most critical in promoting the OBOR as seen in Table 6. The major aims of China’s OBOR may be summarized as establishing China’s own model to promote regional integration, to ease unemployment, and to internationalize its currency. China will promote the OBOR in spite of the U.S. withdrawal from TPP membership. “What is most important for the Chinese economy today is boosting aggregate demand for its industries and that is possible through OBOR.” (Sahoo, 2015, p79) However, China may face many roadblocks in OBOR implementation, and progress will be slow.

Table 6. Consideration and policy targets of the OBOR

Consideration	Policy targets
Trade Policy	Establish Chia’s own model of regional integration
Industrial Policy	Ease unemployment problem by saving SOEs
Financial Policy	Internationalization of Renminbi

While many sectors such as infrastructure, financial and professional services, as well as transport and logistics could expect new business resulting from OBOR projects, there are several risks involving the OBOR due to the size of required investment and economic projects, as well as the sensitive geopolitical initiative covering 65 countries in Asia, the Middle East and Europe. As McKinsey & Company (2016a, b) suggested, the success of the OBOR initiative requires project funding and the strong intention of governments involved in the initiative. China should overcome suspicion concerning China’s strategic intentions and build its capacity in dealing with countries featuring diverse backgrounds in economics and politics. Risks related with political, legal and social issues may arise and the initiative may face these risks during the promotion of the initiative without careful planning involving a constructive approach from bilateral, regional and global viewpoints. The OBOR initiative consists of a series of projects without efficient and transparent rules for dealing with high risk projects. China should quickly build an institutional base regarding investment- and sharing- related costs and revenues with countries involved.

The profitability of the infrastructure will be a key requirement for the sustainability of the OBOR. The ROI will depend on the usage of the newly built logistics facilities. This is closely linked with the liberalization of trade and investment among countries along the OBOR route. Noting that trade liberalization is achieved via the conclusion of bilateral FTAs, China needs to improve its FTA policy and upgrade capacity for FTA negotiations. China's strategy for the internationalization of its currency needs a prerequisite of full convertibility, implying open capital markets. That is,

interest rates must be decided by the market, and free from government control. Banks must be well-regulated and financially stable in order to have full convertibility and to be utilized as an international currency.

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