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Against an international backdrop of slowing global trade and the rise of the service industry over manufacturing, the Chinese economic model is approaching exhaustion. China is struggling to confront over-indebtedness, excess production capacity, declining competitiveness, unfavourable demographics and the flight of capital. In response, the Chinese government is adopting a change in geo-economic strategy, based on two major initiatives: a transformation of its domestic financial system, and the 'One Belt, One Road' (OBOR) project. The success of these initiatives will be vital to China's economic development, political and social stability, and geopolitical emergence.

Xi's rebalance

The elevation of Xi Jinping to the presidency in March 2013 marked the beginning of a new phase in the assertion of Chinese power. Through various political initiatives, both internal and external, China's new strongman formally broke with the approach first conceived of by Deng Xiaoping, and then continued by each of his successors: 'hide brightness, cherish obscurity'. The reconstruction of Chinese power has become voluntarily less discreet, seeking instead to unify the people behind a common goal.

Contemporary China's emergence onto the world stage is based on rebalancing, both internal and external. Externally, China's desire to assert itself in Asia is clear, as shown by the frequent outbreaks of tensions with

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neighbouring countries in the South China Sea. It has been exacerbated by the strategic redirection of American foreign policy under President Barack Obama, in the form of a 'pivot' to Asia that China construes as an incursion into its natural sphere of influence.

Internally, Chinese economic strategy seeks to rebalance regional development, as well as to restore balance to the country's specific levers of economic growth. As impressive as it is, Chinese growth over the last three decades has created a marked imbalance between parts of the eastern coast – which have developed considerably, and where the population has seen its standard of living significantly increase – and the central and western parts of the country, which have lagged behind. The average individual income in the country's western regions stands at 40% of average Chinese income; 650 million individuals in China earn less than $4 per day.[1] China's Gini coefficient (a measure of inequality in a society) stands at 0.49, one of the highest rates in the world, reflecting a situation in which a quarter of the population own less than 1% of the country's total wealth.[2] The risk of social and regional divisions as a result of this imbalance is all the more acute because the poorest regions – including Tibet, Xinjiang and Inner Mongolia – have a high proportion of non-Han ethnic groups.

In addition to this unequal distribution of development's benefits, the Chinese government is now aware that the time has come to change the model of development itself, based so far on the two pillars of industrial investment and exports. Since the 2008 financial crisis, the imbalance generated by this model has become potentially dangerous for the economic and political stability of the country. The desire for rebalancing results from the observation that a process of development begun in 1978 by Deng Xiaoping has run its course. After several decades of strong growth – in a sense, an almost inevitable period of adjustment after long-lasting economic delay – maintaining double-digit growth rates is becoming unsustainable.

The saturation of the Chinese model of growth is the result of a number of factors. Growth was financed by an accumulation of debt that has accelerated over the last few years. While Chinese national debt, at around 55% of GDP, is lower than in most Western economies, the rise in Chinese private debt is of major concern. China's total debt has risen from 160% of GDP at the end of 2007 to reach 290% in 2015.[3]

Political desire to increase national industrial capacity, and particularly to provide jobs to rural populations moving to the cities, has led to an increase in industrial investment. This increase has outpaced business opportunities offered by the domestic economy, at the same time as market opportunities abroad have been slowing up. In 2014, Chinese industrial investment again reached the exceptional level of 45% of GDP.[4] Meanwhile, China has been losing international competitiveness, thanks to a rise in salaries that is considerably higher than its gains in productivity.[5]

The difficulties facing the Chinese economy are also compounded by a demographic shift: a young, rural population has become an ageing and urban one within the space of two decades, partly as a consequence of the one-child policy launched by Mao Zedong. According to the United Nations, although the Chinese population will increase by 40m by 2030, its working-age population will begin to decrease from 2016, contracting by 10% over the next 15 years.[6] Based on these statistics, China will have a similar demographic profile to Japan, a country that has been mired in economic stagnation for a quarter of a century. The Chinese population is likely to become 'old before it is rich'.[7]

Financial modernisation

Although China holds the highest foreign-exchange reserve assets in the world, at more than $3 trillion, and is the leading owner of US treasury bonds, with approximately 10% of America's federal-government debt, China's financial markets and system lag behind those of industrialised nations.[8] This constitutes a major disadvantage for its economic development and geopolitical aspirations.

The Chinese currency, the renminbi (RMB), represents only 1% of world foreign-exchange reserves; the dollar and euro represent, respectively, 64% and 2%.[9] In 2014, among the 188 member states of the IMF, only 38 held Chinese foreign-exchange reserves.[10]

Recent initiatives by the Chinese government show that they understand the problem. The inclusion of the RMB in the basket that makes up the

IMF's Special Drawing Rights constitutes official recognition of the future role that the Chinese currency is called to play in the international financial arena.[11] Though the RMB is in front of the British pound and the Japanese yen, with a weight of 10.92% in the IMF's basket (versus 30.93% and 41.73% for the euro and the dollar), the symbolism of its inclusion is greater than its practical importance: the automatic purchases of RMB resulting from the announcement, worth some $30 billion, represent a small fraction of daily commercial and financial transactions.[12]

For China, acquiring financial-superpower status is all the more important given that the methods of financing that the global economy has used for the last quarter-century are undergoing major changes. Since the 1990s, the West has bought products from China in massive volumes, creating a substantial trade surplus for the country. For two decades, to maintain the undervalued RMB required for its exports, China increased the volume of its currency reserves. These were recycled by purchasing Western government bonds, in particular US Treasury bonds. China's commercial strategy was accompanied by the financial recycling of its surpluses in the West. For 25 years, global growth accelerated according to the interests of two great powers: China found markets for its production, while the United States bought on credit.

This circular pattern came to a halt with the double shock of the American recession of 2008 and the increase in the costs of Chinese production. 2014 saw a notable dip: not only did China's exports contract by 0.7 points as a percentage of GDP to 22.6%,[13] but the flight of capital from China increased by $500bn year on year,[14] leading to a fall in foreign-exchange reserve assets held by the Bank of China from $4 trillion at the end of 2014 to $3.3 trillion at the end of 2015,[15] and a lower recycling of Western financial assets, to the benefit of direct investment in foreign economies (both emerging and developed countries).

The extension of China's ageing demographics and its rise in production costs will result in a reduction of China's trade surplus and the emergence and deepening of a trade deficit. One only has to look at what has occurred in Japan over the last three decades to realise that such a trajectory is probable, and perhaps even inevitable. To prevent it, the ultimate – and ambitious

– financial objective for China is to have the RMB become an international reserve currency in order to attract foreign capital, in an excessive trade-deficit situation, while avoiding too high a rise in interest rates.

In doing so, the Chinese government faces two major issues: it must manage, in the short and medium terms, the parity of its currency without unleashing devastating disturbances in national and international markets; and it must develop China's financial-market infrastructure without undermining the political leadership of the Chinese Communist Party.

To maintain parity of the RMB, the Chinese authorities have three options: continue to maintain stability, allow market forces to self-regulate, or manage a moderate and regular depreciation of the RMB. The Chinese government prefers, and has tried, option one, and fears option two. It will nevertheless decide to apply option three. The implementation of the first option was short-lived: the adoption at the end of 2015 of a basket of foreign currencies to replace the pegging of the RMB to the dollar proved to be an elegant way for the Chinese authorities and for the IMF to respect China's official commitment to monetary stability. But this decision did not convince international investors about the sustainability of the Chinese government's intentions: indeed, the tendency of the RMB to depreciate continued apace.

The Chinese authorities have three options

The second option, which will ultimately be necessary for the RMB to acquire the status of an international currency reserve, obliges China to comply with two conditions that it is currently unable to meet: the total convertibility of its currency, and the opening of fully developed financial markets. Floating the RMB would involve getting rid of capital control and not using currency-exchange reserves to manage currency parity. These conditions are not acceptable to the Chinese authorities, because they mean accepting the flight of huge quantities of capital from China and increased volatility for domestic savings. This is incompatible with a Chinese financial system that is insufficiently developed and robust. The tremors caused by such a liberalisation of capital flow could destabilise the economic and financial fundamentals of the country. The Chinese currency would fall dramatically, with damaging external consequences – probably triggering a global currency war, starting with emerging Asian currencies and spreading to the yen and Western currencies, and destabilising global stock markets – as well as internal consequences. Admittedly, a depreciation of the currency would lead to an almost immediate restoration of cost-competitiveness and a relaunch of exports. But it would contradict the government's other objectives, in particular by reducing household purchasing power at a time when priority has been given to consumer spending over investment. It would also dissuade industrial innovation at a time when the state is seeking to modernise its firms and incite both public and private firms to raise the quality of their industrial specialisations. Finally, it would accelerate the flight of capital, making the RMB less attractive as an international currency reserve.

The third option is optimal for the Chinese authorities: favourable for foreign trade, it allows the government to keep the economy afloat by compensating for any negative effects of industrial restructuring on GDP growth. Yet, against a backdrop of continuing capital flight, the exercise looks decidedly risky. Any intention to moderately and progressively devalue a currency is quickly detected by investors, and provokes them to sell. This can lead the government to intervene in an authoritarian way to avoid a more brutal devaluation.

The Chinese government will have to walk a tightrope, keeping to its policy of progressive structural reform while attempting to soften any short-term negative consequences for GDP growth with a slight depreciation of the currency. This option is realistic given the extent of the Central Bank's currency reserves and the government-administered nature of Chinese financial markets (and capital control in particular). The pace of depletion of official reserves between the middle of 2014 and the end of 2015 suggested that the process of using up the available currency reserves would take seven years, with $3.3 trillion-worth of reserves registered at the end of 2015. The sell-off recorded in December 2015, of $110bn, in a period of wariness and economic crisis, implied a grace period of less than three years. These timelines are nevertheless sufficiently long to enable the Chinese authorities to convince investors of their willingness to see through the structural reforms necessary for the liberalisation of China's financial markets, and that China's financial resources are sufficient to allow Xi Jinping to stay the course. Any destabilisation of his personal power or that of the Communist Party, however, would cross a red line, and put an end to the programme of reforms.

Should the reforms succeed, China's economic rebalance will have consequences for the global economy. Increased domestic consumer spending and reduced internal industrial investment are required to sustain China's economic development. In this transition phase, the natural slowing down of Chinese growth rates will have the long-term effect of exerting less pressure on the cost of raw materials. This will prove positive for the rest of the world, except for the producers of raw materials, which will lose the benefits of their pricing power. The redirection of Chinese savings in mostly Western financial assets towards domestic consumption and towards real assets (infrastructure in particular) will, in time, be favourable for global economic growth. All things being equal, China's rebalance will gradually exert upward pressure on Western interest rates, obliging governments to undertake reforms aimed at freeing themselves from the hold of Chinese savings. Should the reforms fail, we will see a weakening of China on the global economic stage, bringing a contraction of the global economy and international trade, increased volatility in global financial markets and tensions in international political relations.

One Belt, One Road

Transforming the Chinese financial system, needed to free the country from levels of debt that are unsustainable in the long term, is the first major challenge facing the country's authorities. Resolving China's industrial overcapacity is the second. This part of China's strategic transformation is based on One Belt, One Road, a project of vast financial and geographic scale, aimed at opening, or reopening, trade routes on land and sea from Shanghai to Venice, crossing the Eurasian continent and opening up to trade the territories it passes through.

Sixty-four countries are directly concerned by works that cover the entire Eurasian zone, involving the construction of three major land-based economic corridors (China–Pakistan, China–Mongolia–Russia, China–Central Asia–Western Asia) and the navigation of sea routes, together called the 'Twenty-First Century Maritime Silk Road', including the Indian Ocean, the Red Sea, the Persian Gulf, the Suez Canal and the Mediterranean Sea. According to Chinese statements, the OBOR project will affect up to 4.4bn people, or two-thirds of the world's population. The number of projects launched, nearly 900, and the planned funding, approaching $900bn, amount to a project in the medium and long term with the potential to redraw the economic geography of the coming century.[16]

OBOR is driven by a three-pronged ambition: economic, domestic and geopolitical. Its primary motivation is economic. The OBOR initiative should enable the Chinese economy to surpass its current limits by providing access to new markets for its industry. By exporting its infrastructures, China will absorb the excess production generated at home, widening and broadening the demand for its production. By developing new markets in certain Eurasian regions, China is also focusing on securing its supplies of natural resources. This is of major strategic importance for a country that imports three-quarters of its oil, and constitutes a key comparative advantage over regional rival India. In this way, China is set to represent 60% of global petroleum demand by 2030.[17] There is also a financial dimension, as the initiative will allow China to raise national and international capital that will promote the use and development of the RMB as a currency for funding and transactions. OBOR will contribute to the RMB's international currency-reserve status.

China is securing natural resources

The OBOR project also responds to matters of internal politics. It should enable China to successfully meet the challenge of developing its own national territory. By developing the inland regions of China and its hinterland, which lag behind the eastern coast and have insufficient infrastructure, the Chinese government is launching a welcome initiative aimed at rebalancing the domestic economy, and reducing regional political divisions. The historic reference to the Silk Road, moreover, is a major advantage for a political regime that seeks not only to raise the international image of the country but, above all, to unify the people behind a common project of exceptional ambition. OBOR aims to replicate, on a Eurasian continental scale, the domestic success of Chinese state capitalism over the last 25 years.

The geopolitical import of OBOR has drawn comparisons to the Marshall Plan, launched by the United States after the Second World War. In fact, by the numbers, OBOR is even more ambitious. The expenditure planned by the Chinese government amounts to almost four times that spent by the US between 1947 and 1952 in 23 European countries in real terms.[18] By building infrastructures across Asia, China will promote the economic integration of the countries involved, in a market economy for which China has set the agenda and established the framework. Its geopolitical influence derives from the fact that not only its design, but also its financing and construction will be mainly Chinese.

OBOR's maritime dimension is equally strategic. The Chinese navy, a historic weak point of Chinese power since the fifteenth century, will be in a position to benefit from the commercial and military use of sea routes following not only the Indian and Asian coastlines, but also the coastlines of the Middle East, Africa and Europe. For the first time since the expeditions of Admiral Zheng He in 1433, the Chinese fleet will be able to navigate frequently and in huge numbers outside its territorial waters. This will be a large step for a navy currently incapable of opposing its Japanese and American counterparts, including in waters claimed by the Chinese government.

Whether on land or at sea, OBOR will incite reactions from regional and international powers. The economic domination of a zone that includes Azerbaijan, Turkey and Iran – whose geographical positions are key to gaining access to certain regions, or blocking access to natural resources – is a major strategic issue. China will be establishing direct access to energy resources in a zone that is rich in oil, gas and mineral ores. The positions of the other actors will be driven according to their interests and priorities.

The United States' perception of China's growing power in this region, and especially the emergence of a coalition, even if only economic, between China, Russia and Iran, may lead it towards a response of containment. An American move to reinforce alliances, both economic and political, with regional or local powers, such as Kazakhstan and Azerbaijan, is likely.

Russia's position will probably be more ambiguous, best described as either 'if you can't beat them, join them', or 'make the most of a bad situation'. Russia may see an interest in creating a partnership with China to avoid seeing its influence decrease further in Central Asia. This would involve a sharing of influence in the Eurasian zone: economic influence for China and military influence for Russia. The credibility of such a partnership will be based more on China's willingness than that of Russia – a country that today does not have the resources to thwart, in economic terms, the Chinese project.

The two regional powers, Turkey and Iran, are both motivated by considerations that do not fundamentally conflict with China's plans. Turkey sees itself as the potential leader of the Turkish-speaking peoples of Central Asia, while Iran seeks to revitalise Islam there. These two elements – ethnic and religious – are not in immediate, frontal opposition to Chinese ambition. Constructive economic relations are therefore possible between both of these countries and China.

Japan and South Korea appear to be the potential 'losers' in the OBOR project. Japanese interests will be affected by the preferential financing offered by Chinese organisations able to call on greater reserves. Within the framework of the OBOR project, the sources of financing are in and of themselves of strategic importance for the choice of industrial operators, as the lender has the power to influence the providers' 'selection'. The establishment of the Asian Infrastructure Investment Bank in June 2015 is the most obvious example of a new type of competition in a world that, for the entire length of the twentieth century, was dominated by Western countries and led by the United States. For South Korea, the main impact of OBOR is likely to be the emergence of rival Chinese firms in Central Asian markets where Korean companies have a long-standing market position due to the presence of a sizeable Korean diaspora – 183,140 people in Uzbekistan, 103,315 in Kazakhstan and 107,051 in Russia.[19]

The two powers so far absent from the OBOR project are India and the European Union. While the regional rivalry between India and China is clearly an obstacle for New Delhi's participation, it seems difficult to imagine that India will remain forever passive. The construction of a Pakistan–China corridor will be construed as a full-spectrum reinforcement of India's main strategic and political enemy. The maritime component will be seen by India, and by the United States, as an attempt to break the 'string of pearls' approach that is frequently denounced by Beijing. The pipeline projects TAPI (Turkmenistan–Afghanistan–Pakistan–India) and MEIDP (Middle East to India Deepwater Pipeline), aimed at transporting gas from Central Asia and the Middle East to India, are initiatives established to secure Indian energy supplies independently of OBOR.

Though European geopolitical presence in Central Asia faded out over the second part of the twentieth century, the European Union is likely to take advantage of the project by prioritising an economic approach to OBOR. The industrial and commercial market opportunities represent significant opportunities for European companies in a wide range of sectors where they excel, including infrastructure, urbanisation, health and consumer goods. Europe must position itself to avoid being excluded from the most ambitious geo-economic project of the early twenty-first century.

* * *

China is entering a new phase of its recent history. After 25 years which, in hindsight, look like what the French would call a 'long, quiet river', the period that is now beginning will be far more animated. China's domestic economic model must change, as must its financial system. China will attempt to contain its geopolitical rivalry with the United States; the main risk resides in the internal instability that the implementation of China's domestic reforms could cause.

The RMB has a long way to go to be recognised as an international reserve currency, given the under-development of Chinese domestic financial markets, as well as state controls on capital flows which preclude efficient assets financing. The main challenge to OBOR is developing the managerial capacity for such an ambitious programme, both locally in China and in the countries to which it will be deployed. Technical and operational considerations will represent real obstacles.

China must think and act with a long-term perspective – at a minimum, a few decades ahead – as its current trade surplus dwindles. Confronted with popular discontent over rising inequality and environmental pollution, the greatest threat to the Chinese authorities would be the questioning of the country's communist leadership. Any perception that Xi Jinping's personal authority, or that of the Communist Party, is being destabilised will be a red line crossed, and a potentially fatal sign for these reforms.

If Xi's project fails, we can expect an economic and geopolitical Chinese withdrawal, something that would be extremely dangerous both for China and for the rest of the world. International trade and world GDP would contract, the volatility of financial markets would increase and international relations would become tense. It would mark the end of the last quarter-century of globalisation. The result would be a new cycle, probably characterised by less international cooperation and global economic benefit than its predecessor.

Notes

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