PERSPECTIVE

China: Building Roads to the Future

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Mark Mobius
Executive Chairman
Templeton Emerging Markets Group

China is forging new global connections and expanding trade and market access in many ways. The country does seem to be opening its capital markets and working to become more transparent. We have seen the success of stock linkages between mainland China and Hong Kong, and recently, a new bond market connection has been announced. I think index-provider MSCI's recent announcement to include large Chinese mainland shares in its Emerging Markets Index[1] beginning next year represents an important vote of confidence and a recognition that China's growth and capital market size must be taken into account by global investors.

China's ancient "Silk Road" trade route is thought to be traced back to the Han Dynasty more than 2,000 years ago. The importance of silk trading to the region inspired the name of this network connecting land and sea trade routes linking China, Central Asia, the Arab world and stretching into the African and European continents.

In 2013, Chinese President Xi Jingping formally announced plans for a modern system of networks including railroads, ports, pipelines and even electronic information highways. The "One-Belt One-Road" (OBOR) initiative aims to transform economic and diplomatic interests in the region, taking shape in the form of investments in the various countries the program encompasses.

In 2014, China established a special, multi-billion-dollar fund to finance a variety of infrastructure projects along the OBOR routes, creating new economic corridors. The initiative is thought to be perhaps the largest of its type initiated by just one country. The OBOR currently spans more than 60 countries.

The sea-route part of the program includes ports along China's coast, Hanoi in Vietnam, Kuala Lumpur in Malaysia, Jakarta in Indonesia, Kolkata in India, Colombo in Sri Lanka, Nairobi in Kenya and Athens in Greece, where the Chinese have acquired the port of Piraeus.

One indication that the Chinese are putting words into action was demonstrated to me when I recently visited Sri Lanka. Right on the Colombo waterfront was a spanking new giant container port the Chinese had built, capable of handling the world's largest container vessels.

A land-route portion of the project will start in Xian and Urumqi in the West of China, then travel through Kazakhstan and Uzbekistan and Tajikistan in Central Asia, then Tehran in Iran, Ankara in Turkey, Moscow in Russia and Rotterdam in the Netherlands. Of course, a number of other countries such as Pakistan and Georgia will likely be impacted as trade and energy cooperation expands throughout various areas in the region.

In mid-May of this year, the Chinese hosted a high-level OBOR summit. A number of new investments were announced at the summit, augmenting what already has taken place since 2013 when the OBOR was launched. At the summit, China pledged more than $100 billion in new investments.

Officials also announced that Chinese companies had built 56 economic cooperation zones in more 20 countries. The Chinese are emphasizing investments in the South Caucasus and in Central Asia, as those areas represent a strategic link between China and Europe. Agreements made with Uzbekistan represent just one example of the substantial impact of Chinese investments. The two countries have made numerous, multi-billion-dollar agreements including energy infrastructure and a gas supply contract to China.

Transport corridors connect a railway system spanning China, Kyrgyzstan, Uzbekistan and Afghanistan, and also connect to seaports in Pakistan and Iran. At the conference underlining the importance of the Caucasus countries, China also signed a free-trade agreement with Georgia. One attraction of Georgia is the Association Agreement Georgia has with the European Union (EU). Chinese joint ventures in Georgia would thus be eligible for preferential treatment of its products within the EU markets.

In my view, the OBOR program will likely benefit many Chinese companies, but has widespread implications for other countries in the region and beyond. While some countries in Asia are likely to see the biggest initial impact, eventually I also see Africa as a key beneficiary. Even though African countries are not in the direct path of the “One Road” they will be included in the sea “One Belt” projects with various infrastructure improvements already underway. Countries in Europe could also benefit once the program is completed and new trade and investment linkages expand.

While China has established this program to bolster its economic position and power, I think the Chinese are going to be careful to not unduly favor Chinese companies involved in various OBOR projects. The bottom line is that clearly, China wants more global trade and many countries and companies involved in these efforts will benefit. Of course, others may not benefit at all, which emphasizes the importance of being highly selective as an investor in these markets.

A Note on China and Finance

While some observers see the OBOR program as likely to benefit China and many other countries in a number of ways, there are also some risks. China has put a consortium of banks and funds together to help finance OBOR-related projects but many investors remain concerned about the state of China’s financial system.

China does face domestic challenges as it continues to transition its economy away from an export-focused model. China’s pace of growth has been slowing a bit in recent years and concerns about overcapacity in certain sectors has sprung up.

In particular there has been considerable concern about so-called “shadow banking” in China, which refers to financial transactions outside the formal system that lack a strong safety net. This may be one of the reasons why a major ratings agency recently downgraded China, even though the country still maintains an investment-grade rating.

There are signs the Chinese government is moving to clean up some of the excesses in the financial sector, particularly in regard to sales of wealth-management products—a key component of shadow banking.

In June, Chinese authorities ordered banks to suspend business dealings with a Chinese holding company that had a variety of financial services subsidiaries. It was announced that the company’s head was “temporarily unable to fulfill his role for personal reasons.” Apparently the government’s concern related to sales of high-yield financial products to clients in order to fuel real estate and banking assets overseas.

Recently I was in New York and I noticed that the famous Waldorf-Astoria hotel was closed and boarded up. In 2015 it was purchased by the same large Chinese holding company mentioned above. The announced plan was to convert part of the hotel into condominiums, something that fans of the iconic art-deco designed hotel were unhappy about.

The acquisition created a lot of attention and probably raised eyebrows in Beijing. Authorities have been aiming to stem the outflow of foreign exchange to prevent a weakening of China’s currency. Once the renminbi is stable and confidence in the domestic market has risen, I think it will be easier for the authorities to continue with their long-term financial reforms.

With the upcoming 19th Communist Party Congress this autumn, I think it will be important for President Xi to seek to ensure financial stability and to demonstrate that he is capable of presiding over a stable financial system so that China's stock and bond markets will attract more support for the OBOR program.

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1. Indexes are unmanaged and one cannot invest in them. They do not include fees, expenses or sales charges.