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Implications of China's Policies for U.S. Interests

China's leaders describe the economic challenge of these times as maintaining stable progress toward prosperity while transitioning from emphasis on growth *quantity* to growth *quality.* As a high-level mission statement this is reasonable and well-matched to China's state of development and future potential. China's per capita GDP in 2019 was still only $10,300, just above Argentina, Mexico, and Bulgaria. Further growth is essential to China's stability and success as a nation, at home and abroad, and to the Communist Party of China's very legitimacy. It is also entirely possible – provided China can realize its potential.

But demonstrable difficulties behind the veneer of unvarying success necessitate asking what economic challenges China's policymakers will face over the next five years, and, importantly, how those will affect U.S. interests.

In the simplest accounting, all economies have three avenues of growth: growing or improving the labor force (demographics); amassing more resources into productive assets (capital stock deepening); and getting more out of the same labor and capital by being smarter, less wasteful, more technologically advanced, and otherwise more productive. This third wellspring of growth – which economists call *total factor productivity* – was the core of China's post-1978 success. The story of "reform and opening" was foremost about letting markets guide more productive use of labor and capital to produce value. This was not easy. The sheer backwardness of the Chinese economy by the end of the Mao era meant that China could achieve meteoric growth, but only with difficult political reforms and exposure to foreign forces and ideas: the world had progressed while China devolved into ideological discord pre-1978.

Boldness in accepting that exposure and tackling those reforms propelled the People's Republic for several decades, but past market moves are not enough to sustain growth forever. In the 1980s and 1990s, favorable demographics and market-oriented reforms brought millions of workers out of the countryside to work more productively in cities. But the working-age population peaked in 2014 and China's population will likely begin to decrease outright by 2030. China has also underinvested in health and education for its more than 750 million non-urban citizens.

China's capital stock grew at an impressive 11% per year from 2010 to 2017, compared to just over 1% for the US. But the important question is whether there is much return on that vast investment. The answer is that it takes almost 9 renminbi of new credit to drive 1 renminbi of GDP growth today, almost three times the amount needed in the decade before Xi Jinping took office.

With hardwired demographic shrinkage and hurricane headwinds to even more debt-driven growth, a boom in productivity is the only way China will reach high-income status. However, China's performance in that column is trending in the wrong direction, contributing only 0.6 percentage points to average GDP growth from 2014-2018, compared to 2.1 percentage points in the five years prior.

The Xi era began with a reasonably bold plan to address these economic challenges. But implementation proved too scary to manage, and when reform moves caused temporary economic stress and instability, they were kicked down the road rather than risked. Capital account opening was suspended, interbank market cleanup was turned on then off, state enterprise corporate governance reforms were reversed… the list goes on. Unable to push through reform plans without triggering intolerable instability, Beijing is falling back on statist solutions, sending in officials to determine market outcomes. This was evident five years ago in "supply side structural reform" of heavy industries; and it is clear today in the blitz of re-regulation of high-tech industries and leading private firms including Alibaba. While politically expedient for now, reverting to a state-led playbook disregards the lessons of the past about implications for China future, and implications for other nations.

The United States must property understand these implications, even while it prioritizes shoring up domestic foundations.

The first implication is that China cannot negotiate on structural matters if it does not resolve its internal barriers to marketization. Without market-driven productivity, Beijing will need to keep an iron grip on the system to keep it from faltering, and private and foreign interests will be disadvantaged. If in turn Washington and Beijing cannot negotiate progressive economic arrangements, or if US allies settle for promises that cannot be fulfilled, strife will ensue (as it has). If China is unable to build a market system at home, it will prefer to change market systems abroad so as not to be offsides. This was one thing when China accounted for only a few percent of the global economy decades ago. Today, China is 16% of the global economy, and provides 30% of marginal global growth, making its choices are of first-order importance.

A second implication that should be borne carefully in mind is that despite its strong 2020 economic performance, China's recovery is brittle, which means that both the global commercial benefits it delivers and first-order security risks it presents should probably be discounted. China is a hugely important source of revenue for US firms and their competitors from like-minded nations, as well as commodity and raw material exporters in the developing world. But major segments of the Chinese growth equation – such as the property sector – are likely to be sidelined in the near future. Meanwhile, security analysts in the US and elsewhere often presume Beijing's breathless 2035 growth targets should be taken at face value. This is not the case.

<u>China's Attraction as Development Partner</u>

China's demand for foreign products, inbound and outbound commercial investment (FDI), its outward-facing development assistance, and deft diplomacy all play a role in making it attractive to others as a partner. So does the relative withdrawal of US foreign policy vision, money, firms, and ideals in recent years, unfortunately.

However, before considering priorities for reasserting American leadership in international development, it is important to right-size China in the international development context. China's domestic economic challenges effect its outlook as a development partner in at least three ways.

First, China has dramatically scaled-back its outbound lending activity in recent years, in large part due to economic constraints. Project data from the China Africa Research Initiative at SAIS shows that Chinese lending to Africa fell from over $29 billion in 2016 to under $9 billion in 2018. Amid pressure to clean up the financial system after doubling in size *twice* since the Global Financial Crisis, Chinese banks have been

forced to move considerable "shadow debt" back onto their balance sheets, leaving them with less room to make new loans.

Second, just as importantly, Beijing is realizing that its poor return on investment at home is an even bigger nightmare abroad. Often, loans are made out to countries with weak economic fundamentals or are put toward unsustainable projects. As a result, up to one-quarter of China's overseas lending has come under renegotiation as debtor countries have found themselves unable to repay their loans on their original terms. Although debt renegotiations have in a few instances resulted in debt-to-equity swaps (such as the Hambantota port) that are hallmarks of debt-trap diplomacy, most renegotiations end in deferrals or debt rescheduling, leaving banks with increasingly unsustainable balance sheets. The pile-up of bad projects has caused developing countries to rethink the risks of working with China as a development partner, and also to reassess the costs and benefits of the debt-driven "China model".

Third, as domestic challenges lower China's growth, not only can it lend and grant less abroad, but it also is losing its luster as an export destination. China's economic recovery from COVID-19 has been driven in large part by infrastructure and property, which has been good news for global commodities exporters. However, there are now simply too few profitable infrastructure projects and too few young Chinese to buy much more property. With wage growth trailing far behind overall GDP growth, the outlook for domestic consumption is also questionable. These negative trends will cause China's trade and investment partners to question whether China can be relied upon as a long-term source of demand.

Taken together, these issues mean less Chinese economic leverage abroad. The most important reduction in this leverage is not financial, but in terms of the soft power attraction of China's model. It is in the US interest that China contributes to global development to the maximum of its ability, in a sustainable manner. It is not in the US interest that officials across 100 struggling nations with weak institutions are pulled by the allure of a debt-driven alternative to the hard work of capacity building and physical and human capital formation.

The United States has the ability to bring ideas and values to the development process which – once American political foundations are repaired – will prove enduring and suitable to global prosperity. But we must bring resources and practical solutions too. That means access to our markets and a more proactive use of official financial institutions such as the Export-Import Bank and the Development Finance Corporation to compete with China.

Decoupling Abroad Compels Adjustment in China

Beijing is aware that the international environment is now less welcoming than it was in the past. While the most gratuitous aspects of decoupling policy promulgated in Washington 2017-20 will quickly be reversed, not just the United States but indeed most liberal market economies have decided to be less permissive with China in ways that will endure. In truth China was the initial decoupler, well prior to the Trump years, as it stalled on reforms essential to maintaining engagement. Market economies could choose to be patient with China's policy shortcomings and residual statism as long as China was actively transitioning toward markets. But with assurance of that lost, recalibration is inevitable and necessary, though it need not be bellicose. In a classic self-fulfilling prophecy, this foreign reaction to changing Chinese policy fundamentals is reinforcing Beijing's intention to attain self-sufficiency particularly in critical technologies and supply chains.

The impulse toward self-sufficiency is manifesting in a new economic policy formulation from Beijing called "dual circulation"— roughly explained as making the domestic market the mainstay of the economy

and making international and domestic economic activities reinforce one another. While the details of the plan are still being hashed out, the priorities presented at China's central economic work conference in December are informative: 1) improve national strength in strategic technologies; 2) strengthen control over supply chains; and 3) expand domestic demand. Tellingly, promoting reform and opening ranks only fourth.

The prospect of disengagement also compels Beijing to make improved offers in various negotiations and on many issues to ease tensions and shore up external relations. China's concerted push to complete negotiations on the EU-China Comprehensive Agreement on Investment (CAI) and join RCEP are examples. Pledges to achieve a net-zero carbon emissions target by 2060 can also be read in this light. Many democratic governments appear eager to secure any advantages on offer, even while human rights concerns worsen and campaigns like dual circulation and the "3-5-2" program to expunge foreign technologies make the long-term value of today's trade agreements somewhat dubious.

For the United States, China's inward turn under the dual circulation strategy presents challenges—some new, some old. China is redoubling efforts to achieve technological mastery and control over critical technologies. This is not new, but the scale will require a more strategic approach than the US has taken so far. Washington made reasonable strides on defense, such as the streamlined export control and investment screening framework enabled under the Foreign Investment Risk Review Modernization Act of 2018. This enhanced the toolbox for managing security relevant concerns, while at least in principle leaving room for strategically benign commercial engagement to persist – that is the right mix. However, American security and prosperity rely more on forward-looking dynamism and vision than solely on defense, and many aspects of the recent rush to pull up drawbridges have put that US strength in peril. A new US innovation strategy is essential, and in the offing. But as we step into new realms of industrial policy we previously shunned, great care must be taken not to impair the primary, private sources of innovation. Crucially, a successful US strategy must preserve openness to global trade, investment, ideas, and talent—including, more often than not, from China.

Conclusions and Recommendations

Despite strong headline growth numbers, China faces serious economic headwinds. Unfavorable demographics and diminishing returns on investment mean that only productivity growth can vault China into the ranks of high-income countries. Yet the reforms necessary to make that happen have stalled. The resulting return to statism is not a sustainable growth solution, and it will inevitably take China down a blind alley of divergence from international economic norms.

This naturally invites questions about whether China will instead attempt to reshape the economic order to suit its interests, especially as a development partner to low- and middle-income countries. But while the United States needs to up its game, we should also not overstate China's international economic power, which is constrained by the same systemic challenges we see China's leaders wrestling with at home. While those seem trivial compared to the economic challenges on show elsewhere in the world today, they are not: the magnitude of financial difficulties China is building up in the course of reporting steady progress is epic.

China's reversion to statism has sparked market economy debate over how to manage economic relations with a country falling short of promised reforms. The so-far limited international pushback has already prompted Beijing to turn inward, double-down on self-sufficiency goals, and place its bets on the power

of its large domestic market. China's leaders are working to forestall a financial reckoning at home and the formation of a balancing coalition of market economies abroad.

Taken together, these points suggest two recommendations that might be of use to a new administration:

First, many senior US policy professionals across the functional and ideological spectrum have come to accept the notion that China's economic system is sound and strong and will inexorably rise through the decade ahead. But the evidence recommends an open mind on the question of China's economic prospects. Advocates of new US policy priorities counsel massive changes in budget priorities, bureaucratic assignments, controls over the private sector, attitudes toward allies and other departures all on the premise of an ever-growing China. It is time to critically examine that premise, with better evidence.

Second, and relatedly, a right-sized vision of the Chinese economic juggernaut permits us to be smarter in our great power competition. Not all aspects of our engagement merit consideration of decoupling. Gratuitous separation does not serve the American interest, and it will not lay a laudable foundation for our future conversation with the Chinese people. By correctly diagnosing China as a developing nation clinging to statism because it has not succeeded at liberalizing, we can repair a global narrative that has swung dangerously close to believing that illiberal autocracy offers a better route to prosperity and human happiness than open market democracy. That is an American insight that friends and partners can rally around.