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Key points:

- China's economy is undergoing a cyclical economic downturn driven almost entirely by domestic factors.
- The key drivers of the slowdown are tight financial conditions, thanks to a recent financial de-risking campaign, and weak local government investment.
- That said, China's economy is not on the precipice of an implosion – and domestic policymakers are confident in their ability to manage the economy through a down cycle, as evidenced by their measured policy response.
- So far, US tariffs on China have had little macro impact on the Chinese economy – specific companies, industries, and geographies have been disproportionately affected, but in aggregate the effects have been minimal.
- The longer the trade war drags on, however, negative impacts through trade, sentiment, investment, and technological channels are likely to weigh on China's medium-term growth prospects.
- China is already facing substantial medium-term growth challenges as it undergoes a momentous economic transition toward higher-quality growth – this is in addition to its short-term cyclical slowdown.
- As China's economy matures, economic reform will become ever more important in order to unlock productivity gains that can propel economic growth.
- It is important to understand the nuance within China's reform program – some areas, such as marketization and liberalization of the financial sector, will continue apace; more difficult changes like fiscal reforms will move along gradually; and highly difficult areas like SOE reform will remain largely stalled.
- As part of this process, Chinese policymakers will continue to both develop market forces *and* strengthen the state sector – the economy will remain a hybrid economy for the foreseeable future.
- Chinese authorities increasingly see foreign capital inflows – both through FDI and portfolio investment – as key to improving the domestic market; that reality is underpinning a pragmatic market opening streak.
- A unified Party apparatus will oversee these changes to the economy – in the short term, the CCP is not threatened by slowing economic growth, but in the long term, a split among the Party elite is possible, especially the longer that Xi Jinping holds on to power.

Recommendations for US policymakers, in brief:

1. US policymakers should work under the assumption that China will successfully transition to a high-quality economy. If China fails, then it won't be a genuine long-term economic challenger to the US, but if China is successful and the US is not prepared, the US will be at an economic disadvantage.

2. Rather than designing policy to change or influence CCP behavior, US policymakers must make long-term investments in America's competitiveness. This goes far beyond infrastructure spending and extends to significant investment in the education system and government-assisted research in science and technology. It could also include a robust industrial policy that leverages federal money to encourage private investment into strategic sectors.

3. US policymakers should recognize and acknowledge areas where China is making progress – both in terms of regulatory reform and market access. The financial sector is a good example where China is both opening to foreign companies and increasingly looking to roll out market mechanisms.

4. US policymakers should continue to apply significant pressure on their Chinese counterparts to further pursue market opening. Chinese officials understand that they need foreign capital and that the business community has grown impatient with China's excessive promises but slow follow-through. These dynamics, combined with sustained pressure from other foreign governments, have led to progress in market opening over the past 18 months. That pressure should continue to be applied, albeit in a consistent, strategic manner – with a clear endgame and alongside US allies.

5. Perhaps most concretely, the US Congress should invest time and energy in defining exactly which sectors and business activities *do not* fall under the rubric of America's economic national security; ever expanding definitions of this concept on both sides of the Pacific risk completely undermining the US-China economic relationship; if clear rules around national security can be agreed between the US and China, this could provide the backbone of a new operational framework under which the US and China can continue to do business, while decoupling in areas of clear strategic importance

A domestic slowdown – not an implosion

According to China's official statistics, the country is currently growing at the slowest pace since 1990.[1]

Given the growing tensions in the bilateral relationship between the United States and China, it is highly important for US policymakers to understand the sources of China's current economic weakness, the policy response that Chinese officials have laid out to address these challenges, and the likely impact on

[1] While China's GDP statistics are widely considered to be unreliable, even they show historically low growth

China's stance in trade negotiations with the United States – as wells as the country's broader policy toward the US.

China's current economic slump is overwhelmingly – indeed, almost entirely – due to domestic economic challenges and policy choices. While trade tensions over the past year have had a significant effect on financial markets, individual companies, and specific geographies, in aggregate the direct effect on the Chinese economy has been minimal.

However, as I discuss below, the negative effects of trade tensions are likely to grow over time – especially given the latest broadening of tariffs, set to take place on September 1, 2019.

A policy-induced slowdown

The most important factors driving China's current cyclical slowdown are policy choices that Chinese leaders made in early 2017. In April of that year, financial regulators introduced a policy program to slow the growth of credit – seeking to contain the overly fast accumulation of debt that the country had seen from 2010 to 2016 and to de-risk the financial system, which had experienced significant bouts of volatility in 2013 and 2015.[2]

Beginning in early 2017, financial authorities tightened oversight of banks, insurance companies, and other types of financial institutions. Officials also reduced liquidity in the banking system, which raised the cost of leverage and wholesale financing for banks. These moves were combined with a number of inspection tours by central regulators to examine individual institutions and ensure that the local offices of various regulatory bodies were increasing oversight on the ground.[3]

Over the course of the next 18 months, until mid-2018, authorities also handed out a record number and level of fines to institutions and individuals operating in the financial sector.[4]

These efforts led to significant reduction in the pace of credit growth in China. The growth of bank assets, for example, fell from a high of 16.5% y/y in October 2016 (a few months before the de-risking campaign started) to a low of 6.3% y/y in November 2018 – a dramatic reduction in the pace of growth for such assets (see chart 1).

This deceleration coincided in 2017 and 2018 with the first outright contraction in interbank assets since 2010 (which was the year that China's banking system first started to see explosive growth, as authorities employed the banks to stimulate the economy in reaction to the Global Financial Crisis).[5]

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[2] See relevant regulatory documents from the China Banking and Insurance Regulatory Commission here: http://www.cbirc.gov.cn/cn/list/9102/910201/20.html

[3] 21st Century Business Herald, *银监会彻底封堵监管套利路径 强调防范"处置风险的风险"*, January 16, 2018. http://epaper.21jingji.com/html/2018-01/16/content_78690.htm

[4] 21st Century Business Herald, *银监会拆解"影子银行"等风险： 明确 2018 年重点整治八大领域*, January 9, 2018. http://epaper.21jingji.com/html/2018-01/09/content_78229.htm

[5] Geoff Dyer, Financial Times, *China authorises 'massive' stimulus package,* November 10, 2008. https://www.ft.com/content/6e89710e-ae91-11dd-b621-000077b07658

The extreme tightening over the interbank market was particularly important, as it is a key funding source for banking and non-banking financial institutions. In particular, large SOE banks use the interbank market to provide financing to small- and medium-sized banks and other financial institutions. Lack of oversight of the interbank market over the previous decade had allowed it to foster significant leverage, malfeasance, and speculative investments by financial institutions in China. And given that interbank markets often play a starring role in financial crises – including the Global Financial Crisis[6] – de-risking this space was one of the financial de-risking campaign's top initial priorities.

This sustained tightening of credit conditions – while successful in its initial efforts to de-risk the banking system and broader financial system – ultimately had a significant downward impact on nominal growth of the economy beginning in mid-2018, just as the first 301 tariffs went into place in July 2018 (see chart 2).

In addition, at the same time that central officials were seeking to de-risk the banking system, they also sought to harden budget constraints for local governments. Specifically, regulators increased scrutiny over local government financing vehicles (LFGVs), which have been conduits for off-balance-sheet government spending in recent years.[7] Officials also gave cadres lifetime responsibility for the debt profile of the jurisdictions that they oversee.[8]

These two efforts led to a gradual deceleration in local government investment throughout 2017, followed by an additional dramatic reduction beginning in March 2018 (see chart 3) – just as the negative impact from financial tightening was also kicking in. Local government spending levels have still not recovered, despite a significant increase in local governments' ability to obtain bond financing throughout 2019.

The combination of significant financial tightening and regulatory tightening over local government spending are the two key drivers behind China's current growth challenges. Notably, both of these drivers were intentional, domestic-policy-induced measures. And even more notably, as I discuss in depth below, Chinese policymakers have largely kept these policies in place despite the toll on economic growth and the additional economic uncertainty that has arisen from trade tensions with the United States.

Trade tensions are so far having little direct impact on China's economy

While there was a significant element of intentionality behind the policy mix that led to China's current slowdown, policymakers have been caught off guard by three unforeseen developments:

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[6] Gara Afonso, Anna Kovner, Antoinette Schoar, *What happened to US interbank lending in the financial crisis?,* CEPR Policy Portal, April 26, 2010. https://voxeu.org/article/what-happened-us-interbank-lending-financial-crisis

[7] Bloomberg News, *China's New Crackdown on Regional Debt May Curb Bond Sales,* April 12, 2018. https://www.bloomberg.com/news/articles/2018-04-11/china-s-new-crackdown-on-regional-debt-may-curb-bond-offerings

[8] Xinhua, *习近平：深化金融改革 促进经济和金融良性循环健康发展,* July 15. 2017. http://www.xinhuanet.com//politics/2017-07/15/c_1121324747.htm

1. The intensity with which the financial de-risking campaign, and associated economic slowdown, have disproportionately affected China's private sector
2. The speed and intensity with which the global narrative has turned against China – on both political and economic fronts
3. The longevity and intensity of US-China trade tensions

Each of these factors has worked to unnerve Chinese policymakers, and has largely defined China's evolving policy stance since growth began slowing in mid-2018, as I discuss below. However, despite the fact that the prevailing media narrative around China has focused most intensely on the third factor, factors 1 and 2 above have arguably been more critical in shaping China's policy actions.

Chinese authorities are clearly not thrilled with the fact that their economy is growing at the slowest pace in three decades at the same time that they are locked in tense trade negotiations with their largest trading partner.

However, so far the US tariffs appear to have had little ***direct*** macroeconomic impact on the pace of growth for China's economy – especially in comparison to the highly significant impacts that the domestic slowdown in infrastructure investment and tightening of financial conditions have had.

In fact, for most of 2018, given the tiered nature of tariff imposition by the United States, Chinese exports saw strong growth as US importers sought to front run each new round of impending tariffs (see chart 4).

In 2019, that dynamic has largely gone into reverse, and the value of USD-denominated exports to the United States has fallen. Moreover, we estimate that this reduction has taken about 2 percentage points off of overall USD-denominated Chinese export growth. However, that slowdown has been almost entirely offset in local currency terms, thanks to the weakening exchange rate.

Given that the immediate and direct aggregate impacts from US tariffs have been minimal so far, it is no surprise that near-term economic dynamics have thus far not been a key factor in Chinese leadership's approach to the trade negotiations.

However, that is not to say that the tariffs have had no impact whatsoever. Rather, the immediate impact has primarily been psychological – working to undermine private sector sentiment in China, at a time when it was already ailing (thanks to the highly negative impact of financial tightening on private sector businesses).

The effects on sentiment are likely to increase over time. In addition, bilateral tensions in other, more powerful channels including investment and technological competition will further affect China's economy in the medium term. I discuss each of these channels below.

Trade

The most obvious and direct way that trade tensions should affect China's economy is through weaker export growth to the United States. But while these impacts may be significant for specific companies, from a macro standpoint, the overall impact on China's export position has been minimal so far – and as such, the direct impact on the economy to-date has similarly been quite small.

In US-dollar terms, Chinese exports to the United States contracted by -8% y/y in the first half of 2018, according to Chinese customs data, or -12% y/y according to US data. This compares to Chinese export growth to all other countries of 2.6% y/y in the first half of 2019.

Typically, China's exports to the United States grow at a rate that is very closely in line with overall Chinese exports to other countries, so absent current trade tensions, we could reasonably expect that Chinese exports to the United States would have grown by about 2-3% in H1 this year. We estimate that this 10-14 percentage point negative swing in export growth to the United States reduced overall Chinese export growth by about 2 percentage points – coming in at just 0.6% y/y growth in H1 2019.

All else equal, we estimate that this downward adjustment would have taken about 0.4 percentage points off of China's nominal GDP growth in H1 2029 – lowering it to 8.1% y/y from what would have otherwise been 8.5% y/y.

However, given the adjustment of the USD/CNY exchange rate over the past six months, exporters' overall earnings in local currency (CNY) are virtually unchanged from what they otherwise would have been – further limiting the direct impact to the Chinese economy, in aggregate, from weak exports to the United States.

This is thanks to the fact that a weaker Chinese exchange rate not only helps to offset the US tariffs directly, but also increases Chinese export earnings from non-US trading partners in CNY terms, especially given that much of that trade is denominated in US dollars.

That is not to say that individual companies and specific geographies within China have not felt an effect. As numerous media reports have displayed, any company or geography with significant exposure to the US market in a tariffed sector has experienced significant difficulties.

Moreover, the direct aggregate drag from US tariffs on Chinese exports is likely to start increasing soon, now that tariffs have been raised to 25% on USD 250 billion worth of Chinese exports as of May 2019 – and that another round of tariff increases are currently set to take place in September and October.

Sentiment

The impact of US-China trade tensions on private sector sentiment on the mainland is much more difficult to quantify. Anecdotal evidence suggests that trade tensions are negatively impacting confidence in both China's export sector and the global economy.

Moreover, China's Purchasing Manager's Index (PMI) – a key survey of manufacturing sentiment in China – has shown deepening contraction in its employment sub-component in recent months. The PMI has shown contraction in this area for several years, underscoring the role that ongoing domestic challenges play in the sector's woes. However, the recent intensification of the downtrend evidences an additional souring of sentiment among China's manufacturing sector thanks to US-China economic tensions.

As trade tensions grind on – and especially now that US tariffs are set to continue increasing – the psychological sense of economic malaise is likely to deepen, which should ultimately feed into weaker business investment.

Investment

A critical second-order effect of US tariffs on Chinese exports will be slower business investment due to weaker sales and slumping sentiment. These indirect effects on Chinese growth from US-China trade tensions will take time to manifest – as Chinese businesses will, over time, increasingly operate under the assumption that the trade tensions will persist indefinitely, and they may have permanently lost a key export market.

We have already highlighted the ongoing slump in local government infrastructure investment, which is a key driver of China's current cyclical economic downturn. In addition, growth in Chinese manufacturing investment has also decelerated rapidly – albeit from a high growth rate – since November 2018. This deceleration is thanks in large part to the leveling out of a strong policy-induced increase in manufacturing investment throughout most of 2018. It has likely further been exacerbated by the tightening of domestic financial conditions, especially for the private sector.

However, it is likely that growth of private business investment will continue to further decelerate thanks to prolonged trade tensions between the US and China. Were this to occur, the impact on China's overall economy would be much more significant than the direct impacts that we have so far seen from weakening exports. In my view, such a scenario would likely require a change in tack on both domestic policy and in trade negotiations by Chinese officials.

That being said, if such a scenario plays out for Chinese businesses, it is also likely that private business investment in the United States will similarly deteriorate, which may also change the calculus of US policymakers.

Technology

The channel through which heightened US-China economic tensions could prove the most disruptive over time will be in the technological sphere. Chinese officials, including General Secretary Xi Jinping, have clearly stated their desire for technological self-sufficiency and their desire for China to become a "technological superpower."[9]

While domestic industrial policy is largely geared toward achieving those aims as quickly as possible, authorities are keenly aware that they are reliant on the United States and other countries for the purchase of core technologies – such as semiconductors – and will likely remain reliant on sales of these technologies from foreign countries for at least 5-10 more years.

If Chinese companies were to be immediately cut off from these technologies – through actions such as adding companies like Huawei and ZTE to the Entity List – it would have a significant, potentially

[9] See Xi Jinping's Report at the 19th Party Congress

devastating, direct impact on China's economic performance and longer term ability to continue moving up the value chain.

That being said, it is unclear whether this issue is (or should be) directly tied to the US-China trading relationship, per se. It is also unclear whether the US administration will use this issue as a point of leverage in trade talks with the Chinese – or if it is seen as a separate issue of national security, independent of ongoing trade negotiations.

China's policy response

Despite the evident medium- and long-term threats to Chinese growth from the investment and technological channels outlined above, the immediate macroeconomic policy stance is primarily being dictated by the domestic economic challenges of a slumping private sector (thanks to tight financial conditions for private businesses) and weak growth in local government investment.

Because Chinese officials have rightly diagnosed these issues as the primary short-term challenges to economic growth, officials are taking a unique approach to economic policy support. During previous bouts of growth deceleration, authorities have responded by quickly ramping up monetary and credit growth, to boost investment – primarily in infrastructure and real estate.

In 2019, however, authorities have taken a different tack. They have focused economic support measures on attempts to improve the overall business environment – by cutting various administrative and bureaucratic requirements for businesses, as well as reducing various fees and reducing businesses' required contributions to social security programs. Financial officials have also sought to incentivize banks to prioritize lending to small, private sector businesses. Finally, they have boosted efforts to obtain inbound capital flows via market opening in some key areas.

Authorities have also leaned more heavily on the expansion of fiscal policy, as opposed to monetary or quasi-fiscal expansion through the banking system, which they have employed in past downturns. The goals of these policies have been to support on-balance-sheet spending by local governments – and thereby arrest the slowdown in local government infrastructure spending – while containing overall local government debt, and especially reckless off-balance-sheet spending.

This unique – at least by Chinese standards – policy response is unproven, and has so far been much less effective at reviving economic growth than past policy responses. That is partly by design, since authorities are looking to shore up the economy without giving up hard-won gains on financial de-risking, or materially worsening the country's debt load. However, the ultimate impact of these moves has not yet come to fruition. Tax and fee cuts for businesses, alongside reductions in administrative red tape, will take much longer to translate into stabilized economic growth than the investment and credit-fueled stimulus policy that China has relied on in the past.

What is remarkable about this policy approach, though, is that Chinese officials have shown themselves to be willing to take a chance on an unproven – and likely less effective – set of policy tools even in the midst of heightened uncertainty from US-China trade tensions.

In my view, this underscores Chinese policymakers' confidence in their ability to shepherd the economy through this downturn – and also highlights policymakers' focus on domestic economic dynamics, rather than external factors. Chinese officials' confidence in their economic management ability may well be misplaced. However, the fact that this confidence exists should indicate to US policymakers that China's economic growth is not presently a point of leverage for pushing Chinese officials to acquiesce to US demands.

Structural Challenges to China's Economy

Looking out a bit further, as the US-China economic relationship evolves in the coming years, it is also critical for US policymakers to understand that China is not *only* undergoing a cyclical economic slowdown thanks to policy-induced financial tightening from 2017, but more broadly is in the midst of a profound long-term economic transition that will likely see it settle at a growth rate of around 3-4%, somewhere around 2025[10].

This transition will see the nature of economic growth in China change significantly. It is occurring as the economy matures into middle income status, and is driven by a host of factors that are pushing down rates of investment, producing a demographic drag on the economy, and hindering productivity growth.

I discuss each of the three key inputs into China's economy – and the challenges that they are facing – in the following sections of this testimony.

But the critical point for US policymakers is that China's current cyclical downturn is coming on top of a structural, long-term deceleration in economic growth. This dynamic again underscores that China's economic struggles are by-and-large domestically driven, but it also has implications for the length and severity of China's current and cyclical downturn – as well as longer term implications for China's ability to avoid the middle-income trap.

Year to year, China's economic performance should be seen in the context of cyclical movements around a decelerating trend (see chart 5). Given the developing nature of China's economy, cyclical decelerations are unlikely to result in outright recessions – i.e. actual contractions in the size of the Chinese economy – but they will produce business cycles "with Chinese characteristics."

This means that cyclical downturns, such as the one China is now facing, will be deeper and longer-lasting than previous economic downturns have been – while the cyclical upturns will generally be shallower and shorter-lived. In general, then, while Chinese leaders may be confident in their ability to manage the economy, that does not mean that China is necessarily negotiating with US officials from a place of economic strength – but neither is it on the precipice of a devastating economic implosion.

In a best-case scenario for China, this structural economic transition will end in higher-quality, more sustainable economic growth, but at much lower growth rates than in the past. But whether Chinese

[10] David Hoffman and Andrew Polk, The Conference Board, *The Long Soft Fall in Chinese Growth*, October 2014. https://www.conference-board.org/retrievefile.cfm?filename=KBI-FY15---China-Slowdown---Final-Draftv2.pdf&type=subsite

authorities can successfully shepherd the domestic economy through that transition is still an open question – and one that will not be answered for years to come.

This means that uncertainty around China's future economic performance will only continue to grow in the coming years.

In general, however, my recommendation to US and other western policymakers is to design policy toward China on the assumption that the country will mostly be successful in achieving its economic and business goals.

This is not because I believe in Chinese exceptionalism. However, planning for China to succeed, designing a proactive policy agenda to deal with a successful China, and not having to use it in the event of China's failure is an eventuality that the US can live with.

On the contrary, planning for China to fail, and having no contingency plan in the event that the country successfully navigates the transition to a high-value-add, wealthy economy with commensurate geopolitical clout would be a grave error.

Demographics

Perhaps the most reliable forecast for any element of China's economy is that the population will age rapidly over the next 30 years and the working age population will continue to shrink rapidly, as well. According to projections by the World Bank, China's working age population is likely to contract by over 193,000 people by 2050 – a reduction of almost 20% from its 2019 level.

The Conference Board estimates that this shrinking of the employment pool will detract 0.3 percentage points from Chinese growth, on average, each year for the next 10 years. This means that all of China's growth over the next decade will have to be generated from capital services and productivity improvements. It also means that Chinese officials will increasingly be preoccupied with addressing the needs of a large elderly society.

Taken together, these demographic dynamics only further challenge China's ability to successfully move up the economic ladder over the longer term, not least because one of China's perennial economic advantages – a large, improving, and relatively cheap labor force – will increasingly dissipate.

Investment

Capital investment has been the key driver of growth in China over the past two decades (see chart 6). In particular, infrastructure and property investment were both ramped up significantly as part of the government's stimulus package in response to the Global Financial Crisis of 2008-2009.

From 2007 to 2012, gross capital formation grew by an average of 19% annually – constituting 56% of GDP growth on average in those years. And according to independent measures, such as The Conference Board's alternative GDP series for China, capital deepening accounted for a full 90% of GDP growth over that period.

Such rates of capital growth were clearly unsustainable – having quite obviously led to well-known vulnerabilities in China's economy including high debt levels, property bubbles, white elephant government investment projects, non-performing assets at banks, and ever-lower returns on capital.

Indeed, in recent years overall investment rates have already been pulled back – contributing just 5.5 percentage points to GDP growth on average in 2013-2018, down from 7.8 percentage points in 2007-2012, according The Conference Board (see chart 6).

But despite the fact that investment rates have come down from their peak, the pace of capital formation will continue to "naturally" decelerate in coming years. This is thanks primarily to the constraints that very low investment returns have placed on the banking system and local governments, as well as an enlarged capital base.

Productivity

Of the three fundamental supply-side inputs into any economy, productivity is by far the most important. This is because productivity improvements are the only truly sustainable form of economic expansion. People age and returns on investment naturally diminish, but economic efficiency and innovation can always advance, given the right circumstances.

Unfortunately for China, productivity improvements have been the most challenging aspect of the country's growth story over the past five years (see chart 6). Unleashing productivity improvements – through firm-level innovations, institutional reforms, and increased domestic competition – will be absolutely essential if China is to successfully avoid the middle-income trap.

At present, China's trend rate of productivity growth does not look promising. This weak trend has come to fruition largely because key parts of the economic reform program, such as SOE reform, have stalled in recent years – holding back productivity improvements.

Productivity and economic reform

The intensifying need to boost productivity growth in China – as capital formation slows and the population ages – will only add further urgency for policymakers to pursue economic reforms more aggressively in the coming years, in order to find new sources of economic growth.

If the recent past is any guide, Chinese policymakers will make varying degrees of progress on this front.

By now, it has become apparent to most China watchers that when Chinese officials use the word "reform," they usually do not mean the type of liberalizing and marketizing economic reforms long envisioned by western policymakers and economists.

That being said, policy improvements and moves to create a more stable business environment are likely to move forward in various ways – some of which will be based on market principles, while others are not.

Based on my assessment of recent progress on the "reform" front, I conceptualize likely progress along three separate lines.

The low hanging fruit: In some areas, policymakers understand that increased marketization and opening to foreign players can help to improve domestic industries quickly. The clearest example of this is in the financial sector, where authorities have accelerated market opening measures over the past two years – by raising foreign equity caps, increasing the business scope for foreign players, and granting more operating licenses to foreign companies, among other actions.

In addition to market opening, authorities have also undertaken a sweeping financial de-risking campaign (discussed at the outset of this testimony), and have also worked to steadily improve the central bank's execution of monetary policy to be more in line with the operations and oversight activities undertaken by western central banks.

The reasons that Chinese leaders are comfortable pursuing both liberalizing reform and market opening in this space are three-fold:

- Chinese financial institutions have grown so large that foreign entities simply cannot compete with them in terms of market share
- Chinese financial institutions still do not manage risk well, and competition from foreign firms is expected to help introduce greater discipline and sophistication to domestic industry
- China's increasingly complex economy requires financial institutions to allocate resources in a more efficient way

Given these dynamics, reform and liberalization of the financial sector is likely to continue moving forward fairly rapidly – in a way that aligns with what western policymakers traditionally mean by "reform."

Areas like this, where Chinese policymakers are pursuing reform in line with US preferences, should be acknowledged by US policymakers, as they may act as a point of departure for positive, productive dialogue on economic policy issues.

Sticky issues with steady progress: In many areas, authorities have found reform progress more difficult thanks to entrenched political incentives and/or vested interests, among other reasons. However, a relatively high level of political will to address economic inefficiencies means that progress will continue to move forward, but slowly.

On this score, fiscal reform stands out as an obvious example. In the past two years, central authorities have made concerted efforts to harden local government budget constraints, reduce off-balance-sheet spending, and contain overall local government debt (as discussed at the beginning of this testimony).

These efforts have progressed slowly in large part thanks to the structure of the fiscal system. Because local governments are responsible for 80% of fiscal expenditures but pull in just 50% of fiscal revenues, cutting off their ability to tap into off-balance-sheet financing immediately and completely would run the risk of depressing local spending to a truly detrimental degree.

Meanwhile, undertaking a fundamental remake of the fiscal system will necessarily be a protracted and gradual endeavor – as missteps on this front could have devastating economic consequences. Still, US policymakers should recognize and encourage continued progress on this front – as it should facilitate a rebalancing of the Chinese economy toward more consumer-led growth, which would help to address existing imbalances in the US-China economic relationship.

Punting off the truly hard stuff: The third major bucket of the reform program consists of areas that are seeing little to no progress – with SOE reform perhaps the most glaring example. When it comes to SOE reform, in particular, Chinese authorities are not only moving slowly due to the complex nature of improving state-owned behemoths. They are also moving in the opposite direction that US policymakers would like to see – toward greater state and Party control and intervention, as well as SOE consolidation, which only makes such entities bigger and more aggressive.

These are the areas where US policymakers need to continue not only expressing concern to their Chinese counterparts, but also designing domestic policy that can address the incumbent advantages that Chinese SOEs face due to their connection with the Chinese state.

Geopolitical tensions, short-term downturn, and structural economic challenges converge to influence policy

China's short-term and long-term economic challenges are interacting with current geopolitical dynamics to influence domestic policy decisions – perhaps in some surprising ways.

As I mentioned in the previous section of this testimony, there are some sectors, such as finance, where Chinese policymakers see accelerated market opening as being in their own interests – both to help address domestic economic challenges and as a response to the increased and widespread frustration with Chinese trade and investment practices.

So while the prevailing narrative toward China highlights the political and ideological tightening that is occurring – the reality on the ground is more complex. In my view, the current trade tensions and the slowing economy are giving renewed impetus to regulatory reform and market opening.

The prevailing political narrative is too simplistic

It is undeniably true that China has seen a significant tightening over the information environment under the leadership of Xi Jinping, combined with a sharp ideological shift toward the Party's socialist roots. Moreover, the strength and reach of the Party has been significantly buffeted throughout all aspects of society in recent years – including the business environment.

However, the narrative of China's ideological hardening and the increased strength of the Party – while true – is too simplistic. At the same time that the Party has asserted greater influence over the business environment, policymakers are also showing their pragmatic side – enacting genuine, concrete market opening in some areas (which I have outlined throughout this testimony). This pragmatism is driven both by certain economic realities that policymakers must respond to, as well as a seemingly genuine desire to employ market solutions in economic governance where possible.

Perhaps counterintuitively, in many cases a push for market liberalization is even meant to strengthen the Party apparatus, as these moves are designed to break up vested interests. It is important, therefore, for US policymakers to understand that the on-the-ground picture is complicated – with economic liberalization happening *alongside* political tightening.

Boosting the state-led economy and markets – at the same time

A critical question that analysts and foreign policymakers often attempt to answer when it comes to China is whether the state-led portion of the economy or the private sector is winning out.

The complex reality is that both state-sector entities and market-based private sector forces are being strengthened in China at the same time. Over the past year, for example, authorities have taken great pains to ensure that China's private sector companies – particularly SMEs – gain better access to credit. In fact, this push has been the fundamental driver of economic policy since mid-2018. But even as that push has taken place, central leaders have remained committed to the stated policy of making central SOEs "bigger, stronger, and better."

How do we reconcile these two contradictory developments?

In my view, the most straightforward way to understand these competing dynamics is to listen to how Xi Jinping characterizes his goal for market forces. During his speech at the 19th Party Congress in October 2017, Xi stated:

- *"[We should] Develop an economy with more effective market mechanisms, dynamic micro enterprises, and sound macro regulation."* (emphasis added).

Xi's focus on "effective" market mechanisms – as opposed to "efficient" market mechanisms is telling. It underscores that Chinese policymakers are not only okay with market solutions, but they actually prefer them – at least when market forces can be relied upon to achieve desired outcomes. The goal, therefore, is not necessarily for markets to fully determine how resources should be allocated, but rather to allocate resources effectively within pre-determined parameters.

China fundamentally needs FDI and portfolio inflows

One of the fundamental dynamics pushing Chinese policymakers toward a pragmatic embrace of markets forces – despite the increasing ideological crackdown – is the need to continue seeing inbound capital flows from both FDI and portfolio investment. Policymakers were especially unnerved in the 2015-2016 time period when a combination of domestic financial volatility and a string of high-profile outbound investment deals led to strong capital outflows and significant depreciation pressure on China's currency.

In response, policymakers increased restrictions on outbound flows of capital – both through capital controls in 2016 and tighter restrictions on ODI spending in 2017, culminating in the issuance of a new outbound investment catalogue in August of that year.

Policymakers also moved to incentivize more FDI inflows via accelerated market opening in areas such as finance, autos, and oil and gas in 2018-2019. They also sought to stoke inbound portfolio flows through increased linkages with global financial markets, giving investors more channels to bring capital into the country.

These opening measures are fundamentally driven by China's need to balance its own outbound spending – through programs like the Belt and Road Initiative – with commensurate inbound flows, rather than an overarching desire to open China's market, per se. However, the ultimate effect is still the same, as Chinese policymakers have begun to understand that foreign companies and investors will not continue to bring capital into the mainland unless genuine, concrete market opening measures take place.

Economic growth and the CCP

A key pillar of CCP legitimacy over the past 40 years has been its ability to deliver sustained economic growth that has improved the lives of its citizens. However, as China's population grows richer, citizens are increasingly concerned with quality of life issues – such as quality healthcare, good education, and clean food and water. At the same time, numerous high-profile food safety scandals, as well as widespread environmental degradation threaten to undermine CCP legitimacy.

The CCP leadership is aware of the changing needs of its population, and has consequently been changing its economic development model to one that prizes "quality" over "quantity." This shift was most clearly illustrated at the October 2017 19th Party Congress. At the Congress, the CCP made the historic decision to change the "principal contradiction" facing the party from being between "the ever-growing material and cultural needs of the people and backward social production" to being between "unbalanced and inadequate development and the people's ever-growing needs for a better life."

It is hard to overstate the importance of this shift. For the CCP, addressing the principal contradiction is the fundamental imperative guiding all party action. It is rarely changed, and the change in 2017 was the first in nearly 40 years.

The new principal contradiction signaled clearly to all CCP officials that their focus should no longer be solely on boosting economic growth, but instead on providing more intangible benefits to the populace. This is yet another reason that US policymakers should not overread short-term economic developments as a key point of leverage in trade negotiations with the Chinese.

The CCP is here to stay…at least for the time being

The CCP has widespread support in China. Though public opinion polling data in China is difficult to come by, the limited polling that has been done – including by objective foreign institutions – has painted a picture of strong popular support for the CCP.[11] This polling data is reinforced by my own anecdotal evidence, obtained by living and working in China.

CCP legitimacy has been enhanced over the past 40 years by the Party's ability to deliver consistent economic growth. But the more important source of CCP legitimacy comes from a combination of nationalism and patriotism that sees the CCP as the steward of the nation, working to restore China's historical greatness. This means that, even should China encounter serious economic difficulties, it would not necessarily undermine CCP legitimacy.

Perhaps equally important, the CCP enjoys a high degree of security due to the fact that there are no viable alternatives to CCP rule. Opposition to CCP rule is relatively little, dispersed, and unorganized.

This means that regime stability will likely remain unthreatened unless there is a split within the CCP itself. While there are debates over policy within the party, there is not, at present, any discernible faction or group that credibly opposes Xi Jinping. This may change, however, as Xi's rule progresses.

Xi's decision to change Party succession norms was not supported by many in the Party. And the longer he rules, the more that resentment will grow – particularly if it means that other cadres cannot get promoted.

The bottom line, then, is that short-term economic growth is likely to have little impact on high-level politics in China – which, again, is also why short-term growth impacts have not fundamentally played into China's stance on US-China trade negotiations.

Still, the CCP's medium- to long-term viability will always be in question, thanks to the ever-present possibility of an internal party fissure.

Recommendations

Start with the assumption that China will succeed

When designing policy governing US reaction to China, US policymakers should start from the assumption that their Chinese counterparts will be largely successful in achieving their stated policy goals. It is easy to dismiss sweeping claims from Chinese leadership – like their plan to become a global leader in artificial intelligence by 2030 or to boost connectivity throughout Asia via the Belt and Road Initiative over the next decade plus. However, China has a recent history of beating the economic odds and outperforming the expectations of naysayers.

There are two components to this strategy. First, it is imperative that US congressional leaders invest in understanding Chinese policy priorities – with respect to everything from the macroeconomy, to technological advances, to autos, to the environment. Too often, western policymakers are caught by surprise when it comes to Chinese policy ambitions. China's policymaking apparatus is very rigid – meaning policy goals rarely change quickly – and surprisingly transparent. Policymakers rarely hide their ambitions or intentions.

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[11] Extensive discussion of polling data and regime legitimacy in China can be found in *The Dictator's Dilemma: The Chinese Communist Party's Strategy for Survival* by Bruce Dickson; Oxford University Press, 2016.

Chinese officials may not always be successful in achieving their policy aims, but they do always *attempt* to achieve them. So step one is simply to understand what Chinese policymakers are seeking to achieve. To this end, the more internal China expertise that lawmakers can build, the better. This imperative extends beyond congressional committees that are traditionally focused on foreign affairs or intelligence – as developments in China will increasingly impact global markets in everything from agriculture to technology.

Secondly, US policymakers should not only understand the range of Chinese policy goals, but they must also assume that China will largely be successful in achieving its ends. Starting from this assumption will allow policymakers to be proactive rather than reactive in designing domestic policy in relation to China. For example, understanding China's ambition to improve technology in its agricultural and biopharmaceutical sectors will have a global impact. Congress should think through the implications for American companies in these sectors, were major Chinese competitors to emerge, as is likely.

<u>Focus on your own house</u>

Directly influencing CCP behavior and policy decisions via US policy actions will be highly difficult, especially in the absence of a united global alliance. As such, the most reliable way to adjust to China's economic rise will be to invest in American competitiveness. This means prioritizing investment in the American education system – especially in STEM. While such investment should always be a priority in my view, making these investments now is even more critical than in the past because of the heavy emphasis that China is placing on improving its own education system, especially in the sciences. If America wants to sustain its educational and technological advantage over China, increased investment needs to occur now.

In addition to ensuring that American schools are well resourced and high achieving, Congress should also look to support joint research projects between government and private entities – to develop technologies that will power future innovation. China is providing significant government support to companies that are undertaking R&D in everything from semiconductors, to connected vehicles, to drones, and AI. There is little that the US can do to change this dynamic within China, and as such the US should also look to offer government support to such research. In contrast to China, however, the US should do so using market-based, competitive mechanisms that will ensure technological neutrality and minimize malinvestment.

<u>Look for and acknowledge areas of progress with Chinese officials</u>

As I outlined in my testimony above, over the past two years Chinese officials have genuinely accelerated market opening measures in some sectors. This is due primarily to an assessment among top Chinese officials that more foreign participation will help sectors such as finance, chemicals, and oil and gas to improve domestic competitiveness. However, increased pressure from the US and other foreign governments – as well as the growing frustration from the global business community – has certainly helped.

Given the tense nature of economic relations between the US and China, acknowledgement of China's progress in these areas by US policymakers should be part of the conversation, in order to keep dialogue balanced and productive.

Keep up the pressure – but calibrate it better

As I mentioned above, while it is not the only factor driving market opening in China, increased US pressure is working to a certain extent, in that market opening has been accelerated in some key sectors. Increased pressure from other foreign governments, including the EU, and global business leaders has also helped Chinese policymakers realize the extent of global frustration with some of their anti-competitive behaviors.

At present, however, America's ultimate goals in the trade negotiations are unclear. President Trump has cited his desire to lower the trade deficit, other administration officials have focused on economic decoupling, while congressional and business leaders have focused on improved market access for American companies. Congressional leaders should look to articulate what, exactly, an optimal outcome would look like, and press the administration to clarify its goals. This clarification would also likely allow US trading partners to show support for US actions, and a more unified global front would boost pressure on Chinese leaders to respond productively.

Define economic national security more concretely

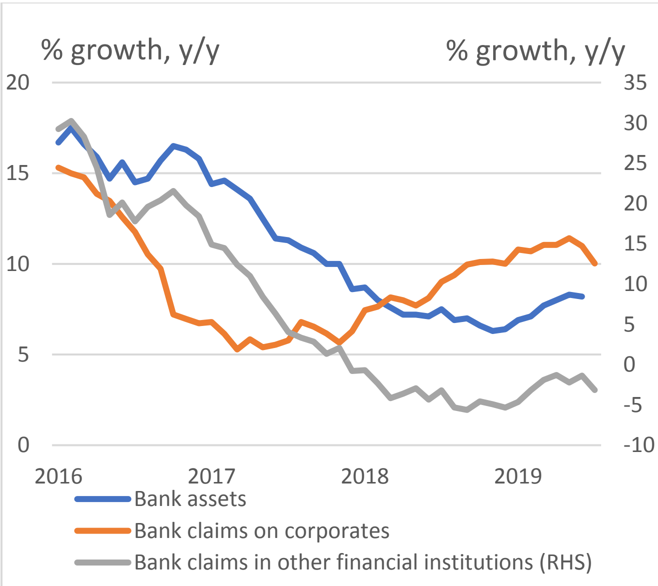
In recent years, Congress has taken a proactive role in defining the bounds of US economic national security, particularly when it comes to Chinese investment in the United States. In particular, the Foreign Investment Risk Review Modernization Act of 2018 (FIRRMA) took positive steps to reform the CFIUS review process – making the process more flexible, especially with regard to Chinese investment.

These actions will help to make the national security review and inspection process more robust, especially when it comes to potentially sensitive investment by state-linked Chinese companies. That said, given that economic tensions between the US and China are likely to continue increasing, Congress should also consider laying out in detail the sectors where national security is *not* a concern.

Officials in both the US and China have outlined an enlarged concept of economic national security in recent years. And at times officials in both countries have gone so far as to indicate that essentially all parts of the economy should be viewed under the rubric of national security. If these definitions continue to expand and morph as competition between the US and China further increases, then the two countries' ability to do business of any kind with each other will be severely hampered.

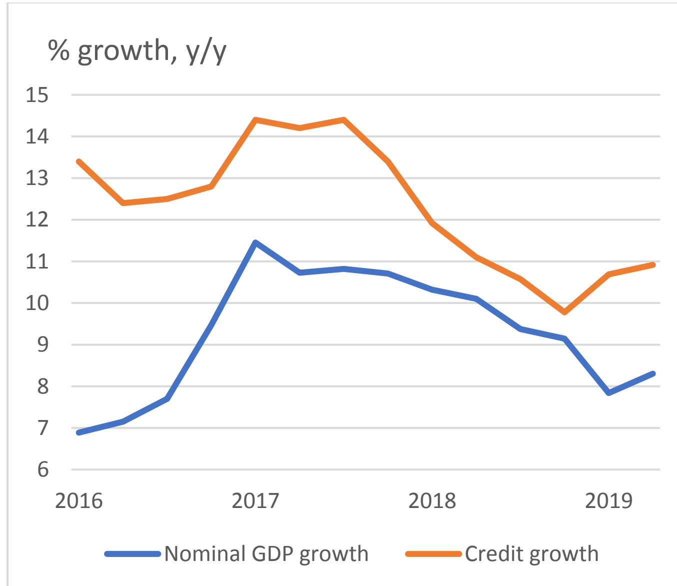
To combat this eventuality, Congress should carefully consider which sectors, industries, and businesses should not be considered as critical to the country's national security, so that private Chinese companies can have a clear roadmap as to what is possible in terms of investing in the United States. Ideally, US policymakers could eventually consult with their Chinese counterparts to agree on a mutually acceptable set of industries that should be open to cross-investment. Of course, both counties will need to retain flexibility to apply national security restrictions due to unforeseen circumstances. But greater clarity and certainty in parts of the US-China business relationship would be a positive development.

Chart 1



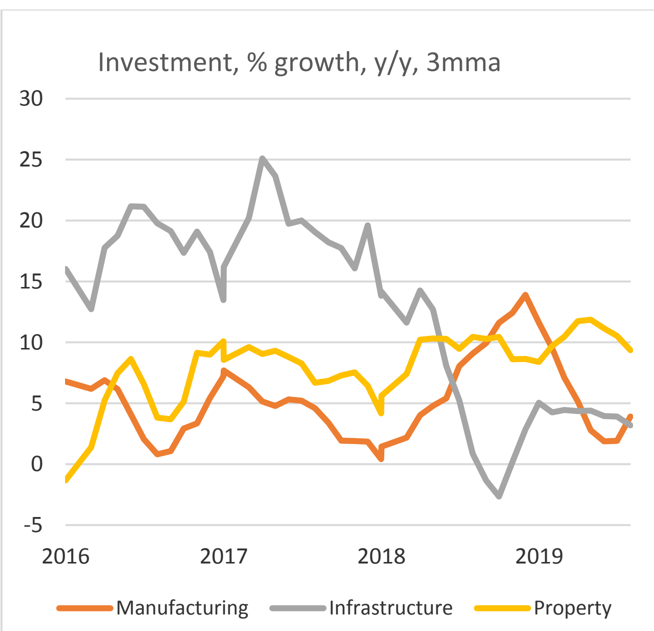
Source: PBoC, WIND Information, Trivium China

Chart 2



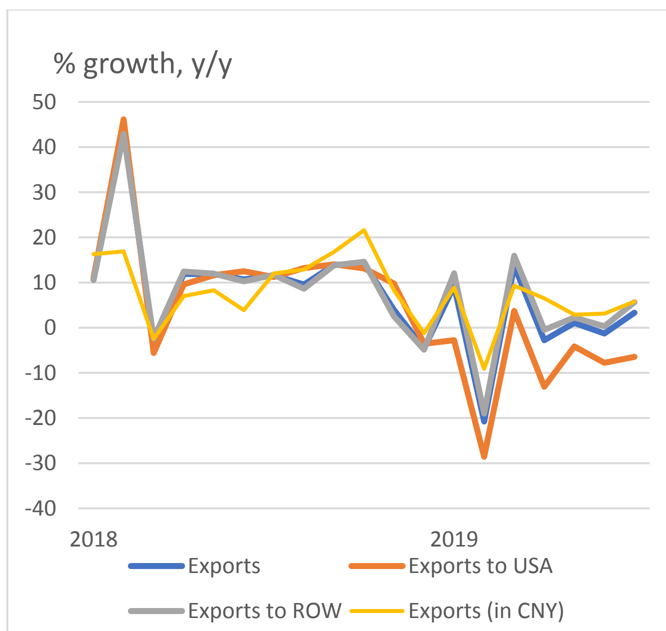
Source: PBoC, NBS, WIND Information, Trivium China

Chart 3



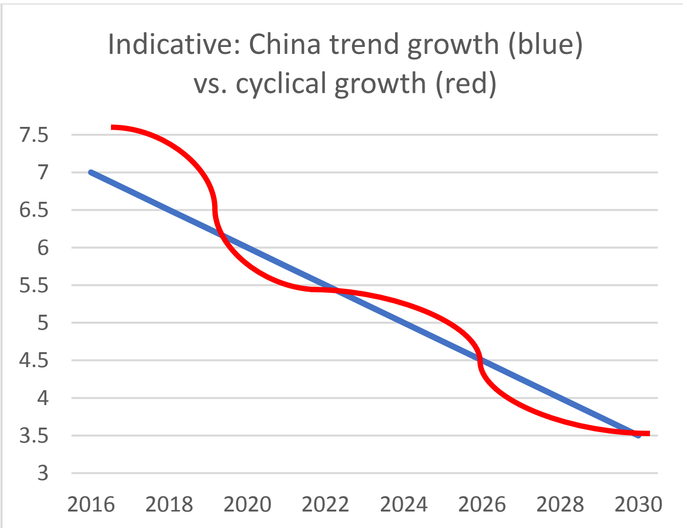
Source: NBS, WIND Information, Trivium China

Chart 4



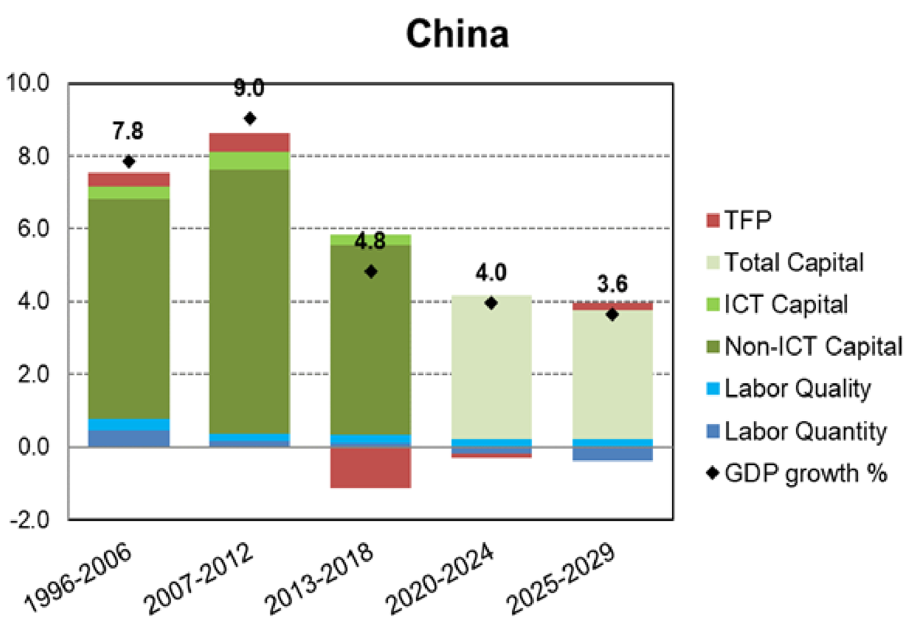
Source: Customs Bureau, WIND Information, Trivium China

Chart 5



Source: Trivium China

Chart 6



Source: The Conference Board, Global Economic Outlook, Fall 2019 update (preliminary estimates)