China’s Economic Weakness and Challenge to the Bretton Woods System: How Should the US Respond?

THOMAS J. DUESTERBERG
SENIOR FELLOW, HUDSON INSTITUTE
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Hudson Institute
1201 Pennsylvania Avenue, NW
Fourth Floor
Washington, DC 20004

+1.202.974.2400
info@hudson.org
www.hudson.org

Cover: Commercial houses under construction in Yichang, Hubei Province, China, on October 18, 2023.
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THOMAS J. DUESTERBERG
SENIOR FELLOW, HUDSON INSTITUTE
Thomas J. Duesterberg is a senior fellow at Hudson Institute. An expert of trade, manufacturing, economics, and foreign policy, Dr. Duesterberg leads project work on trade with Europe and China, reform of the World Trade Organization (WTO), global competition in advanced technologies such as 5G, and the strength of the United States manufacturing sector.

Previously, Dr. Duesterberg was executive director of the Manufacturing and Society in the Twenty-First Century Program at the Aspen Institute. From 1999 to 2011 he served as president and CEO of the Manufacturers Alliance/MAPI, an economic research and executive education organization based in Virginia. He was also director of the Washington office of Hudson Institute, assistant secretary for international economic policy at the US Department of Commerce, chief of staff to Rep. Chris Cox and Sen. Dan Quayle, and associate instructor at Stanford University. He co-wrote *US Manufacturing: The Engine of Growth in a Global Economy* and three other books, and is the author of over 300 articles in journals and major newspapers. He is on the Board of Advisors of the Manufacturing Public Policy Initiative at Indiana University’s School of Public and Environmental Affairs, and the Board of Trustees of the American University of Rome. He is a graduate of Princeton University (BA) and Indiana University (MA, PhD).
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Under the guidance of paramount leader Xi Jinping, the Chinese economy has steadily weakened. It can no longer support the level of growth the nation came to expect in the three decades prior to his regime. Consequently, the People’s Republic of China (PRC) can no longer muster the financial resources it needs to stimulate sustained growth that would pull it into the ranks of advanced economies.

China has severe structural problems: demographic decline; underfunded social welfare programs; severe pollution; and reliance on imported fuel, food, and mineral resources. Because of his suspicions, Xi has undermined key private sectors, industries, and prominent executives, and these actions have inhibited the Chinese Communist Party’s (CCP) ambitions to achieve self-sufficiency in advanced technology industries. His attack on key digital service industries hinders a transition to a services-based economy. A severe crisis in China’s crucial real estate sector threatens the financial stability of its banks and public finances.

High youth unemployment, the collapse in a real estate sector that harbored 70–80 percent of family wealth, Xi’s growing authoritarian surveillance state, failure to address structural problems like inadequate education and social services, and the post-Covid global economic slowdown threaten Beijing’s ability to maintain popular support.

Poor social services and faltering real estate contribute to low consumption as Chinese people save more, which compromises consumers’ ability to stimulate growth. Because China produces too many goods and consumes too little, the country dumps products on global markets, so trading partners enact countermeasures to limit Chinese exports.

Globally, Xi’s attempts to undermine the post–World War II Bretton Woods order have not proven economically successful. Along with his sustained mercantilism, his turn toward military aggressiveness has spurred pushback from the United States, an increasing number of Western allies, and some developing countries in his neighborhood.

China’s accumulation of economic and geopolitical problems presents opportunities for the US and its allies to counter Xi’s trade and geoeconomic programs to incentivize change and deter his efforts to displace the West-dominated, rules-based order.

This report analyzes and recommends deploying programs and tools that can affect China in its weakening economic and geopolitical situation, including in the following areas:

- **Trade policies**: Such measures include the sustained deployment of tariffs, antidumping and countervailing duties under US trade law and the rules of the World Trade Organization (WTO). Trade measures target key industries important to the US economy and national security.

- **Investment policies**: The US should expand controls over inbound direct investment for dual-use technology sectors and outbound direct and portfolio investment into China. These include new and expanded coverage for sensitive areas, such as dual-use and military sectors and high-technology industries that benefit from anti-competitive Chinese subsidies. Expanded disciplines include limits on equity investments in industries and companies of concern, especially those on the Department of Commerce Entity List or selected firms on the White House List of Critical and Emerging Technologies.

- **Export controls**: The report suggests that the US should more rigorously scrutinize Chinese efforts to develop or illicitly acquire sensitive technologies and more extensively deploy export controls to limit Beijing’s ability to access these technologies.

- **Financial sanctions**: Investigations increasingly implicate China’s banks in money laundering for the illicit drug trade on a global scale and circumventing US sanctions and trade
restrictions. They also find that Chinese firms operating abroad engage in tax evasion. Many prominent banks are involved in businesses that employ forced labor and otherwise abuse internationally recognized human rights. The report urges targeted and selective use of sanctions under Section 311 of the Patriot Act or other money laundering regulations, including severing implicated banks from the SWIFT and CHIPS clearance systems, to combat and deter these practices.

- **Combatting China’s efforts to build alternatives to Bretton Woods:** Through its own trade groupings, such as the Shanghai Cooperation Organization (SCO) and BRICS (a grouping that includes Brazil, Russia, India, China, and South Africa), or through financing institutions, such as the Asian Infrastructure Development Banks and the Belt and Road Initiative (BRI), and the development of an alternative trade settlement, clearing system, and digital currency, the PRC is systematically building an alternative to the Bretton Woods Western order. WTO reform to better counter Chinese mercantilism and reform of the International Monetary Fund (IMF) and World Bank is unlikely to succeed due to the WTO’s rigid rules for change and outright opposition from China, its allies, and some developing countries. The report suggests building alternative networks of trade agreements that exclude China, such as rejoining the Trans-Pacific Partnership (now known as the Comprehensive and Progressive Agreement for Trans-Pacific Partnership, or CPTPP), opening the US–Mexico–Canada Agreement (USMCA) to new entrants, and expanding the use of bilateral trade opening agreements. Strengthening alternatives to BRI and BRICS through coordinated development assistance with allies and maintaining stable currencies and open economies are other responses.

Altogether, the various proposals work to weaken China’s attempts to reinvigorate growth by relying on increased trade, attracting more Western capital, and acquiring technology illicitly to increase competitiveness in industries of the future. These proposals will limit Chinese access to Western capital, which the PRC needs for its faltering financial sector and government balance sheets. The measures will also hinder China’s access to Western technology while limiting the PRC’s drive to displace Western industry in global markets.
China presents a rather unique challenge for the United States. It has a distinct ideology with leadership that appears united and determined, and, most importantly, it has built a powerful economy capable of effectively competing with the United States. It is technologically adept and has proven that it is willing to use its economic size, specifically its ability to produce goods at competitive prices, to achieve economies of scale and capture global markets. The nation is also willing to employ selective access to its huge domestic market to induce other countries to cooperate on both economic and political projects. Further, China has employed its technological expertise and economic heft to build a military establishment allowing it to project power around the world and to challenge US leadership.

China’s economic model is, in a larger sense, a direct challenge to the rules-based order built after the Second World War. China has used the forbearance of the West in accommodating it into that order to build its economy, but Beijing routinely flouts the rules of the trade and financial systems of the postwar order. The internal rules, especially of the trade system embodied in the WTO, have proven incapable of inducing or forcing China to abandon its use of industrial subsidies, restricted access to its own markets, lack of reciprocity, selective adherence to intellectual property (IP) protection, and below-market financing to win market share in the global economy. Because of the huge size of China’s markets, efforts by the US to induce change in Chinese behavior have been disappointing or outright failures. US efforts have also failed in part because other major economies continue to seek benefits from trading and investing with China.

Photo: Employees work on the assembly line at a factory of Chinese EV startup Leapmotor on October 25, 2023, in Jinhua, China. (Photo by Hu Xiaofei/VCG via Getty Images)
China’s Policy Change

The paramount leader and head of the CCP, Xi Jinping, has changed his country’s policy of “biding its time and hiding its capabilities” to formalize a historic bid by the Middle Kingdom to become a dominant global economic power and to establish a new political order challenging the liberal, democratic, market-based order that the United States and its allies created and supported in the wake of World War II and the Great Depression. While the PRC has undoubtedly improved the standard of living of its citizens and has become the largest trading power in the world, China’s progress has come at some cost to the United States and its allies. With programs such as Made in China 2025 and the Belt and Road Initiative, China has achieved a strong position in the global economic and political order but has also undermined the varying bases—notably a market-oriented and democratic system—of that order. In recent years the aggressive Chinese push to expand its global markets, acquire leading-edge technological leadership, and promote the attractiveness of its model of social order and governmental organization has begun to engender pushback from the United States and many of its allies in Europe and the Pacific Rim. Xi’s consistent support for his ally Vladimir Putin’s aggression toward Ukraine has reinforced support for the pushback, especially from previously recalcitrant US allies in Europe. At the same time, the economic growth model that China employs domestically—a top-down, state-dominated, heavily subsidized, investment-led system that in important respects violates the rules of the WTO—has also weakened.

Growing debt, low productivity levels, heavy-handed regulation of dynamic areas of the economy, an imploding real estate sector, spiraling levels of government and private sector debt, and an inability to meet pressing social welfare and environmental problems all contribute to a slowing economy vulnerable to recession and possible political unrest. The events that Covid-19 unleashed both exacerbated economic problems and alerted Western nations to the dangers of dependence on Chinese supply chains. China’s support for the Russian invasion of Ukraine has further isolated it in global opinion, while the sanctions on Russia are further cementing China’s entente with Putin and threaten to affect China’s ability to retain relatively unfettered access to Western markets.

Western Responses to Chinese Policy

Because of Beijing’s growing economic weaknesses and consolidation of Western political opposition to its mercantilist policies, China is increasingly vulnerable to more aggressive trade, investment, and export control actions by the US and its allies, many of which were initiated under the Trump presidency and continued under the Biden administration. The United States is consequently in a position to go on the offensive against Chinese mercantilism and attempts to undermine the rules-based global order. Washington may use various tools to influence Chinese behavior, either to encourage it to become a more responsible stakeholder in the US-led economic and political order or to isolate it in some revised and rejuvenated form of a global order.

Most proposals for China policy have emphasized defensive measures that were supposed to induce better adherence to the Bretton Woods model, such as the tariff actions of the Trump administration. Particularly in the second half of the Biden administration, however, other geopolitical considerations have tempered the ambition and scope of the pushback against Chinese economic practices. The often single-minded push to combat climate change has led the Biden team to (1) consistently seek agreement with China to limit carbon dioxide (CO2) and other damaging emissions and (2) restrain Washington’s efforts to achieve change in China’s mercantilist and human rights depredations of the postwar order. US allies, especially in Europe, share this willingness to work with China on climate change despite consistent Chinese policy favoring economic growth that results in continuously higher harmful emissions.

Additionally, US allies want to gain market share in the growing Chinese economy, as do Wall Street and the US technology
sector. Prioritizing economic considerations favors accommodation over confrontation with China. Xi has encouraged Western business and political leaders to accelerate a return to supposed stability with a charm offensive that the CCP designed to convince those leaders that they will have welcome access to the now enormous Chinese market. In the summer of 2023, the Biden administration redoubled initiatives to reduce tensions with China by moderating confrontation with the Xi regime on a variety of economic, human rights, drug trafficking, money laundering, and environmental issues. In the turn toward accommodation by the US and its allies in Europe, the administration has also downplayed Xi’s support for Russian aggression in Ukraine and China’s growing dominance in the South China Sea.

In short, it has become increasingly clear that China’s mercantilist policies have both weakened the economic model of the postwar world and damaged the growth prospects of Western economies. Additionally, China’s strategic acquisition of assets and production capabilities for both defense-related and advanced economy sectors have resulted in greater economic and national security vulnerabilities for Western allies. China has captured practically the entire supply chain for producing renewable energy products such as solar cells, lithium-ion, and other materials used in advanced batteries for electric vehicles (EVs), and rare earths, which are crucial to modern electronics and many defense technologies. Beijing clearly wants to attain as much self-sufficiency and economic autarchy as possible, and as a result will make access to its huge domestic market difficult or impossible. Domestic firms already dominate internet-based retail, electronic payments, and high-speed rail. China intends to capture the lion’s share of EV sales, first in its domestic market and soon thereafter in Europe and the US. By the second half of 2023, China had reached the first goal. The concept of a “dual circulation” economy to promote “common prosperity,” which now drives Chinese policy, will mean that the PRC will limit access to its markets until it acquires sufficient technological and production capabilities to take a dominant role in sector after sector. Achieving this goal will be extremely difficult. But because Chinese efforts will damage the economies of the US and its allies, these countries need to challenge the project and dissuade Xi and his team from these ambitions.

This study explores a more aggressive use of trade and other economic tools to take advantage of growing economic and political problems in China and to incentivize major changes in Chinese behavior. The study will help broaden the range of available leverage options to achieve both defensive goals (i.e., limiting further damage and exposure to unreliable supply chains and mercantilist Chinese policies). It also proposes more aggressive tools, including the creation of a new type of economic order based on economic and political separation into Western and China-dominated spheres and broader use of investment controls in both direct and portfolio investment into China.

In the following section, this study reviews the thinking of policy experts about the most effective means of working with China to integrate it into the Western-led global order. Part I provides a short overview of the directional change in Chinese economic and political policy under Xi Jinping and the growing economic and political problems stemming largely from those policies. Part II discusses a series of predominantly economic policy tools that the US, along with allies where politically feasible, can and should deploy to deter Chinese mercantilism and efforts to undermine Western leadership.

**Previous Research**

Despite the apparent convergence in the US administration and Congress on the need to boldly respond to China’s rise as a challenger to US economic and global political leadership, expert opinions diverge regarding the need for and the means of an aggressive response. With few exceptions, most analysts continue to counsel that working with China will eventually result in at least its more faithful adherence to established trade and governance rules. Some other experts and I are skeptical based on a reading of recent Chinese behavior, the ideology of Xi, the impact of Chinese mercantilism on the so-called rules-based
order, and the overall effects of Chinese behavior on the US economy. Recent developments in China also expose the deep structural problems with the Chinese economic model and, as a consequence, the opportunity to influence Chinese behavior using well-targeted economic sanctions and other actions to take advantage of underlying economic weaknesses. In short, this skepticism suggests that policymakers need to adopt a more aggressive, offensive approach, which this current study will develop.

One strand of the divergence revolves around whether the Chinese economic and political model is sustainable and accommodable in some semblance of what analysts have called (perhaps too simplistically) the liberal, rules-based order. This tendency continues the optimistic tradition that believes a liberalizing market economy will contribute to political liberalization and overcome cultural or ideological barriers to such an evolution. On the positive side of this discussion, the most articulate proponent is Fred Bergsten. He argues that Chinese economic growth will continue for the next three decades and will catapult the Middle Kingdom to both economic leadership and, potentially, global leadership in shaping the economic and political order. He further argues that continuing efforts to rein in Chinese mercantilism ought to temper this trend and that it is possible to do so within a modified Bretton Woods system. Robert Zoellick also supports constructive work within the existing framework, albeit with an organic evolution of the system to accommodate relative economic power shifts and changes in underlying economic goals. Nicholas Lardy recognizes that Beijing has reverted to centralized control under Xi Jinping, but he still agrees with Bergsten that the Chinese economy will continue to outperform those in the industrialized West (using “West” in the generalized way referring to the US, Europe, and the Pacific Rim). These authors and many others thus counsel constructively working with China to continue pursuing the long-sought goal of inducing them to become a responsible stakeholder, partly by consistently sanctioning them for noncompliance with rules such as those in the WTO and the United Nations (UN).

John Micklethwait and Adrian Woolridge take a middle-of-the-road approach. From what we can call a pragmatic or realist perspective, they assert that the Russian attack on Kyiv in 2022 closed the door on the steady advance of postwar globalization trends and that China’s actions represent effective decoupling. But they offer the view that the US and its allies should erect some new, revised, global liberal order to replace the Bretton Woods system instead of allowing the system to deteriorate into a system of two or three (if Europe tries to retain some independence from the US and some ties with the Chinese economy) separate blocs. Daniel Rosen agrees with me that China’s economy is in serious trouble, partly because of its reversion to centralized rule, but Rosen advocates a pragmatic path of working within existing international structures and institutions to encourage China to better adhere to the liberal order. He also argues that the West should “not seek to exploit China’s economic challenges but rather wants to see them sustainably resolved.”

A growing number of other experts have articulated the view that China’s long-term objective is to decouple from the US and its liberal allies and establish its own global order. These analysts assert that the ideology of Xi and the CCP will continue to dominate Chinese political evolution, so Beijing will make economic decisions based on that ideology’s imperatives instead of economic efficiency. This group also includes a number of economists who believe that the Chinese economic model is faltering, if not failing. The latter group attributes the economic fragility to the renewed CCP attempts, under an inflexible Xi, to dominate political and economic power internally and to exact discipline over independent actors, such as privately owned firms. This recentralization comes at the expense of private sector innovation and dynamism. A number of longtime China observers furthermore suggest that CCP dominance will produce not only economic stagnation or worse but also political unrest at some point.
into the early years of the Xi era. These analysts chronicle the slow deterioration of economic growth in China since the Great Recession. They emphasize the accumulation of unsustainable levels of debt in the PRC’s financial system and efforts by Chinese policymakers to mask the true extent of that debt. By the time of the Covid crisis, which further exacerbated the debt crisis, the economic model that China had deployed for the last 30 years could no longer support domestic industrial policy, infrastructure expansion, housing development, or social security spending. Nonetheless, they hesitate to offer a firm view on the model’s sustainability, much less any strong suggestions for how US and Western policies can exploit the weakness to achieve desirable policy results.

Analysts advanced another variation on this theme after China’s economy showed further evidence of significant weakness in the second quarter of 2023. Peterson Institute CEO Adam Posen provides a forceful iteration on the theme that China’s economic model is ending. He gives an overview of the slowdown in investment and consumer spending that indicate a lack of confidence in the future of the PRC economy, which Xi’s consolidation of power in the hands of the CCP largely caused. Posen’s argument is that Xi’s policies and other inherent economic development problems will eventually have inefficiencies analogous to those of the Soviet Union in the postwar period and to the erosion of the fascist economies in the 1930s. His view is that the US, instead of taking measures to retaliate for Chinese mercantilism and aggressive foreign policy, should remain an open economy receptive to Chinese investments and capital flows from Chinese citizens. Such flows would further weaken the Chinese economy. He is critical of the Trump-Biden tariffs, (some) sanctions, and any actions to decouple from the Chinese economy. His analysis does not explore some of the deeper structural problems afflicting Xi’s China, nor does he offer an opinion about whether or how Xi can maintain financial stability in the face of overleveraged government and banking balance sheets.

Rhodium Group analyst Logan Wright recently advanced a much more decisive analysis of the problems with China’s growth model. Wright provides perhaps the clearest explanation of how Chinese policymakers have, over the last three decades, used increased financial leverage to stimulate growth in China, again emphasizing the outsized role of property and infrastructure development. His analysis of the Xi era is especially precise in delineating the increasingly opaque tools that authorities employed to allow the quadrupling of accumulated debt in China, starting with the financial crisis of 2013. The Covid crisis, and the property crisis of the last few years supercharged the proliferation of debt. Wright also shows how Xi’s policy came at the expense of the dynamic private sector, which policy changes starting with Deng had unleashed. He demonstrates how credit has shifted as a result in recent years to the highly unproductive state-owned enterprise (SOE) sector. The overall result of these shifts under Xi, as Wright argues in an earlier research note, is that the “magical credit machine” at the heart of the modern Chinese growth model is no longer viable. He goes on to provide several sensible reform measures that could reverse the downward spiral gripping China but concludes that, under Xi, the country is highly unlikely to undertake such fundamental changes as shifting back to private sector- and consumption-led growth, and is much less likely to do so successfully. He does not systematically explore how Western policymakers could take advantage of the problem he unmasks very convincingly to induce change in the Xi era.

Xi’s increasingly aggressive foreign policy, especially his explicit goal of “reuniting” Taiwan (also known as the Republic of China, or ROC) to the PRC, has generated a final vector of relevant research in the last few years. Most research on how to deter such a destabilizing development, such as an important study by the Council on Foreign Relations (CFR), has focused on various military strategies, with some attention to sanctions denying China’s ability to acquire important and sensitive military technologies. The CFR study does not contemplate using economic pressure in advance of warlike moves by China against Taiwan. Another recent study by analysts at the Rhodium Group and the Atlantic Council goes into considerable detail on how various economic tools could be
deployed in the event of either a blockade or outright military intervention by China against the ROC. But the study focuses on the costs and economic disruption from a blockade or war scenario would create. The authors do not explicitly contemplate the use of economic pressure to deter such aggression, or the costs to China, but their analyses provide an excellent guide to some of China’s vulnerabilities to Western sanctions, tariffs, export controls, and denial of financing that could be deployed to this end.

A 2023 study by colleagues at Hudson Institute, while controversial in its conclusions, does suggest that the US should deploy a broad strategy of economic sanctions in conjunction with military actions to deter or “dissuade” Xi from using force to absorb Taiwan. A key conclusion of this study is that “there is no realistic quantity of forces with which the US military can achieve assured overmatch against the PLA (People’s Liberation Army) in the Western Pacific.” The authors suggest that in the absence of an overwhelming advantage in a kinetic war over Taiwan, a better strategy is to employ various information-age, military, and economic strategies to deter the Chinese before they decide to take kinetic action. Although the authors do not propose specific economic actions to achieve this end, they consider an integrated, “all of government” set of actions as part of a strategy to dissuade.

I have sided with the skeptics about the continued growth of the Xi-shaped economy. My 2021 study emphasized the cumulative effects of the real estate crises, growing indebtedness, and Xi’s assault on the innovative private sector along with long-standing problems of demographic decline, deterioration of the environment, dependence on external sources for goods and raw materials, and the steady decline in returns resulting from new investment. These developments, along with Xi’s single-minded determination to reassert control of the CCP and to achieve zero Covid, suggest that much-reduced future growth in China, or even a prolonged recession, is likely.

The evolution of the Chinese economy, and our understanding of it, in the last two years has only reinforced the conclusions that the PRC is in deep trouble and that the Xi presidency is highly unlikely to take necessary actions to reinvigorate growth on a sustainable basis. The faltering growth path and concomitant inability to improve the social safety net, environmental health, or government balance sheets provide an opening for the US and its allies to exert leverage that may change Chinese behavior and weaken Xi’s leadership position. In recent annual reports, the US-China Economic and Security Review Commission has reinforced the work of economic (and political) skeptics of the current Chinese trajectory. Many of the policy tools that I will articulate in this proposal have the support of the commission. Previous work by Hudson Senior Fellow John Lee also employs an approach and conclusions consistent with the more aggressive tactics that the proposal covers.
Xi Turns toward a More Centralized Economy

The underlying argument of this study is that the increasingly evident and serious economic weakness in the Chinese economy and its related international economic policies present an opportunity for the US and its Western allies to have a material impact on that economy. In turn, it asserts that if the West deploys the policy tools identified in Part II, they can be part of a unified strategy to incentivize changes in Chinese behavior.

In the last few years, it has become increasingly clear that under the leadership of Xi Jinping and his CCP supporters, China will likely continue to reassert centralized control of the economy and use its newfound strength to challenge the West both economically and politically to alter the order that evolved after the Second World War. Indeed, Xi has, if anything, become more aggressive and explicit in asserting his determination to upend that postwar order, going so far as to assert control over Hong Kong in defiance of the 1997 accord with Great Britain and to threaten the de facto independence of the ROC in Taiwan. Xi’s “no limits” support of Russian aggression and tacit support for Iranian and North Korean efforts to undermine regional and global stability also reinforce the understanding of a systematic effort to displace US and allied positions of global leadership.

PART I: CHINA’S GROWING ECONOMIC WEAKNESS AND VULNERABILITIES

Photo: Residential buildings under construction by Chinese real estate developer Vanke in Nanjing, China, on October 9, 2023. (Photo by STR/AFP via Getty Images)
In 2023, Xi joined Putin in a concerted effort to broaden the membership of the so-called BRICS to achieve economic parity with the G7 and to challenge the leadership of the Western-oriented world. They are even contemplating a parallel system of international institutions to displace or rival the Bretton Woods system and a currency arrangement to displace the role of the dollar and Western finance in general. The so-called Shanghai Cooperation Organization of nine like-minded economies is another part of the architecture for an alternative global system. These initiatives do not preclude China from attempting to become more influential in existing multilateral institutions, especially the UN, in ways that serve its own interests. In short, Xi has become explicit in articulating these initiatives as a challenge to Western leadership.\textsuperscript{24}

Xi’s determination to deepen CCP control of China’s economy, despite the obvious negative effects on its growth, reveals his indifference to Western criticism of the mercantilist nature of China’s modern economy and to the idea of becoming a more responsible stakeholder in a global economic system that has benefited his country enormously in the last 40 years. In earlier research, I outlined some Chinese policies that are “uneconomic” in the sense that they overwhelmingly tend to reduce economic efficiency and growth.\textsuperscript{25} These included crackdowns on innovative service industries such as health care, education, and financial services, most notably Ant Financial. The CCP shifted credit away from the private sector and toward the massively inefficient SOEs. It disciplined innovative private sector leaders, including Jack Ma, and many corporate leaders lost their jobs, were sentenced to prison, or “disappeared.” Since then, as capital markets expert Kyle Bass has outlined, the CCP has implemented other measures that also undermine growth, especially private sector growth, which accounts for 80 percent of employment and much of domestic innovation.\textsuperscript{26} Bass and Hudson Fellow Miles Yu noted several uneconomic policy changes, such as defaulting on dollar and euro-denominated debt, cutting off access to fundamental economic data, limiting access of Western auditors to Chinese firms, delisting some Chinese firms from more liquid Western markets, placing CCP operatives on the boards of all firms operating in China, and denying Western due diligence firms access to background research on Chinese firms. Such actions are counterproductive, especially because in China’s slowing economy, access to Western capital and markets is increasingly necessary to maintain stability and growth.

Given China’s intention and preparation for a serious challenge to Western leadership, and Xi’s apparent confidence, some detail about the nature of the current Chinese economic model and its weaknesses will be crucial to making the case for the policy tools I outline in Part II as effective counters to Xi’s challenge. The specific policies connect to specific areas of weakness and vulnerabilities in the current economic model. Our discussion of economic weaknesses focuses on developments in the last two years. There had been some speculation that, in the aftermath of the Covid crisis and the draconian lockdowns, Xi would change direction and adapt different policies to reinvigorate growth. But he dashed these hopes as he continued his determined consolidation of power and chose policies consistent with CCP supremacy and aggressive international goals.

I divide the discussion into sections covering structural problems, longer-term problems, and more recent problems resulting from these policy choices.

### Structural Problems

#### Demographic Transition

Understanding China’s growing economic and governance problems begins with understanding its demographics. Population growth is one of the bedrock components of overall economic growth, and this has been the case in China since the communist regime came to power. But the long-term expansion has turned to decline. Even according to China’s questionable official statistics, its population began what most observers consider a long-term fall in 2022. Figure 1 shows the Shanghai Academy of Social Sciences projection for total population as
The organization forecasts a fall-off from a high of 1.4 billion to 800 million souls by the end of the century. Fuxian Lee, a University of Wisconsin medical doctor, has taken a close look at the underlying dynamics and components of current numbers and concluded that they overestimate the total by some 130 million. There are, of course, numerous incentives for local officials to exaggerate their reporting of population growth, just as there are in the US and Europe, to obtain more resources from central governments. But the size of the gap, if Li is right, is exceptional.

Current reporting, even official reporting by Beijing, strongly corroborates the general direction of decline. In 2022, the number of births China recorded reached a historic low for the modern era, as the overall fertility rate has remained below replacement levels for decades. Figure 2 shows the number of births per 1,000 people over the last two decades. The fertility rates in Beijing and Shanghai are among the lowest in the world, at around 0.7 per woman. The problem is not only the one-child policy, which the Xi regime relaxed after 2015 when it recognized the emerging problem, that explains the persistence of this decline. Numerous commentaries since the onset of the Covid crisis cite how the rising generation of Chinese youth increasingly lack confidence in their future. Exemplifying this trend, marriage rates have in the last two years reached the lowest levels that modern China has recorded. One obvious reason why many Chinese are reluctant to have children is that raising them is much more expensive than in Western countries. A study by a Beijing research firm concluded that it requires about seven times the annual per capita income to raise a child through the age of 18, compared to about four times per capita income in the US or Japan.

The “lying flat” phenomenon also reveals the pessimistic outlook among Chinese youth. In effect, many young people, especially the more educated urban cohorts, have given up

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**Figure 1. Projection of China’s Population**

![Graph showing population projections from 1960 to 2100](https://theconversation.com/chinas-population-is-now-inexorably-shrinking-bringing-forward-the-day-the-planets-population-turns-down-198061)
hope for the successful careers and family life that were characteristic of China in its high-growth period. Instead, they choose to do the minimum necessary to get by, all but abandoning their participation in the economy. Contributing to this phenomenon is the again historically high level of youth unemployment, which has hovered in the high teens and reached over 20 percent in 2023, even after the government lifted the Covid lockdowns. This number has increased steadily from just below 10 percent in 2018. Some analysts argue that the youth unemployment rate is much higher than official statistics suggest, with estimates above 40 percent of the age 16–24 cohort.

One other factor explaining Chinese population decline is that, in stark contrast to the US and Europe, net migration has not nearly compensated for weakness in domestic fertility. About 15 percent of the US population, over 50 million people, is composed of immigrants. In Canada the number is even higher at 21 percent, and in Germany it is 18.8 percent. The number for China is only slightly over 1 million people, or barely 0.1 percent. This contrast likely results from long-standing cultural factors discouraging immigration in China as well as from outward migration due to political factors, such as the growing lack of opportunity, which affects China’s young adult population.

In addition to the decline of the overall population, the inevitable result of low birth rates is the often-observed aging of the population. A prominent Chinese demographer notes that the share of the population aged 60 and above reached 15 percent in 2022 and predicts it will reach 38 percent by 2050. The elderly population is growing by 10 million per year. The number of employed persons in China has already begun to decline, as shown in figure 3. The number of both working-age and employed persons in China peaked in 2015 and has fallen since then (see figure 4). Part of the reason for this fall in employed working-age people is rising productivity in China, especially as many SOEs in the manufacturing sector have consolidated. Nonetheless, as the experience of the US suggests, productivity increases are entirely compatible with increased employment when human and capital resources have incentives to move to newer or more innovative sectors of the economy.
Another consequence of the demographic downturn, the rapid aging of the population, is already having a substantial economic impact. The dependency ratio, the number of elderly and young children per employed worker, has steadily increased in the last decade or more. The ratio was 34 dependents per 100 workers in 2011 but reached 46 per 100 in 2022. Current trends suggest this ratio will rise to above 100 per 100 workers by the end of the century, as figure 5 illustrates. This development is already putting enormous pressure on China’s vastly underfunded social welfare system, for both medical care and old-age pensions. In the discussion of local government finances, I will explore how damaging this has become to the balance sheets and solvency of that sector of government, which is largely responsible for paying for social welfare.

American demographers Nicholas Eberstadt and Ashton Verdery have also explored the impact of the aging population on social bonds and economic vitality in China.36 They found that the demographic vitality of the last 40 years of the twentieth century significantly deepened the kinship structures in China as its population more than doubled. In 2020, for example, Chinese men and women had five times as many cousins as in 1960. This broadening and deepening of family ties facilitated the traditional Chinese practice of children caring for their elderly parents or close relatives, which is one reason the Chinese government was able to avoid building the costly social security and national healthcare systems characteristic of Western societies. They also demonstrated that such social network strength had a high correlation to the historic economic growth China achieved in the 40-year period.37

The link between kinship networks and economic vitality stems from the concept and practice of what the Chinese call guanxi: Eberstadt and Verdery explain this link as follows: “Social capital begets economic capital. China’s ‘kin explosion’. . . may have had highly propitious implications for guanxi, the quintessential Chinese kin-based networks that have always been integral to getting business done in China.”38

![Figure 4. Working-Age Population in China](source)

![Figure 5. Children, Old-Age, and Total Dependency Ratio in China from 1950 to 2020 with Forecasts until 2100](source)
Beginning around 2010, the kinship explosion began to reverse. Projections by Eberstadt and Verdery suggest that in 30 years, the Chinese will have only 20 percent as many cousins as they do today. Half of them will have no daughters or sons to care for them in old age. Their projections indicate that 35 percent of the total population will be over the age of 65 in 2060. Such trends will put enormous burdens on families to care for their elderly kin, which will in turn lead to maintaining or increasing the high levels of precautionary savings they hold for this familial duty. I will explore in greater detail later in this study how this dynamic will continue to undermine Xi’s efforts to stimulate growth more through consumer spending than through investments and exports. This situation will also put pressure on government finances, as I mentioned earlier, due to the greater need to expand pensions and state health care outlays.

As a final and more ominous observation, at least for the ambitions of Xi Jinping and the CCP, Eberstadt and Verdery conclude that the trust that kinship networks fortify in economic activities will erode seriously and undermine “the micro-foundations of the national economy.” This relentless evolution of social structures will undercut economic heft and dynamism, and its fiscal consequences will erode China’s ability “for influencing events abroad through economic diplomacy and defense policy.”

Agricultural Self-Sufficiency and Environmental Degradation

Part of Xi Jinping’s “China Dream” is to get as close as possible to self-sufficiency in food supplies. He reverts to aphorisms such as, “The rice bowls of the Chinese people must always be held firmly in our own hand and filled mainly with Chinese grain.” But like many of his visions, this is more of a pipe dream. China faces the challenge of feeding 18 percent of the world’s population with only 7 percent of global agricultural land and 6 percent of freshwater resources. Not only that, but as China gets richer, Chinese people desire a wider and more diverse diet, especially for meat, so the need for feed grains to feed herds has increased. China’s soybean imports represent about 85 percent of global consumption, and it is the world’s largest importer of corn. Its food self-sufficiency ratio has decreased from 93.6 percent in 2000 to 65.8 percent in 2020 despite massive use of fertilizer, huge land reclamation projects, and subsidies for its relatively inefficient producers. Grain production has not grown commensurate with either Xi’s dream or with increases in consumption as China has become a more prosperous nation. China is also highly dependent on imported cooking oils, which account for 70 percent of its needs. By 2030, analysts expect Chinese food import shares to increase between fivefold and sevenfold over today’s baseline, depending on overall economic growth, according to a study in the US Army’s Military Review.

The realities shaping Chinese agriculture and attempts to become self-sufficient are difficult, and China is unlikely to resolve them. In the first place, China has insufficient water resources (not only for agriculture), and their quality is poor and growing worse with the ravages of Chinese environmental practices. Data for 2018 revealed that water management authorities graded some 86 percent of the water available in China at level IV or V. Level V is unusable for any purpose. China uses up to three times as much fertilizer as Western agriculture but still has mostly lower yields. Northern China, which is the breadbasket of grain production in China, has some of the lowest levels of water availability of any part of the world, with levels approaching those of Libya and Morocco. China’s northern provinces, which produce over 50 percent of the country’s grains, have only 16.5 percent of the country’s domestic freshwater resources. The three provinces in China’s Central Plain (Henan, Shandong, and Hebei), with only 2 percent of the country’s water resources, produce 23 percent of China’s grain.

Beijing’s leadership is trying to address the insecurity problem in several ways. First, through a massive and long-term effort, the PRC has tried to capture water resources from the Tibetan plateau, which provide the lifeblood of much of India and Southeast Asia, and diverted them to central and northern China. Thus far
it has most severely affected the upper Mekong River. China has constructed up to 106 dams for water storage and hydroelectric power on the Chinese portion of this vast river and its tributaries. This has affected the environment, agriculture, and the economy downstream in much of Southeast Asia. 45 China has plans to build massive dams upstream from major rivers flowing into India, Bangladesh, and Myanmar, which would have the same sorts of negative impacts. The project is slowly evolving into a massive international problem.

Second, China is trying to develop more advanced bioengineered plant stock, both by using internal resources and by buying the leading Swiss seed firm Syngenta. Third, it is trying, without real success, to recapture land for agriculture within China. Finally, it is buying up land around the world, especially in the Americas, which are the source of much of the world’s surplus grain supplies. 46 None of these efforts are likely to achieve Xi’s longer-term goal of self-sufficiency. To give but one example, “China’s total arable land decreased from 334 million acres in 2013 to 316 million acres in 2019, a loss of more than 5 percent in just six years.” Analysts project this number to decrease by at least 3.3 million acres by 2030, and likely more. Overuse of fertilizers, salinization, and acidification have degraded more than 40 percent of China’s arable land. 47

Without going into great detail, it is worth noting that China is now the world’s largest emitter of greenhouse gases, accounting for more of the world’s total emissions than the US, the EU, and Japan combined. Despite the persistent efforts of Western countries to convince China to reduce its contribution to this problem, the inexorable growth of Chinese emissions continues because of its heavy and growing industrial base and its reliance on fossil fuels. China’s output of CO2 alone has increased by four times since 1990. China is now the world’s largest refiner of petroleum and has grown to become the world’s leading producer of chemical products. A major contributor to this success is China’s rapidly expanding purchases of oil from pariah states Russia, Iran, and Venezuela, as well as of natural gas from Russia, at below-market prices. 48

President Xi has committed to reaching “peak emissions” by 2030 but, according to the Climate Action Tracker, has not adopted the policies to achieve even this modest goal. Front and center of the policy choices driving the increase in emissions is Xi’s continued reliance on coal-fired generation plants for China’s rapidly expanding electricity requirements. 49 Table 1 shows the acceleration in approvals of new coal-fired plants since the end of the Covid crisis, and the commensurate increase in greenhouse gas emissions. China is on track to double new

<table>
<thead>
<tr>
<th>YEAR</th>
<th>NEW COAL-FIRED POWER CAPACITY (MW)</th>
<th>NEW COAL PLANTS (ANNOUNCED AND/OR BUILT)</th>
<th>EMISSIONS EXCLUDING LULUCF (MTCO2E)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2018</td>
<td>33,476</td>
<td>79</td>
<td>13,115</td>
</tr>
<tr>
<td>2019</td>
<td>48,905</td>
<td>109</td>
<td>13,396</td>
</tr>
<tr>
<td>2020</td>
<td>40,866</td>
<td>98</td>
<td>13,693</td>
</tr>
<tr>
<td>2021</td>
<td>26,247</td>
<td>62</td>
<td>14,218</td>
</tr>
<tr>
<td>2022</td>
<td>27,172</td>
<td>70</td>
<td>14,178</td>
</tr>
<tr>
<td>2023</td>
<td>17,019</td>
<td>82</td>
<td></td>
</tr>
</tbody>
</table>

*2023 1H Only

plant approvals in 2023 over the already high levels of the pre-

China’s dependence on fossil fuels contributes to the degra-
dation of its agricultural land and water. China mines around 4
billion tons of coal per year, more than four times that of the US,
but must import about 10 percent of its total consumption. At
current rates, the Middle Kingdom will import about 375 million
tons this year to supply its growing needs for power generation,
increasing its dependence on suppliers in the US, Indonesia,
Russia, Australia, and South Africa.50

Policy-Related Problems
Systematic Slowdown in Economic Growth

CCP leadership policy choices in the years since the Great Re-
cession have not solved any of the structural problems that the
previous section outlined. Instead, they have steadily contrib-
uted to the unsustainability of the growth model that facilitated
the rapid expansion of the economy under Deng Xiaoping and
his immediate successors. Though economic growth continued
into the early years of Xi Jinping’s rule, it has effectively come to
an end.51 Many observers have argued that China needs to seri-
ously modify its old growth model, but the Xi regime’s decisions
have exacerbated rather than corrected existing problems.

The rapidly slowing growth in late 2022 and 2023 is evidence of
years of policy failures. Even if we accept official GDP numbers
from Chinese authorities, the indicators of decline are all too
obvious. Xi’s administration has, according to well-sourced re-
porting, decreed that it will not permit domestic commentators
to cover the negative developments, such as a real estate crisis,
stressed government finances and state sector banking, loom-
ing deflation, and falling foreign investment and equity prices.
The CCP also restricts access to key data points, such as youth
unemployment and corporate performance indicators.52

Official statistics for the second quarter of 2023 reported growth
of only 0.8 percent over the first quarter, and youth unemploy-
ment remained above 20 percent. The government subsequent-
ly discontinued data for this latter indicator. Housing prices and
overall sales have been in negative territory since the second
half of 2022, and major real estate developers have been de-
faulting on their bonds since 2021.53 Prices for existing real es-
tate have fallen by 14 percent in the last two years, cutting into
the largest source of personal wealth in China. Over 50 property
developers have met default criteria for parts of their bonds.54
Exports from both mainland China and Hong Kong slipped
sharply in the second quarter as well. Those from mainland Chi-
na fell by 14.5 percent in July, and those from Hong Kong have
been falling by double digits in 2023.55 Chinese imports, in an-
other sign of a slowing economy, have also been plummeting,
down 12.4 percent in July of this year. Private equity investment
in China, especially from abroad, has been hitting historic lows
for the last 25 years in 2023.56 Overall confidence in the econo-
my, finally, can be measured by equity prices, which have been
stagnant since the Great Recession and reached new lows in
the summer of 2023.57

In short, the traditional drivers of economic growth in China—
property development, private sector investment, exports, and
population growth—are all declining in 2023, largely a result of
poor policy choices driven by Xi’s increasing centralization of
economic decision-making. No fundamental change in the di-
rection of policy is likely in the coming years.

In my earlier report on “economic cracks in the Great Wall of
China,” he outlined why policy changes under Xi’s regime have
undermined the Chinese growth machine.58 The most important
change under Xi has been a decisive turn toward strengthening
CCP control of the economy. He has favored state-owned en-
terprises over those in the private sector, which had been the
strongest sources of growth, accounting for 80 percent of new
employment and 60 percent of investment in the decades before
he came to power. His anti-corruption campaign targeted many
prominent and successful corporate executives, and he under-
minded the power, prestige, and financing of others, such as Jack
Ma, founder of Alibaba. He also undercut some of the fastest growing and most innovative service industries in education and health care. In an effort to reduce the costs of raising children, Xi basically destroyed the private tutoring industry, which had been one of the fastest-growing service industries and one of the more important sources of employment for recent college graduates.59

As the economic outlook has darkened in 2023, authorities have released speeches by Xi that underscore his deep-seat-ed antipathy toward Western-style economic growth, most notably using various forms of stimulus to pump up domestic consumption. These “deep-rooted objections to Western style, consumption driven growth” are unsurprisingly at loggerheads with the concept of a dual circulation economy that authorities have frequently cited as a means to reignite growth.60 But they are consistent with Xi’s personal philosophy, expressed in many admonitions to the Chinese people to toughen themselves and “eat bitterness,” and with his drive to reassert the absolute dominance of the CCP in the domestic economy. Relying on the spending priorities of individuals provides less dependable control of the economy than allocating capital for state-driven priorities in infrastructure or industrial development, or for other state priorities, such as military modernization and growth or the Made in China (MIC) 2025 program.

The turn toward SOEs resulted in dwindling shares of bank loans for the much more efficient private sector. Net corporate bond issuance, which Beijing highly regulates and allocates, has been negative in most years since 2018 when measured year over year.61 Another consequence of the shift back to SOEs under Xi has been falling productivity. This is especially evident for capital productivity, as the capital output ratio has deteriorated to levels in the high single digits in recent years due to the state’s misallocation of resources and the lack of incentives to improve labor productivity in SOEs.62

Xi’s deleveraging campaign aimed at deflating the property bubble and reducing financial leverage in the state-driven economy has had especially severe consequences for the financial sector, local government balance sheets, and attempts to shift the source of growth to a more consumer-led model. As I outlined in a 2021 report, property development was one of the essential components of growth in China in the last 25 years. Selling land and development rights supercharged income for local governments. The rapid urbanization that accompanied the years of rapid growth in the manufacturing sector facilitated the success of this sector. Individual home ownership came to be the primary source of wealth accumulation among China’s rapidly expanding middle class. Property came to account for 70–80 percent of wealth for individuals and families.63 As prices rose over the decades of rapid economic growth, families were able to fulfill their traditional obligations to care for their elderly parents and relatives and could increase consumption.

The real estate bubble strengthened local government coffers as the sector prospered. In the modern era, this sector of the government has been responsible for social welfare and for investments in infrastructure and growth in manufacturing and new services. Beijing depends on local government to actualize its sometimes-grandiose ambitions for industrial growth (such as the MIC 2025 program), investments in the technologies of the future, and the infrastructure necessary for a modern economy. Local governments frequently compete to build the best firms and infrastructure as long as the income is available to finance them. Competition between localities and provinces to build new ventures often leads to the overproduction of products like steel or later semiconductor firms, which in turn leads to a need to export products and often to inefficient projects. Together with mercantilist trade and investment policies, this dynamic produces chronic trade surpluses.

It is also worth noting that in China’s closed, state-dominated financial system, exporting firms must sell the foreign currency they earn from exports to the central bank. In effect, the central bank “mops up” the foreign currency and prints Chinese yuan. In the period of rapid expansion and large trade surpluses, this
resulted in excess monetary expansion, which contributed to asset inflation.\textsuperscript{64} Such interactions were self-reinforcing, maintaining an ever-expanding, wealth-effect-driven growth path extending back largely to the property-driven balance sheets of local governments.

Impacts of Property and Demographic Decline on Local Government and Family Finances

Nonetheless, after years of rapid growth and increases in asset values, as well as increasing debt to stimulate growth and improve social services, the banking system has become more and more distressed.\textsuperscript{65} Between 2007 and 2016, in Wright’s calculations, total assets in the Chinese banking system expanded by around $24 trillion, equaling one-third of global GDP by that date. Property represents about $11 trillion of this increment.

Noted Wall Street short seller Jim Chanos, in testimony to the House Select Committee on Strategic Competition between the United States and the Chinese Communist Party, offered a pessimistic view of debt levels in China. In his calculations, total debt, both public and private, reached 360 percent of GDP in 2022, a much higher estimate than the World Bank’s, which is closer to 300 percent.\textsuperscript{66} Chanos argues that the high levels of debt, overbuilding, and high prices of real estate in China, which discourage any increases in consumption, present a serious threat to Chinese and American financial stability.

Around 2016, Beijing recognized that the growth in real estate inventories and values, financed by debt, was causing instability in the banking system. By 2022, some 27 percent of all bank loans outstanding were connected to the real estate colossus.\textsuperscript{67} This was also the case with so-called shadow banks. These mostly private sector firms raised capital by selling short-term, high-paying wealth management products (WMPs). In turn these were financed by longer-term debt that caused problems for the shadow banks. WMPs have become an important source of funding for real estate developers. Small regional banks and trust funds, a largely unregulated sector, tried their hand at selling WMPs and invested heavily in developer bonds. Shadow banks and trust funds paid higher interest rates than the traditional banking sector and siphoned funds away from them. As the real estate sector became overbuilt and began to slow, these various institutions became distressed, and many defaulted.

Beijing began a systematic deleveraging campaign to address the threats to the state banking system and to deflate the real estate bubble that weakened the shadow banks, trusts, and regional banks. Over the next seven years and continuing today, numerous developers were unable to finish projects and defaulted on bonds, largely dollar-denominated bonds, and eventually housing prices began to deflate. This undermined family finances as well as the network of financing institutions that funded the developers. By 2023, as property development hit new lows in terms of sales and prices, trust fund WMPs again came under great stress, in part due to their real estate portfolios. Zhongzhi Enterprise Group, with over 150,000 WMP customers, suspended payment on their products, endangering middle-class and wealthy investors who had sought higher returns than those available through the banking system. This caused Beijing to fear political instability.\textsuperscript{68}

Over time, Beijing’s deleveraging campaign was squeezing shadow banks, trust instruments, and overleveraged small banks away from real estate. In effect, it gradually moved credit provision back toward the more highly regulated, state-dominated large banking system, giving Beijing even more control over the expansion and allocation of credit. Total credit growth in China slowed dramatically. New credit expanded by 32 percent in 2009 and by 24 percent in 2010, then by 18–19 percent in 2011 and 2012. But growth fell to single digits after 2016.\textsuperscript{69}

Another aspect of the deleveraging campaign that Beijing encouraged was to shift the financing of real estate development for housing from the array of lightly regulated, private-sector-dominated shadow banks to buyers of residential property. The system of selling housing units in advance of construction...
became the effective means of financing real estate. Eventually, after the effects of deleveraging began to take effect, the administration reduced credit, Covid slowed the economy, and mortgage holders began to push back against developers and the banks that issued mortgages to them. In 2023, the most prominent and largest property developer in China, Evergrande, has more than 800,000 unfinished housing units on its books, and efforts to restructure debt to complete these units are flailing. The fall in prices and in uncompleted projects for a system that came to harbor trillions of Chinese yuan in mortgages in turn weakened consumer finances and contributed to the failure of Xi’s dual circulation economic project to rebalance growth through stronger private consumption. Household consumption as a share of GDP actually declined from an average of 47 percent in 1960–2021 to the high 30s in the Xi Jinping years. The average of 124 countries in the world is around 63 percent for comparative purposes. Wright concluded that the rise in credit risks associated with mortgage finance represents “the most probable path to a systemic crisis in China’s financial system.”

The decline in revenues from property development after 2021 added to the perilous and unsustainable position of local government finance. Income from land sales and related taxes reached a high of 37 percent of total revenues in 2021. It then fell by nearly a quarter in the aggregate in 2022 so that it represented 29 percent of local government revenues. This is a huge problem because local governments were in recent years responsible for 85 percent or more of total government expenditures while directly receiving only 53 percent of revenues.

The problems with local government finances are almost certainly worse than official statistics describe. In recent years, local governments have sought to avoid the limits that Beijing imposed on local and regional authorities issuing bonds for ordinary purposes. Beijing typically sets the size of the bond authorities annually and normally justifies them based on the need to shore up the balance sheets of distressed local and regional governments. To avoid these limits while nominally adhering to Beijing’s guidance, these units of government have resorted to obtaining loans from firms loosely called local government financing vehicles (LGFVs). They use funds from these entities to make up for budget shortfalls for infrastructure, industrial development, completion of property projects, or other public purposes. As land sales to private property developers have sharply declined in the last several years, local governments have frequently tapped LGFVs to fill the void by buying land, but all too often LGFVs are not able to develop the land. According to Caixin, from February 2021 through September 2022, 41 percent of all land sales went to LGFVs, most of them unable to develop the land. Their debt is often short term, with some $350 billion due by the end of 2023. At least $85 billion of LGFV debt is denominated in foreign currencies, typically dollars or euros, on which borrowers normally default first in the Chinese system. In effect, local governments are selling land to themselves since they are ultimately responsible for repaying the LGFVs, which they control.

Table 2. Rhodium’s List of the Top 10 Cities by Debt Service Burden

<table>
<thead>
<tr>
<th>CITY</th>
<th>INTEREST/FISCAL CAPACITY IN 2022</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lanzhou</td>
<td>113%</td>
</tr>
<tr>
<td>Gulin</td>
<td>113%</td>
</tr>
<tr>
<td>Huzhou</td>
<td>58%</td>
</tr>
<tr>
<td>Kunming</td>
<td>55%</td>
</tr>
<tr>
<td>Chengdu</td>
<td>53%</td>
</tr>
<tr>
<td>Tianjin</td>
<td>43%</td>
</tr>
<tr>
<td>Guyang</td>
<td>41%</td>
</tr>
<tr>
<td>Xianyang</td>
<td>36%</td>
</tr>
<tr>
<td>Xi’an</td>
<td>35%</td>
</tr>
<tr>
<td>Huai’anv</td>
<td>34%</td>
</tr>
</tbody>
</table>

By 2023, total LGFV debt reached the staggering total of $9.5 trillion, approximately half the size of Chinese GDP, according to an IMF study. Additionally, some 20–30 percent of LGFV bonds are devoted exclusively to paying back existing debt.

According to an analysis by the Rhodium Group, many local governments are “tapped out” in terms of their ability to service their debt loads, largely to LGFVs. Table 2 reproduces their chart of the top 10 most stressed cities. The interest payment obligations range from 36 percent to 113 percent as a ratio of their available fiscal resources, which include fiscal revenues, income from funds, and cash flows from their LGFVs. Over 200 cities in China have burdens of 10 percent or more of their available funds, and obligations are growing rapidly as land sales diminish.

In yet another somewhat desperate tactic to reduce risk in this sector, in August 2023, Beijing announced a program allowing provincial authorities to issue bonds to repay $139 billion of LGFV debt. Such a sum represents but a tiny fraction of the overall debt inventory, but the measure further indicates the CCP strategy of managing risk by moving it away from the most vulnerable parts of the system and off their recognized balance sheets. The central government will expect the large banks to buy most of the resulting bonds, keeping the debt within the state-dominated financial system. Later that month, after a Politburo conclave, central authorities announced a new $206 billion authorization for local governments to issue more debt to pay off LGFVs and a central bank program to provide longer-term, low-interest financing for local and provincial debt. Beijing is so concerned about “hidden debt” in local and provincial governments, which Goldman Sachs estimated at the high end at $13 trillion, that in August it also sent auditors to the 10 most indebted provinces to scrutinize their books and find ways to reduce, or better manage, their obligations.

In the fall of 2023, the IMF weighed in on the growing problems of local government financing, with some focus on the perilous condition of LGFVs and the deterioration of the property sector. It noted that these financing vehicles have debt of 45 percent of total Chinese GDP, and nearly one-third of LGFVs would be insolvent without further government support. Since banks hold 80 percent of LGFV debt, they are extremely vulnerable to further decline in the property sector. IMF economists conducted stress tests assuming slower growth in China and estimated that even half the cost of restructuring LGFV debt would absorb $465 billion of bank capital, reducing it by 1.7 percent. The IMF lowered its growth projections over the next four years to 4 percent from a previous estimate of 4.6 percent. Finally, it projects that total government debt, including LGFV liabilities, will reach 149 percent of GDP by 2027, higher than that of Italy at 141 percent.

Paying for the Covid lockdowns certainly exacerbated the finances of local governments even more, as they are responsible for the delivery of health care and other social welfare services. During the height of the lockdowns in major cities, which stalled economic activity and reduced tax revenues, many Chinese cities ran out of funds to pay for the billions of testing kits citizens had to take. Reduced tax revenues and higher costs for the lockdowns also led to reductions in other local services and, in some cases, to missed salary payments to employees and contractors. Some cities also lowered monthly payments for insurance under the national and local health care plans and cut back coverage of these plans for major medical emergencies. In late 2022 and into 2023, there were numerous protests by locked-down residents and unpaid workers. Toward the end of the lockdown period, protests often turned violent. Li Qiang, founder of China Labor Watch, commented, “These protests became very violent because trust toward the government and laws is very low.” Some cities also had to sell public assets, cut back services such as bus transportation, and reduce the wages of regular employees. Such actions added to the loss of trust in CCP leadership.

Public investment in infrastructure and new enterprises has been another casualty of deteriorating local finances. Bloomberg reports that one-third of Chinese provinces have seen lower fixed-asset investment in the first half of 2023. The Ministry of
Finance connects this poor performance to slowing land sales and related development. Tianjin’s debt was nearly three times its revenues, and three other provinces had debt levels ranging from 144 to 172 percent of revenues. Since locally financed investment has always been a major source of growth in modern China, this backsliding bodes ill for future productive capital accumulation as well as for revenues to pay for social services.

The Weakening Social Safety Net

Part of the social contract in communist China has been building a strong social safety net. But weak revenues at all levels of government and Xi’s long-standing antipathy toward social welfare schemes have challenged decades of effort to accomplish this. Both the pension and health care systems that the CCP put in place now cover most of the population, but at levels far below Western standards. These systems also do not meet the challenges that the country’s deteriorating demographics pose.

Benefits for health, old-age pensions, and unemployment insurance are tied to individuals registered in the Hukou system, that is, based on the official residency of workers. The most generous is an urban system that is qualitatively superior to its sister urban-rural system, which covers rural workers and the nearly 300 million migrant workers living mostly in large cities. It also covers the non-employed, dependent children, and spouses of employed workers. Figure 6 shows the distribution for the two systems. The urban component, favored by public policy and driven by rapid urbanization, is growing faster than the predominantly rural system.

Figure 6. Number of People Covered by Public Pension Insurance in China

<table>
<thead>
<tr>
<th>Year</th>
<th>Basic Public Pension Insurance for Urban-Rural Residents</th>
<th>Public Pension Insurance for Urban Employees</th>
</tr>
</thead>
<tbody>
<tr>
<td>2012</td>
<td>0.3B</td>
<td>0.48B</td>
</tr>
<tr>
<td>2013</td>
<td>0.32B</td>
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<td>2014</td>
<td>0.34B</td>
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<td>2015</td>
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<td>0.5B</td>
</tr>
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<td>2016</td>
<td>0.38B</td>
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<td>2017</td>
<td>0.4B</td>
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</tr>
<tr>
<td>2018</td>
<td>0.42B</td>
<td>0.52B</td>
</tr>
<tr>
<td>2019</td>
<td>0.43B</td>
<td>0.53B</td>
</tr>
<tr>
<td>2020</td>
<td>0.46B</td>
<td>0.54B</td>
</tr>
<tr>
<td>2021</td>
<td>0.48B</td>
<td>0.55B</td>
</tr>
<tr>
<td>2022</td>
<td>0.55B</td>
<td>1.1B</td>
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</table>

Although there has been rapid growth in enrollment in both the pension and healthcare programs, benefits remain modest. As of 2022, full retirement beneficiaries receive an average of $461 per month in the urban program, compared to only around $25 per month for the rural counterpart.\textsuperscript{90} For the health care program, average per capita expenditure has reached about $580 per enrollee, although the quality of care is vastly superior in urban areas.\textsuperscript{91} There are about half the number of doctors and hospital beds in rural as compared to urban regions, and China has only about four intensive care beds per 100,000 population, compared to about 38 in the United States.\textsuperscript{92} Medical insurance covers less than half of individual outlays. Moreover, the rate of growth in expenditures for this system has slowed rapidly in recent years as government finances have been under constant pressure. Table 3 shows the most recent comprehensive numbers for total outlays in China under the health insurance program. In 2021 the total outlays reached 7 percent of GDP.\textsuperscript{93} Good data on healthcare expenditures is very difficult to find.

One clue to why China has relatively low social welfare expenditures is President Xi’s aversion to undermining China’s traditional work ethic. In a speech in 2021, he reportedly said, “We must not aim too high or go overboard with social security and steer clear of the idleness-breeding trap of welfarism.”\textsuperscript{94} Because of this approach, unemployment insurance is a paltry $220 per month, and what passes for a welfare system for those unwilling or unable to work offers only about $70 per month in urban areas and half that in rural areas.\textsuperscript{95}

The problem for China is that, despite growth in expenditures for pensions and health insurance, demands from the aging population and consumer expectations are growing more rapidly than the country’s ability to pay for them in a debt-challenged and slowing national economy. Compared to other nations, China’s pension system is woefully undercapitalized, as table 4 illustrates. At 2.2 percent of GDP for total pension assets, China compares unfavorably to countries at the high end of the scale, such as the Netherlands (over 200 percent of GDP for reserves

<table>
<thead>
<tr>
<th>YEAR</th>
<th>HEALTH EXPENDITURES IN BILLIONS OF YUAN</th>
<th>PERCENTAGE INCREASE FROM PREVIOUS YEAR</th>
</tr>
</thead>
<tbody>
<tr>
<td>2015</td>
<td>4,097.46</td>
<td>N/A</td>
</tr>
<tr>
<td>2016</td>
<td>4,634.49</td>
<td>13.11%</td>
</tr>
<tr>
<td>2017</td>
<td>5,259.83</td>
<td>13.49%</td>
</tr>
<tr>
<td>2018</td>
<td>5,912.19</td>
<td>12.40%</td>
</tr>
<tr>
<td>2019</td>
<td>6,584.14</td>
<td>11.37%</td>
</tr>
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</table>

Source: National Bureau of Statistics of China and the Ministry of Health (China)

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</thead>
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<tr>
<td>China</td>
<td>1.4</td>
<td>1.5</td>
<td>1.6</td>
<td>1.6</td>
<td>1.8</td>
<td>2.2</td>
<td>-</td>
</tr>
<tr>
<td>United States</td>
<td>131.5</td>
<td>134.9</td>
<td>147.1</td>
<td>134.3</td>
<td>149.6</td>
<td>169.5</td>
<td>-</td>
</tr>
<tr>
<td>Russian Federation</td>
<td>3.5</td>
<td>4.0</td>
<td>4.2</td>
<td>3.9</td>
<td>4.0</td>
<td>4.3</td>
<td>-</td>
</tr>
<tr>
<td>Canada</td>
<td>154.8</td>
<td>157.6</td>
<td>159.5</td>
<td>154.3</td>
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<td>179.7</td>
<td>-</td>
</tr>
<tr>
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<td>170.4</td>
<td>182.2</td>
<td>196.6</td>
<td>170.9</td>
<td>191.2</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Mexico</td>
<td>13.7</td>
<td>13.7</td>
<td>14.4</td>
<td>14.1</td>
<td>16.3</td>
<td>20.4</td>
<td>-</td>
</tr>
<tr>
<td>Japan</td>
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<td>29.1</td>
<td>28.6</td>
<td>28.5</td>
<td>28.5</td>
<td>30.1</td>
<td>-</td>
</tr>
</tbody>
</table>

in their national retirement plan) and the US at 153 percent, and to middle-income Mexico at 20 percent. The program will likely be technically bankrupt within 5–10 years absent significant changes, according to analysis by China’s National Academy of Social Sciences. Data from the academy indicates that the system has experienced net outflows since 2016.96

One potentially constructive policy response was a 2022 regulation allowing (and encouraging) private-sector-managed, individually funded pensions. Individuals can now open IRA-type accounts with contributions of up to $1,880 per year as a supplement to the national pension program. Early results indicate that up to 33 million Chinese have opened accounts, but it is unclear how many are actively contributing. China has also licensed fully owned and controlled Western financial firms to participate in this program.

In effect, China now relies on individual investors and savers, and to some extent on Western financial expertise, to buttress its failing pension system. This is already creating more bur-

![Figure 7. Expected Sources of Retirement Income in China, 2022](https://www.statista.com/statistics/1077947/china-expected-sources-for-retirement-income; “China Retirement Readiness Survey 2022,” Fidelity, https://www.fidelity.com.cn/media/filer_public/7c/a9/7ca98a80-978b-4b8d-bf82-d2e920ab732e/china-retirement-readiness-survey_2022_cn_final.pdf.)
dens for the overstretched population, which has to save to supplement the lack of coverage for many illnesses and the loss of purchasing power due to the fall in value of their largest financial asset, their homes. Savings for medical care, retirement, and work interruptions are overwhelming the CCP’s effort to turn to private consumption to stimulate growth in recent years.

A 2022 Ant Financial and Fidelity survey (see figure 7) demonstrated a marked lack of confidence, especially among younger people, in the likelihood of a stable retirement from government pensions. Only 28 percent of Chinese 18- to 34-year-olds have confidence that the system will be able to meet their retirement needs, compared to 42 percent among those 35 and older. Reliance on their children (5 percent), private annuities (7 percent), and income from property ownership rounded out expectations for supplementing retirement security. Such tepid confidence in Beijing’s signature social security program, and in the ability of health care insurance to meet emergency needs, bodes ill for the CCP’s ongoing effort to retain trust and support.

External Credit Problems Due to BRI, Development Aid, and Foreign Loans

Another growing problem affecting both the banking sector and central government finances stems from Xi’s aggressive programs to assert Chinese influence around the world while bolstering its export-oriented, autarchic economy. Through the BRI and expansion of infrastructure and commodity development projects abroad, China has become a major player in international finance while solidifying its export markets and gaining control of raw materials and supply chains crucial to its increasingly sophisticated industrial and technology sectors.97 The BRI especially has had some success in building out infrastructure to increase exports and to strengthen supply chains under its control, but it is experiencing problems with the investments and credits that it extends to foreign countries, especially in Africa and in low- and middle-income countries.

Xi has three primary objectives for the BRI. First, he aims to facilitate access to external markets and necessary raw materials, such as grains, fossil fuels, rare earths, and other minerals for its manufacturing economy. Building out infrastructure in transportation, mining, and processing industries enhances access and provides markets for Chinese construction and processing. Increasing its global market share in manufacturing has been a valuable supplement to China’s long reliance on exports to

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Figure 8. Development Assistance Committee (DAC) and Other Countries’ Official Development Assistance (ODA) and China’s Foreign Aid on a Grant-Equivalent Basis, 2015–19

compensate for chronically weak domestic demand. It is worthwhile to note that Chinese exports to BRI countries now exceed those to the US, the EU, and Japan combined. Second, the BRI and both development aid and capital investments abroad are part and parcel of China’s long-term ambition to become a dominant global actor and to gradually displace the influence of the US and its allies in the rules and operations of global institutions and in shaping the global order. One example of the success of this effort is that 75 percent of votes from BRI members in the UN that are of interest to China support the Chinese position. Third, the maritime and transcontinental infrastructure vectors of the BRI provide the growing Chinese military with the means to project power in a growing sphere of influence across Asia to Africa, in the Western Pacific, and increasingly in South America. This, of course, supplements its efforts to become the dominant global power and to reduce the influence (both political and economic) of the US.

Over the last two decades, China has devoted at least $1 trillion to projects associated with this coordinated external growth program. But the structure of its overall aid sharply contrasts that of Western countries, the traditional source of development assistance, including that of the Bretton Woods institutions, the World Bank, and the IMF. China structures most aid as market-rate loans or direct investments in which Chinese firms take a direct ownership interest. Only a small part of overall Chinese assistance takes the form of concessional development assistance. Figures 8 and 9 show the overall levels of what typically

Figure 9. Net ODA Disbursement from DAC and Other Countries and China’s Net Foreign Aid, 2001–19

Source: Kitano and Miyabayashi, “Estimating China’s Foreign Aid.”
China has provided about one-tenth the level of concessional rate loans or grants over the last decade that the US provides, and considerably less than those from Japan and West European countries. For Western government providers and the World Bank, for every nine dollars of concessional aid, either from outright grants or below-market loans, China offers one dollar of loans at commercial rates. For China, the opposite ratio applies. China collateralizes most non-concessional loans, and they often result in foreclosure on real property or projects in recipient countries. In the last decade, China has become the largest single creditor to developing countries, surpassing the World Bank, the Paris Club of Western banks, and the IMF. Figure 10 shows the steady rise of China as a creditor, overtaking Western sources after Xi came to power. China’s loans to low- and middle-income countries in this period have nearly equaled those from the rest of the world combined.

The problem for China is that many of its investments have not been economically successful. Sixty percent of its loans from 2016–21 were to countries, especially in Africa, in financial conditions that the World Bank considered “distressed.” Data sources cover 2008–21, and four-fifths of the bad debt occurred after 2016. China covered much of it by rolling it over or refinancing it through swap lines with its central bank. Argentina was the largest recipient, with $111 billion in loans, and 45 percent of all China’s external loans are for African nations. In addition to Argentina and Pakistan, African nations Zambia, Ghana, and Angola have defaulted on some of their loans.

Many of the direct investment projects that China financed, nearly all of which China-affiliated firms built and operated, have proven to be market failures. The most well-known example was the Sri Lankan port development project at Hambantota. China financed it, and soon after completion Sri Lanka defaulted on its loans. China subsequently negotiated a 99-year lease on the port. This gave rise to the term debt trap aid to describe China’s assistance. Another all-too-frequent feature of Chinese involvement in the developing world is the nexus of corruption that often allows China to win contracts in major projects and leads to collusion with local officials for mutual gain. The research group AidData estimates that 35 percent of all Chinese development projects involve some form of corruption, including labor or environmental violations of international standards. A particularly blatant example is its role in the oil extraction sector and related infrastructure in Angola.

The combination of commercially nonviable projects and aid to countries with distressed finances has in recent years led to even more nonperforming loans in the Chinese banking sector and in government institutions involved in development assistance. The research cited above estimates that up to $240

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**Figure 10. China is the Largest Official Creditor to Developing Countries**

<table>
<thead>
<tr>
<th>Year</th>
<th>Debt to China</th>
<th>Debt to all Paris Club governments</th>
<th>Debt to the World Bank</th>
<th>Debt to the IMF</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
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<tr>
<td>2015</td>
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</tr>
</tbody>
</table>


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$400B

$300B

$200B

$100B

0


Aggregate external public debt owed to different official creditors

Debt to China

Debt to the World Bank

Debt to all Paris Club governments

Debt to the IMF

Figure 10. China is the Largest Official Creditor to Developing Countries

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34 | HUDSON INSTITUTE
billion in Chinese credit to low- and middle-income nations has had to be written off or refinanced.\textsuperscript{109}

Given the post-Covid global economic slowdown and rising interest rates, developing countries will be more likely to default. This will be a huge detriment to the world's largest creditor: China.

Due largely to the quasi-commercial structure of Chinese aid, much of which its large, state-owned banks finance, China is an outlier in efforts to renegotiate distressed debt for developing nations. China requires that most of its loans cannot be subject to Paris Club restructuring programs. It is reluctant to extend loans or to reduce their amortization, unlike Paris Club members, as doing so would undermine the capital base of its largest banks. It has held up restructuring efforts for highly vulnerable nations such as Zambia, Gambia, and Ghana. Western leaders have attempted to convince China to be more flexible in restructuring programs.\textsuperscript{110} These efforts are ongoing but have seen little success as of mid-2023. China remains inflexible, wants to choose its own path on extending or refinancing loans, or, as noted above, simply plans to absorb the losses.

China has already experienced significant losses on its foreign debt and development-related investments in its BRI program. In a climate in which its financial sector is already under deep duress for domestic reasons, the large outstanding credits the PRC and its banking system have extended to low- and middle-income countries add one more danger to its financial system.
As Beijing assessed its economy going into the second half of 2023, its leaders recognized that they badly needed to take action to restart growth. But they also realized that, largely due to the balance sheet problems of local and provincial governments and the wealth effects of a faltering real estate market, one of the few options for stimulus would be to halt or reverse the downward trend in foreign trade and investment in China. Therefore, Xi authorized a charm offensive, which the Biden administration quickly embraced. The Biden team perceived a need to respond to pressure from Wall Street and major technology firms whose export books had been weakened by Trump- and Biden-imposed export controls, tariffs, or other restraints on two-way trade. Administration leaders also wanted to respond to environmental activists hoping to gain more cooperation from Xi on climate change. A series of high-level visits by US cabinet members followed, and both sides pledged to deepen dialogue.

Despite these moves toward easing tensions, a more assertive US approach is both desirable and potentially effective. Because of the vulnerabilities and weaknesses in the Chinese economy that Part I of this report outlined, the US has considerable leverage. It can undermine China’s attempt to restart growth by increasing access to external goods and services trade and by attracting greater foreign investment.
The US should use this leverage not simply because it would be blocking or weakening its primary geostrategic opponent. For decades, PRC programs have aimed to weaken US economic dominance and the rules-based order that undergirds this dominance, and these actions justify a set of policies to incentivize change in Chinese practices. Even though China is a WTO signatory, it is far from being faithful to the organization’s many rules and obligations. Economic analysts, the US government, and WTO executives charged with enforcing its rules have long cited China’s trade and investment policies as detrimental to the rules-based order and to the economies of other members.

The most recent recitations of the many ways China fails to maintain its WTO commitments and other bilateral or multilateral agreements, such as the Phase One agreement that China and the US signed in 2020, appear in the annual report from the White House Office of the US Trade Representative (USTR) on “Foreign Trade Barriers.” For example, China imposes tariffs averaging 14 percent on agricultural imports and applies phytosanitary restrictions to genetically modified crops and US meat exports. China heavily subsidizes its fishing fleets and aggressively exploits protected and national waters to the extent that its catch is twice the size of its nearest competitor’s. It is also responsible for depleted stocks of many species of fish due to overfishing.

The OECD continues to rate China’s services sector as one of the most restrictive among the world’s major economies. China has all but barred US internet platforms, online retailers, and telecommunications providers from operating within its borders. It has only partially opened the financial services sector, starting in the last two years, even though it committed to open fully to foreign entrants when it joined the WTO in 2001. In the meantime, China developed its own national champions and excellent software capabilities in this sector and built up its own economies of scale and loyal customer bases, making it nearly impossible for foreign firms to compete.

The most directly harmful Chinese strategy to developed economies over the last 40 years is the subsidization of its manufacturing industries. Growth of its steel and aluminum manufacturing in the twenty-first century alone (after China joined the WTO) registered 71 percent, and production reached half of global capacity. Growth in its aluminum industry was some 1,400 percent. Competition between regions or large cities in China, which are responsible for implementing Beijing’s directives to develop industry, often generates excess capacity. Excess capacity results in the need to export to absorb production. Many countries have responded with antidumping cases in the WTO against China. The US has far and away been the largest complainant, followed by Canada, the EU, India, and the UK.

In the Xi era, China has doubled down on the cycle of subsidy and overproduction in a drive to become self-sufficient in at least 10 high-technology industries of the future, including telecommunications, aerospace, biotechnology, EVs, advanced computing, and semiconductors. The USTR estimates that China has already poured over $500 billion into the MIC 2025 program. While the US and some of its allies have long held competitive and even dominant positions in semiconductors and EVs, the PRC offers these sectors massive public investment and other incentives. These measures threaten to repeat the pattern of steel, solar, and high-speed rail in which China gradually displaces the industries of advanced economies. A recent estimate suggests that China has invested around $290 billion into new semiconductor production in 2021 and 2022, much of it in direct subsidies, tax abatements, and improved infrastructure to support new factories. A study for the Semiconductor Industry Association (SIA) calculated that over $150 billion in direct subsidies to the Chinese industry helped it achieve cost advantages of about 40 percent in semiconductor fabrication and 16 percent in production, although China still cannot compete at the most advanced levels of production.

Due in part to export controls on production equipment and design technology and in final production, China has not ful-
ly achieved competitive parity in the more advanced parts of the semiconductor industry. But subsidies have helped shift some production by more advanced companies to China. In September 2023, Huawei announced that it had produced a 7-nanometer (nm) chip for its cell phones, two generations behind world leaders. However, it is unclear whether the company can produce this product at scale. The US was once a leader in fabrication as well as design and equipment for semiconductors but now accounts for only 12 percent of global fabrication.

A less sophisticated, larger, and faster-growing sector that China has come to dominate is the EV industry. China has fostered auto production within its territory by levying an import tariff of 25 percent on EVs, but more importantly by incentivizing overproduction of these automobiles of the future. US firm Tesla led the way by building a gigafactory in Shanghai and bringing its technology and production know-how to that facility. European carmakers also produce EVs in China both to sell into that market and to export, mirroring Tesla but not as successfully. Following the pathway of the steel industry, Beijing set a goal of 80 percent self-sufficiency in EVs under Xi. Most provinces, large cities, and large companies rewarded this guidance by building EV factories in their territories, or on their land in the case of private companies. By 2019, there were over 500 EV factories in China, but that number shrank to around 100 by 2023. As Chinese firms perfected their technology and learned from Tesla and others, they began to increase their market share, but at some cost to their profit margins. Chinese firm BYD, with longtime backing from Warren Buffet, led the growth of the homegrown EV industry, overtaking Tesla as the world’s largest producer of these vehicles in 2022. Due to its competitive pricing and technology, China also became the world’s largest exporter of EVs in 2023 and began to displace European and US automakers in their own markets, despite the high tariff barriers of 10 percent in the EU and 27.5 percent in the US. Chinese automakers reached 50 percent market share in their domestic market in early 2023, up from about 25 percent when Xi came to power and the total market was tiny.

As China began to rapidly displace European EV makers in their own home market, and EVs became a larger part of that total market, EU Commission President Ursula von der Leyen decided to initiate an anti-dumping case against the Chinese in September 2023. She argued that “global markets are now flooded with cheaper Chinese electric cars. And their price is kept artificially low by huge state subsidies.”

One other component of Xi’s integrated mercantilist foreign economic policy is his signature BRI. Announced in 2013, this program has invested over $1 trillion to build an ambitious network of land, sea, and air transportation and communications infrastructure. It serves, among other purposes, as an outlet for China’s surplus production of construction materials and capacity and a venue to enlarge markets for its surplus manufac-

tured goods. It has also been a key component of a strategy to capture the raw minerals necessary for supply chains in rare earths and battery materials as well as in oil and gas and feed grains to fuel China’s economic growth.

While there are other geopolitical and military objectives for the BRI program, its most important result has been to buttress the steady expansion of the Chinese export machine. China has strategically located most of the infrastructure projects—roads, railroads, airports, ports—in central and southern Asia, Africa, and Latin America. But the direct rail connections to the heart of Europe have also cut transport costs and delivery times to the huge market of the European Union. Figure 11 provides data on the expansion of exports and trade surpluses for China since 2011. China’s exports to Africa have more than doubled, while imports rose by around 45 percent. For Latin America, exports were only slightly ahead of the growth rate for imports, as China bought more grains, petroleum, and raw minerals to feed its population and industrial sector. China’s trade surplus in goods with Europe, in contrast, nearly quadrupled in this time frame as nearly a thousand trainloads now cross the Asian steppe into Europe each month. EVs are not the only source of the trade surplus with the old continent.

One could argue that the growth of trade surpluses in BRI countries is simply an expression of China’s comparative advantage in manufacturing and logistics. But the reality is that subsidization of industry and pricing of goods to increase market share also contribute to this result. Moreover, the mechanisms and deployment patterns of BRI projects, particularly in the developing world, are highly exploitative and are all too frequently a result of corrupt practices. As this report noted earlier, the watchdog organization AidData at the College of William and Mary estimates that 35 percent of BRI projects are beset by corruption, labor abuses, and environmental degradation during implementation. In terms of financing, China is now the world’s single largest source of government development assistance. In contrast to Western-origin and World Bank official and commercial financing, China typically prices loans at commercial rates and demands collateral for them.

Trade Policy Responses

Due to China’s systematic disregard of the obligations it undertook when it joined the WTO, and to the damage its state capitalist and mercantilist policies have done both to US competitiveness and to the rules-based order, there is ample justification for continuing the restrictive trade measures that the Trump administration put in place and the Biden administration has largely continued. Not the least of the justifications is that such measures certainly have contributed and will continue to contribute to the economic torpor now gripping the Chinese economy. As China persists in its mercantilist behavior, these restrictive measures help make the argument that the US and its allies are determined to counter those practices and are not willing to assist China in its efforts to jump-start growth in a deteriorating economy.

Business-based and principled free-market advocates argue that the Trump Phase One agreement retained too broad a net of tariffs on China’s exports, which are of little or no compelling economic interest and indeed were counterproductive because they had some impact on raising prices for US consumers and contributed to the inflationary cycle of the last few years. They also led to a rise in tension and countermeasures from the Chinese side.

Nonetheless, the bedrock principle of reciprocity at the core of any open trade system, in the context of continued violations of WTO obligations, is ample justification for maintaining a broad but selective high tariff regime. As US and other foreign producers based in China, and indeed many Chinese firms, realize the seriousness of the US response and recognize Xi’s determination to protect an authoritarian and state-driven economy, they are shifting production out of China to other often lower-price locations, such as Southeast Asia and India, mitigating the economic consequences for US consumers of the tariff regime the US has imposed on China.
In September 2023, David McCormick, former US undersecretary of the treasury for international affairs, advanced sensible ideas for maintaining a strong response to China’s state capitalism while not squandering leverage by limiting trade in low-technology products not likely to affect national security or the ability to combat life-threatening emergencies. His proposal is to focus more on sensitive high-technology sectors, such as those China has targeted in the MIC 2025 program. He also noted that a broad tariff regime targeting China should be coordinated with allies to the extent possible to amplify its impact. China’s policy toward increasing autonomy under Xi, along with its actions undermining the WTO and the postwar international architecture generally, have resulted in greater willingness among US allies, especially in the Pacific Rim, to support an aggressive economic posture toward the Middle Kingdom. And the impact of China’s dominance of green technologies in general and of EVs in particular is further motivation for allies to join the US in pushing back against the PRC. Figure 12 illustrates the predominantly negative views that have developed worldwide, especially in advanced economies, in the last decade. Pew Research surveys of 19 developed countries over the last 20 years indicate that the dominant reasons for these negative views have been China’s human rights abuses (79 percent of respondents), its growing military aggressiveness (72 percent), and economic competition (66 percent). Consensus regarding controls on both incoming and outgoing foreign investment has matured in the last five years as the extent to which the US and its allies have lost technology important to national security or economic dynamism has become more visible. The US has broadened its use of the CIFIUS (Committee on Foreign Investment in the United States) inward-bound investment review process because of the growing competition for key technologies and has seen increasing cooperation with European and Pacific Rim allies. In 2023, a Biden administration executive order (EO) at least temporarily resolved the long debate over whether to extend screening to outward-bound direct investment by setting up an interagency “reverse” CIFIUS process that the Department of the Treasury will head. Congress had debated but never passed legislation dedicated to creating an outward-bound investment review process for many years. Congress still may take its own action, as many criticize the narrow scope of the EO.

In a hearing before the House select committee on the CCP, David McCormick outlined a broader program and received
support from both the majority and minority chairs of the committee. The EO covers only direct investments in advanced semiconductors, microelectronics, quantum information, and artificial intelligence (AI) for China and for countries with close military cooperation with China, such as Russia, North Korea, and Iran. Implementation of these regulations will likely take up to a year to finalize and will be subject to review and comment from all parties, so investors will be in a state of uncertainty for a crucial time frame given the rise of tensions between China and Taiwan and the ongoing war in Ukraine that China’s ally Vladimir Putin has unleashed.

McCormick and Chairman Mike Gallagher both noted in the September 12 hearing that the EO covers a very narrow set of technologies and does not address the question of equity investments in Chinese firms with military capabilities or sectors linked to high technologies, such as aerospace or advanced materials that have dual-use significance. The EO also does not cover equity investments in other sensitive technologies, such as AI and biotechnology. Nor does it cover the same sectors in other adversary nations, especially North Korea, Russia, and Iran. McCormick noted that the CIFIUS process as well as the EO ought to cover medical technologies, where the Covid crisis exposed dependence on China as a national concern. He cited critical minerals, which are key components of numerous products vital to national security. He also argued that technology transfers resulting from joint ventures and venture capital investments should explicitly be subject to more comprehensive review for both inbound and outbound investment.

Gallagher and co-chairman Raja Krishnamoorthi are among the many commentators who joined McCormick in calling for the inclusion of portfolio investment in the new screening program. They noted that US exchanges list more than 250 Chinese companies with a market cap of around $1 trillion. US-based mutual funds have directed tens of billions of dollars into Chinese companies listed on US, Chinese, Hong Kong, Singaporean, and European exchanges. At the September 12 select committee hearing, Chairman Gallagher asserted that the EO covers only 17 percent of US direct investment in China and none of the portfolio investment. Another witness, commentator Anne Stevenson-Yang, noted that much of the portfolio investment flows directly into Chinese companies that the Chinese military owns or controls. Krishnamoorthi also stated that mutual funds for the savings of US federal employees, the Thrift Savings Plan, had positions in Chinese firms with technologies crucial to building advanced fighter jets for the People’s Liberation Army, including the state-owned Aviation Industry Corporation of China (AVIC), which is devoting billions to fighter jet technology as well as to commercial airliner technology to compete with Boeing and Airbus.

At an earlier 2023 hearing of the select committee, human rights advocate and Hudson Senior Fellow Nury Turkel advocated for portfolio investment restrictions on any Chinese firm on the Department of Commerce Entity List or the Department of Defense list of Chinese companies supplying the PLA. The American Financial Markets Integrity and Security Act, which Senator Marco Rubio introduced in 2021, calls for such action to extend to all affiliates and subsidiaries of the 60 companies now on the Commerce Department’s export ban list for Uyghur atrocities, such as the use of forced and slave labor or what can be called labor camps. This would include many apparel companies relying on cotton grown in that northwestern province and solar panels produced with silicon made there.

Moreover, the financial reporting transparency of most Chinese firms traded on foreign exchanges does not meet the standards of comprehensiveness, accuracy, and timeliness that Western regulators require. In the past year, Chinese authorities have compounded the problem by restricting outside accounting firms’ and due diligence firms’ access to the books of Chinese companies on national security grounds. Severe deficiencies in reporting are also apparent in bonds that China either issues in US markets and denominates in dollars or euros or simply sells to US investors. The property bonds that stressed prop-
Property firms in China typically put at the head of the line for delinquency or default are dollar or euro bonds. China seldom adequately reports the risks to US and other foreign investors and often provides inadequate information to assess those risks. The US-China Economic and Security Review Commission described in its 2020 report a crippling flaw in Chinese bond rating agencies that “obfuscates the debt risk” and engages in systematic ratings inflation that “may ultimately harm overseas investors exposed to China’s fixed income markets.”

To protect American markets and especially US investors, US financial authorities need to scrutinize Chinese equities and bonds more thoroughly to ensure they are complying with Western reporting standards, as the Holding Foreign Companies Accountable Act of 2020 requires. Unfortunately, the Biden administration has not placed a high priority on enforcing this law, which requires delisting firms not in compliance after a short period once regulators have made a negative determination. Instead, the US ought to rigorously enforce the act and delist the numerous firms that brazenly ignore its requirements, in many cases because of requirements of Chinese national security and espionage laws. Bonds that appear on US exchanges or that US securities firms sell should face the same fate.

As many analysts have noted, a final reason for concern about investors’ exposure to Chinese securities is that, unlike those in the West, foreign holders do not have any legal ownership rights to the underlying asset of PRC securities. As Wall Street’s Jim Chanos explained to the Gallagher committee on September 12, the PRC created a variable interest entity (VIE) ownership structure to get around long-standing prohibitions on foreign buyers owning PRC shares. “Western investors in VIEs do not realize that they do not have legal ownership rights to the underlying assets. . . . Instead, investors actually own a piece of paper in an overseas entity.” He notes, too, that the opaque structure combined with a hostile and often unpredictable authoritarian government results in “major risks” for foreign investors.

For all these reasons, the US needs to greatly expand the Biden EO on outward investment in China. Expansion is necessary for both the sectors it covers and for inclusion of equity investments. New legislation would be the preferable means of expansion to provide certainty and regulatory stability. Again, it is important to coordinate with allies to the extent politically feasible on the industries and geographic limits that the legislation will cover. Broader coverage should consider whether the US and its allies are capable of filling supply chain requirements, including for upstream raw materials, for the sectors and technologies they deem vital to national and healthcare security. This especially applies to dual-use technologies such as semiconductors, computing, and AI. As McCormick argues, direct investment, joint venture investment, and portfolio investment review policies should have a presumption of denial for China for covered sectors and technologies.

The expansion should not ban nonstrategic trade and investment with China or routinely subject it to non–most-favored-nation (MFN) tariffs, although it should maintain the use of countervailing and antidumping policies to thwart unfair trade practices.

**Some Impacts of Trade Restrictions in 2023**

Part I of this report argued that China currently has few choices to reinvigorate growth, as its financial situation, including the balance sheet problems of governments and families, has deteriorated and remains largely closed off to massive expansions of credit as a means to achieve this. So the charm offensive of 2023 was one response from PRC authorities to fill this gap. The obvious goal was to fill the gap by restarting the export trade engine so weakened by the Covid crisis and by, as the *South China Morning Post* reported, “an all out effort to attract foreign capital.” Figures 13 and 14 show that both exports from China and foreign direct investments into China have deteriorated to levels not seen in decades. Black Rock closed its China fund in mid-2023 after its value declined by over 25 percent since its inception in 2017. Scrutiny of this fund by the China select committee was possibly a factor in this action,
although the fund had already stopped taking new investments after a 30 percent drop in value in 2022. Equity investors have been pulling record amounts of money from Chinese equities since the Covid crisis. A JP Morgan survey showed investors pulled a record $12 billion from Chinese equities in August. The survey indicated that a “net 0%” of money managers think China’s economy will improve next year. Bloomberg reports that 2023 has seen the “worst capital outflows” from China since the 2015 economic crisis and that the resulting impact on its current account is a major contributor to its weakening currency.

There is, of course, a multitude of explanations for the lack of confidence in China’s economy and for reducing exposure to its markets. But Xi’s turn toward state capitalism and US-led restrictions on trade and investments clearly contribute to the development. Despite the best efforts of Beijing’s charm offen-

![Figure 13. Foreign Investment Flows into China](source: Macrotrends, "China Foreign Direct Investment 1979-2023," accessed October 31, 2023, https://www.macrotrends.net/countries/CHN/china/foreign-direct-investment.)
US policy has made it more difficult for the CCP authorities to compensate for their policy failures and renew a growth path consistent with China’s dual-circulation ambitions.

**Alternatives to the WTO and the Bretton Woods System**

The role of the WTO in today’s world is a crucial question confronting Western policymakers. On the one hand, China’s participation in the quintessential rules-based global system, which was put in place to reduce tensions stemming from autarchic competition in the 1930s, is extremely problematic. CCP- and Xi-led China adheres to WTO obligations when it suits its interests. For decades, Western commentators have chronicled the multitudes of violations of its rules in fact or in spirit. While the WTO rules regarding state subsidies and intellectual property rights (IPR) protection have sporadically been effective in limiting the most egregious Chinese practices, the state subsidies of the mercantilist Chinese leadership and ongoing IPR appropriation continue to undermine Western economies. Originally driven to dominate global heavy industries such as steel, cement, and high-speed rail, China has moved on to programs by which it aims to supplant Western leaders, such as in solar, wind, and EV technologies, and is attempting to do the same for computing and AI. It has become evident that the WTO sanctions that the US, Europe, and other allies have brought against China cannot alter its intentions and practices.

Consequently, the question for Western policymakers is whether to take tougher actions, such as denying MFN status to China, as presidential candidate Ron DeSantis apparently favors, or applying total, across-the-board, punitive tariffs on China, as former President Donald Trump supports. It is also worth noting that other major economies, especially India, maintain prohibitively high levels of tariffs and insist, like China, on protecting developing industries. China’s efforts to develop economic ties with the expanded BRICS and its BRI sphere of influence are other roadblocks to any attempt to change Chinese behavior through existing Bretton Woods institutions.

On the other hand, the US and its allies have, partially in response to Chinese mercantilism, embarked on a new era of industrial policies replete with substantial subsidization of high-technology industries, especially semiconductors and advanced computing, and green industries. The EU, Japan, South Korea, India, and other countries are mirroring the huge industrial policy initiatives of the Biden administration, efforts that have considerable Republican support. This creates a type of competitive industrial policy dynamic among developed countries, which developing countries that cannot afford to compete with either Chinese or Western national champions heavily criticize. Western nations, following the EU’s leadership, are also considering a new type of variable carbon border adjustment mechanism (CBAM) that would, in effect, put new tariffs on the carbon embedded in imports. EU adoption of the program in October 2023 will probably compel other nations to follow this path. The Biden administration is considering a similar plan for steel and aluminum imports that it hopes to expand to the EU and other like-minded nations. The industrial policy competition between the US and its allies undermines their credibility in trying to enforce and improve WTO subsidy disciplines and further alienates developing countries that cannot afford to compete with them. These measures widen the gap between developed and developing nations and make any attempt to reform the WTO, which still requires unanimity to achieve most substantive changes, all but impossible to achieve.
In an address to Hudson Institute on September 18, 2023, former Vice President Mike Pence accused some of his competitors in the 2024 campaign of “isolationism.” A major component of the drift toward withdrawing from reliance on global institutions, which is increasingly evident in both Republican and Democratic ranks, is more support for protecting US industry through trade policy as well as industrial policy. Such tendencies are also apparent in Europe, especially in France, as political leaders predominantly on the fringes of the right and left react to what they perceive as deindustrialization caused by, but not limited to, Chinese mercantilism. The new growth of industrial policies and the broad application of tariff protections among Western nations contributes to this drift.

Despite the siren calls for more robust industrial policies and what in reality is a tendency toward economic autarchy reminiscent of the 1930s, moving precipitously toward the decoupling that would follow the revocation of China’s MFN status and effectively abandoning the WTO would be too damaging to the US economy and US consumers for the country to fully embrace. The American Action Forum estimates that full revocation of MFN status would reduce US exports by 17 percent and increase inflation by 5.9 percent. If China retaliated in a reciprocal way, exports would fall by 44 percent. GDP would decline by about $25 billion. Instead of a near-term and decisive decoupling from China, if it continues on its current path and ignores the many new trade and investment restrictions that the first part of this section outlined and the report will discuss later, the US may need to take some interim steps, such as suspending Chinese firms’ access to listing and selling stocks and bonds on US exchanges, expanding Section 301 tariffs to all Chinese exports to the US, and expanding existing export controls to all dual-use technologies that benefit the Chinese military or China’s MIC 2025 ambitions.

Largely because of the determined mercantilist policies of CCP-led China, and the lesser roles of ongoing failures to integrate less-developed countries into the WTO system and the growing protectionism in the West, any reform of the WTO to correct its many flaws or update its rules is fated for failure. The unanimity principle for agreeing to substantial reforms makes it extremely difficult in the best of circumstances, such as in the glory days of neoliberalism in the 1990s and early 2000s, to achieve any fundamental changes. The US and its allies should not abandon the WTO, but they will have to meet the challenge of China by relying on other policies and institutions while maintaining the WTO’s limited ability to address Chinese dumping and other practices where possible.

Rather than expending its political capital on the Sisyphean task of WTO reform, at least in the foreseeable future, the US should embark on a campaign to build parallel institutions to the WTO and indeed to the other pillars of the Bretton Woods system, the World Bank and the IMF. Chinese attempts to use the latter institutions for its own ends have weakened them, as have its larger ambitions to undermine the postwar order by building alternative institutions, such as BRICS, the SCO, and the Asian Infrastructure Investment Bank (AIIB). China’s efforts under the BRI and its measures to undermine the dollar and the Western payments systems are part and parcel of this program.

The proposed program in this report would involve building trade agreements and other alternatives to both the WTO and the newer Chinese institutions and partnerships. The US would have to develop them in close coordination with like-minded allies and exclude China. No single global institution or agreement is likely or desirable because it would be overly ambitious in current circumstances, which have seen global institutions founded on North-South and democratic-authoritarian differences. Rather, a series of related agreements that rebuild a parallel rules-based order among allies would be the principal building block. If the US-led group could trust China or its allies to adhere strictly to the requirements of the agreements at some point in the future, it should be open to China’s participation.

Robert Atkinson sketched an outline of a trade order that he labeled a “NATO for Trade,” although he did not flesh out his
idea other than to invoke the NATO analog in a world divided into competing blocs, as evolved in the years after the Depression and until the collapse of the Soviet Union. The objective of such an organization would be to recruit as many allies as possible to counter China while agreeing on the largest possible set of common trade and investment rules.

To convince much of the developing world to join, any newer trade grouping would have to offer more than the vague trade facilitation, fairness, supply chain coordination, and “clean economy” invocation that the Biden administration’s Indo-Pacific Economic Framework (IPEF) embodies. Any allies, whether in the developed or less-developed world, will demand concrete economic gains from any US-led group to offset the benefits, however attenuated by exploitative and self-serving conditions, that the Chinese typically offer. The growing public and elite antipathy toward China around the world is not sufficient to win less-developed or middle-income countries to a new Western trade and investment system.

In the Asian context, there are already seeds of a NATO for Trade that the United States helped create. To pursue this objective, the US ought to rejoin the CPTPP, which it helped to negotiate during the Obama administration. It does provide concrete benefits in the form of better access to US, Japanese, and newly added British markets to the nations of ASEAN (Association of Southeast Asian Nations). It would also aid other Asian and Latin American nations, including India, which might have an incentive to join if the US became part of the agreement. Many potential members are already benefiting from an exodus of Western firms from the increasingly difficult and closed Chinese market. The US and the EU combined, or the US alone, already

Figure 15. Foreign Direct Investment in ASEAN, 2021

represent more direct investment in the ASEAN nations than China, and the same applies to India.\textsuperscript{152} The infographic in figure 15 shows the most recent FDI results for ASEAN. The US and EU both more than doubled Chinese investment in ASEAN in 2021. China is only ASEAN’s third-largest investor and has not always provided more investment than Japan in any given year. The CPTPP has the benefit for the US of very strong rules for industrial subsidies and the new digital economy, which could be a model for expansion or for other agreements. Convincing South and Southeast Asian nations to work more closely with the US-led economies would be one of the most significant accomplishments in the contest for economic and political leadership in the years ahead.

The US should also consider, as Senators Bill Cassidy and Michael Bennet and influential commentators from Canada have suggested, opening the USMCA agreement to other Latin American nations.\textsuperscript{153} This is probably a distant hope as most of these countries are unfortunately somewhat hostile to the US, with the possible exception of Costa Rica, which is also economically better prepared to join than most of its neighbors. At various times in the recent past, Argentina and even Brazil were willing to discuss more open trade with North America and could rekindle this interest as the vagaries of politics swing in another direction. There was also a flurry of interest in 2021 in the United Kingdom to join this agreement. However, a more likely outcome would be a standalone bilateral free trade agreement with the long-standing US ally and liberal trade supporter.

Another path to advance a more open trade and investment regime among allies would be to cooperate on a sectoral basis in areas where they view dependence on Chinese providers as a problem for national security or economic security. Cooperation is ideal in relation to dual-use or systemically important technologies, such as quantum computing and communications, advanced semiconductors, and AI. Battery materials and other green technologies or critical minerals, such as rare earths, gallium, and manganese, are also sectors where reliance on China compromises security and supply assurance. Allied cooperation is also important in view of Chinese export controls on rare earths and gallium as a tool of geostrategic policy in the past. Instead of relying on an economically duplicative, costly, and inefficient cycle of competitive industrial policies to reduce dependence on China or to minimize risk, it would be preferable to lower tensions among allies and find ways to cooperate based on variable national endowments of natural resources and strengths in production technology.

The Biden administration has tacitly admitted the need for such cooperation and the need to lower tensions by negotiating ways around EV-related US subsidies under the so-called Inflation Reduction Act. This path would apply to allied nations already proficient in battery production, such as South Korea, Japan, and Europe. The US has also worked with its Pacific Rim friends to cooperate on advanced semiconductor technology. It is difficult to get around the legislative requirements for US content and production facilities in these sectors, but good faith efforts to do so can contribute in the medium term to some common and nondiscriminatory rules for an alternative framework to meet and undermine Chinese state capitalism.

US dialogue with Europe, which it has embodied in the Transatlantic Trade and Technology Council (TTC) under the Biden administration, also addresses the need for cooperation in vital sectors important to the China challenge. A more recent and geographically broader initiative to align allies on critical supply chain issues is the Minerals Security Partnership, which includes mining powerhouses such as Canada, Australia, and Norway and technology leaders such as Japan, Germany, and the US.\textsuperscript{154} These initiatives can contribute to a de-risking program and, with bolder US political leadership, decrease reliance on American industrial subsidies and protectionist programs to create larger alliances in the face of Chinese mercantilism.

One champion of trade openings for the CPTPP, bilateral free trade agreements with the UK and Japan, and allied cooper-
ation instead of competitive, protectionist industrial policies is former Vice President Pence. The Biden administration, with congressional support, has gone in a different direction featuring industrial policies and hostility to any new trade agreements. It is unlikely to achieve the sort of broad allied cooperation or attract the developing countries necessary to effectively counter China’s trade and BRI strategies. Former President Trump is resolutely set on an America-first program. A break with current US trends, including conservative and progressive support, will be difficult to achieve. It will require determined and articulate leadership to make the case for even a minimal return to a zone of economic liberalism as this report outlines. But a return to the autarchic policies of the 1930s will not achieve the unity necessary to incentivize change in China or to promote an alternative rules-based order that will avoid some of the worst impacts of 1930s protectionism.

Countering BRI, BRICS, De-dollarization, and China’s Alternative Development Finance Initiatives

Another important thrust of China’s ambition to displace the US and the Bretton Woods liberal order is the outward-looking BRI, along with the growing and expansive effort to create an autonomous financial sphere that displaces the dollar in international transactions. Groupings such as the BRICS, the SCO, and the AIIB embody this effort. China conceived the AIIB, which opened in 2020, as a direct competitor to the World Bank but limited it to infrastructure projects on the Asian continent. It is open to any country belonging to the World Bank group. To date, 105 countries have signed up as members. China also controls 27 percent of the AIIB’s capital, more than three times that of the next-largest member, India, making it the dominant force in the allocation of the bank’s lending. As of early 2022, the bank had finalized only $11.6 billion in projects, but another $31 billion had preliminary approval. India, Indonesia, and Turkey are the largest borrowers, but the amount of lending pales in comparison with that of the World Bank. A Congressional Research Service report on the AIIB noted that many analysts “question the AIIB’s independence from China” and that China “has often supported large-scale infrastructure projects throughout Asia with less regard to social and environmental standards” than other multinational development banks. The report also emphasized that borrowers overwhelmingly favor Chinese firms to build AIIB projects. These aspects of AIIB work mirror those from bilateral aid through the BRI and the limited number of development aid grants that China issues.

BRICS is the central part of the program as Xi explicitly conceives of it as an alternative to the liberal economic order. The most committed members of the group, authoritarian Russia and socialist South Africa, have embraced Xi’s initiatives to accept trade settlements in yuan and to settle all trade transactions in local currencies, especially the yuan. The newest members of this club, notably Saudi Arabia, Iran, and the United Arab Emirates (UAE), have indicated some willingness to use local currencies for commodity trading. But the data does not show any full-scale transition toward actual settlement in yuan except on a bilateral basis in their China trade.

Trade among the BRICS nations, with the propulsion of Russian imports from its “partner without limits,” China, and the latter’s growing purchases of below-market-priced oil and gas, have doubled in the last five years. The rise of the Indian economy and its external trade also strengthens at least the economic size of this group. Trade will grow further with the addition of the Gulf States, Argentina, Iran, Egypt, and Ethiopia to its membership. One key driver of this growth is the Middle Kingdom’s voracious appetite for importing oil and gas to power its economy, including the auto and chemicals industries. Of its total petroleum use, it imports 72 percent from the Middle East, and Saudi Arabia is the largest source. But China is also circumventing sanctions on oil exports from Iran. Reporting indicates that China tripled imports from global pariah Iran in the past two years and pays an even steeper discount off world prices for this source than for Russian oil.
Despite the outward show of momentum coming from the South African summit, it is difficult to understand how countries as diverse, economically and politically, as China and India, and the other smaller states, can coalesce into an enduring cooperative block, even if limited to economic relations. Indeed, China’s support for the Russian aggression in Ukraine has set back the political impetus for closer cooperation, as even Brazil, India, and the Gulf States are wary of backing Putin’s agenda and China’s state-driven mercantilism. Such differences are a clear impediment to the sort of fulsome cooperation now apparent between Russia and China.

It will also prove difficult to displace the dollar either as a reserve currency or as the currency for international trade and investment transactions. Data on the use of the yuan as a reserve currency (see figure 16) implies a broad reluctance to displace the dollar in international finance and transactions. After China’s attempts to build global acceptance of the yuan as a reserve currency, its market share reached only 2.6 percent in 2022, compared with 59 percent for the US dollar and nearly 20 percent for the euro.

Two major impediments work against substituting the Chinese currency for those of the West: the inconvertibility of the yuan (a bedrock policy of the CCP to prevent capital flight and undermine the currency’s value) and the technical problems inherent in adapting global payments systems to Chinese-language clearing software. The Chinese payments clearance system that is now widely used in China is called CIPS, for Cross-Border Payment System. Chinese tourists traveling abroad also use it. Beijing is trying to compel or incentivize friendly trading partners to convert to this system. Nonetheless, it lags far behind the well-developed Western system. The clearing component of the Western system is called CHIPS, for Clearing House Interbank Payments System. The communications component is the well-known SWIFT, or Society for Worldwide Interbank Financial Telecommunications. CHIPS processes 40 times the number of clearing transactions as the newer CIPS. But due to deficiencies in software, 80 percent of all CIPS transactions must use the SWIFT messaging system.161 Figure 17 provides an overview of the data comparisons between the dominant Western and Chinese payments and clearing systems. CIPS accounts for just 2.2 percent of all daily transactions worldwide.

China is a leader in developing a digital currency. The PRC is also trying to convince close partners to use this currency for trade transactions. The CIPS system is part and parcel of the effort to decouple from the Western banking and payments clearance system. The US and its allies have very successfully barred adversary regimes in North Korea, Iran, and now Russia from access to SWIFT and CHIPS in the past. Cutting them off from this clearance system makes it extremely difficult for them to conduct international business. One important drawback of

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**Figure 16. The US Dominates World’s Allocated Reserves by Currency**


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<thead>
<tr>
<th>Currency</th>
<th>Market Share</th>
</tr>
</thead>
<tbody>
<tr>
<td>US dollars</td>
<td>59%</td>
</tr>
<tr>
<td>Euro</td>
<td>19.8%</td>
</tr>
<tr>
<td>Japanese yen</td>
<td>5.5%</td>
</tr>
<tr>
<td>Pounds sterling</td>
<td>4.8%</td>
</tr>
<tr>
<td>Chinese renminbi</td>
<td>2.6%</td>
</tr>
</tbody>
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China’s digital currency and its CIPS system is that they can track all transaction activity by those who use them. In this way, they can be tools for extending China’s nearly ubiquitous domestic surveillance system to a global reach. China is already skilled at exploiting its surveillance capabilities for its own authoritarian governance and social control apparatus.

A final reason to remain skeptical of the China-led effort to undermine the dollar and build a separate trading and investment bloc is the economic underperformance of most of the BRICS members and much of its networks built up through the BRI and the AIIB. With China’s growth model under threat, predictions that the BRICS alone could overtake the G7 or the entire Bretton Woods system appear considerably premature. Dating back to the global financial crisis, the collective equity market performance of the original five BRICS members lags behind US peers by over 400 percent, as figure 18 illustrates.

In the last several years, China has had to cut back on its BRI-related development assistance, in no small part due to the growing number of nonperforming loans it has issued to fund projects. It funded only 10 new BRI projects in 2021, for instance, compared to an average of well over 50 at the height of the program. Moreover, China has depleted about one-quarter of its foreign reserves to rescue defaulting loans and underperforming foreign investment projects. Deterioration in its current account balance sheet due to slowing inward investments and outflows of capital from its financial markets also depletes its foreign currency reserves.

Figure 17. Comparing CIPS, CHIPS, and SWIFT Usage and Transaction Value
The US and its allies have become increasingly concerned about the problems of supply chain dependence on China for raw materials, which the BRI and China's cooperation with Russia have helped to create. To slow or reverse the asymmetry in access to raw materials, such as rare earths and minerals for lithium-ion batteries, the US and its allies need to broaden and improve their development assistance programs. They also need to increase support for domestic firms seeking to compete with China to mine, refine, and use important minerals for defense-related products, such as rare earths, and for minerals required in green products. The June 2021 G7 meeting provided at least a rhetorical new start to allied cooperation and new financing of global projects to offer concrete alternatives to BRI and related Chinese development aid. The so-called Build Back Better World program requires attention and consistent financing to become an effective alternative. The G7 meeting in May 2023 also pledged to raise $600 billion for infrastructure projects as a follow-up to the Build Back Better World pledges its members had made two years prior. The European Commission, under the leadership of President von der Leyen, announced a parallel program in 2021 called the Global Gateway Initiative, which they similarly dedicated to supporting transportation and digital infrastructure programs in the developing world, especially in Africa and Latin America. The European Commission announced a goal of $300 billion in support through 2027 for these efforts. One notable project is a $53 billion commitment for strategic mineral production and processing.

A related initiative with a broader group may have more near-term promise. Coming out of the G20 meeting in September 2023, which Putin and Xi did not attend, the Biden administration announced a plan to work on a transportation and communications corridor connecting India to Europe via the Middle East. The members labeled it the India–Middle East–Europe Corridor (IMEC), and it has substantial support from Saudi Arabia and the UAE, which clearly have the resources necessary for such an ambitious project. The G20 countries also conceived the IMEC as a strategic response to the BRI that would leverage the movement of supply chains from China to India via new rail connections and ports in the corridor. A pipeline component may provide for oil, gas, or even hydrogen from the Middle East to Europe in the long run.

Unfortunately, the war between Israel and Hamas, unleashed with the support of Iran, has upset the dynamic for the IMEC project, especially since it has forced the Gulf States to distance themselves from Israel. Reviving momentum for an economic connection between India and Europe via the Middle East will be a worthwhile project for the US and Europe, presuming Israel, Hamas, and their allies can settle the war. The connection can assist in building out alternatives to China's BRI program and demonstrate commitment to more effective development assistance by Western allies.

The Biden administration has also announced collaborations with African and Saudi partners on projects to develop dedicated supplies of necessary raw materials. When asked to comment on these announcements, US Representative Cathy McMorris Rogers, chair of the House Energy and Commerce Committee,
acidly replied, “If the administration were serious about reducing our dependence on China, they wouldn’t be shutting down mining and making it impossible to process and refine critical minerals domestically.” There are many things the US administration could and should do to encourage domestic production, as well as siting processing plants in the US. The Department of Defense has backed two US plants for processing critical minerals in Texas and California. These contracts are for refining rare earths crucial to national defense equipment needs that the US would otherwise source from China.

Another way to weaken China’s BRI program stems from the way China finances most development aid and from the endemic corruption associated with its aid. This report recounted earlier the parameters of these exploitative practices. Angolan human rights researcher and activist Rafael de Morais and I proposed means to “shame” Chinese practices and to take concrete steps to undermine them. First, the US should spearhead an effort to dissuade China from writing their loan contracts to exclude Paris Club–type resolution of serious arrears and defaults. China frequently tries to convince the IMF and World Bank, in which the US and allies essentially hold a blocking majority, to participate in restructuring using their own funds. Such relief accrues to the benefit of China because the Bretton Woods financial institutions pay off their troubled loans. The US and its allies should work with those institutions so that bailing out the Chinese does not take place. One possible tactic is for the Western allies to assume responsibility for the distressed debt obligations in return for taking over the underlying projects. The Chinese would then lose their investments in the troubled projects. A second tactic is to invoke the legal concept of “odious” debt, essentially holding that a successor regime can renounce any debt contract that a corrupt regime enters for illegitimate purposes. Nobel Prize-winning economist Michael Kremer and a colleague revived this legal concept two decades ago in a paper for the IMF. The widespread Chinese practice of engineering abusive and un-economic development projects would become largely too risky to pursue if the IMF and World Bank adjudicate even a few cases of debt contracts with corrupt regimes using this mechanism.

**Dollar Dependence and Vulnerabilities in the Financial System**

The previous section provided an overview of China’s strategy to free itself from dependence on the Western-dominated global financial system, especially the US dollar. However, the evidence strongly suggests it is far from achieving this goal. As long as the Western allies maintain stable currencies and well-functioning market-oriented economies and build better alternatives for trade and development assistance to attract South Asian, Latin American, and African nations to the Western orbit, China will be able to create neither a competitive economic bloc or sphere nor an alternative payments system that meets all the needs of these nations.

Of central importance to future economic performance is the PRC’s continued dependence on Western clearance and payments systems and Western finance to reinvigorate a faltering economy, which is now threatening the stability of its own finances. Such dependence provides considerable leverage to the West in its efforts to incentivize changes in Chinese behavior. Because of the widespread problems in real estate, local government finance, and debt levels now afflicting the Chinese economy, the US and its allies should consider the tempered and progressively aggressive use of this leverage and calibrate it to incentivize change in China.

An earlier section of this report described the structure of development finance programs that China has offered in recent decades. In a 2019 report from the National Bureau of Economic Research, Carmen Reinhart and colleagues calculate that China denominates over 75 percent of BRI and other development assistance loans in dollars. Many loans have become nonperforming because of corruption, poor economic design, and overleverage. At least 20 countries have had to
refinance over $240 billion in loans, and China has in some respects become an alternative to the World Bank and the IMF as a lender of last resort.\textsuperscript{171} The major state banks that dominate Chinese finance originated most of these loans and have had to refinance the bad debt through rollovers, maturity extensions, or other rescue financing. In the post-Covid global economy, the dollar is increasing in value, and the yuan is declining; so the total debt in yuan is often greater after the rollover than before. One macroeconomic result of the accumulation of distressed and defaulted foreign debt and the poor design of investment projects has been a drawdown in China’s dollar-denominated foreign reserves. This dynamic has also constrained new BRI lending.

Although accurate data for China’s real estate and overall private sector balance sheets is notoriously hard to obtain, what is available indicates an important role for the dollar- and euro-denominated loans that China uses to finance this $7–9 trillion sector. As a 2022 MIT Sloan School paper reported, at the end of 2019, the Chinese banking system had at least $590 billion in outstanding dollar bonds, $236 billion or 40 percent of which were in the property sector. Much of this total was to LGFVs. These are known totals that most likely have grown in value since then, with rollovers and new debt added in the last few years.\textsuperscript{172} A Reuters report in early 2022 indicated that from 2022 through 2024, Chinese property developers faced at least $92 billion in maturing dollar bonds.\textsuperscript{173} In October 2023, Chinese property developer Country Garden, which analysts previously considered one of China’s strongest, announced it could not meet payment on a $60 million loan denominated in Hong Kong dollars, whose value remains linked to the US dollar. Country Garden registered its first formal default for dollar bonds on October 18. At the same time, it announced that repayment of all its dollar bonds was unlikely and suggested it would try to put a restructuring program in place. Reporting by the Wall Street Journal noted that at least 30 other property developers, including of course the largest, Evergrande, had already defaulted on dollar bonds.\textsuperscript{174}

The MIT study also notes that the size and systemic importance of the Chinese banking system, with total assets of 325 percent of GDP in 2021, is “high by global standards.” It has over $1.5 trillion in total dollar liabilities but only slightly over $1 trillion in dollar assets, indicating a “funding gap” of $471 billion, or over 20 percent of total external debt. Moreover, the authors report, “Typically a dollar funding gap is associated with a reliance on short-term dollar liabilities to fund long-term dollar assets, representing a potential source of financial instability.”\textsuperscript{175} The risk is the ability of developers or bondholders to fund rollovers with new dollars. These could come from other sources, such as currency swaps with other banks or foreign currency derivatives. The possible final collapse of Evergrande, with its $375 billion in debt as well as the ongoing distress of the nation’s largest developer, Country Garden, with $192 billion in liabilities, at a minimum suggests a substantial risk of an acute crisis if international lenders decide they cannot aid in filling the dollar gap. Since the property bubble largely burst in 2021, companies representing 40 percent of home sales in China have defaulted on some or all of their debt.\textsuperscript{176} China may choose to draw down its official reserves even further to fund the dollar gap, but clearly it is trying to avoid taking full responsibility for the burgeoning real estate bankruptcies. The problem for China is where to find the dollar resources to roll over debt and avoid adding more bad debt to its banks’ balance sheets.

The US Federal Reserve Board does not have a currency swap line open with China, which might be one possible large source of emergency funding in case of a real crisis in China. The steady drawdowns of US equity investments in the Chinese markets suggest that the private sector in the West is wary of the growing risks of Chinese property and industrial markets. While US policymakers cannot interfere with decisions on Fed actions, notably opening a precautionary swap line with the People’s Bank of China (PBOC), they can send signals regarding the advisability of such an action. The current political climate in the US would likely not be supportive of any new program that politicians and their constituents might view as bailing out the
Chinese economy, even in the case of an acute crisis. It would be even more controversial if the Fed were to lend money to the PBOC, essentially giving it the ability to allocate the relief funding necessary to avert any crisis. The massive response of the Fed after the global financial crisis of 2008, in contrast, was obviously crucial to the US economy, although the Fed found it necessary to assist private firms and foreign central banks to prevent an even broader crisis in 2008 and afterward.

There are other ways the US should send a clear message to Chinese authorities indicating that it will not help resuscitate the deteriorating balance sheets of China’s state-driven banking system. And there are compelling policy reasons to send strong signals about the role of the Chinese banking system in various problematic practices. For example, Chinese banks are increasingly complicit in many of the human rights abuses by Chinese authorities or companies, implicating both domestic firms and their global investments. Western leaders are also increasingly aware of the widespread and growing money laundering schemes supporting the global drug trade, tax evasion by Chinese firms or individuals operating abroad, and violations of arms trafficking sanctions involving Chinese banks. These issues, too, should motivate more forceful pushback against the Chinese banking sector.

China’s growing role in the international drug trade and the associated money-laundering industry is the clearest direct justification for putting sanctions on Chinese banks, including major Hong Kong banks. Not only is the Chinese chemical industry now the major supplier to Mexican drug cartels of the raw materials and equipment necessary to make this deadly and addictive drug, but it is expanding its reach in the sale of heroin and other drugs around the globe. In cooperation with the traditional Triad gangs in China and the cartels in Mexico, the money laundering associated with the drug trade has become, according to my Hudson colleague David Asher, the largest money laundering operation in history. The Hong Kong Shanghai Bank (HSBC) has been fined and sanctioned numerous times for its role in money laundering but apparently continues its activities well after paying a $1.9 billion fine to US authorities in 2013. Authorities in Spain, Italy, and France have fined and sanctioned two of the four major Chinese banks, the Agricultural Bank of China and the Industrial and Commercial Bank of China, for drug money laundering and tax evasion in those respective countries. Italy and France have also cited the Bank of China for complicity in money laundering for tax evasion. Spain, the United Kingdom, and the State of New York have all cited various Chinese banks for money laundering.

In April 2023, the bipartisan leadership of the Banking and Armed Services Committees of the US Senate introduced the FEND Off Fentanyl Act to strengthen ongoing law enforcement efforts to penalize individuals and institutions involved in trafficking this deadly drug and those facilitating it through money laundering. The proposed legislation explicitly invokes Sections 311–313 of the USA Patriot Act, which imposes strict detection, reporting, and prosecution strategies to better control the money laundering associated with the illicit drug business. The original target of the act was, of course, money laundering and financing of terrorist networks and acts. The US has applied Section 311 to Iran-, North Korea-, and Macau-based actors and institutions in the last two decades.

Chinese banks have been complicit in enabling the arms trade of North Korea and other rogue states. They have also been complicit in masking trade transactions with industries allegedly employing forced and slave labor and avoiding trade restrictions on products made in Xinjiang. It is highly likely that they are also implicated in the illicit purchase of Iranian oil in recent years and in the circumvention of sanctions on Russian oil and technology industries. In conjunction with domestic banks, the World Bank’s private financing arm, the International Finance Corporation (IFC), has previously supported Xinjiang industries using forced or slave labor or making products in what are, in practical terms, labor camps. The huge Chinese Agricultural Development Bank partnered with the IFC on projects in Xinjiang.
IFC has invested almost $550 million in projects implicated in malign practices. The US is the largest shareholder in the World Bank and ought to use its voting rights, along with those of its allies when possible, to block these misguided investments. The US ought to sanction banks implicated in these projects, along with the IFC, under Section 311 of the Patriot Act. As Olivia Enos has written in a paper for a non-profit, activist group in Hong Kong:

The Committee for Freedom in Hong Kong Foundation also calls for employing Section 311 of the Patriot Act to sanction Chinese and Hong Kong banks. This component of the Patriot Act allows labeling of whole jurisdictions and banks as “primary money laundering concerns” (PMLC). Labeling alone, the report argues, “typically has a chilling effect on the willingness of industry to do business with the PMLC.”

There are thus a multiplicity of good reasons and legal authority to sanction Chinese banks, and using the broad tool of the Patriot Act to deter the cooperation of Western banks with those in China is one good method. Sanctions for egregious violations could include bans on participation in the SWIFT and CHIPS clearing networks. Since European and US authorities have fined and sanctioned the Bank of China and at least two of the major policy banks in China, it ought to be possible to improve the cooperation of law enforcement agencies as well as banking oversight authorities in deterring and preventing the huge global money laundering networks with China as an operations center. Selective but well-targeted and tough sanctions on a few banks, especially those in Hong Kong, which is the locus of well over half of the clearing and currency trades for the PRC, would send a strong message to Beijing.

More than a decade ago, the Senate Permanent Subcommittee on Investigations issued a long report on money laundering as a growing global threat to US interests, with a particular focus on HSBC. The committee recommended much stronger oversight and vigilance by the appropriate US regulatory agencies in a prescient analysis of growing problems. Oversight clearly includes observation of cooperation between US and foreign banks in which prohibited behavior is in question. The major recommendations of the bipartisan report were as follows:

The OCC [Office of the Comptroller of the Currency] needs to strengthen its AML [Anti-money Laundering] oversight and revamp its AML supervisory and enforcement approach to bring them into closer alignment with other Federal bank regulators. Five reforms are key. First, it should treat AML deficiencies as a matter of safety and soundness, not consumer protection, and ensure ineffective AML management is taken into consideration when assigning a bank’s CAMELS management and composite ratings. Second, the OCC should allow its examiners to cite violations of law for individual pillar violations as well as program-wide violations. Third, the OCC should ensure that narrowly focused examinations are considered in tandem with examinations that take a holistic view of a bank’s AML program. Fourth, the OCC should make more use of informal enforcement actions and reconsider its standards for issuing formal enforcement actions to compel AML reforms. Finally, the OCC should instruct its Examiners-In-Charge to accurately reflect AML examination findings, without turning them into such mild recommendations that they mislead bank management into thinking their AML programs are functioning well, when they are not. Many OCC examiners see the problems; it is OCC supervisors and enforcement that need to act to strengthen the OCC’s AML oversight efforts.
Senate Investigations Subcommittee issued its seminal report, continued attention to its recommendations is certainly warranted. Finally, based on historical precedent with various sanctions on rogue adversary countries, it is feasible to cut egregious money laundering banks off from the SWIFT and CHIPS systems for persistent violations of international and national laws. Nonetheless, in a consideration similar to that for revoking MFN status for trade with China, such an action would be so damaging and provocative as to threaten a systemic economic crisis, and the US ought to consider it only in emergency circumstances, such as a Chinese kinetic attack on Taiwan or a full naval blockade. This could also be triggered by its armed intervention on the side of Russia in Ukraine or the Middle East. Given China’s nearly unprecedented increase in debt levels and its reliance on the dollar in international transactions and debt markets, even partial measures to reduce Chinese options to solve systemic problems and jump-start sustainable growth could have a powerful impact on PRC leadership, if not on Xi Jinping. Selective removal from SWIFT/CHIPS of individual banks such as HSBC, however, could be a strong message carrying severe economic impacts.

**Export Controls**

The US has successfully employed export controls to limit or restrict Chinese access to technologies key to its MIC 2025 ambitions and its drive to equal or surpass the West in defense technology. The best example remains restrictions on access to semiconductors used in 5G telecommunications. Restrictions on needed chips crippled Huawei’s ability to compete with Western firms to produce the most advanced smartphones, and the company remains at least two generations behind Western-system competitors such as Apple and Samsung in this sector.

A flurry of interest in a possible leakage in existing restrictions emerged during the September 2023 visit of US Secretary of Commerce Gina Raimondo to China, when Huawei stealthily interrupted the narrative of her success by unveiling a 7-nm chip for its Mate 60 smartphone. It remains uncertain whether Huawei and its suppliers can produce this chip at scale in the quantities required in this mass consumer market, but it is entirely possible that China has the equipment and know-how to produce the chip. Later reporting suggested that Taiwanese firms have been regularly assisting Chinese semiconductor makers, including Huawei, “to effectively break the American blockade.” It is conceivable that China has successfully acquired production technology from the many Western semiconductor firms with plants in China. Many allies, notably the Netherlands and Japan, have joined the US in barring the most advanced equipment and supplies for producing 3-nm and 5-nm chips, which power the most advanced equipment for smartphones made in South Korea, Taiwan, and China. The US Department of Commerce recently approved a one-year extension for South Korean and Taiwanese firms to export production equipment to China for Huawei’s existing facilities, which currently cannot produce below the 14-nm standard at scale. The extension precludes the export of equipment, such as extreme ultraviolet lithography machines, that might allow the production of 7-nm or smaller chips.

The rollout of the Mate 60 is a warning sign that China is determined to become self-sufficient in the crucial semiconductor sector that is so important to defense, communications, and modern computing, among other advanced sectors. China is already a major competitor of the US and Pacific Rim allies in the production of so-called legacy chips, which are commonly understood to be chips at the 28-nm level or higher. Such products are the workhorses of everything from washing machines and automobiles to numerous weapons systems. Shortages of these products were an important reason for the shortages of new cars and appliances during and after the Covid lockdown crisis. Analysts expect the value of legacy chips for the auto sector alone to be over $118 billion by 2030. China and Taiwan, which have numerous facilities on the mainland, represent 65 percent of the legacy business as of 2021, for chips of 16 nm or
above. The two countries also had 43 percent of the dynamic random-access memory business as of January 2022. US firms Intel and Micron Technology (for memory chips) have been especially hard hit by growing Chinese production. In the spring of 2023, China banned Micron chips from its infrastructure projects, claiming they represent a security risk.

The increasing reliance on China for legacy chips gives Xi Jinping an important point of leverage (similar but not quite as extensive as that over the rare earths and battery minerals sectors) over Western manufacturing companies, as the experience of the auto shortages indicated. China is constantly investing more to grow this segment as well as the advanced segments of the semiconductor industry. It recently announced another $143 billion in subsidies for the chip industry. These levels of support have already undermined the profitability of other legacy producers, most notably Intel. Moreover, China has stepped into the breach to offer its “friend without limits,” Vladimir Putin, much of the legacy chip supply he needs to circumvent Western sanctions and keep his war machine functioning. Hong Kong is part of the network funneling advanced and legacy chips to Russia.

Because of the importance of both the advanced and legacy industries for national security and competitiveness, and to prevent Xi from gaining leverage over US industry, the US should redouble efforts to identify Chinese companies receiving significant subsidies and illicitly acquiring semiconductor products, equipment, design technology, and trade secrets for production. It should expand export controls and anti-dumping duties for firms complicit in these practices and utilize outward-bound investment tools to limit or ban Western capital investment in offending firms. Expanding Western production capacity through the US Chips Act and production incentives in Europe and Japan will require considerable time to reach a production scale that can compete with subsidized Chinese products. In short, the US should use existing tools and work with its allies to tenaciously limit China’s ability to further dominate legacy industries and its ability to become competitive in advanced parts of the market by using massive subsidies and IPR theft.

There are other important sectors for which the US needs to tighten export controls, in conjunction with limiting equity or portfolio investment, to prevent both the loss of competitive economic advantage and the leaking of crucial dual-use technologies to China’s growing defense sector. The aerospace industry is one crucial example.

Since at least the mid-1990s, China has been attempting to learn from US and European aircraft makers and has poured tens of billions of dollars of subsidies into its own infant industry. McConnell Douglas agreed to assemble its narrow-body jetliner in China as part of a sales deal in 1992, and Boeing opened a 737-assembly facility in Zhoushan in 2018. Requiring foreign firms to build assembly plants was part of the normal Chinese tactic to learn and acquire technology and to eventually compete with foreign producers. The prime example of this tactic was in high-speed rail, an industry China now dominates globally.

Despite decades of investment and attempts to acquire Western technology licitly or illicitly, China’s national champion, the Commercial Aviation Corporation of China (COMAC), was able to produce its own narrow-body jetliner, the C919, and received regulatory certification in China only in 2023. Moreover, it imported at least 40 percent of the components for this aircraft from Western suppliers. In a 2020 paper analyzing the composition of the C919, Center for Strategic and International Studies researchers estimated that 90 percent of this plane’s value came from American and European suppliers. At a minimum, it is known even now that COMAC imports the engines, electrical systems, landing gear, and flight control systems—even the tires—from the West. The C919 literally could not fly without vital components from the West.

It is also known that most of the Chinese suppliers working with COMAC—or with its parent the Aviation Corporation of China
and its many subsidiaries—are also working with the PLA to improve and build the advanced jets that China needs to compete with Western jet fighters and integrated Western defense strategies. As the US and its NATO allies improve their own equipment and tactics to take advantage of advances in communications, systems integration, and computer processing for new software-driven and AI-based strategies, in which they maintain a technology lead just as they do in jet engines and avionics,

preventing access to these new capabilities will be crucial.

The Chinese aerospace industry is known to use espionage, including from Chinese nationals working in US companies, to acquire US technology. It also employs more overt means of gaining access to Western aerospace technology. US Air Force Brigadier General Robert Spalding, now a Hudson Institute senior fellow, observes that China uses its “thousand talents” program and large financial incentives to attract aerospace engineers and scientists from the West. He also notes that China has been able to acquire advanced technology via lucrative contracts with Western firms that will eventually give it the capability to “deploy weapons on American soil.”

Beijing is slowly reducing purchases of Boeing aircraft, following first on the review of the 737 Max air disasters, which led to a three-year pause in deliveries of planes it had already ordered. The PRC is now reducing future purchases in favor of the C919, in another blow to Boeing. It will be important to employ export controls to prevent Chinese access to these advanced systems. Again, experts under the leadership of the Departments of Defense and Treasury should carefully calibrate the coordination of export controls and investment restrictions.

These are just two of the many examples in which dual-use technology is important to both national defense and commercial competition. The US has leverage in these two areas because of its lead in technology and systems integration know-how and ought to employ it either to deter Chinese mercantilist practices and counter its military strategies or to undermine its ability to achieve its larger ambitions, which are linked to the continued growth of its economy and its self-sufficiency. Both commercial aviation and semiconductors are large and growing components of China’s modern economy, so taking advantage of available leverage can be an effective method to prevent Xi from achieving his ambitious China Dream, which requires domestic growth for political stability. There are many other sectors—such as advanced materials, quantum technology, and software-based digital industries—in which similar coordinated strategies can effectively thwart Chinese ambitions.
China’s economy under Xi Jinping is foundering and is not likely to regain a strong growth path by relying on domestic resources. The PRC’s accumulated debt in the public sector—which is increasingly merging with the business sector as the PRC favors SOEs to the disadvantage of successful private firms—is so sizable as to preclude the kind of massive stimulus that China used in 2008–22 to bolster faltering growth. And the infrastructure investment that has traditionally been the focus of stimulus spending has become more and more inefficient due to overinvestment and the use of inefficient, state-owned construction firms. The huge property sector, which was both a primary engine of growth in the last two decades and the bedrock of local government balance sheets through land sales and related taxes and fees, has now reversed course and remains in deep recession. In turn, the drop in property values has undermined the confidence and wealth of households, resulting in high levels of savings. Cutbacks in services such as medical care, compensation for public employees, and pay for contractors, which were necessitated by poor balance sheets, have reinforced the propensity to save. Due to funding problems, local governments have not been able to improve poor public education and pension systems, which also motivate precautionary savings. Demographic decline further contributes to the deterioration of public finances and the need for precautionary savings. All these factors result in the inability of authorities to stimulate an economy that relies on higher levels of consumption, which most economists see as a solution to slow growth and possible recession.

Absent consumption and government investment growth, the options open to Beijing’s leaders for reviving growth are limited.

CONCLUDING REMARKS

Photo Caption: People attend the Eighth Belt and Road Summit on September 13, 2023, in Hong Kong, China. (Photo by Hou Yu/China News Service/VCG via Getty Images)
They can increase exports and attract more foreign investment, or reverse the CCP’s drive to renationalize the economy and shackle the private sector as it becomes successful and offers alternative avenues for social and political leadership. Xi’s and the CCP’s determination to maintain their leadership and policy priorities, even at the expense of economic efficiency and growth, precludes the latter course.

The continued dominance of China’s state-directed, mercantilist model—along with increased recognition of China’s exploitative foreign development practices, human rights and environmental abuses, attempts to export authoritarian surveillance political models, support for Russian aggression, and challenges to the Western-dominated, rules-based order—all contribute to pushback against China’s trade and external investment policies. Finally, the gradual turn toward limiting the ability of foreign firms to operate in China or sell into its market has combined with other policy problems to lead to the conclusion that Gina Raimondo articulated: China has become “uninvestable.”

The US, especially if it continues to expend political capital to gain cooperation with allies, has many tools at its disposal to weaken China’s ability to restart growth. The tools I have outlined in this report include the use of the accepted rules of fair and reciprocal trade, most of which China nominally agreed to when it joined the WTO, to impose limits on trade and investment through tariffs, anti-dumping duties, and other trade restrictions. They also include the use of export controls to limit China’s ability to acquire the technologies it needs to achieve its often-articulated goals of becoming self-sufficient in the industries of the future and building military capabilities equal or superior to those in the West. Aligning US investment restrictions with export controls is a key element of a successful strategy.

Public opinion polling consistently suggests that the state-driven, authoritarian, mercantilist Chinese model is not attractive to other countries. The US and its allies need to present better alternatives to countries such as those in South Asia, Latin America, and Africa in terms of trade, investment, and other development assistance to win their support for the Western economic and political order. Another tool to incentivize more support for a US-led economic and political model is to build economic institutions parallel to the Bretton Woods systems that exclude China unless there is a massive change in China’s policy direction.

Such a set of policies would at least limit the ability of Xi and his CCP colleagues to achieve their domestic and geopolitical goals. Perhaps most importantly, they would inhibit Xi’s ability to address the long-term structural, severe environmental, and social welfare problems whose improvement is important to maintain social and political stability. Economic growth is the key to solving the financial problems now inhibiting meaningful solutions to these longstanding problems. Signs of unrest—including from unemployed or discouraged youth cohorts, underpaid workers, retirees without adequate pensions, mortgage holders whose properties are no longer worth their cost or have not been delivered to them, and members of the general population lacking the standards of education and medical care commensurate with expectations in a middle-income country—have appeared consistently during and since the brutal Covid lockdowns. The US may not want to be coldly complicit in worsening China’s problems, but it can give Xi the choice to either change course or forgo US help in solving the problems that CCP leadership has engendered.


8 John Lee, Ambition and Overreach: Countering One Belt One Road and Beijing’s Plans to Dominate Global Innovation (Washington, DC: Hudson Institute, 2020), https://www.hudson.org/indicators/9f84d6e5-3db5-4934-81b7-059d8f4f72c7; John Lee and Agatha Kratz, “The Politics of China’s Deleveraging Campaign: Applying emerging-technologies-engage-succeed-information-age-bryan-clark-dan-patt,


18 Clark and Patt, Campaigning to Dissuade, 8.


22 Shorthand in this study will refer to “Western” allies even though many are located in South and East Asia.


CHINA'S ECONOMIC WEAKNESS AND CHALLENGE TO THE BRETTON WOODS SYSTEM: HOW SHOULD THE US RESPOND?


60 Wright, Grasping Shadows, 56.

61 The capital output ratio measures how many dollars of new investment are required to create one dollar of incremental GDP. See Wright, Grasping Shadows, 16.


63 The best account of this dynamic is Wright, Grasping Shadows. See also Walter, Red Dream.


67 Wright, Grasping Shadows, 37–38.


Wright, Grasping Shadows, 66.


Wright, Grasping Shadows, 58.

Feng and Wright, “Tapped Out.”


Xie, “China’s Cities Struggle under Trillions of Debt.”


For a granular analysis of the urban-rural health care divide and its consequences, see Scott Rozelle and Natalie Heil, Invisible China:
null


123 See Duesterberg, *Mixed Record*.

124 See Morais and Duesterberg, “Odious” Legacy.

125 Malik et al., *Banking on the Belt and Road*.


141 See Jessica Matthews, “Why Investors Dumped $1 Trillion in Chinese Equities—and What Comes Next;” *Fortune,* October 10,


148 A recent study by the Rhodium Group and the Atlantic Council estimates the economic impact of several sanctions scenarios on China and relates them to a potential Chinese attack on Taiwan. A full set of Russia-like sanctions on the financial sector, for instance, would endanger $3 trillion in global economic activity and threaten a global banking crisis. Sectoral trade impacts from full interruption of trade flows with China would also impact the US economy, but less than that of Europe, in material ways by causing interruption of trade flows with China would also impact the US economy, but less than that of Europe, in material ways by causing


155 Mike Pence, “Presidential Speech Series.”


157 A legitimate question from a long-term historical perspective, which often motivates Chinese leaders as they seek to justify the overall direction in their policies, is whether the sum of China’s programs to create an alternative to the postwar order that the victors of World War II put in place is similar to Japan’s ambitions in the 1920s and 1930s to create a “Greater East Asian Co-prosperity Sphere.” There are obvious similarities in Xi’s efforts to control the South China Sea, to unite Asian countries for trade and development, and to counter Western economic and political influence in greater East Asia. While the temptation to draw this analogy is strong, I argue that a more direct threat to Japan’s economic well-being motivated its program because of the US response to Japan’s aggressive actions in conquering Korea, North China, and much of Southeast Asia. In contemporary China, the US and its allies do not seek to undermine China’s economy but to convince it to become what Robert Zoellick called a “responsible stakeholder” in the postwar economic and political order. Additionally, China has not repeated Japan’s outright territorial conquest, apart from its program to incorporate contiguous territories such as Tibet and Xinjiang, which have been loosely associated with China since the Ching dynasty. Nonetheless, if the CCP is more successful and forceful over time than it has been thus far in creating alternatives to the rules-based order of the Bretton Woods system, and if it uses force and territorial expansion to achieve this goal, such an analogy would have more salience. The CCP itself gives a more benign analogy from the famous Ming dynasty, when the seafaring
exploits of Admiral Zheng He were part of an effort to participate in the era of global trade expansion that the great Iberian Sea explorers initiated. For a brilliant exposition of how Chinese leaders use and shape the historical record to legitimate their policies, see Charles Horner, Rising China & Its Postmodern Fate (Athens and London: University of Georgia Press, 2009).


163 See Duesterberg, Mixed Record, 6.


175 Kodres, Shen, and Dufle, “Dollar Funding Stresses in China,” 5.


