China’s Economic Slowdown: Root Causes, Beijing’s Response and Strategic Implications for the US and Allies

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His articles have been published in leading policy and academic journals in the United States, Asia, and Australia. He is the author of *Will China Fail?*, published in 2007 and updated and republished in 2009.

His opinions have been published in over fifty major newspapers and current affairs magazines around the world, including leading broadsheets in the United States, Asia, Europe, the Middle East, and Oceania.

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# TABLE OF CONTENTS

**AUTHOR’S NOTE**

I. EXECUTIVE SUMMARY AND INTRODUCTION

II. CHINA RUNNING OUT OF PUFF
   - Running Out of Puff
   - Real Estate
   - Shadow Banking
   - Local-Central Government Fiscal Imbalances
   - The Foundations for a Fiscal Crisis
     - Declining Growth in Revenues
     - Rising Demands by the Chinese People
     - People’s Liberation Army Sequestration with Chinese Characteristics?

III. DEFERRING PROBLEMS TO STIMULATE A SECOND WIND
   - The Rise of Xi Jinping
   - The Official Numbers
   - What Has Happened to China’s Debt since 2015?
     - The Size and Nature of the Debt
     - Tactical Measures to Prevent a Financial and Fiscal Crisis
     - Kicking the Can Down the Road
   - Conclusion

IV. MADE IN CHINA 2025 AND THE FUTURE OF CHINA’S EXPORT-ORIENTED MODEL
   - Reaching the End of the Old East Asian Export Manufacturing Model
   - China’s “New” Export-Oriented Model
     - What is MIC 2025?
     - The Chinese Game Plan
   - Conclusion

V. THE BELT AND ROAD INITIATIVE: TRANSFORMING DOMESTIC VULNERABILITY INTO GRAND STRATEGY
   - External Solutions to Persistent Domestic Problems
   - From Extracting Economic Rents to Grand Strategy
     - Strategic Support States
     - A New Approach to Authoritarian Promotion
   - China’s Comprehensive Approach to Pre-Determine the Rules and Outcome of Competition
   - Conclusion

Glossary

Endnotes
sailed through its difficulties, just as it did after its export markets in the major advanced economies collapsed from 2007 onward. Although official indicators of Chinese growth were slower, at 6–8 percent, than a decade before, the talk was about “successful rebalancing” and “higher-quality growth.” The layperson’s view was that China had again proved that its authoritarian leaders were skillful and adroit economic managers.

Around this time, Xi Jinping also seemingly emerged as the most powerful leader since Deng Xiaoping, and in the view of others, the most dominant leader since Mao Zedong. Moreover, under Xi, China abandoned the more cautious diplomatic and strategic approach of “hide brightness, cherish obscurity” that it had taken since Deng. Xi confidently put forward visions of what a Sinocentric economic and strategic region might look like and left few doubts that China’s objective was to become the preeminent power in Asia and possibly the whole of Eurasia. This was the new setting in which this project recommenced in mid-2018.

The fundamental questions I posed back in 2014, far from needing to be changed, seem even more apposite in 2020. China’s growth has slowed moderately to around 6 percent per annum. Many unofficial estimates are that it is considerably lower. Is that significant, and what are the strategic consequences of slower Chinese growth for the US and allies? Did China really sail through its difficulties leading up to 2015? What are the ramifications of how it managed its problems?

Have China’s difficulties made it stronger, or is overreach more likely at a time when Beijing is projecting a far more confident (and assertive) image of itself with promotion and expansion of ambitious plans, such as the Belt and Road Initiative and Made in China 2025?

More generally, what are the strengths and vulnerabilities of the “new China” under Xi? Have these changed from several
years ago? Finally, what are the points of leverage and worry for Washington in an era of deepening competition and rivalry between the US and China?

In this context, the monograph is part forensic (e.g., how did China manage the problems it had just a few years ago to be where it is now?), part explanatory, and part analytical (i.e., what is the link between its vulnerabilities, the way it has managed these, and its current policy settings?). It is also policy or action based (i.e., how should the US and allies respond?).

I would like to thank Allan Song, program director, Smith Richardson Foundation, for his guidance in helping to define the contours of the project, as well as his patience during the two years (2016–18) when work on it was suspended. I am also grateful to SRF for funding this project.

In addition, I thank Hudson Institute for continuing to back my work.

Finally, I thank my wife, Dr. Lavina Lee, for her constant encouragement and support.
I. EXECUTIVE SUMMARY AND INTRODUCTION

Good policies and responses depend on accurate analysis, sound assessments of the strengths and vulnerabilities of oneself and one’s competitor, and appreciation of structural and other trends that are difficult to shift or circumvent.

The Donald Trump administration has recognized that China poses the most comprehensive and formidable challenge to American interests and values. It is a view increasingly shared by both major political parties, the national security community and policy elites, and the general population.

The United States openly discusses its strengths and weaknesses. The difficulty is in coming up with sensible and

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Photo caption: A Chinese bank employee counts 100-yuan notes and US dollar bills at a bank counter in Nantong in China’s eastern Jiangsu province on August 28, 2019. China’s currency slid on August 26 to its weakest point in more than 11 years as concerns over the US trade war and the potential for global recession weighed on markets. (STR/AFP via Getty Images)
effective responses to an opaque competitor or rival that is increasingly adept at controlling grand narratives by trumpeting apparent strengths and concealing weaknesses.

This monograph attempts to argue and/or demonstrate three main points.

First, it looks at why there were credible fears about the stability and viability of the Chinese economy — especially the financial and banking system — leading up to the end of the Twelfth Five Year Plan (2011–15), and what these were. To understand why Beijing was so concerned, the monograph draws out the serious structural problems that were leading inevitably to a permanent slowdown from the double-digit growth rates of the first three decades of reform.

Importantly, it is not a slowdown in and of itself that matters, but what the slowing economy represents and reveals about the Chinese political economic model. After all, when the second-largest economy in the world grows at 6 percent, this is still a considerable achievement. Instead of focusing on official or estimated GDP growth rates, which are not analytically useful because they provide little indication of whether the economic activity is commercially sound or sustainable, the monograph focuses on the cost to the regime and broader economy of managing and stabilizing an economy that has poured far too much national wealth into unproductive or commercially irrational areas. This is the basis for the economic, financial, and fiscal crisis that the Chinese Communist Party (CCP) desperately tried to avert.

The purpose is not merely to give a descriptive or academic account of recent economic history, but to introduce the serious structural problems that continue to have political and strategic policy ramifications relevant to the US and allies.

Second, the monograph looks at what occurred from 2015 to the present, and how China apparently overcame its economic difficulties. In fact, it has not overcome its problems, but deferred them to a future time in ways that only its unique authoritarian political economy is able to do.

We are therefore witnessing an outwardly more confident and muscular China emerging at a time when it is failing to effectively tackle its domestic problems, which are getting worse. These tactical measures to put-off or ignore the consequences of its economic and financial problems leaves Beijing in an even poorer structural position than in 2015.

Third, it is clear the Communist Party is not passively awaiting an unhappy economic fate in connection with its mounting imbalances and domestic economic dysfunction. In many respects, its leaders have been highly creative in seeking solutions that do not entail a weakening of the party’s hold on economic power.

On the contrary, the party has been busily shaping and pursuing grand strategic policies such as the Belt and Road Initiative (BRI) and Made in China 2025 (MIC 2025) to solve or alleviate many of its domestic political-economic problems.

This monograph argues that these and other outward-focused initiatives stem most fundamentally from Chinese weaknesses and vulnerabilities but are being remade and recast into initiatives that will strengthen the position of the CCP domestically, ensure greater resilience for its political economy, and advance its ambitious strategic and international objectives at the same time.

In summary, it is about the Communist Party cleverly transforming domestic vulnerability into grand strategy and using economic approaches to gain pre-eminence and “win without fighting.”

Part two in the monograph series, to be published in early 2020, will examine methods of confronting, countering, or else undermining these Chinese strategies and initiatives. It will do so by taking seriously the challenge they present and suggesting
responses that take into account Chinese vulnerabilities and the points of leverage available to the US and its allies. This linking of China’s vulnerabilities and weaknesses, on the one hand, and its ambition and purpose with respect to its outward-focused policies, on the other, is essential for effective policy responses. If the domestic is not linked with the external, US policies are much more likely to become complacent, counterproductive, or susceptible to overreaching.

In linking analyses of Beijing’s domestic political economy with its external policies, the monograph will challenge some enduring but incorrect grand narratives that play into the hands of the CCP:

These include:

• The external policies of Xi Jinping and the Communist Party begin from a position of unprecedented strength and national resilience, with few domestic vulnerabilities. In fact, the truth is quite the opposite: Xi and the party are engaged in an approach — high risk and with a high economic cost — of pursuing growing Chinese ambitions abroad while concealing festering internal weaknesses and vulnerabilities.

• There is a unique economic and governance competence that must be attributed to the authoritarian Chinese political economic framework, in contrast to the chaos and dysfunction of liberal democracies. For example, China has the proven ability to sail through economic crises. In fact, the Communist Party and its authoritarian model are showing an inability to learn from past errors and a stubborn unwillingness to address serious problems.

• China does not need the US and other advanced economies to achieve its objectives. It is already a sufficiently large and sophisticated nation and is close to achieving a terrifying self-sufficiency. In fact, China cannot achieve its external objectives without the cooperation of the US and other major advanced economies. Despite its economic size, its economic tools and levers in the world are surprisingly limited in important respects. Even the resilience of its domestic economy is enormously vulnerable to US policies.

• The US and other countries have little ability to influence domestic Chinese politics, especially when it comes to challenging Xi’s authority. In fact, Xi’s high tolerance for risk is causing immense angst for other senior Communist Party members and Chinese policy makers. The more Chinese failures and the rise in international resistance are attributed to Xi’s actions, the more pressure he will feel to retreat and take a more cautious approach.

China is the most formidable and comprehensive challenge the United States has faced since the Soviet Union. In many respects, China is a more complex and difficult competitor and rival.

The response to China must be based on a good understanding of its strengths and vulnerabilities, and how these both drive the CCP’s policies and behavior.

To borrow two well-known Chinese aphorisms, we should always “seek truth from facts,” and “if you know your enemy and know yourself, you need not fear the result of one hundred battles.”
One decade ago, several authors speculated about the limits of China’s authoritarian model and its capacity to lift the country out of the so-called “middle-income trap.”¹ The broad argument then was that China’s authoritarian political economy retarded the development of institutions and economic practices that were common to all high-income economies. These included institutions such as the rule of law, protection of intellectual property rights, and efficient and transparent regimes for dispute resolution. Beijing’s political economy is characterized by massive misallocation of capital, systemic graft, and other serious forms of growth-inhibiting corruption. China was already a formidable power but could not surpass the United States with its authoritarian model. That view was certainly not then the consensus one and these authors were in the minority.

However, around 2015, China bears found themselves in the ascendency. Headlines included “Where Did China’s Economy Go Wrong?,”² “China’s Economy: Stuck in a Vicious, Stubborn Cycle,”³ and “Forget Greece: China’s Economic Slowdown Is the Biggest Problem of the Year.”⁴ The World Bank, normally staid and reluctant to stray from economic consensus, had released a substantial report two years earlier that largely supported those earlier pessimistic assessments.⁵ Jointly produced with China’s Development Research Center of the State Council, the report predicted that growth would be halved from the double digit rates of the 2000s to about 5 percent by 2026, before slowing

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Photo caption: An abandoned construction site at Caofeidian, in the city of Tangshan within China’s Hebei province in 2013. Workers deserted the site at the end of 2012. The construction zone was built on reclaimed land that was made possible through huge bank loans. After being half built, all bank loans were halted and projects suspended due to rising costs of raw materials and a lack of government support. (Gilles Sabrié/LightRocket via Getty Images)
The concerns leading up to the end of the Twelfth Five Year Plan (2011–15), emanating from China’s enormous credit expansion, pertain to three specific problems: a real estate bubble, the growth of the shadow banking system, and a highly leveraged local government sector. All of these are intrinsically linked, and managing them successfully will absorb a significant and growing share of China’s public resources (and national wealth).

**Real Estate**

Real estate has made an increasing contribution to China’s GDP since liberalization of the sector began in 1990. In 1997 it contributed about 4 percent of GDP, rising to about 9 percent in 2008. The Chinese government implemented stimulus measures starting that year, and by 2015, real estate accounted for around 16 percent of GDP. Indeed, it is estimated that more than one-quarter, and perhaps a third, of all fixed investment went into real estate from 2008 onward, and nearly half of the total national debt up to 2015 is linked to the real estate sector.

It is often assumed that urbanization is driving this dynamic, but with real urbanization advancing at a steady rate of only 1–1.5 percent each year, the massive recent increases in real estate construction have little to do with urbanization needs. Instead, local governments have long raised revenue by appropriating rural land to rezone it for industrial or residential construction and use. In the decade leading up to 2005, an estimated 40–70 million farmers were forcibly evicted from their land for this reason, often with inadequate compensation or no compensation at all.

The recent record makes clear that rezoning from rural to urban has little to do with the demand from urbanization. From 2001–08, proceeds from land-use rights (for both industrial and real estate projects) represented 40.5 percent of local government income averaged across all localities. Within two years of the 2008 government-ordered fiscal and monetary stimulus, proceeds from rezoning land from rural to urban dramatically increased — to 61 percent of local government income, and possibly 70 percent by 2014. Such reliance on land sales was enhanced by local governments’ creating an estimated

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*Running Out of Puff*

The concerns leading up to the end of the Twelfth Five Year Plan (2011–15), emanating from China’s enormous credit expansion, further prior to 2030. That was the optimistic scenario. Without far-reaching reforms of Chinese institutions and policies, the report warned, the outlook was likely to be more dire.

A common response to predictions of a Chinese economic slowdown is, “So what?” Most governments would do anything to grow at even 4 or 5 percent, and China’s economy is already the second largest in the world. This misses the reason that Beijing is apprehensive about the slowdown. It is not the slowing economy per se, which is only the symptom of profound problems. Rather, it is the cost to the government of managing the consequences of an economy that has poured far too much national wealth into fixed investment and has seen debt rise to dangerous levels at precarious speed.

This section will focus on understanding the reasons for the economic slowdown that were of high concern to Beijing leading up to the end of the Twelfth Five Year Plan (2011–15). It also sets the scene for the beginning of the Thirteenth Five Year Plan (2016–20), which the next section will address.

The purpose is not merely to give a descriptive or academic account of recent economic history. It is to highlight those serious structural problems that have strategic and other policy ramifications for the US and its allies. This section explains what these problems are. The next two will look at how Beijing has managed them and how its management has influenced and shaped Chinese strategic and other policies that are now of concern to the US and allies.

The last two sections will look at how allies can more effectively respond to take advantage of China’s weaknesses and counter its actions by better understanding the political and structural factors (and vulnerabilities) driving Beijing’s behavior.
155,000 local government financing vehicles (LGFVs) to get around restrictions on their taking on debt. LGFVs became major recipients of the credit binge ordered by the central government, and many of these entities (which are effectively local state-owned enterprises, or SOEs) forged commercial partnerships with property developers to gain a share of real estate sales built on rezoned land.

The extent of the debt racked up by local governments and their LGFVs is not widely appreciated outside China. In two years, from the beginning of 2008 to the end of 2009, the local government loan balance had increased to approximately $1.19 trillion, an increase of 70 percent. By mid-2013, local government debt had reached an estimated $2.89 trillion, and by 2015, most estimates placed such outstanding debt at $4 trillion at least, or around 40 percent of GDP and one-fifth of all provincial GDP. The French banking firm Société Générale believes local government debt is closer to $4.83 trillion. Conservatively, we can say that local government debt has increased from around $700 billion at the end of 2007 to $4 trillion by 2015 — with much of it used for construction or to repay the interest and/or principal of existing debt.

If the pure size of local government debt is not worrying enough, we must also understand the link between this debt and the so-called shadow banking system, which is beyond the regulatory sight and reach of the government. This refers to all credit extended outside the formal and regulated banking system, even though state-owned banks are generally the starting point for shadow bank lending and reap the ultimate rewards and risks of such loans.

**Shadow Banking**

Chinese shadow banking has grown exponentially since around 2010 for several reasons. First, it was one way for banks to circumvent regulatory scrutiny and prudential restrictions in the rush to maximize profits, by ramping up lending in a loose credit environment while still charging high — even exorbitant — interest rates, well above ceilings imposed by authorities for formal bank loans.

This also allowed banks to create off-balance-sheet wealth management products (WMPs) and trust products to sell to individual and groups of investors. These offer short-term investment returns five to fifteen times bank deposit rates, while the bank-owned entities selling these WMPs and trust products can charge a high interest rate to borrowers unable to secure sufficient credit from commercial banks. For private firms starved of formal capital, it is one way of gaining a line of credit to tap into a booming economy. For SOEs and LGFVs, it is an easy way of acquiring finance and doubling or tripling down on rapid gains from the property market.

From 2008, shadow banking loans in China was growing at above 30 percent each year and had more than tripled in volume by early 2014. At that time they accounted for about half the increase in overall credit in the economy since 2008 and approached 55 percent of GDP. The China Banking Regulatory Commission estimated WMP assets alone to be worth around $2.08 trillion as of September 2014, with trust products worth roughly the same again (even though there is some double counting). Bear in mind that a large proportion of these WMPs and trust products are used as collateral to lend to developers, including local governments (LGFVs), to fund further property and infrastructure projects, while shadow banking institutions are creating new WMPs just to pay their obligations to retail investors.

It was estimated in 2013 that 30–40 percent of such unregulated lending was extended to property developers and 20–30 percent to LGFVs. Those engaged in real estate were the major beneficiaries of shadow banking loans, a fact reaffirmed by figures showing that debt-to-equity ratios for real estate and construction firms had increased to 250 percent by 2013, up from about 150 percent in 2008. For SOEs engaged in the property sector, including LGFVs, leverage has increased...
similarly, from under 200 percent in 2008 to about 250 percent as of 2015.\textsuperscript{19}

To be sure, experts disagree on whether local government debt is manageable (and whether the shadow banking sector presents a systemic risk in and of itself to the entire financial system).\textsuperscript{20} But it is undeniable that evidence of fragility is growing. For example, in 2014, the central authorities instructed lending institutions to roll over up to $600 billion worth of maturing local-government debt for a further three years, meaning that an estimated $800 billion worth of debt matured in 2018. In that same year, investors in the $500 million China Credit Trust Co., a shadow bank trust fund, were bailed out after government intervention, indicating that Beijing acted to avert the possibility of a contagion effect from the failure of an off-balance-sheet scheme.\textsuperscript{21}

What is certain is that when credit slows, and the cost of capital goes up markedly, a high number of LGFVs (and property developers) will be unable to meet their debt obligations and will face a real risk of insolvency. The whole local government financing and fiscal system would then be vulnerable to breakdown and grinding to a halt. Simultaneously, credit-issuing institutions, including those in the formal banking sector and the informal shadow banking sector, would suffer a growing number of defaults by borrowers, which in turn would affect their capacity to issue new loans.

Similarly, the eventual cooling of the real estate market, leading to a slowdown in land sales and construction, would cause liquidity problems for all real estate investors, including LGFVs. There are enough reports of “ghost cities” and empty houses, as well as studies of poor housing affordability, to indicate that the economic fundamentals of the real estate driven model are questionable. For example, official figures reveal that the ratio of unsold property to annual sales reached 51.5 percent in 2014, up from 24.7 percent in 2011. Housing prices began to fall for the first time this century in September 2014.\textsuperscript{22} Periodic episodes such as this are bound to create significant fiscal problems for local governments and liquidity problems for financial institutions that are dependent on a robust property market and cheap borrowings for interest obligations to be met and principal from maturing loans to be repaid.\textsuperscript{23}

Local-Central Government Fiscal Imbalances

The previous analysis does not predict whether a property bubble will eventually trigger a serious financial and fiscal crisis for China, as interesting and important as this question is in and of itself. Instead, it explains how China has managed to achieve rapid economic growth, especially since 2008, through the systematic underpricing of capital, land, and labor — pursuing a supercharged fixed-investment model where SOEs have been major players and the primary beneficiaries. Slowing growth is unmistakable evidence that such a model is nearing exhaustion, and that more and more resources (i.e., credit) are required just to stabilize the model (e.g., pay back interest and principal obligations) rather than drive productive economic expansion. The next stage of even moderate growth will prove difficult to attain.

Moreover, and as argued earlier, the challenge facing Beijing is not slowing growth per se, but managing the imbalances created by its stuttering growth model. A serious financial and fiscal crisis is by no means inevitable. But doing nothing will only mean a harder reckoning in the future,\textsuperscript{24} as the government already knows.\textsuperscript{25} Recent examples serve as a warning: prolonged loose monetary policy in North America and Europe led to the global financial crisis for these advanced economies from 2007 onward. In addition, Japan’s tardiness in properly recognizing bad debts and recapitalizing its banks as financial institutions — with regulators waiting in vain for a return to stratospheric asset prices — plunged the country into an economic stagnation in the early 1990s, from which it is only now recovering. But successfully preventing a similar downturn in China will involve significant actual and opportunity costs for the central government.
By late 2015, there were signs that credit growth was declining and growth in fixed-asset investment was being wound back from the heady years of 2009–13. In addition to declining capital-output ratios, these were obvious reasons why growth was slowing. These developments, part of Xi Jinping’s “new normal” of slower growth, were widely applauded by economists. It is arguable whether this new normal was engineered by the central government or is an automatic consequence of the laws of economic gravity. Either way, the new normal brings with it risks and costs that are directly relevant to the resources Beijing can deploy to continue China’s “rejuvenation” in external affairs.

At the heart of the problem is the increasingly brittle and unsustainable central-local government fiscal setup — the driving motivation behind the seemingly irresponsible economic profligacy and recklessness by local governments. To understand this point, we must go back to the dramatic fiscal recentralization that took place from 1994 onward as part of the tax-sharing reform initiatives. Prior to 1994, approximately 78 percent of fiscal revenues went to local government, which made 72 percent of fiscal expenditures. After the reforms, an increasing amount of fiscal revenue instantly went to the central government. The initial idea was for the central government to collect 60 percent of tax revenues and make 40 percent of expenditures, with a 20 percent surplus to be deployed to less-developed regions.

But it was not to be. In the year the reforms were enacted, local government’s share of revenue went down from 78 to 44 percent within a year, even as its expenditure rose slightly. By 2008, according figures released by China’s National Bureau of Statistics, 55 percent of fiscal revenue went to the central government, even though it was responsible for only around one-quarter of all national expenditure. In other words, local governments were responsible for 75 percent of fiscal expenditure but received only 45 percent of all fiscal revenue. By 2013, local governments received 53 percent of all fiscal revenue but were responsible for 85 percent of all government expenditure.

This is the setting for what occurred from 2008 onward, when the central government instructed banks to flood the economy with credit. As mentioned earlier, proceeds from land rights (which includes land sales revenue and real estate construction) represented some 40.5 percent of local government income from 2001–08, before jumping to over 70 percent by 2014. Whereas local government expenditure constituted between 65–70 percent of all government expenditure from 2008–13, local government share of all government revenue went up from 45 percent to over 55 percent by 2013, driven by the doubling down on land transfers and the property market. From the central government’s point of view, this killed two birds with one stone: allowing local governments to take the lead hastened the stimulus effect while offering local governments some fiscal relief from their burdens.

Even then, this was never going to offer an adequate or sustainable solution. By the time the central government decided to gently cool the property market in 2013, the gap between what local governments needed to spend and the share of fiscal revenues they received was still well into the double digits. The fact that revenue from selling land leases to developers alone declined — from about 50 percent in early 2013 to about 15 percent toward the end of 2014 — demonstrates that this model of rapid local government revenue growth is nearing its end. As the property market cools, and as the debt burden of LGFVs rises, the gap between expenditure commitments and available revenues will only widen. Ratings firm Moody’s and Nomura Securities estimated that half of all local Chinese governments had insufficient cash flows to cover debt repayments in 2013, which is one reason why the central government eventually demanded that financial institutions roll over $600 billion worth of local government debts the following year. The point is that the supercharged credit boom since 2008 could never be a lasting solution to the central-local fiscal imbalance, and reforms reversing the centralization of fiscal revenues are inevitable.
ticket reforms was expected, priority was given to addressing the misalignment between central and local fiscal budgets. This included the central government’s taking on some spending on social services currently overseen by local governments. But these were not substantial reforms and will make little difference to local governments’ capacity to meet shortfalls. And as the slowdown takes hold, it will result in both worsening revenue problems and rising expenditure obligations for Beijing.

The Foundations for a Fiscal Crisis
The Xi Jinping government is well aware of the central-local fiscal problems. In the 2013 third plenary session of the Eighteenth Central Committee meeting, where the announcement of big-
Declining Growth in Revenues

By the end of 2014, China’s government debt as a proportion of GDP reached a still comfortable 55 percent.\(^{36}\) The question is what a credit- and property-led slowdown — which is already taking place in structural terms — will do to total government revenues. At the beginning of 2015, even factoring in these projected slowdowns, the Ministry of Finance forecast growth of 7.3 percent in central revenues and 3 percent in local revenues. Independent financial institutions such as Deutsche Bank were far more pessimistic, forecasting only a 4.5 percent growth in central revenues and a 4.9 percent decline in local revenues. Who was right? When the January–February 2015 figures were released, they revealed a 1.7 percent decline in central revenue and a 9.1 percent decline in local revenues.\(^{37}\) This gave rise to a renewed emphasis on debt-based stimulus, which will be discussed in the following section.

The longer-term trend that confronted CCP leaders by the end of 2015 did not appear promising: the slowdown in revenues appeared to be amplifying. From 1993 onward (after the “Tiananmen Interlude” of 1989–92), growth in total government revenues averaged almost 19 percent per year, with expenditure increasing almost 20 percent per annum according to official figures from China’s National Bureau of Statistics.\(^{38}\) From 2001–06, before the monetary stimulus that began in 2008, revenue growth remained close to 19.5 percent and expenditure growth still averaged 17 percent. In the 2007–12 period of profigacy, revenue growth still averaged 20.5 percent … before falling precipitously to 10.2 percent in 2013. Expenditure growth similarly averaged 17.5 percent … before falling to 11.3 percent in that same year. In 2014, revenue growth increased a mere 8 percent, while expenditure growth was about the same. For the first six months of 2015, total government revenue increased 6.6 percent, even as government expenditure from April-July jumped 24.1 percent on the back of government attempts to stimulate the economy.\(^{39}\)

When offered in this context, it should be clear why the January–February 2015 preliminary revenue figures shocked the government. Even the seemingly over-optimistic official forecast of about a 5.5 percent increase in total revenues in 2015 is a three-decade low that was unfathomable until just two years earlier. With expenditures increasing at double-digit percentage rates for all but one of the last twenty-four years, any fiscal shock resulting from the current economic slowdown will not be trivial.

Additionally, while local governments have extremely limited revenue-raising avenues outside sales of land and property, the central government’s revenue and tax base means that the slowdown will amplify the hit to the coffers. If we take the 2013 central government budget as an example, over 34 percent of the revenue comes from a domestic value added tax, or VAT (in which producers pay at every stage of production), and 24 percent comes from corporate taxes. In contrast, only about 24 million people, or less than 1.8 percent of the population, pay income taxes, meaning only 6.5 percent of revenue came from income tax.

This very unbalanced tax base has several implications specifically relevant to a Chinese economic slowdown. One is that the heavy reliance on corporate performance for tax revenue makes the budget exceptionally vulnerable to corporate downturns, since tax receipts are tied heavily to the performance and profits of corporations rather than to household or personal income. Another pertains to China’s extremely unbalanced reliance on fixed investment to generate growth: a dramatic slowdown in fixed investment growth will disproportionately impact corporate performance, and therefore corporate tax revenues. This problem is exacerbated by the country’s SOE-dominated political economy, in which SOEs have been the primary commercial beneficiaries of growth and opportunity. As the downturn bites, and heavily indebted SOEs use more capital to fund debt obligations, their declining profitability will minimize the dividends the government can extract from them.

Using 2015 figures, around ten firms account for about 70 percent of all profits made by central SOEs, while up to half of all
SOEs do not make any profits. By any commercial measurement (such as return-on-investment, return-on-assets, or total factor productivity), SOEs tend to be 30–50 percent less efficient than private-sector firms — even with all the capital, land, regulatory, and taxation advantages offered to them.40 Add in an estimate that some 70 percent of central SOEs have dipped their fingers in the real-estate pie.41 The bottom line is that the nature of China’s fixed-investment slowdown will do sustained damage to Beijing’s corporate tax receipts.

There are also considerable doubts as to whether proceeds from VAT can pick up the slack in the long term. Since VAT is leveled at every stage of production (even if it ultimately is passed on to the final consumer), collections depend heavily on industrial production growth, which is slowing. Neither can VAT collections from a boom in domestic consumption allow a “business as usual” approach. The main reason is China’s low level of domestic consumption, which at about 35 percent of GDP is comfortably the lowest of any major economy in the world. (According to World Bank figures, only Equatorial Guinea, Kuwait, and Saudi Arabia have lower levels as a percentage of GDP.) Over the reform period from 1979 onward, the figure has steadily fallen from over 50 percent in the 1980s, to over 40 percent in the 1990s, to the current figure over the past decade. It is not conceivable that any increase in consumption would be sufficient to offset declining fiscal revenues from the corporate sector.42

**Rising Demands by the Chinese People**

Declining revenue growth, if not contraction, for the total government budget is a virtual certainty. This is a problem because since 2007, the funding gap (between fiscal revenues local governments receive and what they spend) has ranged from 8–10 percent of GDP (approximately $800 billion to $1 trillion in current terms) — and most of the shortfall is made up with land and property sales. With revenues from land sales alone likely to fall from a high of just under $700 billion at the end of 2013 to about $400 billion toward the end of 2015,43 local governments will increasingly demand a greater share of total government revenue as the economic slowdown continues and property markets subside.

So far, Beijing has resisted significant fiscal reform. In fact, even as local government spending has increased from 70 percent to 85 percent of all government expenditure (1994–2013), central government expenditure has been increasing at a significantly faster rate than fiscal revenue receipts since the 1994 reforms. Rather than undertaking genuine fiscal decentralization, Beijing has chosen to implement some Band-Aid solutions to relieve the local government’s plight. One has already been mentioned (involving forcing lenders to roll over maturing loans); another involves measures allowing local governments to issue bonds in their own right.44 Even then, demand for such bonds has been adequate only because they are implicitly guaranteed by the central government, meaning a large proportion will become a central government liability upon maturity, given the indebtedness of local governments.

The problem for the central government is that the local government shortfalls cannot be quarantined or ignored. While the central government assumed primary responsibility for national external and internal defense, external diplomacy, and national infrastructure projects, local governments continue to take the lead in local construction and infrastructure, education, healthcare, and most other social and public goods. Any fiscal crunch at the local government level would therefore impact households immediately and severely and inevitably lead to spikes in dissatisfaction with the government at the grassroots level. What makes this worse is that recent well-received social schemes have been announced with little serious thought given to funding. For example, the current government announced in August that it will extend minimal public health insurance to almost 95 percent of the population by the end of 2019, with local governments expected to pick up much of the expense.

Public Chinese demands on local governments are only going to grow. Demographics is a compelling factor. Despite China’s
aging population, only around one-third of all urban residents and less than 5 percent of rural residents have some form of central, provincial, or local pension. Although the current pension scheme covers a minority of citizens, the consensus among researchers is that the state’s pension liability still amounted to about $2.9 trillion in 2013. Other reports estimate that this pension liability could grow to $10.8 trillion over the next two decades (or almost 40 percent of GDP based on a generous assumption of 6 percent GDP growth each year).

More generally, as of 2015, China spent just over 25 percent (one-quarter) of its total governmental budget on social goods such as welfare safety nets, healthcare, and education, with local governments responsible for about 95 percent of spending in these areas. This compares to an average among lower-middle-income countries of around 36 percent of their budgets spent on these public and social goods. The figure is 33 percent for upper-middle-income countries and 42 percent for OECD countries.

The major problem for local governments is the gap between revenues from their limited taxation and transfers from Beijing, and expenditures. This gap, estimated at $800 billion–$1 trillion, has been addressed mainly through proceeds from land and property sales over the past decade. But with local government revenues from land-related sales likely to slow or even decline in absolute terms, there could well be an additional $500 billion local government fiscal gap by the end of the decade, which will have to be somehow narrowed, as reducing local government services is not an option.

Added to local government’s debt burden is the need to stave off insolvency for its LGFVs and prevent a contagion risk to the whole financial and banking system. This means many hundreds of billions of dollars — estimated to be around one-third of all local government borrowings — that need to be found each year just to tread water and contain the problem. If the government takes the bull by the horns and chooses to formally recognize what may be more than a trillion dollars’ worth of distressed and non-performing loans, it will require hundreds of billions of dollars to rescue and recapitalize the balance sheets of state-owned lending institutions.

Then we must consider the expanding demand for social and public goods that will come from Chinese citizens, especially those in urban areas. For China to reach a similar level to other low-middle-income countries (in terms of proportion of government spending on social and public goods as a percentage of GDP), the government will need to find an additional $1 trillion per year. Throw in liabilities from existing but unfunded pension schemes in an aging society, and we already may have fiscal pressures unprecedented for any major economy in recent times.

For a government receiving $2.26 trillion in revenue in 2014, these actual and deferred liabilities are not trivial amounts. The Ministry of Finance estimate of a $180 billion deficit for 2015 either grossly underestimates the enormity of China’s fiscal woes, or shows a government that is choosing to ignore the problem staring it in the face and refusing to recognize and prepare for existing and future liabilities. More generally, simply relying on growth as a cure-all — China’s approach from the 1990s onward — is no longer possible. Indeed, high growth, which can only be driven by even higher credit growth, lies at the heart of the imbalances and will make the government’s fiscal position even worse in the medium term.

The CCP is not blind to the seriousness of fiscal and broader economic challenges. In 2017, the Nineteenth Party Congress declared China’s most pressing challenge to be the contradiction “between unbalanced and inadequate development and the people’s ever-growing needs for a better life.”

People’s Liberation Army Sequestration with Chinese Characteristics?

As the following section will note, Beijing may well come up with clever policy responses to many of these problems and
shortfalls, such as deepening government and corporate bond markets to fund shortfalls; implementing reforms that widen the tax base to help government revenue become more immune to business cycles; or implementing institutional reforms that dramatically reduce corruption in the use of public monies in order to gain a greater bang for the fiscal buck. Even then, none of these or other imaginable possibilities can alter the final conclusion: efforts to enhance national power and security cannot continue in the same way as in the previous fifteen years.

Bear in mind that about 41 percent of central government expenditure (after transfers to local government) currently goes to the People’s Liberation Army (PLA) and to domestic security, which includes the People’s Armed Police (PAP), a military-trained force whose primary purpose is to control domestic unrest and serve as a fighting force within continental China in times of war. Local governments spend around 5-6 percent of their budget on the PLA and PAP. The bottom line is that Chinese government spending on the PLA and domestic security is over 11 percent of the entire budget. If one accepts outside estimates, such as those by the Stockholm International Peace Research Institute (SIPRI), that the true PLA budget is 55 percent higher than the official one, then more than 60 percent of central government expenditure (not including transfers to local government) is for external and internal security, which equates to around 14 percent of total Chinese government spending.

This brings us back to central-local government issues, which will increase pressure on Beijing’s capacity to continue to grant the PLA rapid increases in its budget each year. The PLA’s budget has been increasing at double-digit rates that significantly exceed GDP growth per annum for the majority of the past fifteen years. Beijing has essentially prioritized supercharging national power and security at the expense of transfers to local governments, which oversee the provision of the vast majority of social and public goods. But the conditions for sustained fiscal deterioration already exist, meaning that local governments will come calling, and Beijing cannot afford to ignore them.

Just as other countries have been forced to eventually accept fiscal reality and wind back growth in military spending when debt-fueled economies slow, Beijing will soon have to confront its own economic reality and fiscal mortality. The solvency of local governments that are overwhelmingly responsible for providing social and public goods, and the stability as well as solvency of the entire financial system, are presumably higher priorities than even rejuvenating the Chinese nation through the rapid advancement of military power.

The “long-standing task for China to safeguard its maritime rights and interests” is a main theme in China’s 2015 Defense White Paper, which notes that “the [United States] carries on its ‘rebalancing’ strategy and enhances its military presence in this region [while] Japan is sparing no effort to dodge the post-war mechanism, overhauling its military and security policies.” This amplified the slightly softer line in the 2013 Defense White Paper that “China is a major maritime as well as land country.” If the transition from land-based to maritime-based great power continues, as is likely, then the CCP will be breaking with an eighty-year PLA tradition.

In times of fiscal well-being and plenty, a rising tide tends to lift all boats. Opportunity costs are minimal, and strategic and operational ambition is easily articulated and accepted. With difficult fiscal times ahead, deciding CCP and PLA strategic and military priorities becomes far more fraught and contested. Continued government largesse to enhance the capacities of the PLA Navy (PLAN) might not prove as forthcoming, for a couple of major reasons.

The first is the certainty of intensifying competition for resources between the PLA and PAP. As the 2015 Defense White Paper and countless other documents and speeches confirm, two
of the top three priorities are to prevent independence for East Turkistan (Xinjiang) and Tibet, and to deter Taiwanese moves toward independence — all second only to preserving the CCP’s political power. Xinjiang and Tibet are regions actually controlled and administered by Beijing, and together they constitute about one-third of China’s current continental territory. Xinjiang also has significant oil and gas resources, while Tibet has become a critical site for the Chinese strategic nuclear arsenal vis-à-vis Eurasia and South Asia.

While China has little direct control over what happens in Taiwan, it has no tolerance for any adverse developments in Taiwan’s western regions, over which Beijing has formal sovereignty and control. In these areas, the PAP usually responds first to any ongoing problems. Indeed, the lion’s share of the enormous resources allocated to the PAP is deployed in the country’s western inland region, and problems in Xinjiang are only worsening: repression of Uighurs has intensified, alongside alleged acts of Uighur terrorism.

Add to this the growing official instances of “mass unrest” in China (defined as fifty or more people protesting against government officials), which have increased from 8,700 in 1993 to as high as an estimated 230,000 by 2010. (The government has refused to release more recent estimates.) Responding to these remains the responsibility of the PAP. By all estimates, the number now is regularly well over 100,000 each year. This guarantees rapidly increased funding for the PAP no matter the economic or fiscal circumstances.

Second, the PLA, unlike its competitors with tight budgets, has not had to negotiate difficult and zero-sum funding decisions. But dormant interservice rivalries within the PLA will intensify as budgetary belts tighten. This is as significant as weaknesses that exist (vis-à-vis the United States and even Japan) in almost all aspects of the PLA’s organizational, human capital, training, capabilities, logistical, and integrative capacities across all the services.

Furthermore, competing priorities in what Beijing coins its “core missions” will increasingly undercut each other in a tighter fiscal environment. For example, “containing separatist forces” will require different spending priorities, as will “resisting aggression” from China’s land-border neighbors such as Russia and India. Finally, core missions such as “safeguarding border, coastal, and territorial air security” require enormous and ongoing investment not just in the PLA Navy but also in cyber and space assets. This is part of the “winning local wars under informatized conditions” concept, which drives China’s anti-access/area-denial capabilities, designed primarily to counter the U.S. Seventh Fleet.

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III. DEFERRING PROBLEMS TO STIMULATE A SECOND WIND

If the period of the Twelfth Five Year Plan (2011–15) ended with dark economic clouds looming for China, the Thirteenth Five Year Plan (2016–20) declared strong optimism that the country will achieve its objective of “building a moderately prosperous society in all respects.”

In some senses, this was a surprise. The Thirteenth Five Year Plan recognized that China had an “unbalanced, uncoordinated, and unsustainable growth” model. But this plan, far from having China retreat into its shell in the face of formidable economic problems, was arguably Beijing’s most ambitious. Rather than focusing only on addressing the structural imbalances detailed in the previous section, the plan gave the impression that it was “full steam ahead” for the country. The blueprint based the next five years on five key themes.

Two of these themes addressed internal reforms that had long preoccupied Beijing in the Hu Jintao era (2003–12). They emphasized the importance of “coordinated development,” meaning confronting problems such as the widening disparity in regional economic development (especially between coastal and inland provinces); the problem of inefficient industrial
policies and practices; lack of reform of the hukou, or household registration system, which prevented labor mobility; and the lack of public services, especially in poorer areas.

The Thirteenth Five Year plan also recognized the importance of “inclusive growth.” This refers to ensuring that more citizens are given access to economic opportunity and lifestyle improvements. Toward this end, the plan set targets for alleviating poverty and providing better accessibility and affordability for healthcare and social services.

A third theme was the importance of “green” growth to address the severe environmental degradation that had occurred over decades of rapid growth. It included targets for using energy, improving air quality, lowering carbon dioxide intensity, and reducing soil and water pollution.

The other two themes are more closely associated with the Xi Jinping era. The first was an emphasis on the importance of “innovation.” According to the plan, China would rapidly move up the global value chain and enhance its future global competitiveness and comprehensive economic power. The plan set ambitious targets with respect to moving up the global rankings for innovation, increasing the share of research and development (R&D) as a percentage of GDP (from 2.1 to 2.5 percent), increasing the number of individuals working in R&D, and almost doubling the number of patents filed (from 6.3 to 12 per 10,000 people). Much of this was encapsulated in the MIC 2025 blueprint, formally released in 2015, which will be discussed in further detail shortly.

The second was summarized under the innocuous and neutral-sounding virtue of “openness”: Exports will be increased. China will promote outbound investment and the increased use of the renminbi (RMB). Beijing will play a larger role in global economic governance and trade, including through internal economic zones such as the Beijing-Tianjin-Hebei Integration Plan and the Yangtze Economic Belt. Significantly, these sub-regions will be integrated with the expansive BRI.

As the following sections will argue, these latter two themes (and related initiatives such as MIC 2025 and BRI) have emerged as major geostrategic and economic concerns for the United States and other countries. Interestingly, the problems with the Chinese political-economic model have not been resolved. Indeed, this section will show that they have worsened.

Moreover, in what seems at first instance to be a paradox, the following section will make the case that Xi's ambitious and expansive geostrategic and economic objectives are inextricably linked with China's worsening domestic and economic imbalances. His ambitions are both driven by these imbalances and weaknesses and formed to deflect from them. Not only is this important for a better understanding of the driving forces behind Chinese policies over the past few years; it will also offer valuable insight into how best to counter many of those aspects of Chinese policies that negatively impact US interests and values.

The Rise of Xi Jinping

Domestic and economic uncertainty usually leads to the centralization, or else diffusion, of power. Under Hu Jintao (2003-12) and Jiang Zemin (1993-2002), the puzzle was to identify the various factions and other centers of power to peer inside the black box of Chinese decision-making. In the context of foreign policy, a 2010 SIPRI paper entitled New Foreign Policy Actors in China was representative of the oft-repeated comment by China watchers that the Communist Party was not a monolithic entity that spoke with one voice, and that power did not only flow from the party. Others argued, more persuasively, that while the CCP was not monolithic and there were other entities with influence, the party maintained an iron grip over all the institutions and levers that matter.

Much of that China-watching debate has changed since 2016. Power has been centralized in a manner unseen since the end of the Mao Zedong period in 1976 and the emergence of the Deng Xiaoping era in 1978. The efforts by Xi Jinping to centralize...
power for himself — and his apparent success in doing so — have been as striking as they were unexpected.

Over the past two years, several changes have occurred that lead back to Xi. Central authorities have accrued political and policy power at the expense of bureaucratic ministries and provincial and local governments. To enable this, small but powerful ad hoc groups have been empowered or else created to guide the policy work previously performed by ministries.

Since 2012, it is estimated that at least twenty-nine leading small groups (LSGs) have been created to add to the fifty-four in existence before the Xi era. Prior to that, LSGs existed to collect information and offer guidance. Over the past few years, they have increasingly taken the lead in policy formulation. Xi chairs at least eight LSGs — earning him the moniker “chairman of everything.”

Most of the party-led LSGs formally cover foreign policy, domestic and external security, and domestic politics. Although an estimated nineteen of the twenty LSGs on the economy are state rather than party LSGs, it is becoming clear that the party exercises immense, if still undefined, influence over important areas of economic policy. For example, the most active LSG seems to be the one on comprehensively deepening reform (LSGCDFR), chaired by Xi. According to some accounts, the LSGCDFR acts as a virtual state council and has issued authoritative policy guidance documents on legal and public security issues, the economy, the environment, resource use, public administration, science and technology, public administration, party discipline, SOE reform, and culture and sports.

The point is that these powerful entities operate opaque but cut across all areas of policy-making in the Chinese system. While their interaction with formal ministries and other state entities can be unpredictable, the rise and prominence of LSGs signals a return to a more powerful party and its control over the apparatus of state.

Less subtle than institutional redesign have been measures to directly boost Xi’s personal authority and standing. Much has already been written about his unprecedented anti-corruption campaign, which has snared over one million officials since it began in 2012, including at least thirty-five Central Committee members — more senior figures than were disciplined by all previous anti-corruption campaigns, from 1949–2012. It is also clear that from 2015 onward, the anti-corruption campaign intensified and became far more politicized in terms of advancing Xi’s personal political power. The politicized nature of the process, the additional resources given to the campaign, and the lower threshold and “simplification” of evidence required for disciplinary procedures to commence, have led to the “considerable expansion of the CCDI’s [Central Commission for Discipline Inspection’s] anticorruption investigative capacities and a significant increase in Xi Jinping’s leverage to impose political loyalty and compliance upon Party officials in the future.”

In this setting, there was little surprise when in March 2018, the National People’s Congress “voted” overwhelmingly — 2,958 to 2 — to amend the constitution to remove presidential term limits. The same gathering unanimously approved a petition to add “Xi Jinping Thought on Socialism with Chinese Characteristics for a New Era” as one of the guiding principles in the constitution. “Xi Jinping Thought” offered additional policy content and specificity to Xi’s earlier “China Dream” or “Rejuvenation of China” notion by naming multiple goals, such as pioneering global influence, turning the military into a “world class” force, eradicating poverty, and economic reform with Chinese socialist characteristics. By writing himself into the constitution, Xi joins Mao Zedong, the only other person to have his doctrine enshrined in the document. He also joins Mao as the only paramount leader seeking to build a “cult of personality” and not just glory for the party.

The noteworthy aspects of these developments are that since around 2015, Xi has decisively abandoned the “hide your strength, bide your time” approach that has been in place since Deng Xiaoping. Whereas Hu Jintao and his predecessors
emphasized China’s many domestic challenges to reassure the world that its rise would be peaceful and even inward looking, Xi has gone out of his way to project an image and construct a narrative of strength and confidence. Whereas his predecessors were seemingly selling the message of building toward something indeterminate but non-threatening, Xi is telling the world that China’s time in the sun is imminent and that its ambition ought to be marveled at rather than resisted.

At the same time, a more confident and muscular China is emerging in a period when serious problems with its political economy have become apparent. Xi’s centralization of power has led some to argue that he is now better positioned to take on the vested interests necessary to any painful economic reform and policy tonic.79

In fact, this section argues that most of what has occurred is the opposite of promised reforms, and this has important strategic ramifications for China and other countries.

The Official Numbers
While China’s official GDP growth figures have slowed to their lowest levels for several decades, they display an apparently remarkable consistency and resilience in the face of more dire predictions around the 2015 period. Nevertheless, we should bear in mind that China’s official GDP numbers are unreliable and almost certainly overstated for political reasons.80 One recent investigation suggested that China had been overstating its GDP by an average of 1.7 percent each year since 2008, which means that the size of its economy could be 20 percent smaller than the official figure.81 If that is correct, then the size of the Chinese economy was $11.1 trillion at the end of 2018, rather than the official figure of $13.4 trillion.

For the purposes of this monograph, it is not productive to enter more deeply into China’s “true” economic size. We will accept the official National Bureau of Statistics figures as they are and devote effort to forensically drawing out what has occurred since 2015 and how China has apparently stabilized and corrected its imbalances.

According to these official figures, the economy grew 6.66 percent, 6.8 percent, and 6.4 percent in 2016, 2017, and 2018, respectively. Importantly, the growth in fixed capital during those periods was in the single figures (between 5–9 percent), while consumption increased by between 8–11 percent. Indeed, consumption as a percentage of GDP grew from 51.8 percent in 2015 to just under 54 percent by the end of 2018.

The seemingly good news did not end there. Between 2017 and 2019, domestic household consumption increased almost 20 percent over 2015–17, while government consumption expenditure increased almost 22.5 percent. Private consumption as a percentage of overall consumption remained at about 73 percent, with government consumption as a percentage of overall consumption at around 27 percent. Beijing has used these figures to make the argument that the great rebalance away from fixed capital as a driver of GDP growth and toward consumption has occurred to a significant degree.

Perhaps more impressive are official figures suggesting fiscal resilience and recovery. From 2015–16 and then 2016–17, public revenue grew 4.5 percent and 7.4 percent, respectively. This is against public expenditure growth of 6.3 percent and 7.6 percent respectively in the corresponding periods, which seems to set China on a more sustainable fiscal path. During 2016–17, central government revenues grew over 17 percent, and local government revenues increased by 10.2 percent.

These official figures reinforce the reality that the years when budget revenues grew at over 20 percent (which last occurred in 2011) are long gone, while double-digit government revenue growth (which last occurred in 2013) is likely also over. However, growth in government expenditures of over 20 percent (which last occurred in 2011) is also probably over, while central and
local governments seem to be tightening their belts. Have fiscal recovery and stabilization genuinely been achieved?

**What Has Happened to China’s Debt since 2015?**

To many American and other analysts, China seems to be able to consistently defy the laws of economics. Its financial system serves mainly to provide funding for a state sector even though the private sector uses capital twice as efficiently as the former. Its banks have impressive profits, but not, however, because they allocate capital efficiently. Rather, it is because they have the artificial advantage of existing in a virtual oligopoly and reap the benefits of heavily regulated interest rates — with the spread between benchmark bank deposit rates and lending rates, set by the People’s Bank of China, around a generous 3 percent for the past two decades. Liquidity in the system is maintained even when return on capital is low or negative because China can force financial institutions to lend to each other or to corporate firms to maintain desired levels of growth. And even in the absence of political instruction, banks and other financial institutions will continue to lend to SOEs rather than more profitable and dynamic private firms because SOEs enjoy an implicit government guarantee, making them less of a credit risk than a more profitable and deserving private firm.

The obvious upshot of a massive misallocation of capital is a slowdown in growth. This arises from the declining returns in economic output from each dollar of capital invested and the need to use more new capital to pay off the growing interest burden from existing debt.

Even so, the negative fiscal ramifications of the structural slowdown seem to be modest rather than dramatic, despite the warnings leading into 2015. In 2015 and 2016, growth in fiscal revenues was just 1–2 percentage points below reported GDP growth, while in 2017, fiscal revenue growth was above reported GDP growth.

What has China done with SOE debt and other debts effectively guaranteed by the government? According to one estimate, outstanding debt owned by LGFVs alone might well have been around $6.5 trillion by the end of 2015, which amounts to about two-thirds of GDP in that year. Of interest is what the consequences might be for China’s fiscal situation and capacity to project power, given the way it has managed its debt issues.

**The Size and Nature of the Debt**

By early 2019, global research and/or ratings organizations estimated that China's total debt was approximately 300 percent of GDP. One of the estimates at the higher range was from Goldman Sachs, which had put the figure at 317 percent of GDP earlier in 2019. According to these and other credible sources, the breakdown of debt is roughly along the lines shown in Table 1.

Note that it is misleading to look at China’s relatively unremarkable government debt-to-GDP ratio, which is just over 50 percent, and compare it to that of other countries. As the previous section points out, the Chinese government offers substantial explicit and implicit guarantees over the liabilities of formal and informal financial institutions (including shadow banking lending and WMPs), central and local state-controlled entities, and local government entities such as LGFVs.

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**Table 1: Location of Debt in the Chinese Economy**

<table>
<thead>
<tr>
<th>DEBT BREAKDOWN</th>
<th>HOUSEHOLDS</th>
<th>NON-FINANCIAL ENTITIES</th>
<th>FINANCIAL ENTITIES</th>
<th>GOVERNMENT</th>
</tr>
</thead>
<tbody>
<tr>
<td>% of GDP</td>
<td>54</td>
<td>155.5</td>
<td>43.1</td>
<td>51</td>
</tr>
</tbody>
</table>

Sources: Institute of International Finance, BIS, Haver, National Bureau of Statistics, Bloomberg
Figure 2 shows government debt as a proportion of GDP in a selection of Asian economies, and government debt as a percentage of GDP compared to other forms of debt held in developing Asian countries.

It is impossible to determine with any accuracy what the government's liability might actually be; because the country's economic and financial system is opaque, there is no way to know to what extent the government will follow through on implied guarantees. We can surmise that the government would honor these guarantees if failure to do so would lead to more serious or even systemic risks to the economic and financial system. Even so, whether a default will lead to a serious or systemic risk is always dependent on context and other contiguous and contemporaneous events, which cannot be known ahead of time.

We can make the following broad but pertinent estimations. The debt owned by the government is obviously a direct liability, while the overwhelming proportion of the debt owned by financial entities is an implied liability. Most of the debt owned by households does not enjoy any explicit or implicit guarantee by the government. Household debt is mainly significant as an indicator of the extent to which households can increase consumption to help fuel economic growth. It is also one important indicator of whether households are overleveraged when it comes to the residential property market. As explained in the previous section, this has considerable bearing on both fiscal finances and the country's financial system more generally.

The great variable of high consequence is the extent to which there is an explicit or implicit obligation for the government to guarantee corporate debt by non-financial entities. According to most credible estimates, state-controlled enterprises hold more than 80 percent of corporate debt in the Chinese economy. This means that state-controlled entities hold debt that equals around 125 percent of GDP (compared to just over 80 percent of GDP in 2007–08.) That estimation is consistent with official data released by the State Council, which estimated state-controlled entities had debts of around $17 trillion at the end of 2017. It is also conservatively estimated that debt held by non-financial commercial entities controlled by local governments has increased from around 40 percent of GDP in 2008 to almost 75 percent.

Adding together the explicit and implicit liabilities for the government leads to a figure of approximately 220 percent of GDP, or about $33 trillion. Note that there has been an increase in non-financial corporate debt (of state-controlled and private firms) from around $6 trillion in 2007 to about $30 trillion currently, and that this has occurred despite an incremental capital output ratio (i.e., unit of capital input required to achieve one unit of additional output) that has deteriorated from about 3.5:1 in 2007 to about 6:1 in 2015 and about 7:1 currently.
It is true that profits of state-controlled firms have been growing, which provides some measure of fiscal comfort for China. This is reflected in the reasonably stable tax revenues Beijing has received since 2015. However, the sustainability of this situation depends on whether the policy of prioritizing state-controlled firms at the expense of more efficient private firms can continue. This in turn depends on whether it is possible for these state-controlled firms to take on and manage more and more debt for capital investment when economic growth is slowing and profitable investments (at least in the domestic economy) are becoming increasingly difficult to locate, given the overinvestment that has already occurred. It is in this context that we turn to how China — and state-controlled firms in particular — have managed their ballooning debt levels.

**Tactical Measures to Prevent a Financial and Fiscal Crisis**

Although Beijing’s accumulation of debt since 2008 is the most rapid in recorded peacetime economic history in both absolute and relative terms, China enjoys a “perverse resilience” as a result of its unique political economy.

Bear in mind that while state-controlled companies have incurred about 80 percent of the debt of non-financial firms in China, their return on investment has been halved since 2007. This means that the following has occurred:

- Growth in borrowing by state-controlled firms has increased by more than twice the levels of GDP growth since 2007;
- At the same time, state-controlled firms have been using capital far more inefficiently than in 2007. (The chart below shows only the return on equity of listed state-owned firms, which are by some distance the most efficient SOEs in the Chinese economy. Even then, the deterioration in their performance is considerable.)
- At the same time, the government has become more reliant on fiscal revenues gained from the increasingly inefficient activities of state-controlled firms, which receive the lion’s share of capital in the country.

Figure 3 shows the deteriorating performance of Chinese listed state-controlled companies from 2007–17, when measured by return on equity.

![Figure 3: Return on Equity of Listed Chinese State Companies From 2007–17 (In Percent)](image)

Moreover, the fact that much of the debt is held by state-controlled corporate entities rather than the government or households has some advantages. In China’s case, the central government has ultimate control over the way debt and liquidity is managed in the macroeconomy, especially as it relates to state-controlled entities. This means that Beijing can devise policies to manage the timing, pace, and process with which debts are repaid or non-performing loans are recognized and handled.

In contrast, indebtedness in official government accounts leaves less room for maneuver because governments have less ability to quickly raise revenue or restrict spending without

convertible “near money” such as savings deposits, money market securities, mutual funds, and other fixed-time deposits.

The fall in money supply is reflected in and consistent with Figure 5, which shows the dramatic slowdown in Chinese fixed-investment growth from the highs of the previous decade, especially from 2015 onward.

Second, in 2017, China identified “financial risk” as one of three critical battles (along with pollution and poverty). Intent on reducing “excessive leveraging,” Beijing put much of its effort into cracking down on off-balance-sheet activities between lending institutions and from these institutions to firms and individuals — that is, the so-called shadow banking sector.

immediate negative social and political consequences. It is also more difficult to conceal government fiscal problems than financial stress for corporations. With respect to households, they have fewer options when it comes to managing and repaying onerous debt and debt burdens. A household under severe debt stress is less able to ride out tough times than is a state-controlled enterprise with the explicit or implicit backing of the Chinese government.

Even so, Beijing has had to find tactical ways to forestall a financial and economic crisis in recent times. It has achieved that in the following ways:

First, it has slowed the availability of credit to prevent debts from spiraling out of control.

Figure 4 shows the fall in growth of M2, a measure of money supply that includes cash, checking deposits (i.e., M1), and
firms held a declining share of debt as a proportion of GDP from 2016 onward (even though absolute debt held by non-financial firms continued to grow). Instead, households, government, and financial firms took on an increased share of national debt.

From a systemic risk point of view this was preferable, as household and central government debt remained manageable, while the lending and borrowing activities of the formal financial sector were more easily monitored and regulated than activities by non-financial firms. Incentives for households to take on more debt also offered the prospect that this would fuel much-needed increases in domestic private consumption to offset relative declines in fixed investment from the corporate deleveraging process.

Figure 6 shows the rapid rise up to 2013–14 of non-bank credit as a percentage of overall lending in the Chinese economy, followed by its relative decline.

Figure 7 shows the rapid rise, then decline, then re-emergence of shadow bank lending in China.

From a macro balance sheet point of view, these tactical measures worked. As Figure 8 demonstrates, non-financial

By the end of 2017, regulators announced they had uncovered nearly 60,000 instances of wrongdoing involving about $2.5 trillion. Fines worth over $400 million were issued against almost 1,900 banks, and more than 1,500 financial employees were punished with fines and even lifetime bans. As a result, non-bank credit as a proportion of overall credit was halved from the highs of 2013–14, and from 2018 onward, repayments of shadow bank loans exceeded new loans issued.

Figure 6 shows the rapid rise up to 2013–14 of non-bank credit as a percentage of overall lending in the Chinese economy, followed by its relative decline.

Third, in keeping with the directives of the Thirteenth Five Year Plan, Beijing identified around 350 central state-controlled
firms that had suffered losses for three consecutive years and did not fit in with the priorities of the country’s broader industrial policies. Local governments were also pushed to identify “zombie” local state-controlled firms that met those criteria.

In practice, the plan to eliminate these zombie firms within three years has only succeeded in modest and narrow terms. The focus has been mainly on coal and steel producers, while state-controlled firms that make profits only through the significant government advantages they are afforded (through cheap or free credit, subsidies, tax relief, inflated invoicing, etc.) are left alone. Indeed, at the time of writing, the plan to phase out zombie firms seemed to have stalled.

Figure 9 shows the decline in workers in heavy industries such as iron, steel, and coal since 2013–14.

Fourth, China introduced a new debt-for-equity framework in March 2016, though its approach was not new. In the late 1990s and earlier this century, Beijing set up and funded four asset management companies (AMCs) to inject capital into distressed banks by purchasing bad or questionable debts to offer some relief from loan sheets weighed down by non-performing loans (NPLs). The theory was that AMCs would specialize in the recovery of debt, ensuring that the proportion of NPLs recovered would be significantly higher than if the NPLs had remained with the banks. In return, the AMCs issued promissory notes and bonds to the banks for from 50 percent to as much as 100 percent of book value. The purpose was to lower NPLs on banks’ balance sheets. It is estimated that almost $170 billion worth of NPLs was taken off the books of China’s four largest banks over that period.

The expectation was that AMCs could recover 40–50% of the NPLs. Ernst & Young conservatively estimates the average cash recovery rate to be about 25 percent. Fitch Ratings estimated the most generous recovery rates for these to be about 30 percent, meaning a loss of 70 percent — significantly worse than the 40–50 percent recovery rate officials reported as the minimum. A Deutsche Bank report revealed that in 2003, the AMCs were burdened with about 19 percent of the state banks’ NPLs and had liquidated about a quarter of them. The cash recovery rate was only about 20 percent. Indeed, at the time of writing, the plan to phase out zombie firms seemed to have stalled.

The more recent version of the framework (from 2016 onward) contained modifications, as the primary objective was to assist distressed non-financial firms rather than distressed banks. In fact, five of China’s biggest banks — Industrial and Commercial Bank of China Limited, China Construction Bank Corporation, Agricultural Bank of China Limited, Bank of China Limited, and Bank of Communications Co., Ltd. — became the main executing entities driving the debt-for-equity swap arrangements, rather than AMCs.

Under the current scheme, the government takes less of a direct role. Instead, banks are encouraged to work with third-
party investors (including private entities) to set up debt-for-equity investment funds. These funds inject equity into heavily indebted companies, which use the new capital to pay back debts to banks and other lending institutions.

In 2017, China’s Ministry of Finance announced that it intended to swap more than $150 billion of debt for equity through this framework.97 By late 2018, only about $22 billion worth of such swaps had occurred, despite an announcement that $157 billion worth had been agreed upon.98 Constant tinkering with the scheme to make it more attractive to state-controlled and private entities has led to significant increases in executed debt-to-equity swap agreements. By the end of 2018, the estimated figure was $145 billion executed.99 Even so, we know the amount of distressed debt held, especially by state-controlled firms, has grown exponentially.

Figure 10 shows significant improvement in the implementation of China’s debt-to-equity swap program.

Fifth, as mentioned in the previous section, local governments are now permitted to issue bonds, following revision of the 1994 Budget Law. This was done to ensure that local fiscal budgets became less reliant on proceeds from land and property sales and LGFVs became less dependent on the shadow banking sector.

In China’s bond market, which is still relatively undeveloped, local government bonds have been hugely successful in raising revenue for these governments. One notable scheme was a “debt swap” program, begun in 2015, which allowed local governments to convert the debt held by LGFVs (which includes bank debt, monies owed to non-bank entities, and LGFV bonds) into local government bonds. About half of the
At the NPC’s most recent meeting, Chinese authorities significantly increased the 2019 quota for local government bond issuance. They set the quota at CNY3.1 trillion (3 per cent of GDP, or $450 billion), almost one-third more than for 2018, undoubtedly to offset the general slowdown and the Trump economic offensive.

Finally, desperate local governments have used private-public partnerships (PPPs) to bypass the central government’s deleveraging instructions. This is being done by having LGFVs entice investors to inject capital into low-return projects by promising them guaranteed returns on their capital, guaranteed buybacks, or redemptions at an agreed time and price that are more generous than the market would allow. This clearly has the opposite of the intended deleveraging effect, as LGFVs are offering even more generous terms to third-party entities in their desperation to secure capital and keep their fiscal revenues stable.
By the end of March 2019, almost 9,000 PPP projects by LGFVs had been registered with the Ministry of Finance, worth about $1.9 trillion. The ministry, recognizing the prevalence of the practice, announced that it would assess these projects to see the extent to which they were designed to bypass regulations and increase the off-budget debt of local governments.

Kicking the Can Down the Road

When Xi came to power in 2012, he promised to allow the market to play a “decisive role in the economy.” As he explained later, this was necessary because China’s economy was “big but not strong” and “bloated” and “frail.” Low “innovative ability” was its “Achilles Heel.” This led many in the US and elsewhere to predict that Xi would be the great liberal economic reformer that China had been waiting for since Deng Xiaoping.

Those believing that the market would soon play a “decisive role” in China missed a critical part of something about which Xi was always upfront: in the quest for greater innovation, efficiency, financial stability, and economic resilience, the party will play an even greater role in shaping the priorities and policies of the economy and state-controlled firms, and hand-picked “national champions” will continue to dominate leading sectors of the economy.

In short, China will remain a Leninist political economy in that all tools of economic power will be used to further the dominance
First, identifying zombie companies is essential for working out which firms to phase out, as these entities are the greatest drag when it comes to (mis)allocation of resources. These are also the firms that exacerbate NPL issues, as constant borrowing by loss-making firms makes it less and less likely that loans will be serviced, let alone paid back.

Furthermore, debt-to-equity swaps work only if the distressed firm is able to return to profitability, which is necessary to allow it to buy back the equity from the rescuing entity or ensure that the equity taken on by the rescuing firm has future value for that firm. If the distressed firm does not return to profitability, then a debt-for-equity swap merely represents a transfer of losses from the distressed company to the rescuing company. This is problematic, since much of China’s bad debt is held by state-controlled firms that are fundamentally uncompetitive. It would obviously increase the number of NPLs in the financial system and for individual lending institutions.

One of Beijing’s stated goals is to exclude zombie companies from any such debt-for-equity schemes. However, there is no guidance on how to identify and exclude them from either bailouts or debt-for-equity swaps. Regulators might respond that it is up to “the market” — or more precisely, individual banks and investors — to determine whether a distressed firm is worthy of assistance. The problem is that the party-led political economy is designed to assist and protect less-efficient state-controlled firms. These trends are a reversal of what occurred during the three decades prior to 2014.

In macroeconomic and fiscal terms, this is a problem for Beijing. The private sector accounts for about half of the country’s tax revenue, about 60 percent of GDP, and 80 percent of urban employment. These political priorities also create serious longer-term challenges for Beijing in achieving sustainable economic growth and managing the debt and fiscal issues in the medium-to-longer term.

Consider the tactical measures to manage debt, deleverage, and stabilize and grow fiscal revenues above.

Figure 13 compares the increase in the profit growth of state-controlled industrial firms with the decline in profitability of private firms in China since 2016.

It is now common to describe the economic situation in China as “the state advances — the private sector retreats.” Under Xi, the unequal treatment of the private sector has been extended further: state-controlled firms are being offered easier and cheaper access to credit, privileged access to some of the most lucrative sectors in the economy, and regulatory and legal protection from local and central governments. This is demonstrated by data showing that private-sector profits have been generally declining since around late 2014 — and fell by 22 percent in 2018, the largest decline since 1978 — while profits of state-controlled firms have been increasing since late 2015. This is occurring even though private firms have a return on assets around three times better than that of state-controlled firms, and their use of capital is twice as efficient as state-controlled firms. These trends are a reversal of what occurred during the three decades prior to 2014.

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to LGFVs and other state-controlled firms to underplay their level of distress and overvalue their debts in order to receive a larger-than-warranted equity injection. At the same time, state-controlled rescue firms are generally happy to accept inflated estimates of the distressed company’s health in order to attract third-party investors to join the debt-to-equity scheme. As there is no developed framework to determine which entity bears the cost if the distressed company ultimately fails after the debt-for-equity swap, the likelihood is that the local government will bear the cost or will lean on state-controlled banks to mop up the spill. Indeed, the uncertain prospect of repayment means that state-controlled firms such as China’s five largest state-owned banks continue to be the major investors in the scheme and will most likely be forced to absorb any losses. Many banks are even forced to resort to selling WMPs (offering generous rates of return) to raise funds from private investors to participate in debt-to-equity swaps for fundamentally unsound companies. That increases systemic risk on several levels. More broadly, the simple solution of a direct bailout in the first place makes more sense and entails less unknown risk in some circumstances.

Moreover, the rescuing entities have no capacity to replace the management of the distressed firm or even influence its governance practices. Debt-to-equity schemes tend to work when they lead to plausible plans as to how distressed firms will deleverage, turn the business around, and recapitalize. In China’s case, the debt-for-equity scheme is intended primarily to rescue distressed state-controlled firms rather than change the corporate and market practices that led to the problem in the first place.

In any event, even if the distressed firm were operating soundly, debt-to-equity schemes would not make a significant impact on the deleveraging process. One study by the Peterson Institute for International Economics estimated that by the end of April 2019, there was just over $131 billion of executed swaps, which is around a three-fold increase since the end of 2017.

Even so, this pales in comparison to the almost $21 trillion in outstanding non-financial corporate loans at that same time. The $131 billion in executed swaps is less than the estimated $148 billion in new non-financial corporate loans in the month of April 2019 alone.114

Similar principles apply to the PPP schemes. It is revealing that perhaps as many as 75 percent of firms participating in PPP arrangements are state-controlled entities rather than private firms.115 One report, which is typical, suggests that most private firms surveyed were concerned that local governments would not honor their agreements and would not enforce investor rights against local government entities.116

Figure 14: Local Government Bond Pricing Versus Debt-To-Revenue Ratios of Local Government Issuers (By Province, 2018)

Information Source: CEIC Data; RBA; WIND Information
Figure 14 shows the unusually even pricing of local government bonds in China, despite the significant differences in debt-to-revenue ratios of different local government entities.

This tends to suggest that bonds are all low risk because there is an explicit or implied government guarantee that they will be honored. This leads to a familiar moral hazard problem in which local governments can issue bonds at artificially low prices and therefore do so with little discipline. (The same logic is at play when lending institutions offer credit to state-controlled entities at substantially lower cost because they are confident that the government will bail these firms out if necessary. This encourages the firms to increase financial leverage even more). Conversely, those who purchase the bonds do so with little due diligence and subsequently use them as AAA-rated collateral for further borrowing. This increases the fragility of the financial and economic system and undermines the central government’s deleveraging objectives. It will also inevitably lead to serious dilemmas for the central government. If it leans toward offering a guarantee for local government bonds, then the moral hazards described above worsen. If it allows local governments or LGFVs to default, then panic by bond holders and entities accepting these bonds as collateral could trigger a cascading and catastrophic crisis for the financial system of that locality, or even the country.

In recent times, the central government has made attempts to introduce better market-based pricing of different types of bonds. For example, in 2018, it introduced a prohibition on local governments’ guaranteeing LGFV debt. This did lead to larger spreads between the lower-risk bonds issued by local governments and those issued by LGFVs.

However, the larger spread ultimately increased funding costs for local governments. As the economy slowed and the increase in transfers from the central government similarly slowed, the pressure to lower the cost to local government of raising debt became greater. Inevitably, the pressure on Beijing...
to offer stronger implicit guarantees to lower bond costs for local government grew. This is what occurred from mid-2018 onward due to the sluggish economy and the ongoing effects of the trade tensions with the United States.

One possible buffer against systemic risk is that the central government is limiting the monetary value of bonds that local governments and LGFVs can issue to “safe” levels. However, if the quota is set too low, then local governments and LGFVs will simply revert to the shadow banking system, as they have done from time to time in recent years. Allowing these bonds to be issued largely means repackaging products to permit local governments to spend more than they earn; it does not, in and of itself, impose fiscal discipline or create an enduring source of unencumbered fiscal revenue.

Figure 16 shows the differences in type of investor in local government bonds between China and the US and Japan. In China, investors in local government bonds are dominated by state-controlled commercial banks. It is worth noting that China’s commercial banks (which make up around half of the Chinese banking sector) purchase around 80 percent of all local government bonds, which is a very narrow investor base compared to other major economies.

One reason to encourage local governments and LGFVs to transition to bonds for finance is that this spreads the risk of default throughout the economy. In China’s case, that risk is offered stronger implicit guarantees to lower bond costs for local government grew. This is what occurred from mid-2018 onward due to the sluggish economy and the ongoing effects of the trade tensions with the United States.

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It is instructive to see what occurred when the combination of the continual structural economic slowdown and the exogenous shock of economic tensions with the US caused some panic in Beijing. The credit impulse measures change in new credit as a proportion of GDP. Total social financing represents off-balance-sheet forms of financing outside the conventional banking system (shadow banking) and includes loans from trust companies and bonds.

It is clear that the only reliable way Beijing has of maintaining adequate growth — needed for fiscal stability — is to increase credit in the system. China cannot significantly deleverage and resolve its debt issues without wholesale changes to its political economy, which would be fundamentally incompatible with the Leninist mindset on which Xi is doubling down.

Moreover, due to state-controlled enterprises’ privileged access to formal finance, such as standard bank loans, the private sector is heavily reliant on the shadow banking sector. The crackdown on shadow banking has been disproportionately disruptive for private firms. Given that these firms pay around half of all taxes, the government is being forced to relax controls on the shadow banking sector as the economy slows further. This all but guarantees a rerun of the risk and systemic concerns of 2015.

**Conclusion**

Economic reformers such as Zhou Xiaochuan, governor of the People’s Bank of China from 2002–18, might have preferred the path of gradual corporate deleveraging, coupled with structural reforms that better allocated resources and opportunity to more deserving private and state-controlled firms. A more efficient and effective use of capital would likely have restricted the growth of corporate and government debt, supported a more rapid increase in household income (rather than state-controlled corporate revenues), and achieved moderate growth at the same time.

The alternative growth model favored by Xi sees the continual buildup of investment and credit and little progress on structural
reforms. Under this current model, less deserving companies continue to receive the lion’s share of opportunity and credit, and the enormous misallocation of capital will likely worsen. An increasing amount and proportion of credit will go to inefficient, over-capacity, and even loss-making sectors. The private sector and household income will remain artificially suppressed.

The Communist Party under Xi believes that this scenario offers the best prospect for it to retain its hold over the levers of economic power and opportunity, and therefore, political power and control. This is the model on which China is betting its future in the Xi era.
At the time of writing, Chinese banking authorities had lowered the reserve ratio requirements for the nation’s commercial banks more than half a dozen times over the previous twelve months. State-controlled companies continued to receive most of the formal finance, which led to Beijing’s urging lending institutions — and in some instances, pressuring them — to offer more finance to private firms.  

There were 35 cases of bond default in 2017, rising to 119 in 2018. Companies formally defaulted on around $6 billion of domestic bonds from January–April 2019, which was about 3.4 times the total for the same period in 2018. While the increased pace of defaults is concerning, the absolute amount is relatively modest. Bear in mind, however, that formal defaults record only those bonds that were not refinanced (as there were not sufficient profits or cash flow to honor them from existing balance sheets) or bonds that were repackaged by state entities to prevent any default.

Photo caption: A light installation commissioned by Huawei mimics the Aurora Borealis above the Tower of London, to promote the launch of the Huawei P30 Pro phone, on April 4, 2019 in London, England. (Joe Pepler/PinPep via Getty Images)
In the first quarter of 2019, almost 79 percent of LGFV bonds were used to repay or refinance maturing debt or to swap debt for other instruments. The figure was just over 19 percent in 2013. In Figure 19, the majority of “unexplained use” bonds are also likely for this same purpose.

More broadly, the pattern of additional borrowing to manage existing debt is clear, strengthening, and seemingly unchangeable. Given the fundamental unreliability of Chinese macrostatistics, better insights are usually gained from extensive bottom-up analyses.

One recent and compelling analysis was performed by the Rhodium Group, which looked at the bond prospectus documents of almost 2,500 LGFVs. Its investigation showed that the problem discussed in Chapter II — using new credit to help manage existing debt rather than for new projects — has worsened considerably.

In the first quarter of 2019, almost 79 percent of LGFV bonds were used to repay or refinance maturing debt or to swap debt for other instruments. The figure was just over 19 percent in 2013. In Figure 19, the majority of “unexplained use” bonds are also likely for this same purpose.

We could also put this another way. In the first quarter of 2013, almost 81 percent of bonds were issued for capital projects. By the first quarter of 2019, the figure was just over 21 percent.

Furthermore, all components of growth are clearly slowing or
Since the Second World War, rapidly developing East Asian economies — Japan, South Korea, Taiwan, Singapore, Malaysia, Thailand, and, most recently, China — have all relied upon a remarkably similar export-manufacturing model. They seek to grow by making exported products for consumers in advanced economies more cheaply, quickly, and reliably than other countries or regions can.

At the heart of the so-called East Asian model of rapid economic development and industrialization is the emphasis on developing a strong export-manufacturing domestic sector that is bolted onto a highly protected domestic consumption market. The countries using this model have a natural advantage in being able to offer a cheap and plentiful supply of low-cost labor, and they have also implemented state interventionist policies to attract foreign firms and capital into the export-manufacturing sectors. These include tax concessions and subsidies to domestic and foreign firms to locate manufacturing plants in the country. Export-enhancing policies also include currency regimes that artificially suppress the value of the domestic currency relative to Western currencies, making it cheaper for Western firms to inject capital and for Western consumers to purchase the exported goods. The export-oriented model has stagnating in structural terms. It is obvious that overinvestment has led to overcapacity and overleverage, while it is unlikely domestic consumption will be able to underpin the next phase of growth envisaged by the Thirteenth Five Year Plan and beyond. Figure 20 shows the trends and expectations of Chinese growth and credit metrics up to 2025 with and without reform.

The orthodox consensus is that China needs liberal and market-based political-economic reform, but Xi is committing to other approaches. This chapter looks at how MIC 2025 and the philosophy behind it are related to the economic vulnerabilities described above.

Reaching the End of the Old East Asian Export Manufacturing Model

However, there is a structural problem. The combined population of Japan, South Korea, and Taiwan in 1970 — when these countries were in the midst of pioneering the export-manufacturing path — was only about 150 million. The combined population of the industrialized economies in North America and Western Europe, their main markets, was around 400 million at that time. But this balance will be reversed for the next generation of ambitious exporters. There are one billion or so consumers in the handful of advanced economies, while there are now some two billion people living in developing countries in East Asia. Sluggish growth in the advanced economies means those scales will not tip soon, even if we add in the fifty to one hundred million consumers in China with similar buying power to their counterparts in advanced economies. This does not even allow for the very real possibility that other low-wage countries with large populations, like Mexico, Ethiopia, or Nigeria, will also try to break into the export-manufacturing game.
Figure 23 shows the components of Chinese exports, broken down by ordinary exports (finished goods) and processing exports (intermediate parts of an unfinished good), as a percentage of total trade, along with the domestic value added of exports, from 2005–2017.

In China’s case, merchandise trade as a share of GDP is falling, even though in absolute terms, trade and services and trade volumes are still rising, albeit slowly. From a GDP growth perspective, net exports are no longer a significant contributor, as they were in the mid-2000s.

What is significant is that the share of processing (intermediate parts) trade of exports from China is falling while the domestic value-added component of China’s exports is increasing. This means it is transitioning from a low-cost assembler of exported products toward an exporter of domestically generated value. In other words, China is increasingly capturing more of the value of a traded product.

China’s “New” Export-Oriented Model

In May 2015, the State Council launched MIC 2025 to guide the upgrading of Chinese industry, production, and innovation over the next ten years. The blueprint identified the sectors below as essential.

MIC 2025 did not arise in a vacuum. In 2006, the Hu Jintao regime issued a Fifteen Year Plan to enhance “indigenous innovation” and subsequently identified seven strategic emerging industries (SEI) that were essential for China if it was to evolve into an “advanced economy.”128 That plan set a target for SEI-related industries to account for 8 percent of the economy by 2015 and 15 percent by 2020.

What is MIC 2025?

MIC 2025 pursues the same central planning and target-setting approach in seeking to implement an industrial policy that
However, MIC 2025 is far more extensive and significant for several important reasons. First, the program seeks control over, and dominance of, entire manufacturing processes, supply chains, and associated services for the sectors identified in the MIC 2025 plan. For example, it specifies targets for the domestic content of core components and materials: 40 percent by 2020 and 70 percent by 2025 (a violation of World Trade Organization rules). It makes explicit reference to how much of China’s technology markets in various sectors should be controlled by Chinese companies and how many component parts in various relevant products need to be “Made in China.” It sets out industry-specific and tech-specific targets in detail. These include market share targets for Chinese technology, quotas for smart machinery use, targets for the number of patents per RMB 100 million in revenue, and details about the development of world-class brands in these selected industries.

Moreover, while the state and state-controlled sectors will still lead, MIC 2025 will co-opt and use indigenous private firms to ensure that value creation is created in and retained within China. All state-controlled and private indigenous firms are potential partners and participants in MIC 2025, and those advancing the blueprint’s objectives will be offered financial, commercial, regulatory, legal, and political support and assistance.

Additionally, MIC 2025 reads like a comprehensive blueprint for domestic reform to “upgrade” the entire Chinese economy. For example, its stated goals are linked, and one follows from the other: improving manufacturing innovation, integrating information technology and industry, bolstering the industrial base, fostering world-class Chinese brands, enforcing green technologies, promoting breakthroughs in ten key sectors, restructuring the country’s entire manufacturing base, promoting service-oriented manufacturing, and having Chinese firms globalize manufacturing. Performance indicators are given and taken seriously.
For these reasons, it is superficial to compare MIC 2025 to Germany’s 2013 Industry 4.0 plan. MIC 2025 might have been inspired by the German blueprint, but Industry 4.0 merely seeks to consolidate German leadership in mechanical engineering in a world of increased digitization and the Internet of Things. MIC 2025’s objectives of global dominance are not mirrored in the German plan. Importantly, as argued below, the means by which China will seek to achieve MIC 2025’s goals are in a different league altogether.

The Chinese Game Plan

The public pronouncements and implementation of MIC 2025 gathered pace from about 2017 onward due to the urgency to combat China’s structural slowdown. Increasingly, Beijing put MIC 2025 forward as an industrial plan that would help China escape from the “middle-income trap,” and party officials and the state-sanctioned press even linked it to Xi’s “great rejuvenation” or

![Figure 26: Key Performance Indicators for Made in China 2025](image-url)

<table>
<thead>
<tr>
<th>CATEGORY</th>
<th>MANUFACTURING TRANSFORMATION KPI</th>
<th>2015</th>
<th>2025</th>
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<tr>
<td>Innovation Capability</td>
<td>1. R&amp;D cost/revenue($)</td>
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<td></td>
<td>2. Patents/billion RMB of revenue (#)</td>
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<td>Quality and Value</td>
<td>3. Manufacturing quality competitiveness (index)</td>
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<td>85.5</td>
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<td></td>
<td>4. Manufacturing value-added increase over 2015 (%)</td>
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<td></td>
<td>5. Average annual labor productivity growth (%)</td>
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<td>6.5</td>
</tr>
<tr>
<td>IT and Industry Integration</td>
<td>6. Broadband penetration (%)</td>
<td>50</td>
<td>82</td>
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<tr>
<td></td>
<td>7. Digital R&amp;D and design tool penetration (%)</td>
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<td>84</td>
</tr>
<tr>
<td></td>
<td>8. Key process control rate (%)</td>
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<td>64</td>
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<tr>
<td>Green Industry</td>
<td>9. Energy decrease over 2015/industrial value add (%)</td>
<td>-</td>
<td>34</td>
</tr>
<tr>
<td></td>
<td>10. CO₂ decrease over 2015/industrial value add (%)</td>
<td>-</td>
<td>40</td>
</tr>
<tr>
<td></td>
<td>11. Water use decrease over 2015/industrial value add (%)</td>
<td>-</td>
<td>41</td>
</tr>
<tr>
<td></td>
<td>12. Industrial solid wastes utilization ratio (%)</td>
<td>65</td>
<td>79</td>
</tr>
</tbody>
</table>

“China dream.” Although in recent times China has downplayed MIC 2025 to remove it as a lightning rod and appease the Trump administration, it remains a primary industrial blueprint for Beijing.

Indeed, by the end of 2018, the government had issued around 450 authoritative documents detailing MIC 2025 implementation measures. In that year, the Ministry of Industry and Information Technology identified five focal points: establishing indigenous specialization in MIC 2025 national demonstration zones; establishing world-class industry clusters in industrial internet and emerging industries; introducing innovations in basic general technologies; establishing manufacturing innovation centers; and reorganizing fiscal support frameworks to advance these objectives. Of the approximately 4,000 projects linked to MIC 2025, around 3,600 were announced from 2017 onward. At least thirty MIC 2025 pilot cities have been established, and each is tasked with developing specific MIC 2025 sectors. These comprise over 50 sub-industries and 115 industrial sub-fields.

Importantly, indigenous private firms, motivated by a lighter regulatory touch and commercial and other incentives, have been strong supporters of MIC 2025. This is evident in fields such as artificial intelligence, electric vehicles, facial recognition technology, big data, 5G, and advanced communication systems. At the same time, state-controlled firms continue to play an outsized role in the manufacturing component of these sectors, complementing the strength of private firms in driving commercialization and service-related aspects. Given this dynamic, Beijing is increasingly looking to fuse state-controlled and private firms through PPPs, or else mergers and acquisitions.

The United States and other advanced economies are deeply concerned about several aspects of the purposes and implementation of MIC 2025.

First, the plan represents a considerable evolution in the rise of “China Inc.” or the Chinese corporate state under Communist Party direction. Beijing is producing state-directed economic goals and blueprints for both the private and state-controlled sectors in industries and sectors that will create and store an increasingly large proportion of economic value into the future. This is a strong signal of its intention to strengthen its grip on the political economy rather than loosen it.

It is also a firm indication that the more important and potentially lucrative a sector is in the future, the more China will retreat into an economically nationalistic mindset. The country’s quest to escape from the “middle-income trap” is leading to a strengthening and deepening of economic nationalism and mercantilism in China.

Moreover, this is occurring at a time when repression, surveillance, and coercion in China are gathering pace, when Xi is centralizing power for himself and reviving the cult of personality — all aided by the use of advanced technology. For example, the so-called Integrated Joint Operations Platform is being used for mass surveillance in Xinjiang, tracking people’s movement by monitoring their phones, vehicles, and identification cards. When “irregular” movements are detected or they are outside police-designated areas, police and/or security forces are immediately alerted, and an investigation is launched.

China’s use of technology for repression is being complemented by advances in big-data gathering and analysis and facial and speech recognition applications — all relevant to MIC 2025. Beijing appears to be creating and advancing a “Leninist technonationalism” in which economic entities and technological progress are deployed to enhance the coercive, repressive, and surveillance capabilities of the state, and therefore the uncontested power of the party. The evolving “social credit” system is perhaps the manifestation of the “brave new world” that China envisages under Communist Party rule. This system uses various technological advances to monitor, rate, and regulate the financial, social, moral, and political behavior of China’s citizens and companies. It achieves this through a
Second, MIC 2025 can be treated as a blueprint to build the early foundations of a future mercantilist export-oriented approach to growing the economy. As previous chapters argue, the era of export-oriented growth in traditional merchandise trade will not drive the next phase of Chinese growth. There is a general problem of overcapacity in the production of traditional merchandise goods. In addition to the rise of manufacturing technologies such as automation and robotics, which lower the costs of production and reduce the importance of low labor costs, traditional merchandise goods are suffering from oversupply, and there is insufficient net demand in the world to absorb surplus production.

Additionally, the production and supply chains for traditional merchandise goods are becoming more local or regional, meaning they are being produced closer to the end consumer. This makes it more difficult — not easier — for Chinese exporters to target the still vast consumer economies of North America and Europe. The reverse is occurring with trade in high-end professional services and high-tech products and services, where trade is becoming more global — helped along by technologies such as cloud computing, artificial intelligence, and the Internet of Things. These are precisely the sectors that MIC 2025 is seeking to target. It is becoming clear that the plan is not about creating win-win economic relationships with trading partners, but about dominating the sectors that China identifies as being of high economic value into the future. Beijing will continue to export its way to further growth at the expense of trading partners, including the United States.

It is worth noting that in practice, MIC 2025 sets specific market-share targets and defines strategic priorities for Chinese firms that extend beyond the ten core industries identified. The MIC 2025 industries are only the foundation for a strategy that seeks to transform China into the primary global hub for high-tech industries. This would then allow the Chinese political economy to absorb and localize entire value chains. There is also growing appreciation in the United States and other economic partners that China is playing a zero-sum, even illegitimate game in pursuing MIC 2025 goals. In seeking to create and entrench new export markets and other external opportunities, Beijing’s goal is to capture and localize high-tech value and supply chains. At present, China still relies heavily on import of high-tech components, machinery, know-how, and intellectual property. Using its National Bureau of Statistics definition of “high-tech,” which correlates closely with MIC 2025 sectors, China has an account deficit once computers and telecommunications equipment are excluded. The other high-tech sectors include biotechnology and life-sciences, opto-electronics, electronics, computer-integrated machinery, and aerospace materials and applications.

Beijing seeks to make up this shortfall by offering privileged market access to foreign firms with these technologies, or access to the

Figure 27: China’s Trade Balance in High-Tech Components (in BN USD)

Further analysis reveals that around two-thirds of these industries’ products imported from China to the US are produced by foreign-invested firms based in China. This is significant because those firms do not have to base operations there. Not only does doing so mean that they face concerns about IP transfers and theft, but also, when the next destination or end destination for their product is the US, the tariffs levied on them make China-based operations commercially less attractive.

Third, Beijing’s plans for the new export-oriented phase of growth are not just about economics and the desire to grow fiscal revenues through success in future external markets. As the 2017 National Security Strategy puts it, “a geopolitical competition between free and repressive visions of world order is taking place in the Indo-Pacific region.”

China’s exporting of its technology is not value-neutral. Adam Segal from the Council on Foreign Relations notes that “in Xi’s words, cyber-sovereignty represents ‘the right of individual countries to independently choose their own path of cyber development, model of cyber regulation and Internet public policies, and participate in international cyberspace governance on an equal footing.’”

The emerging fragmentation of cyber into “two internets,” one led by the United States and the other by China — as predicted by Google’s Eric Schmidt and others — is based on both the deepening strategic rivalry between the two countries and the widening differences in political and moral values. Ongoing efforts by the US and allies such as Australia to ban Chinese firms from participating in future 5G rollouts are largely driven by these differences. Suspicions of the innocuous-sounding “Huawei cities,” which seek to offer other governments tools similar to those Beijing uses to keep the Uighurs under surveillance and control, are further evidence of the exporting of Chinese values and standards — not just goods and services.

It is highly significant that Huawei — a Chinese “national champion” and critical firm for MIC 2025 — is leading the Chinese market through more favorable joint-venture agreements. Other methods include acquiring foreign firms through foreign direct investment channels and eventually absorbing and repatriating their technology and know-how. More egregious is China’s industrial cyber-theft, committed against foreign firms inside or outside the country to secure these technologies.

Figure 27 shows China’s trade deficit in high-tech products and components (excluding computers and telecommunications), which suggests that China relies heavily on foreign components and know-how.

Indeed, an analysis of tariffs levied by the White House against Chinese goods under section 301 of the Trade Act of 1974 revealed that of the targeted trade with China, 80 percent (by value) was in industries identified as “patent-intensive” by the Department of Commerce. These include computer/electronic products and machinery/equipment. Those sectors constitute about 30 percent and 22 percent of Chinese exports to the US, respectively.

One of the justifications the United States offers is that these are the industries heavily targeted by Chinese efforts at forced transfers and IP theft. The US is also clearly seeking to weaken the foundations for China’s indigenous and export dominance of MIC 2025 sectors into the future. The tariffs seem designed not only to “target” Chinese-based firms in these high-value-creating and patent-intensive industries; they also appear aimed at making it less commercially attractive for foreign firms to invest or engage in joint or cooperative ventures with local firms to produce high-value-creating intermediate parts in China. These two sectors (computer/electronic products and machinery/equipment) are prominent in integrated regional and global supply chains. Moreover, approximately one-third of all Chinese exports of these products to the United States is directly related to the business operations of US-based firms. In other words, around one-third of these Chinese products imported into the US form part of the supply chain for US-based firms.
export of this kind of technology and command systems under what it markets as “safe cities” platforms, ostensibly as a tool of law enforcement but with obvious uses for authoritarian regimes. The first buyers of Huawei’s safe cities products and services were authoritarian regimes including Russia, Pakistan, Venezuela, Laos, Angola, and Ethiopia.149

It is important to note that technological bifurcation is both a driver and a consequence of supply chain and value chain competition. The United States and China will place increasing pressure on other countries to adopt their preferred infrastructure, platform, software, supply chain, etc., even if the economic and/or transactional costs of doing so are higher. The purpose is to lock other countries into their preferred technological ecosystem or operating system and prevent their rivals from doing the same.

This principle also applies to the setting of “standards,” which have been described as the “‘connective tissue’ between technology and [its use in] the market, providing specifications for products, services and systems.”150 Standards can also be defined as the voluntary specifications that enable the interoperability of products and technologies. These can be simple, such as the size of rail gauges, or complex, such as those relating to the interoperability of technologies such as 5G networks. With respect to the latter, complex technical standards can involve patented technologies and the use of a company’s intellectual property, which entrenches privileges for the firm holding the rights.151

China has taken a state-led, strategic approach in order to privilege its own firms and domestic practices, becoming an increasingly effective participant in international standards-setting organizations.152 This applies to emerging technologies such as 5G and artificial intelligence. Indeed, Beijing has identified the setting of standards as a critical battleground for political and commercial advantage over other advanced economies. In contrast, in liberal democratic political economies such as those of the US and the EU, standards are usually influenced by industry bodies and leading firms.

Note that it is not a like-for-like choice. The consequences of buying into the technological ecosystem of an authoritarian state like Xi’s China are very different from those that flow from participating in the technological ecosystem of the United States and other democratic partners.

**Conclusion**

There are already many precedents to indicate China’s game plan. In the well-known case of solar panels, government support for Chinese firms, combined with state-backed theft of intellectual property, allowed these firms to dominate global exports at the expense of US and European firms. MIC 2025 follows the same approach: localize and indigenize R&D and control key segments of the global supply chain; proceed with domestic substitution after reducing dependence on foreign technology; and capture dominant global market share after Chinese technology and brands are developed and entrenched.153

The US concern is reflected elsewhere. The European Union, though reluctant to take bolder action, has similarly taken aim at “distortions in China’s economic system.” These include Beijing’s state-driven policies like MIC 2025, preservation of domestic Chinese markets for “national champions,” and shielding of those entities from legitimate competition. As the EU sees it, this is achieved through selective market opening; licensing and other investment restrictions; heavy subsidies to both state-owned and private sector companies; closure of its procurement market; localisation requirements, including for data; the favouring of domestic operators in the protection and enforcement of intellectual property rights and other
As Beijing looks outward for new economic opportunities, it increasingly exports its political values and standards. This is very different from the previous few decades, when buying “Made in China” did not entail the same political and moral compromises that it does now.

From a global economic point of view, Chinese approaches inherently undermine what globalization and interdependence are designed to facilitate and enhance: the maximization of efficiency and creation of new opportunity for participants based on market forces. China’s approach in the global economy reflects its own political-economic setup, which is designed to ensure that the party retains the levers of economic power and relevance. While all governments intervene in the domestic and global economy to some degree, the nature, scale, and extent of intervention by the party and Chinese state mean that authoritarian China plays a vastly different game from other major economies in the global system.

This is the paradox of MIC 2025 and the Xi era more generally. Domestic weaknesses and vulnerabilities have caused Xi to increase his outward ambitions. MIC 2025 is both the product of domestic Chinese economic and technological vulnerability and the expression of an aspiration to future economic dominance.

domestic laws; and limiting access to government-funded programs for foreign companies.\textsuperscript{154}

The EU estimates these subsidies to be in the hundreds of billions of dollars.\textsuperscript{155} It also chides Beijing for creating an unlevel playing field in common export markets by offering Chinese companies “access to state backed loans and export credits at preferential terms and applying different corporate and labor standards.” In addition, it calls out China for investments in many countries that frequently neglect socioeconomic and financial sustainability and transfer of control over strategic assets and resources. This compromises efforts to promote good social and economic governance and, most fundamentally, the rule of law and human rights.\textsuperscript{156}

In September 2018, trade ministers from the US, the EU, and Japan issued a joint statement criticizing such practices.\textsuperscript{157}

The ramifications are immense. China is seeking to find new ways to grow its economy while increasing the power of the party and its control over the Chinese economy and society.
The Belt and Road Initiative is accurately and widely described as President Xi Jinping’s flagship policy and even China’s most ambitious comprehensive strategic and economic strategy since the Deng Xiaoping period, which began in 1979. Some commentators have even called it China’s version of the post–World War Two Marshall Plan for Eurasia and the Indo-Pacific.158

Promoted to the world in economic rather than strategic terms, and formally introduced by Xi in 2013, the BRI encompasses the “Silk Road Economic Belt” through the Eurasian continent and the “Twenty-first Century Maritime Silk Road,” which links China with Southeast Asia, Oceania, the Indian Ocean rim, Africa, and the Mediterranean. With respect to Europe, the plan is to link China with railways that go through Central Asia, Russia, Eastern Europe, and Spain. The Maritime Silk Road extends from China to Southeast Asia, the Indian Ocean, the east coast of Africa, through the Suez Canal, and into the East

Photo caption: Alibaba Chairman Jack Ma and Hong Kong Chief Executive Carrie Lam pose during the inauguration of the Belt and Road Cross-Professional Advancement Programme on December 12, 2018 in Hong Kong. (Zhang Wei/China News Service/Visual China Group via Getty Images)
Mediterranean Sea. Figure 28 shows the overland and maritime routes of the BRI.

In a March 2015 Chinese white paper, “Vision and Actions on Jointly Building Silk Road Economic Belt and 21st Century Maritime Silk Road,” the most comprehensive official document issued on the BRI, Beijing described the plan’s five goals as policy coordination, facilities connectivity, unimpeded trade, financial integration, and people-to-people connections.\textsuperscript{150}

In practice, the BRI has no formal institutional structure or set of guidelines. In contrast to the situation with the Asian Infrastructure Investment Bank, a multilateral entity with established rules and processes, with the BRI, terms for countries and individual firms are negotiated directly with the Chinese government, state-owned firms, or state-sanctioned firms. Memoranda of understanding between China and other countries and commercial terms between firms under the BRI banner are not generally available to the public.

Moreover, many projects involving Chinese firms in the sixty-five or more countries within the geography of the BRI are counted as BRI projects even if they were not conceived with the BRI in mind or preceded the BRI’s formal announcement. Claims that the project could be a $4 trillion scheme should be understood with the previous caveat in mind. Banks such as Morgan Stanley believe the BRI is so far a $200 billion initiative and is likely to entail investment of $1.2–$1.3 trillion by 2027.\textsuperscript{160} If we count all known projects that appear to be part of the BRI the figure could be above $600 billion.\textsuperscript{161} In this sense, the BRI is both a hugely ambitious and consequential concept but a significantly inflated one.

Even so, an investment gaining designation as a BRI project can be meaningful. The Chinese government has established funding mechanisms for BRI projects, including the Asian Infrastructure Investment Bank and the $40 billion New Silk Road Fund. Joint ventures with Chinese firms under the BRI banner can open up funding from Chinese financial entities such as the China Development Bank, the New Development Bank, the Export-Import Bank of China, and the China Investment Corporation sovereign wealth fund. Funding from these sources for BRI projects is frequently less restrictive in initial phases of investment and is given on non-commercial terms. Chinese firms can also gain fast-tracked financial and regulatory approvals from domestic authorities when partnering with foreign firms on BRI-designated projects.

For our purposes, it is important to recognize that the BRI began as a way for China to find solutions for many of the economic problems described in earlier sections. From that attempt to address vulnerabilities, the BRI has morphed into a grand strategic plan, but one that seeks to make a virtue out of necessity. The initiative is ambitious but also dangerously optimistic, based on domestic weaknesses and limitations that are severely underappreciated by outsiders, and perhaps by many Chinese officials as well. From this perspective, we should not be blown away\textsuperscript{162} or dismissive\textsuperscript{163} of the BRI.
External Solutions to Persistent Domestic Problems

Prima facie, there are sound economic reasons for the BRI that are strategically neutral or else benign. In reality, they are largely the result of the persistent lack of reform in the Chinese domestic political economy, and the BRI’s origins are better understood as a creative way for China to find external avenues of economic growth and opportunity while resisting reforms that would lessen the party’s role and that of state-controlled firms in the domestic economy.

When the BRI was launched in 2013, it described cooperation in five areas: 1. coordinating development policies, 2. forging infrastructure and facilities networks, 3. strengthening investment and trade relations, 4. enhancing financial cooperation, and 5. deepening social and cultural exchanges. That same year, the party’s Central Economic Work Conference treated it as a platform for new thinking on Chinese development and outbound investment.164

It was only several years later that Xi latched on to the BRI as his flagship foreign policy initiative, referring to it as the “Project of the Century.”165 The point is that while the BRI has some genuinely profound strategic objectives and ramifications, it began as a policy framework to relieve pressure resulting from some serious domestic economic problems.

First, China’s model of capital-intensive growth, which accelerated after 2008, was becoming more and more inefficient with rising domestic intolerance toward effects such as pollution. There was worsening overcapacity in all major hard industrial products and commodities, such as steel, cement, and industrial glass. Beijing needed to locate or create external markets in these capital-intensive sectors for Chinese firms, many of which were state controlled. The higher priority was to ensure the medium-term viability of struggling or loss-making state-controlled firms through other means and not simply to close them.

Figure 29: Fixed-Asset Chinese Investment by Firm Type in Select Industries

In this sense, the much-talked-about “rebalancing” of the Chinese economy was not just a domestic economic matter. Domestically, the rebalancing was about greater reliance on consumption over fixed investment (and net exports). Externally, the emphasis came to be on outbound investment as a source of revenue, profits, and growth. This could be achieved only through increasing aggregate demand in investment and export markets that suited China’s state-controlled firms. Figure 30 shows the percentage of Chinese exports going to the economies of BRI partners.

In 2015, outbound investment exceeded inbound investment into China for the first time since the reform period in 1978. The leading sectors for BRI-denominated projects include transportation, energy, shipping, mining and minerals, petrochemicals, real estate, telecommunications, and agriculture. These are all sectors with a dominant or heavy state-controlled element with respect to Chinese firms.

Second, and this is related to the first point, Chinese industry and manufacturing are still suffering from a confluence of several negative trends. The so-called demographic dividend is well past. This refers to the tens of low paid but hard-working millions of rural workers moving into urban regions with many of them benefitting from the export-manufacturing sector. That dynamic led to gains in productivity without rapid increases in wages and gave China a huge advantage in labour-intensive industries such as traditional manufacturing. China’s comparative advantage in labour-intensive production peaked in the middle of the previous decade. Additionally, China’s aging demographics mean that the working population has been growing at ever-decreasing...
rates, with 2015 marking the year when more workers were leaving the workforce than entering it. This scarcity of labor placed further upward pressure on wages.\textsuperscript{169}

The point is that China needed a new model for export-led growth to drive industrial activity and growth that was not based on comparatively low labor costs. MIC 2025 identifies the high-value industries that will become more important in the future. BRI complements this by providing the infrastructure, finance, logistics, and agreements required between China and regional trading partners to lay the foundations for industrial activity and a new era of export-led growth.

Note that China was already capturing a significant share of regional supply chains in the production of exported goods. The case of electronics, the single biggest category in regional trade, is instructive. By 2015, the value of Chinese electronics output was over $700 billion, about 38 percent of global output. Beijing’s aim is to extend its dominance at medium- and high-value-added levels in the supply chain of exported goods, from contemporary electronics to the MIC 2025 industries.

Figure 31 shows the percentage of exports of electronics within the Asia 16 economies: 10 ASEAN countries, China, Hong Kong, Japan, Taiwan, South Korea, and India, 2001–16.
While the BRI does not include the United States, it does extend as far as Europe. Beijing intends to create and capture dominant shares of the export markets in low-, medium-, and high-value-added export sectors based on the economic needs of countries along the BRI: from developing economies in Central and Southeast Asia and Africa to the advanced economies in Western Europe.

In fact, China’s trade balance with BRI countries has been in surplus since 2014. It is early days, and the results could be as much about Chinese success in vertical integration of manufacturing supply chains as they are about the success of specific BRI policies. Nevertheless, Chinese exports to the overwhelming majority of BRI countries have increased significantly since around the time the initiative became policy.\textsuperscript{170}
Figure 32 shows the share of Chinese goods in overall trade figures for BRI economies in 2000, compared to 2017.

Figure 33 shows China’s trade balance with BRI countries, which has been in surplus since 2014.

Third, the BRI allows China to bilaterally adjust its financial interactions with BRI countries in a manner and at a pace that suit it. This Beijing achieves by negotiating financing terms on a project-by-project basis, without having to meet the normal standards demanded by institutions and governments from particularly advanced economies.

The financing of BRI projects also allows China to oversee the gradual internationalization of its financial sector and the RMB without excessive exposure to open financial and currency markets that could create the instability and unpredictability it loathes. Beijing rejects the model that its financial institutions ought to participate in the global economy as independent entities impartially chasing more profits and better returns. Instead, it believes that Chinese financial institutions ought to advance national objectives even as they seek out opportunities. The BRI allows these institutions to offer development finance options that are negotiated with individual BRI countries and participating firms. From that perspective, Beijing retains a degree of control even as Chinese financial institutions gradually creep outwards into foreign markets.

With respect to the RMB, it is neither free-floating nor freely convertible. This continues to place severe limits on the extent to which it can become a “store of value” and therefore a genuine reserve international currency. The latter allows countries such as the United States the “exorbitant privilege” of reduced borrowing costs, given the enduring demand for US dollars. Moreover, although commitment to a “managed currency” offers China some measure of currency stability and protection against the destabilizing effects of “currency speculators,” it also means Beijing effectively outsources the value of its currency to other countries—and to the US most of all.

Given that Beijing will continue to resist opening its capital account and freely floating the RMB, there are limitations to how much it can be internationalized, even though internationalization would bring considerable benefits to China: reduced transaction costs if trade is performed in RMB rather than US dollars or another currency; greater control over the value of the currency; and greater leverage over and relevance to foreign entities and governments holding RMB as a "store of value."172

However, the BRI will promote greater use of RMB for various purposes: for settling trade, conducting investment within the BRI platform or agreement, and for RMB-denominated bonds issued as part of BRI financing packages.173 These include BRI-specific domestic bonds; “Panda” bonds in RMB, issued by international companies inside BRI corridors or by foreign firms for specific BRI projects and sold to the domestic market;
and “dim sum” bonds, issued by Chinese and international companies in Hong Kong but denominated in RMB.

This is already occurring with numerous developing countries participating in the BRI. For example, China’s banks have become important foreign creditors for many countries in Southeast Asia and Africa. In April 2017, the RMB was used for the first time as a currency of bond issuance in Africa. In that same year, more than one-third of BRI countries signed bilateral swap agreements, which in turn helped to deepen trade and economic integration between them and China by a statistically significant 30 percent.174

It is worth noting that investment by Chinese entities in the BRI offers the prospect of better return for passive or “parked” Chinese capital compared to bonds with yields that are low or negative (in real terms), such as US Treasury bonds. Additionally, framing BRI projects as being between China and

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the partner country will create new opportunities for Chinese firms engaged in related services such as cross-border e-commerce, real estate, tourism, banking, and legal and other professional services.

Fourth, it is highly significant that the contemporary roots of the BRI can be traced to a September 2013 speech by Xi delivered at Nazarbayev University in Astana, Kazakhstan. In that speech, Xi mentioned the “ancient Silk Road” and the singular importance of Central Asian countries to China, arguing that China and these countries, to lay the foundations for a “new golden age,” should “take an innovative approach and jointly build an ‘economic belt along the Silk Road.’” This entailed improving road connections to create a “major transportation route connecting the Pacific and the Baltic Sea”; investing in cross-border transportation infrastructure and a transportation network connecting East Asia, West Asia, and South Asia; and promoting “unimpeded trade” by removing trade barriers and reducing the costs of inter-border trade. Figure 34 shows the income spread or disparity between different provinces and regions in China.

The issue is the persistent disparity in wealth (absolute and per capita) between the eastern coastal provinces and the central, southwestern, and western regions. Beijing has had a “western development strategy” since 1999, aimed at invigorating the economies in the dozen or so provinces that did not benefit from the era of opening up and export-oriented growth and have been left behind economically. Despite massive injections
of funds into the fiscal budgets of these regions’ provincial governments, enormous capital made available to mainly state-controlled entities in these regions, and other preferential tax and regulatory policies, the results have been disappointing. In fact, these state-directed policies have tended to crowd out the private sector even more than in other parts of China, with Xinjiang, Tibet, Qinghai, and Gansu scoring particularly poorly on measures of private sector activity.177

In this context, the BRI was initially seen as one way to create burgeoning, self-sustaining opportunities for these provinces through economic partnerships with countries in Central and Southeast Asia. The idea was to build platforms, regimes, and infrastructure that will facilitate trade, investment, and other economically beneficial exchanges between the poorer Chinese provinces and countries such as Kazakhstan, Pakistan, and Myanmar.178

This largely explains the thinking behind the formation of various BRI "economic corridors" in the region. Examples include the China-Pakistan Economic Corridor (CPEC), Bangladesh-China-India-Myanmar Economic Corridor (BCIMEC), China-Indo-China Economic Corridor, and New Eurasia Land Bridge Economic Corridor.

Most of the Chinese funds invested in CPEC—over $50 billion—are being spent on building and updating the overland connections between Xinjiang and the Arabian Sea across the Himalayas. This includes a road network extending about 3,000 kilometers, the port of Gwadar in Pakistan, and a rail and oil pipeline between China and Pakistan. CPEC is complemented by a substantial bilateral trade agreement between the two countries.

This corridor is part of a vision to enhance connectivity between China’s western regions and countries such as Iran, Afghanistan, and the Central Asia Republics (India is not a BRI partner). CPEC is designed to enable Chinese imports of oil while avoiding the Malacca Straits and the maritime routes in Southeast Asia. However, it must still successfully negotiate a path through disputed territory between India and Pakistan.

The New Eurasia Land Bridge consists mainly of an extensive railway line from Lianyungang in Jiangsu Province through Alashankou in Xinjiang to Rotterdam in Holland. The sections in China include the Lanzhou-Lianyungang railway and the Lanzhou-Xinjiang railway, which passes through eastern, central, and western China. From there, the railway line passes through Kazakhstan, Russia, Belarus, and Poland and into coastal ports in Europe. To enable China’s western regions to benefit from the New Eurasia Land Bridge, Beijing has invested in an international freight rail route linking Chongqing to Duisburg (Germany); a direct freight train running between Wuhan and Pardubice (Czech Republic); a freight rail route from Chengdu to Lodz (Poland); and a freight rail route from Zhengzhou in Henan province to Hamburg (Germany). All these rail routes offer rail-to-rail freight transport as well as expedited cargo inspection processes.

The China-Indo-China Economic Corridor connects Southeast Asian capitals such as Singapore, Kuala Lumpur, Bangkok, Phnom Penh, Ho Chi Minh City, Vientiane, and Hanoi with Nanning in the Guangxi region. The network is not new; it is an enhancement of networks developed as part of the earlier Greater Mekong Sub-region initiatives.

The proposed BCIMEC has been hobbled by persistent objections from India.179 It is envisaged as an expressway and high-speed rail links between Kunming in Yunnan Province and Kolkata in India via Mandalay in Myanmar and Dhaka in Bangladesh. Meanwhile, China, India, Myanmar, and Bangladesh have also agreed to build airways and waterways connecting each other as well as power transmission lines and oil pipelines. A combined market of over 400 million people has encouraged Chinese manufacturing firms to
move further west in attempts to access the Indian and Myanmar consumer markets.\textsuperscript{180}

Previously, a high percentage of goods produced in China for export left the country through ports on the eastern coast. The corridors described above are designed to create the infrastructure and markets to export Chinese goods through road and rail networks in central and western China. The vision is twofold: 1. to create new hubs of export-manufacturing and export services in central and western China, and 2. to develop, grow, and capture new consumer markets in Central Asia and Southeast Asia for Chinese firms. The success of that vision also depends on the rapid liberalization of labor mobility, as much of the current expertise in export manufacturing and services remains in the eastern provinces.\textsuperscript{181} This liberalization has yet to occur. Indeed, if the investment going into BRI infrastructure within China fails, then the efforts could resemble previous extravagant capital expenditure programs in central and western China, which worsened the debt situation without adequate countervailing benefits.

Finally, there are enormous fiscal impacts riding on blueprints such as the BRI and MIC 2025. Under a series of reforms since 2007, state-controlled firms are required to transfer profits (in the form of dividends) into a state capital management budget (SCMP) account, which will eventually be integrated into the general central government budget. Although the government passed a directive in 2013 stating that a dividend ratio of 30 percent was to be paid into the SCMP, the figure has remained a little over 20 percent.\textsuperscript{182} The economic slowdown has made Beijing reluctant to lean too heavily on state-controlled enterprises.

In this context, stable and growing profits for state-controlled firms are essential, particularly in the poorer western regions. Firms in the three poorer provinces—Xinjiang, Shanxi, and Qinghai—rank among the top five in the three indicators of debt to revenues, leverage, and debt service burden.\textsuperscript{183} Continually offering largesse and privileges to these firms is only making the situation worse.

All companies are also obligated to contribute to social insurance, which covers employee pensions, medical funds, unemployment safety nets, maternity leave, and work injuries. The idea is to offer relief from the inadequate fiscal budgets of local governments. In practice, compliance is piecemeal and unpredictable due to poor enforcement and/or companies’ inability to meet these obligations.\textsuperscript{184} Beijing is determined to lower social insurance obligations but ensure much more strict and thorough enforcement. Firms in sectors such as telecoms, machinery production, computers, military applications, and electronic equipment will likely suffer the biggest hit to their profits if these reforms occur.\textsuperscript{185}

These are the same sectors highly valued by Beijing for reasons of strategic and national interest. The only solution is to seek new avenues for increased profit outside China.

Figure 36 shows the expected loss in net profit for firms in select industries from planned social insurance collection in China.
If there are any doubts that the BRI is a Chinese-centered plan to export excess capacity and capture export markets, let us look at the numbers. According to the CSIS Reconnecting Asia database, 89 percent of contractors participating in Chinese-funded projects are Chinese.\textsuperscript{185} Only 7.6 percent are from the country where the project is taking place, and 3.4 percent are non-Chinese foreign companies. In projects funded by multilateral development banks, 29 percent of contractors are Chinese, 41 percent are local firms, and 30 percent are non-Chinese foreign firms. Port investments and upgrades involve finance, design, construction, and servicing, all activities that Chinese firms provide at lower prices, given the domestic advantages and assistance Beijing provides them. Indeed, infrastructure financing for BRI projects offered by China is frequently tied to exclusive procurement agreements for Chinese firms.\textsuperscript{187}

There is also growing discomfort within host countries with the close connection between the funding arrangements of Chinese firms and government-controlled financial entities. A case in point is China COSCO Shipping Corporation, which in 2017 received over $26 billion from the China Development Bank to invest in BRI-sanctioned projects. These firms are given loose lines of credit to advance government policies and not just to maximize their commercial success. A counter-argument is that well-regulated economies such as those in Europe can dictate the laws and regulations that apply to assets in their sovereign territories, but such assets can likely be used to benefit the Chinese economy disproportionately.

For example, COSCO Shipping's investment in, and control of, the Greek port of Piraeus mean the port will cooperate with Chinese ports to boost synergies. This is evidenced by a June 2017 agreement with Shanghai International Port Group to cooperate in project planning, staff training, and information exchange. As a complement to the Chinese purchase of Piraeus, Chinese banks provided loans to Greek shipping companies to build additional commercial vessels in Chinese shipyards.

Furthermore, with respect to BRI activities in Europe, it is clear that the MIC 2025 blueprint (and other industrial policies) are fundamentally mercantilist, designed to enhance Chinese self-sufficiency in important strategic sectors and secure Chinese export dominance in international markets in these sectors. BRI corridors and networks promise to enhance the flow of goods, services, and information between China and BRI countries and in doing so, facilitate Chinese economic and industrial dominance. It is significant that China is promoting increased connectivity without undertaking significant domestic measures to remove what the EU terms “significant market distortions.” This includes CCP control over the financial system and policies offering preferential treatment for domestic companies. Chinese businesses in BRI-related sectors receive land at artificially low prices, access to cheap energy, preferential access to capital, suppressed borrowing costs, and beneficial pricing for raw materials and commodities.

Foreign investment in the most important and lucrative sectors of the Chinese economy is heavily restricted, and entry is via joint ventures—which leads to the new problem of large-scale, state-sponsored theft of intellectual property and trade secrets. In addition to China's still-closed capital account and discriminatory regulatory and antitrust laws, it is extremely difficult for foreign firms to gain permanent and meaningful footholds to thrive in Chinese industrial and consumption sectors—while China is laying the groundwork for even greater access to European markets.

Indeed, Beijing has not made a convincing case that improved networks throughout Eurasia exist to spread the opportunity of globalization and share the spoils of greater economic integration evenly.\textsuperscript{188} The BRI and Beijing's interest in assets such as ports remain China-centric. China is paving the way to sell and buy what it wants according to economic and strategic policies produced by the CCP. When Chinese firms negotiate opaque deals with Asian, African, and European countries, they begin with the largesse and non-commercial advantages that come from state assistance. In other words, the exchange is rigged from the start.
From Extracting Economic Rents to Grand Strategy

China’s official Blue Book of Non-Traditional Security (2014–15) states that two of the purposes of the BRI are to mitigate US-led geopolitical machinations and ideas and promote a new international system of discourse and order that enhances China’s national and soft power. While the BRI came about largely as a result of domestic vulnerabilities and is implemented opportunistically by many domestic entities (with disparate objectives) and in a fragmented manner, it is also clear that Xi has seized on it as a framework for an outward-focused “grand strategy.” That must be taken seriously and has several manifestations and approaches.

Strategic Support States

Investment in BRI projects should be considered in the context of the concept of ‘strategic support states’ which came to prominence amongst Chinese strategists earlier this decade. In a 2015 consensus of fifty Chinese scholars on China’s ‘periphery diplomacy in the Xi Jinping era’, a ‘strategic support states’ is achieved through regional cooperation and providing economic and public goods as China expands westward. According to one extensive analysis, one of the principles of cultivating a ‘strategic support state’ is ensuring “China has the ability and resources to guide the actions of the country so that they fit into [China’s] strategic needs.”

There is ample evidence to suggest that this is not abstract strategizing by academic thinkers.

A study published in March 2018 found that one-third of sixty-eight economies receiving BRI loans are “significantly or highly vulnerable to debt distress.” In Pakistan, enormous Chinese investments, like those in the Port of Gwadar, have given the economy an instant sugar hit but have burdened the country with debt that it cannot repay and turned it into a long-term Chinese client state. A similar situation is occurring in Sri Lanka, where unprofitable and debt-heavy projects such as the Hambantota Port have forced the country into a $1.1 billion debt-for-equity swap with China, giving Beijing long-term control of a military-capable port and considerable leverage over Colombo’s foreign policy. Over the past five years, China has invested over $5 billion in Cambodia, a sum equivalent to about one-quarter of the country’s GDP, in return for Phnom Penh’s pushing Chinese interests in organizations such as the Association of Southeast Asian Nations. This investment includes 100 percent ownership of the Koh Kong New Port in Cambodia, and according to media reports, Beijing has signed a secret agreement to construct a military port there. Like Pakistan and Sri Lanka, Cambodia cannot change course while it is caught in a Chinese-created “debt trap.”

A similar dynamic is occurring in the South Pacific.

It is more difficult for China to purchase direct influence in economies such as those in the EU, given that many European countries are better able to access diverse sources of capital and economic opportunity, and given the presence of robust liberal-democratic institutions that are more difficult to corrupt. Even so, there have been opportunities. Greece, unlike other Western European countries, has openly welcomed Chinese investment, and in 2017 then prime minister Alexis Tsipras boasted of China’s investment in the port of Piraeus as the opening for “China’s gateway into Europe.” In 2017, Greece blocked an EU statement to the UN Human Rights Council on Chinese human rights violations, which a Greek official called “unconstructive criticism of China.” This marked the first time the EU has failed to make a statement to the UNHRC.

Another case is that of Hungary, which is seeking to position itself as Eastern Europe’s “gateway to China”—and receiving Chinese BRI-linked investment, including for the $3 billion Hungary-Serbia railway project, which would connect the Chinese-run port of Piraeus with the European heartland. Realizing that political obeisance is one pathway to receiving immediate financial largesse, Hungary has emerged as China’s most enthusiastic spokesperson in Eastern Europe. For example, Budapest has strongly argued that the EU should grant China’s economy
“market status.” In 2017, Hungary derailed an EU consensus when it refused to sign a joint letter denouncing China’s torture of detained lawyers. Both Hungary and Greece remain unwilling to criticize Chinese actions in the South China Sea, thereby preventing the EU from presenting a unified voice on this issue.

The point here is not Chinese investments per se, which are of concern, but China’s tendency to link investment with political demands and expectations. This applies regardless of whether such investment is BRI designated or not. However, BRI projects have become the sweetener for countries desperately needing an injection of capital and economic activity when they are not pouring in from other sources. For this reason, Italy’s March 2019 signing of a memorandum of understanding with China to officially join the BRI is cause for concern. For less economically competitive and less commercially attractive European countries like Greece and Hungary, dependence on Chinese capital can be subsequently used to create significant pressure on governments to alter policies so that they favor Chinese interests.

Europe is also instructive in that China has used the lure of enormous infrastructure investments, including development of Greek ports, as an economic development gateway into the Balkans to divide and conquer the EU. The main mechanism is the China-initiated 16+1 grouping, which includes sixteen Central and Eastern European states, eleven of which are EU members, plus China. In late 2016, China announced it had established a $11.1 billion Central and Eastern European (CEE) Fund to finance projects in the group-of-sixteen economies to support the BRI. An ulterior motive is to create an economic investment zone that will decide on investments according to China’s rules and processes, rather than the more stringent and transparent EU standards preferred by Western European states such as France and Germany.

Consider the case of Slovenia, which was promised a $1.5 billion financing package for a railway in exchange for a ninety-nine-year lease of the Port of Koper. In 2018, in spite of raised eyebrows in Western European countries, China and Slovenia signed a memorandum of understanding on cooperation in transport and infrastructure that focused on integrating sea transport with the development of railways, motorways, and logistics as part of the BRI concept. This includes a cooperative agreement between the Port of Koper and China’s Port of Ningbo-Zhoushan to increase trade between China and the CEE economies.

Although the CEE Fund is underperforming because of a lack of confirmed funding and agreed projects, it indicates China’s intention to circumvent EU rules and standards or undermine broad support for these rules and standards by getting potentially recalcitrant EU members such as Greece and Hungary on side. Serbia, a likely future EU member, has accepted large amounts of Chinese capital, and in return is supportive of China’s stance on issues such as Taiwan, the South China Sea, and human rights in Tibet and Xinjiang. Once again, in this context, it is not the investment in port or other facilities per se that is of concern, but China’s use of big spending promises to alter established EU norms and commercial standards for investment.

A New Approach to Authoritarian Promotion
When it comes to authoritarian strategic objectives and policy implementation, the BRI fuses economic partnership and opportunity with developmental assistance and political support: BRI countries and projects are inherently drawn into a world of Beijing’s desire and making.

The previous section looked at China’s use of BRI to create and nurture strategic support states. That must be considered alongside China’s emergence as a major provider of development assistance and non-concessional loans, to the tune of almost $230 billion between 2009–14, compared to just under $69 billion from 2000–08. It is obvious that autocratic regimes are overrepresented. For example,
from 2009–14, six of the top ten recipients of development assistance were dictatorships, and three were countries where authoritarian regimes controlled and dominated formal electoral processes and outcomes. With respect to the top ten recipients of concessional loans, half were dictatorships and three were dominant authoritarian regimes thriving in countries with formal electoral institutions. Only two — Ecuador and Brazil — were democracies.

Bear in mind that Chinese economic assistance usually does not include demands for good governance, respect for human rights, and relevant economic reforms, which are characteristic of assistance by organizations such as the International Monetary Fund and World Bank. Beijing justifies this as being consistent with its stated principle of “non-interference in the internal affairs of other states.” Instead, it offers support and cover for regimes to insulate themselves from reform pressures. Examples of this have been documented with Chinese investment and assistance to countries in Asia, Africa, and the Middle East.

This must be placed in the broader context of a Chinese-led authoritarian revival and promotion currently taking place. On the day of President Trump’s inauguration, the Chinese state-owned newspaper People’s Daily devoted an entire page to editorials criticizing Western democracies as chaotic and suffering from “social crises.” They claimed that democracy had “reached its limits” and contrasted it unfavorably with China’s one-party system, which, they said, offered stability, social harmony, competent policymaking and implementation, and economic progress. Xi, in announcing that he had abolished presidential term limits during the Nineteenth Congress of the CCP in October 2017, declared that China is moving to “center stage” and that its authoritarian model “offers an option for other countries and nations who want to speed up their development while preserving their independence; and it offers Chinese wisdom and a Chinese approach to solving problems facing mankind.”

Importantly, China has abandoned the model in use since Deng Xiaoping of “hiding strength and biding time.” According to Xi, as China becomes a leading global power from 2035 onward, the Chinese people will enjoy the “common property” of the international system. Xi has also stated that “the Chinese nation will stand with a more high-spirited image in the family of nations” and “socialism with Chinese characteristics” is a “new choice” for other developing nations seeking to grow economically while maintaining their independence.

As the previous section argues, China is not just promoting authoritarian values, but teaching tactics for repression and exporting apparatuses used for domestic coercion to willing authoritarian clients. It has gone beyond forcing foreign firms to agree to its restrictive internet and social media standards to championing its standard of “internet sovereignty,” which gives every government the right to regulate online information and rejects a universal freedom of information standard. In the United Nations, China promotes the innocuous-sounding “community of shared future for human beings” or “community of common destiny” as an alternative to the notion of universal human rights. The former concept is based on the right of each country to interpret what “human rights” actually means, and insists that other countries should respect and accept that human rights will have different meanings for each country. Perhaps most concerning is China’s increased willingness to interfere in, and covertly influence, the domestic decision-making institutions and debates in democratic nations. This includes the promotion of Chinese authoritarian values.

Proponents of this model in China and elsewhere begin from the position that any political system ought to be assessed according to practical outcomes, and that there is no intrinsic value to liberal-democratic systems that emphasize individual rights and freedoms without regard to the consequences. China argues that it has resolved the alleged contradiction between the subordination of individual rights and freedoms to one-party rule, on the one hand, and positive social and economic
outcomes, on the other—a contradiction the Communist regimes of the Cold War failed to address. As Xi argues, the CCP is meeting the basic needs of over one billion people, and its authoritarian system has made it possible for people to live fulfilling and materially better lives.\textsuperscript{208}

This is a compelling message in an Indo-Pacific region where the overwhelming majority of countries are developing economies that have yet to fully industrialize. Only Japan, South Korea, Singapore, Taiwan, Australia, and New Zealand can be considered fully industrialized. The rest are straining to become middle-income economies, while only a small number of the others, such as Malaysia and Thailand, are seeking to break out of the so-called middle-income trap.

It is also true that authoritarian systems such as China's have demonstrated an impressive capacity to generate rapid economic growth through the forced mobilization of capital, land, and even labor—if only at the earlier stages of development. This leads to the narrative that autocratic competence is outstripping democratic dysfunction. An editorial in China’s state-owned \textit{Xinhua} argues that “endless political backbiting, bickering and policy reversals, which make the hallmarks of liberal democracy, have retarded economic and social progress and ignored the interests of most citizens,” and that they constitute the “crisis and chaos swamp[ing] Western liberal democracy.”\textsuperscript{209} In contrast, China actively promotes its authoritarian model as one that is politically stable, technically superior, and better able to pursue sensible policies in a consistent manner.\textsuperscript{210}

These messages are effective because achieving “order” and “development” rather than guaranteeing “justice” for the individual remains highly valued in the region. In this context, the BRI is promoted as China’s grand plan for the region—not just to advance economic development, but to reframe and reset objectives, policies, and standards in a manner that places China as primary creator and guardian of progress in a non-US-centric Indo-Pacific region.

\textbf{China’s Comprehensive Approach to Pre-Determine the Rules and Outcome of Competition}

While the BRI is as much a vision or aspiration for what China wants to create as a framework for policy and action, we dismiss it at our peril. It might have arisen out of a desire to adapt to domestic vulnerabilities without the need for genuine reform. But it represents a fusing of strategic, political, economic, and diplomatic goals throughout Eurasia and the Indo-Pacific on a grand scale. It supports and integrates the Communist Party's objectives in the following ways.

First, it dilutes even further the distinction between public and private economic activity and enterprises. Chinese public and private firms are obligated to advance the objectives of the Communist Party and Chinese state. They do that through acquiring and/or developing innovations and technologies using legitimate and illegitimate means, assisting each other to crowd out and prevail over foreign competition, creating markets and infrastructure that privilege Chinese firms and the Chinese market, and assisting each other to prevail over foreign competition. The framework allows (or in some instances forces) Chinese firms to coordinate and/or merge their R&D resources to advance state objectives. This takes the long-standing “going out” or “going global” directive to a different level, with profound strategic consequences.\textsuperscript{211}

These approaches inherently undermine what globalization and interdependence are designed to facilitate and enhance: the maximization of efficiency and creation of new opportunity for participants based on market forces. China’s BRI blueprint reflects its own political-economic setup, which is designed to ensure that the party retains the levers of economic power and relevance. While all governments intervene in the domestic and global economy to some degree, the nature, scale, and extent of intervention by the party and Chinese state mean that authoritarian China plays a vastly different game from other major economies in the global system.
For example, a recent survey of the largest ninety-eight companies in China revealed that fewer than one-quarter were privately owned. In all state-owned firms, the CCP has a significant, if not decisive, say in major corporate decisions and senior managerial appointments. Even for private firms, the Company Law of the People’s Republic of China stipulates the establishment of party committees in all commercial entities “to carry out the activities of the party in accordance with the charter of the Communist Party of China.” Similarly, the 2017 National Intelligence Law demands that “any organization and citizen shall … support, provide assistance, and cooperate in national intelligence work, and guard the secrecy of any national intelligence work that they are aware of.” The poor separation of political and economic agencies allows the party-state to bluntly manipulate markets and distort competition to achieve the party’s goals.

Second, it is important to understand the implications of blueprints such as MIC 2025 being integrated into the broader BRI framework. Chinese firms have installed significant mobile and digital networks in around forty countries, most of which are BRI countries. Vertically integrated companies such as Huawei are able to deliver far more complete “packages” that bundle together hardware and software for the entire platform or facility; all relevant standards (which suit Huawei and other Chinese firms); the labor and expertise to build and sustain these platforms; and even relevant regulations and legislation for the foreign client nation to get the platform up and running in a manner that suits the authoritarian tendencies of client regimes. Where the Chinese firm does not have the expertise or capability, Beijing will ensure that other Chinese firms are included in the package if this advances the objectives of the BRI.

The greater prominence of MIC 2025 in achieving broader objectives is clear when we look at the changes in foreign direct investment (FDI) by Chinese firms. Roughly two-thirds of Chinese FDI is taken by state-controlled firms or else “national champions” such as Huawei. From 2018 onwards, there have been significant increases in FDI (mainly by state-controlled firms and “national champions”) in the technology, healthcare, agriculture, and logistics sectors.

In the chart above, many of the sectors in the increase in the “Other” category coincide with MIC 2025. This is consistent with both MIC 2025 goals and broader BRI objectives using well-practiced comprehensive approaches: offering favorable access to capital for acquisitions in technology; investing in joint ventures and/or buying companies in advanced economies; giving preferential treatment for high-technology imports (while protecting local innovation); helping facilitate lower technology and spare capacity transfer to BRI-participating economies; and promoting Chinese technology standards within the BRI-participating economies to help open up markets for China’s products.
At this point, it is instructive to contrast the original Trans-Pacific Partnership (now the Comprehensive and Progressive Agreement for Trans-Pacific Partnership, which excludes the US) with the BRI. The CPTPP, which is based largely on the TPP, is designed to shape the rules and standards for how nations and firms compete.\(^\text{221}\) This applies to at-the-border and behind-the-border barriers as well as labor and environmental standards, investment rules, the role of state-controlled enterprises, and intellectual property rights. The idea behind the TPP was to use the size and attractiveness of the US domestic market especially to persuade members to sign on and abide by these rules, and eventually to persuade non-members such as China to agree to the provisions in order to join the economic regime.

From this perspective, it was not about privileging US firms or allowing them to extract economic rents from their position of power. Instead, it was an attempt to define “fair” competition and economic activity rather than a plan to permanently exclude China from the economic grouping.

This is unlike the BRI and MIC 2025, which are inherently China-centric blueprints designed to ensure Chinese entities remain the primary and permanent beneficiaries. In that sense, it is about China seeking to build a hierarchical economic order, with Beijing able to arbitrarily offer and retract opportunity for political and strategic reasons. This should not be surprising, as that is simply the regional vision based on the domestic setup within China.

Third, the BRI (and blueprints such as MIC 2025 and Internet Plus) have significant implications for the enhancement of China’s military-industrial capabilities. For a start, the BRI has been used as a carrot to persuade the EU to lift its post-Tiananmen embargo on exports of military hardware—so far with little success. While the EU is beginning to view China as an authoritarian “technological competitor,” there is little policy agreement between EU countries on what that ought to mean in practice.\(^\text{222}\) For example, Germany acknowledges China’s desire to emulate and overtake Western technological leadership. But there are relatively few restrictions on Chinese takeovers of German firms or on German firms engaging in joint ventures with Chinese firms even when there are strategic consequences in doing so.\(^\text{223}\)

It is this lack of policy agreement and the slowness of European countries in coming to agreement that Beijing will seek to exploit. While there is a lack of coordination between the US and allies on industrial policy, China will continue to benefit from foreign technologies in dual-used sectors such as semiconductors, artificial intelligence, quantum applications, and biotech.

Moreover, the digital silk road has direct military implications. Chinese-led submarine cable projects, which were 20 percent of global undersea cable projects between 2016–19, compared to 7 percent from 2012–15, are directly boosting Beijing’s intelligence and anti-submarine capabilities. BRI projects are increasing the export and upgrade of BeiDou, a satellite navigation system, which allows a shift away from reliance on US GPS capability.\(^\text{224}\)

Bear in mind that MIC 2025 and aspects of the BRI are merely the outward-facing or export-oriented part of broader plans to upgrade China’s domestic industrial base, including for military purposes. China’s earlier National Medium- and Long-Term Plan for the Development of Science and Technology (2006–20) directs the domestic private and state-controlled industrial base to “digest and absorb advanced technology, conquer critical technologies bearing on the national strategic interest, [and] develop major equipment and critical products that harness independent knowledge,” while urging the economy to expand international R&D cooperation.\(^\text{225}\)

The process to fast-track innovation is to ‘introduce, digest, absorb and re-innovate’ (IDAR). The success of the IDAR process, which uses foreign markets and expertise to enhance the domestic base, will largely determine the success of the MIC 2025 and digital silk arm parts of the BRI. But IDAR (and therefore MIC 2025 and the BRI) must also be understood in the context of China’s
military-civilian fusion (MCF) domestic initiative, which creates incentives for domestic firms to sell or share their technology with the PLA. According to the Thirteenth Five-Year Special Plan for the Development of MCF in Science and Technology, MCF in science and technology is a crucial domestic strategy to ensure that resources are shared between domestic civilian and military entities in order to build an advanced defense-industrial complex. This includes “mutual open sharing of basic science and technology resources” and “two-way technology transfer.”

In short, free and open economies should not take comfort in the argument that they are more innovative and creative at the fundamental levels than China’s authoritarian model. From Beijing’s perspective, it does not matter that its political economy has not produced pioneers such as IBM, Google, and Microsoft. Its still inefficient and largely unreformed authoritarian model is better at IDAR and MCF, which will give it the economic and military edge in the future.

Conclusion
The BRI is both more and less than it appears: it is a plan of immense grandeur and significance, but not as vast and successful a scheme in practice as admirers might suggest. It is a plan to create and capture new opportunities for China’s economic growth without the need for greater reform of its political economy. It is also a plan to ease out and exclude the US from the broader region in economic and technological terms to “win without fighting,” as Sun Tzu would have advised.

Although it is clear that China will be the primary beneficiary of the BRI, the initiative is at present a more meaningful “brand” to the BRI’s dozens of partner countries than the US Free and Open Indo-Pacific. A plan originally formulated to address Chinese weaknesses and vulnerabilities, the BRI now feeds the narrative of Chinese strength, relevance, and future dominance. In contrast, the Free and Open Indo-Pacific has been explicitly endorsed only by Japan and Australia (and to some extent India). Southeast Asian nations have only just begun to engage with the US concept. Likewise, attempts by the United States and other countries to counter the BRI are at an early stage. For most countries in the region, China is more determined, creative, and proactive. These are dangerous times for the US and its standing in the region.
GLOSSARY

asset management companies (AMCs)
Bangladesh-China-India-Myanmar Economic Corridor (BCIMEC)
Belt and Road Initiative (BRI)
CCDI (Central Commission for Discipline Inspection)
Central and Eastern European (CEE) Fund
China-Pakistan Economic Corridor (CPEC)
Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) (confirmation)
foreign direct investment (FDI)
introducing, digesting, absorbing, and re-innovating (IDAR)
Leading Small Group for Comprehensively Deepening Reform (LSGCDR)
leading small groups (LSGs)
local government financing vehicles (LGVFs)
Made in China 2025 (MIC 2025)
military-civilian fusion (MCF) (confirmation)
non-performing loans (NPLs)
People’s Armed Police (PAP)
People’s Liberation Army (PLA)
PLA Navy (PLAN)
private-public partnerships (PPPs)
renminbi (RMB)
state capital management budget (SCMP)
state-owned enterprise (SOE)
Stockholm International Peace Research Institute (SIPRI)
strategic emerging industries (SEI)
Chinese Communist Party (CCP)
total social financing (TSF)
Trans-Pacific Partnership (TPP)
wealth management products (WMPs)
ENDNOTES

1 For example, see Minxin Pei, China’s Trapped Transition: The Limits of Developmental Autocracy (Cambridge, MA: Harvard University Press, 2006); John Lee, Will China Fail? (Sydney: CIS Press, 2007); Yasheng Huang, Capitalism with Chinese Characteristics (Cambridge: Cambridge University Press, 2008).


9 This is urbanization excluding the hundreds of millions of itinerant and seasonal migrant workers who have no land ownership rights in urban areas, do not contribute significantly to infrastructure and construction demand in cities, and do not stay permanently in cities.


20 See Huang and Bosler, China’s Debt Dilemma.


22 See Jun Nie and Guangye Cao, “China’s Slowing Housing Market and GDP Growth,” Macro Bulletin, 25 August 2014, https://www.kansascityfed.org/publicat/research/macrobulletins/mb14Nie-Cao0825.pdf. Even then, and according to National Bureau of Statistics Figures, real estate investment continues to grow at above 10 percent each year, while real estate floor area sold has been declining by 10 percent each year since 2013.


31 China National Bureau of Statistics


34 Huang and Bosler, China’s Debt Dilemma, p. 16.


36 This does not include the debt held by financial institutions and non-financial firms of 65 percent and 125 percent of GDP, respectively — a large number of which are SOEs and enjoy formal or informal government guarantees for paying back their loans. McKinsey Global Institute country debt database figures, found at http://www.mckinsey.com/-/media/McKinsey/Insights/Economic%20%20Studies/Debt%20and%20not%20much%20deleveraging/MGI%20Debt%20and%20not%20much%20deleveragingFullreportFebruary2015.pdf.


As above, pp. 23–28.


See Elizabeth Economy, “China’s Imperial President,” Foreign Affairs (November/December 2014).


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73 Ibid.


85 China Credit Conundrum: Mapping China’s Credit, vol. 2 (New York: Goldman Sachs, 2 February 2018.)


89 Margit Molnar and Jiangyuan Lu, “State-Owned Firms Behind China’s Corporate Debt,“, at p. 17.

90 Margit Molnar and Jiangyuan Lu, “State-Owned Firms Behind China’s Corporate Debt,“.


96 As above.

As above.


See Holmes and Lancaster, "China’s Local Government Bond Market."


126 United Nations trade statistics figures.


132 As above.


138 Computers and telecommunications equipment are excluded because China is merely the primary assembler of imported components and materials in the world. For this reason, China accounts for nearly half of global exports of electronic devices, and approximately 70 percent of electronic devices imported to the United States are assembled in China. The next three-largest suppliers — Mexico, South Korea, and Vietnam — account for about 19 percent combined. China is the primary “assembler” of devices, and thus much of the value of each device is not produced or captured there. For example, China adds from 4–20 percent of the value of each iPhone, even though most of the phone is assembled in China. Since assembly of today’s computers and electronics is not where value will be created in the future, if these categories were included, this would give a misleading impression that China’s high-tech deficit vis-à-vis advanced economies is smaller than it is. See Enrique Duarte Melo et al., “Unpacking the US-China Tech Trade War,” BCG, 5 June 2019, https://www.bcg.com/en-au/publications/2019/us-china-tech-trade-war.aspx.


140 Above, p. 13.


142 See Mary E. Lovely and Yang Liang, “Trump Tariffs Primarily Hit Multinational Supply Chains, Harm US Technology Competitiveness,” Policy Brief, Peterson Institute for International Economics,

143 China Customs Administration figures.


152 As above.


163 For example, see Tom Holland, “Why China’s ‘One Belt, One Road’ Plan Is Doomed to Fail,” South China Morning Post, 6 August 2016, https://www.scmp.com/week-asia/opinion/article/1999544/why-chinas-one-belt-one-road-plan-doomed-fail; Tanner Greer, “One Belt, One Road, One Big Mistake,” Foreign


196 These are the latest reliable figures available.

197 AidData refers to non-concessional loans as Other Official Flows (OOF), which are defined as transfers where the grant component comprises less than 25 percent of the total and the primary purpose of the transfer is commercial or representational in nature. See AidData, www.aiddata.org/china.

198 The top ten in order were Russia, Pakistan, Angola, Laos, Venezuela, Turkmenistan, Ecuador, Brazil, Sri Lanka, and Kazakhstan.


