Understanding and Countering China’s Approach to Economic Decoupling from the United States

BY DR. JOHN LEE, SENIOR FELLOW, HUDSON INSTITUTE
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Cover: Chinese President Xi Jinping delivers a keynote speech at the opening ceremony of the Eighth Ministerial Conference of the Forum on China-Africa Cooperation FOCAC via video link in Beijing on November 29, 2021. (Photo by Huang Jingwen/Xinhua via Getty Images)
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Many experts have highlighted American efforts to partially decouple from China. Yet China began pursuing a far more ambitious and comprehensive decoupling strategy vis-à-vis the United States long before Donald Trump entered the White House.

This monograph examines China’s evolving approach to economic decoupling from the US. It makes the following arguments and conclusions.

First, on the back of a preexisting mercantilist political economic structure, China has been explicitly pursuing economic decoupling from US and allied economies on Chinese terms for at least a decade.

Second, while the US seeks to decouple some aspects of its economic activity from China, the latter seeks to dominate vast segments of the Asian economy and to decouple these segments from the US. This is the Chinese strategy and threat that the US vastly underappreciates.

Third, the most important segments are the high-tech and high-value sectors. These sectors are where competition is the most consequential and where decoupling on US terms needs to occur.

Fourth, China faces increasingly serious problems and obstacles regarding its decoupling strategy. Many of these arise out of structural weaknesses inherent in its political economy.

The monograph is written to assist the Biden administration and those who follow it to possess a deeper understanding of:

- China’s actions and the motives behind them;
- China’s strengths, weaknesses, and vulnerabilities; and
- How the US and its allies can craft an evolving approach that better plays to their individual and collective strengths and advantages.

China hopes the US and its allies will adopt a cautious, gradualist, and ineffective approach to countering Beijing’s strategy and objectives. The Chinese Communist Party knows the US and other advanced economies still have immense advantages despite clever Chinese messaging to the contrary.

The US and its allies continue to enjoy considerable leverage and remain well placed to partially decouple from China on their preferred terms, but they need to act quickly, collectively, and decisively.
This monograph is the result of a proposal funded by the Smith Richard Foundation. The project was approved and began in late 2020.

In July 2020, Chinese President Xi Jinping articulated a new “dual circulation” strategy. Seeking to walk a middle line between the unrestrained economic globalization of the previous decades and the “domestic circulation” or autarkic approach of Mao Zedong, dual circulation is about “unleashing the full potential of [China’s] domestic demand,” building technological and other forms of “self-reliance” as quickly as possible, and putting China in a better and more resilient position to engage with international markets on superior terms. This includes creating self-sufficient cycles of production, distribution, and consumption for domestic economic development.

Many China watchers immediately surmised that this was the inevitable Chinese response to the decoupling policies adopted by the Trump administration—if the United States seeks to decouple from China to strengthen its economy and perhaps weaken China’s, then Beijing will craft its own response, which will achieve the converse outcome.

As a matter of geo-economic historical accuracy and in terms of the public discussion about properly allocating blame for the deterioration in US-China economic relations, this sequence is incorrect. China has tirelessly pursued its version of a decoupling strategy vis-à-vis the US since long before Donald Trump entered the White House. Beijing might not have ever used the term decoupling, but Chinese decoupling policies partly persuaded the Trump administration to craft its decoupling policies, which the Biden administration has largely adopted.

Moreover, real policy implications are at stake that depend on understanding the proper sequence of policies and events and the motivations behind these policies. Chinese plans to decouple from the US and to ensure greater economic self-reliance and resilience precede the contemporary US discussion on this issue. The Chinese Communist Party (CCP) has long pursued self-reliance in many areas. More recently but before the arrival of the Trump administration, Beijing has sought to delimit its economic exposure and dependence on the US and to craft strategies to advance a Sinocentric economic order that excludes the US in important regards and limits US involvement in others. In short, Beijing has a head start on Washington when it comes to formulating and implementing related policies. Understanding this is vital because it would be a grave error to treat China as a passive bystander waiting to see America’s moves and taking only reactive or defensive approaches to US measures.

To be sure, economic decoupling is a fraught activity filled with unintended and unknown consequences. The notion of decoupling, which began during the Trump administration, largely began with an anti-globalization sentiment. Many Americans believed that globalization and economic interdependence had shortchanged them while developing countries such as China benefited at America’s expense. Since then, and in an era of geopolitical rivalry with China, the US is clearer as to what it seeks to achieve through some element of economic decoupling from China. Given Beijing’s expansionary and aggressive intentions, there is bipartisan agreement that the US should not help China grow its material power if Beijing will use those capabilities against the US and its allies.

At the same time, Washington should understand the Chinese strategic and economic mindsets, interests, and economic plans that already exist and what these are designed to achieve in a decoupling context. Doing so would help officials understand Beijing’s objectives and lead to more strategic economic, financial, industrial, technological, and regulatory policies.

With respect to the definition of terms, the contemporary discussion tends to use decoupling as a catch-all. For the purposes of clarity, decoupling can mean a full split in the supply or value chain or sector. It can also mean some element of disentangling, which
implies loosening or unraveling elements of the supply or value chain (which might be a precursor to decoupling or merely a precautionary risk management approach). **Diversification** implies a risk management or hedging approach of guarding against over-reliance through developing supply or value chains elsewhere (but is not necessarily a precursor to decoupling or disentangling).

These three broad approaches are all included under the term **economic decoupling**. The monograph will deploy greater precision in terminology where it is necessary. In short, this report examines how China thinks about economic decoupling from the US, which includes hard decoupling, disentangling, and diversification. It makes the following arguments and conclusions.

First, on the back of a preexisting mercantilist political economic structure, China has been explicitly pursuing economic decoupling from US and allied economies on Chinese terms for at least a decade.

Second, while the US seeks to decouple some aspects of its economic activity from China, the latter seeks to dominate vast segments of the Asian economy and to decouple these segments from the US. This is the Chinese strategy and threat that the US vastly underappreciates.

Third, the most important segments are the high-tech and high-value sectors. These sectors are where competition is the most consequential and where decoupling on US terms needs to occur.

Fourth, China faces increasingly serious problems and obstacles regarding its decoupling strategy. Many of these arise out of structural weaknesses inherent in its political economy.

Finally, the US and its allies have considerable leverage and powerful options to ensure that they achieve decoupling from China on their preferred terms. The first steps are to understand:

- China’s actions and the motives behind them;
- China’s strengths, weaknesses, and vulnerabilities; and
- How the US and its allies can craft an evolving approach that better plays to their individual and collective strengths and advantages.

In the above contexts, this monograph hopefully makes an important contribution to the US strategic and policy approach.
It would be a mistake to treat the Chinese decoupling mindset as a purely defensive measure to lower reliance on, and vulnerability to, the US. As this report will observe, the mindset includes strong defensive elements.

However, in the context of decoupling, there is also a proactive strategy to overarching blueprints such as the Belt and Road Initiative (BRI), which Beijing specifically designed to advance geostrategic and geopolitical objectives in Asia and beyond. This section focuses on the CCP’s strategic outlook and approach, and how plans such as the BRI fit into this broader outlook and approach.

**SECTION A: THE GEOSTRATEGIC DIMENSIONS OF CHINESE ECONOMIC DECOUPLING**

**China and Geostrategy**

Geographical and material conditions have played a decisive role in shaping China’s approach to the region given Beijing’s objectives. Aaron Friedberg describes the geostrategic terrain appropriately:

*Strategic Asia is very large; distances are huge, and one key player (the US) is more than six thou-*
sand miles away. Save for China and Russia, and partly for China and India (which are separated by the Himalayas), the major powers are not physically contiguous. Nations that wish to deter, coerce, or attack enemies must generally be prepared to project power across great expanses of water and airspace.²

In the decisive maritime areas of East Asia, and since the end of the Second World War, only the US has possessed the capabilities and relationships to either dominate or intervene decisively in these areas. China’s approach from the 1990s onward has been about acquiring capabilities that dissuade the US from intervening decisively by being able to inflict (or threatening to inflict) prohibitive costs.

Over the past decade and more, Beijing has increasingly focused on acquiring the geographical presence and capability to project dominant power beyond its periphery, which largely accounts for its recent actions in contested regions such as the East and South China Seas. Although Japan has the potential to reemerge as a great regional power, China still realizes that it is largely dealing with an assorted collection of “small states.” While some small states, such as Vietnam and Indonesia, may yet become formidable strategic actors in their immediate localities, their primary strategic value is to render assistance to great powers as enablers or blockers.

The region’s obsession with US-China relations and comparisons is understandable given the preponderance of small states with no ability to individually affect the balance. A small state is obviously a relative concept but reflects the reality that East Asia is a lopsided geostrategic and geopolitical construct. Geographically, China is the enormous continental heart of East Asia and is surrounded by several significantly smaller states in terms of landmass when it comes to the maritime domain. For example, China is about 6.5 times larger than Indonesia, over 14 times larger than Myanmar, almost 19 times larger than Thailand, and 25.5 times larger than Japan, although these are the four largest states by landmass after China.

These countries are also small in relative terms when comparing their military capabilities and potential to China’s. According to 2020 figures, China spends more than the rest of Northeast Asia and Southeast Asia combined, and its military spending equates to almost two-thirds of all East Asian spending. Its military budget is currently more than 6.5 times the combined military budgets of the Southeast Asian nations. China’s military budget is more than 5 times that of its nearest East Asian rival, Japan, and the gap is growing (See figure 1).³ Later this monograph will draw out implications of smallness on the strategic culture and psychology of certain states.

These regional disparities mean that China has long been obsessed with identifying strategic, military, and other non-material weaknesses pertaining to the US.⁴ Beijing has also realized that the US’s much greater distance from maritime East Asia can be both a structural advantage and a disadvantage. It is the former for the US because the prospect of an Asian hegemon creates more apprehension among resident smaller states than the existence of a distant one. The distant US power requires greater acquiescence from regional states to retain its presence and relevance in the region. In that sense, the US is more structurally bound to provide public security goods than an Asian hegemon would be. That partly explains why most states still welcome the US as a superpower.

Yet the structural disadvantage for the US is that strategic neutrality of these small states can be crippling, while it would be only inconvenient for an Asian hegemon such as China. Hence, Beijing does not have the same strategic or military need for cooperation from local allies and partners as the US does. Therefore, Beijing has the easier task of seeking to merely neutralize US allies and partners rather than the more difficult task of acquiring these allies for itself. If China can change the cost-benefit calculations of these allies and partners in its own
favor, then the US is immensely exposed as a geographically distant power. In other words, simply minimizing the strategic and military relevance and agency of Southeast Asian states works in China’s favor, given it is the People’s Liberation Army that is strengthening its presence in the region and not the US and its northern and southern allies. Achieving that was always a central pillar of China’s strategy of seeking to “ease the US out of Asia” and therefore “win without fighting.”

To be sure, recent Chinese behavior has caused Japanese and Australian allies to reaffirm and enhance their alliances with the US and their security relationship with each other. But if Japan and Australia serve as the northern and southern anchors of the US-led security system, the soft heart or underbelly of maritime Asia remains Southeast Asia.

Xi Jinping has put noticeably more strategic and diplomatic emphasis on small states than his predecessors did, frequently under the banner of “all-dimensional diplomacy.” Doing so makes eminent sense from the Chinese perspective. Small states are less powerful and usually less important to other great powers. This means they are more likely to hedge or remain neutral rather than balance against powerful countries, even if there is an aggressive power in their neighborhood, such as China. At the same time, Beijing does not need the consent of other states to maintain and extend its presence and influence. There is therefore more scope for China to coerce and intimidate neighboring small states than there is for a country such as the US.

For China, winning over or buying silence or neutrality from small Southeast Asian states is also “cheaper,” especially if they are low-income authoritarian political economies where elite capture becomes much more feasible. From a Chinese perspective, relatively insignificant increases in state-directed investment, infrastructure building, or tourist visits create a disproportionately large benefit for these struggling smaller economies. Following this practice, China has ensured that ASEAN is incapable of arriving at a consensus that would be detrimental to Chinese interests. Bear in mind that each state carries the same voting rights in institutions like ASEAN (even if their influence might be disparate).

These states’ smallness does not preclude some of them from being important from a geostrategic or military point of view. Of the 42 ports in 34 countries that Chinese firms have helped construct and that could serve Beijing’s strategic interests, the majority are in small states where such investments buy considerable influence. These include Hambantota in Sri Lanka, Kyaukpyu in Myanmar, and Sihanoukville in Cambodia.

A growing discourse among Chinese strategists about cultivating “strategic support states” reaffirms this conclusion. A 2015 consensus of 50 Chinese scholars on “China’s periphery diplomacy in the Xi Jinping era” concluded that Beijing can acquire strategic support states through regional cooperation and the provision of economic and public goods as China expands. According to one extensive analysis, one of the principles of cultivating a strategic support state is ensuring that “China has the ability and resources to guide the actions of the country so that they fit into [China’s] strategic needs.”

Figure 1. Major military spenders in Asia, 2020–21

![Figure 1. Major military spenders in Asia, 2020–21](source: "Asia’s Military Spending Up 2.8% in 2021, Bucking 1.8% Global Drop," Nikkei Asia Review, February 15, 2022.)
The cultivation of (small) strategic support states has taken several main forms and encompasses strategic, military, political, economic, nonmaterial, and psychological forms. These are summarized below.

**Shifting from Defending to Promoting Authoritarianism**

In the recent past, China merely wanted to deflect criticism of its authoritarian system. It still seeks to do that but is moving to promote its approach as a superior way for developing economies around the region and world.

Importantly, China has abandoned Deng Xiaoping’s model 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 also stated that “the Chinese nation will stand with a more high-spirited image in the family of nations” and that “socialism with Chinese characteristics” is a “new choice” for developing nations that want to grow economically and maintain their independence.8

Beijing’s promotion of its political values and standards goes far deeper than official pronouncements and mere declaratory policy. The CCP leadership has augmented support for authoritarian regimes—for example, that of Cambodia’s Hun Sen.9 Autocratic regimes receive a significant share of Chinese financing.10

China not only promotes authoritarian values but also teaches tactics for repression and exports apparatuses for domestic coercion to willing authoritarian clients.11 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.12

In the United Nations, China promotes the innocuous-sounding “community of shared future for human beings” 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.13 With respect to ASEAN, China promotes an ASEAN-China Community of Common Destiny to engineer a smooth transition to a China-centric and hierarchical region.14 Perhaps most concerning is China’s increased willingness to interfere in, and covertly influence, domestic decision-making institutions and debates in democratic nations. This includes the promotion of Chinese authoritarian values.15

The 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 in the Cold War era failed to address. As Xi claims, the CCP meets 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.16

There is immensely fertile ground for such messages to take hold. In a Southeast Asian region where Singapore is the only high-income-per-capita economy, the promise of rapid development under authoritarian rule is attractive. In Asia, only Japan and the Philippines had a sustained experience with democratic governance prior to 1990. There are few genuine, committed democrats in Asia (i.e., those who reject all other forms of government no matter what occurs). Instead, people here view democracy in somewhat more instrumental terms. A 2017 survey by the Pew Research Center found that in the Philippines, Vietnam, and Indonesia, only 15 percent, 8 percent, and 12 percent of citizens, respectively, were “committed democrats” who favored electoral democracy under any circumstances. The majority—67 percent, 79 percent, and 75 percent, respectively—
had a positive view of electoral democracy but would consider less democratic governance by experts, a strong leader, or the military under various circumstances. ¹⁷

Bear in mind that more than half of the region’s people were born after 1981 and have had no direct experience of the “hard authoritarianism” that characterized much of Asia in the decades after World War II.¹⁸ Whereas committed democrats will blame the party in power for suboptimal outcomes that do not meet popular expectations, uncommitted democratic societies may well blame the system itself for perceived failures. Indeed, this deeply embedded “instrumentalist” view of democracy appears to help account for the phenomenon of either authoritarian resilience or democratic erosion in Asia in recent times.

Setting “Discourse, Prices, and Policy” in the Region
China previously focused on benefiting from the regional and global order while reducing its vulnerabilities to external actions and exogenous shocks.

While China still needs to participate in the regional and global order, the country is tirelessly and creatively trying to set “discourse, prices, and policy” in ways that lock in its privileges, advantages, and agency when it comes to the setup and practice of institutions (e.g., membership in groups that decide norms, policies, or actions). These attempts would normalize certain forms of economic activity and influence technological, technical, or legal standards in Southeast Asia. In this context, initiatives to reduce domestic vulnerabilities and create new avenues for economic growth and exports without reforming the Chinese political economy (such as the BRI and Made in China 2025) have transformed into a grand strategy that tries to rewrite the rules for how regional nations compete and interact.

If Beijing could set discourse, prices, and policy, it would have far more leverage over smaller states, especially those in Southeast Asia, than it would otherwise have as it places China in a unique position to predetermine or decide the current and future winners and losers of various interactions. From this point of view, the objective is to institutionalize and entrench the Communist Party’s Leninist approach to political economy (i.e., a system in which all economic activity serves the interest of the Communist Party and the Chinese state) beyond China’s borders and throughout Southeast Asia.

In this sense, the goal is not just for China to benefit disproportionately from economic activity in Southeast Asia. Beijing wants the ability to offer or withdraw opportunities according to political and strategic considerations and cobble together a system in which Southeast Asian states can receive access and opportunity if they offer China fealty and tribute.

Controlling and Manipulating Grand Narratives
If China possesses a “magic weapon” to help it gain support for its strategic and security policies in Southeast Asia, it is the considerable success Beijing has had in controlling and manipulating grand narratives.

Under Xi, the narrative that China offers to the Southeast Asian audience has changed remarkably. Previously, China was desperate to emphasize its sense of vulnerability and the scale of its domestic challenges to counter fears about its accumulation of power. But since around 2014, China has moved toward promoting (rather than downplaying) strength and concealing (rather than highlighting) vulnerability.

This is evident in its 2019 defense white paper, which is as much a propaganda piece as a doctrinal or policy document. For example, unlike the previous nine defense white papers, the 2019 version is proudly littered with examples of PLA activity even when referring to contested regions, such as the South China Sea. While the 2019 paper is open about the military and technological gap that the PLA must narrow to become a global military leader, it is nevertheless boastful about the increasing tempo and sophistication of PLA activities: “Since 2012, China’s armed forces have deployed vessels on over 4,600 mari-
time security patrols [in the South China Sea] and 72,000 rights protection and law enforcement operations, and safeguarded maritime peace, stability and order.”

Similarly, Beijing prefers to overstate rather than understate the expansiveness and ambition of flagship economic industrial policies such as the BRI and Made in China 2025 (MIC 2025). The BRI began as a policy framework to relieve pressure on some serious domestic economic problems (such as to create external markets for excess capacity arising out of massive and chronic overinvestment and to develop stubbornly moribund economies in the inner and western provinces). But Xi’s May 2017 speech at the first Belt and Road Forum framed the initiative as one emanating from the enduring greatness of the Chinese civilization in grandly laying out its vast ambition.

More broadly, and unlike his predecessors since Deng Xiaoping, who all stressed the scale and depth of Chinese vulnerabilities and challenges, Xi makes the case for the inevitability of Chinese success and dominance to an external audience. One can see this in the way Beijing actively promotes its model and approach as politically and economically superior to those of the US. According to my conversations with interlocutors from Southeast Asia, Chinese officials they engage with consistently and persistently appeal to the narrative of inevitable Chinese dominance.

An important corollary of this narrative is that the region is an “optional” strategic interest for the US. In any event, other global priorities will periodically distract the US (such as in the Middle East), and US foreign policy will be inconsistent as administrations and domestic politics change. In contrast, Communist Party–led China is permanently in the region, unchanging in its objectives, fundamentally undeterrable, prepared to pay any cost to achieve its objectives, and focused first and foremost on Asia.

Buy-in to these narratives is the essential underpinning of Chinese strategic success. For small states, the will to resist even a coercive great power is greatly diminished if there is consensus that the great power will dominate regardless of whether other states disapprove of China’s behavior. Striking an uneven accommodation or removing oneself from the fray is preferable to balancing against the future dominant power—one must not fight the future but learn to make the best of it.

Chinese Authority, Legitimacy, and Leadership over Smaller States

If China relied only on coercion and insidious forms of “sharp power,” then Southeast Asian states would be more likely to embrace Donald Trump’s Free and Open Indo-Pacific or Joe Biden’s Safe and Prosperous Indo-Pacific. They would also countenance more active balancing measures against the prospect of Chinese dominance. However, China has been proactively and creatively persuading Southeast Asian states to hedge rather than to balance themselves against Beijing.

As a complement to these grand narratives, China is thinking more deeply and creatively about enduring and effective foundations for the accumulation and exercise of power and influence over Southeast Asian states. Beijing is cognizant of the likelihood that the significant powers in the region will not become Chinese allies in the manner that Japan and Australia are with the US.

Indeed, the 2019 defense white paper reaffirms that Beijing will not seek alliances with any country. For that reason, dominance based on overwhelming material superiority is probably not possible, or at least would not be enduring even if achieved. Constant coercion of other states might eventually convince these states to balance against Beijing. These alone cannot be a sound future basis for Chinese power and influence.

For these reasons, Beijing is attempting to enhance its authority and legitimacy as its power grows in relative terms, but it is also aware that its relative power will not increase indefinitely.
Whereas coercion relies on threats or actual punishments to shape or change the behavior of others, the notion of authority is based on the legitimate exercise of power. Such authority is a more efficient and enduring way to exercise power because it induces compliance from smaller powers that recognize or accept China’s right to impose obligations on them.

The recognition of that “right” might be moral, normative, or based on a longer-term material calculation. Whichever it is, the point is that smaller countries come to accept that there are rules for the great Chinese power and different rules for smaller powers. Unlike the US’s rule-based framework, the Chinese proposition is inherently hierarchical. If accepted, that hierarchy reduces the need for China to rely on mere threats or punishments.

Consider the primary forms of diplomatic messaging China uses for Southeast Asia and Pacific Island countries compared to messaging reserved for Western liberal democracies such as Australia, the US, and the European Union states. With respect to the latter groups, China promotes the notion of “mutual benefit” and “win-win.” In my conversations with Southeast Asian interlocutors, they have said that China emphasizes the Chinese civilization’s permanence and greatness, which is the enduring basis for hierarchical, stable, and benevolent relationships with smaller states in Asia. Importantly, according to Beijing, the permanence and greatness of Chinese civilization both guarantee the success of China’s reemergence (as that reemergence is natural) and back Beijing’s claims that the Chinese overlord will be just and fair (as it has been for millennia, according to the Communist Party’s view of history).

China has attached these narratives to actual policies directed toward Southeast Asian states. For example, the BRI is designed to spur “common development” through the strengthening of infrastructure, networks, connectivity, and enhanced people-to-people interactions and exchanges. To Southeast Asians, Beijing is not apologetic that the BRI is China-centric or even that Chinese entities are its primary beneficiaries. Countries are often flattered by being told that they form essential nodes in a vast China-centric network. But the overriding message is that benefits can flow to the entire region only if the great Chinese civilizational state is at the center of economic, political, and diplomatic life in the region.

Whereas the impersonal and ruthless market-based principles will create short-term winners and losers through the merit-based measurement of profitability, China insists that its system will give guaranteed and enduring benefits to all participants, even if these are unevenly distributed.

Southeast Asian countries realize that Chinese financing, infrastructure building, and even designation of Approved Destination Status to boost Chinese tourism numbers are based partly on Chinese largesse. In contrast, impersonal market forces seem to drive Japanese, American, and Australian economic activity in Asia. This is all about China making a moral, normative, and material case for its unique hierarchical authority.

Bear in mind that the primary target for China is elites, and the moral, normative, and material case is largely designed to achieve “elite capture” or co-optation throughout Southeast Asia. Domestically, elite capture is how the modern CCP has remained in power and what it has learned to do best. In Southeast Asia, Beijing has discovered that the most efficient way to gain consent for its strategic and security policies or to at least stifle opposition is to either win over elites or silence them. One report, which is consistent with my observations, is that elite-to-elite diplomatic outreach accounts for about 90 percent of China’s outreach to these countries.

It is also worth noting that an important external objective for China’s United Front Work Department, which collects intelligence on and tries to influence elites and stakeholders in target countries, is to complement all the above objectives by promoting the following ideas:
The dominance and greatness of the Chinese civilizational state are inevitable.

The CCP-led Chinese state is fundamentally undeterrable and is willing and able to absorb any cost in achieving its objectives. In contrast, the US is undependable and may abandon Southeast Asia.

China’s hierarchical order is more virtuous than the US-backed rules-based order. This message contrasts the guaranteed gains derived from embracing that hierarchical China-centric order to the uncertain benefits of the rules-based order.

Chinese strategic and security policies (including in the South China Sea) are a necessary component of this more virtuous and beneficial order.

The CCP has been entrusted with the great rejuvenation of Chinese civilization, and it is the only legitimate authority over the Chinese peoples (including those in other countries). Therefore, opposing the policies and principles of the CCP is tantamount to defying the will of the 1.4 billion people who are part of the enduring civilization.

Note also that China realizes any smooth and legitimate transition to a China-centric hierarchical system requires the co-optation of, or at least must complement, the existing ASEAN framework. Since China became an ASEAN Dialogue Partner in 1996, it has established almost 50 mechanisms with ASEAN. Common to all these mechanisms is the intention to establish and entrench Chinese moral and normative authority and legitimacy based on China’s central role in providing stability and security through promoting economic development and connectivity. A prominent example is China’s attempts to integrate the BRI with ASEAN's connectivity agenda, with the modification that the benefits of ASEAN connectivity can be maximized only if the latter is linked to a broader BRI framework. As Singapore’s Bilahari Kausikan further argues, China’s natural gravitational pull is being enhanced by various infrastructure projects… These projects have geopolitical consequences, intended or not. They could in effect merge southwest China and mainland Southeast Asia into one economic space. International boundaries will . . . remain as lines on maps. But they could be relegated to inconveniences or irrelevancies.

When one analyses mechanisms from upgrading the ASEAN-China Free Trade Area to a Special ASEAN-China Defence Minister’s Meeting to ASEAN-China Cultural Cooperation, the fundamental approach and message is the promotion of China-centric economic opportunities in underpinning political, security and cultural advancement and cooperation. A smooth, peaceful, and prosperous transition to an inevitable Sino-centric region is only possible, according to Beijing, when there is little or no resistance from Southeast Asian states. And that can only occur when the latter states accept the “natural propensity of things”—the notion of “shi” and “harmony”—and seek to work with rather than against it. As Xi Jinping puts it, “When the big river is full of water, the smaller ones never run dry.”

Even with mechanisms at the subregional levels that are not explicitly ASEAN, such as the Pan-Asian (or Kunming to Singapore) railway or Lancang-Mekong Cooperation, the underlying approach is the same. It is all about connecting the material (and therefore political and security) destiny of these nations to a psychological sense of dependency, with all pathways beginning and ending in China.

Consider the powerful bond and pull for these smaller states: resistance is pointless, but small states giving themselves to the “propensity of things” and embracing that as “natural” will condition these states to act in accordance with China’s wishes.
Deng Xiaoping’s exhortation to “Hide brightness, cherish obscurity”—to avoid antagonizing major powers while quietly building national comprehensive power—survived into the first decade of this century. In particular, Beijing’s pledge that it would pursue a “peaceful rise” or “peaceful development” was a continuation of Deng’s dictum. This Chinese approach fueled optimism that China would emerge as a responsible stakeholder in a US-led strategic and economic order.

Many view the emergence of Xi Jinping as paramount leader in 2013 as marking a decisive shift away from Deng’s conservative three-decades-old approach. More likely, the main difference between Xi and his predecessors relates to the former’s bolder style, willingness to take on risk, and lack of patience than to a sea change in Beijing’s objectives.

Indeed, “Hide brightness, cherish obscurity” was largely formulated to prevent Chinese overreach and the formation of powerful coalitions against a still-weak and vulnerable Beijing. Political and strategic documents reveal that China had been preparing for an enduring and intense competition and rivalry with the US since the mid-1990s. In my own survey of over 100 Chinese strategic documents and articles from the late 1990s to 2008, about four-fifths were about competing with the US. They focused on how best to bind, circumvent, restrict, or overcome...
The CCP long rejected the US expectation that it would gradually commit to political and economic reforms as China grew richer and became more integrated with the US and global economies. China’s force development and modernization over three decades aimed to counter US capabilities most of all. In other words, there is little evidence that authoritarian China was genuinely willing to emerge as a responsible stakeholder under US leadership, and the shock and disappointment among many US policy elites were more a result of misplaced expectation than of a sudden Chinese shift in direction.

This is the contemporary context within which China’s economic policies toward the US and in the region ought to be understood. By the end of the first decade of this century, and despite three decades of double-digit economic growth, the Chinese economy remained far less resilient than was then widely assumed. China still needed Western markets and consumers to drive its export-driven growth. (Net exports remained the primary driver of GDP growth up to the global financial crisis in 2007.) To sustain constant improvements and support its rising export-oriented and domestic manufacturing, the country depended predominantly on foreign (especially US) technology, innovation, expertise, and commercial know-how.

Refusing to subject its currency to the whims and fluctuations of international markets, Beijing persisted with a “managed RMB currency” that was largely pegged to the US dollar at a level determined by the People’s Bank of China. Even in recent times, China has few options but to park the bulk of its foreign exchange reserves (largely acquired through the accumulation of enormous trade surpluses with the US) in US dollar-denominated assets given the size of its reserves and the need to hold US dollar assets in maintaining the peg. This means that in return for RMB stability and partial immunity from the whims of international currency markets, Beijing is more vulnerable to the whims of US monetary policy.

Therefore, the high point of US optimism that an economically more successful and integrated China would play by US-preferred and existing global economic rules was an illusion. For China, greater economic cooperation and integration were a means rather than an end, a tactical measure rather than a desired strategic outcome. Beijing had not previously used the term economic decoupling, common in the US, but seized upon Washington’s use of it as an indication of US bad faith and disruptiveness. But as China became more powerful, it was always likely that it would seek to renegotiate or reframe the terms of its economic engagement with the US. In the name of national resilience, and increasingly as a competitive strategy vis-à-vis the US, Beijing was effectively cobbled together its own version of economic decoupling or distancing from the US.

From Defense to Offense: Xi Jinping and the BRI

While China’s desire and attempts to decrease economic reliance on, and vulnerability to, US policies and actions preceded Xi Jinping, he is far more proactive and ambitious than his predecessors. Xi has moved from previous defensive mindsets, which focused mainly on protecting China from external (especially US) actions, to plans to entrench a dominant economic role for China at the US’s expense and to shape the institutions and environment to achieve and sustain that role. In this sense, economic decoupling or distancing on Xi’s terms has been defining many of Beijing’s goals since his ascent in 2012. These goals are part of what Xi refers to as pursuing “a new model of major country relations between China and the US.”

Indeed, China’s main outward-facing economic blueprints should be understood as Beijing seeking to decouple or distance on its own terms. Consider the BRI, which is rightly described as China’s most ambitious and comprehensive economic and strategic blueprint since the Deng Xiaoping era.
began in 1979. It comprises the Silk Road Economic Belt, which goes through the Eurasian continent all the way to Western Europe, and the Maritime Silk Road, which links China with Southeast Asia, Oceania, the Indian Ocean Rim, Africa, and the Mediterranean. The BRI’s authoritative white paper describes its objectives as comprising policy coordination, facilities connectivity, unimpeded trade, financial integration, and people-to-people connections.38

Much has already been written about the BRI, the challenge it poses to US interests, and the poor outcomes it often leads to for unwitting participants. For example, one recent and comprehensive study by Daniel Kliman et al. argues that the BRI poses seven key challenges for participating states: erosion of national sovereignty, lack of transparency, unsustainable financial burdens, poor relevance to local economic need, geopolitical risk (i.e., draws countries unnecessarily into geopolitical disputes), poor environmental standards, and poor checks against corruption.39

In practice, the BRI does not have a formal institutional structure or set of iron-clad guidelines. Rules, processes, and terms are negotiated directly between the Chinese government, a state-owned enterprise (SOE), or a state-sanctioned firm on the one hand and the BRI country or individual firm on the other. In the recent past, Beijing has tried to institutionalize aspects of the

Caption: A China-Europe freight train departs from Jinhua, China, for Dourges, France, on November 26, 2020. (Photo by Shi Bufa/VCG via Getty Images)
BRI, such as by establishing dedicated BRI courts and dispute
settlement entities and processes that sit outside existing re-
gimes (e.g., the World Trade Organization). Even so, these BRI
courts and tribunals are constituted by China and abide by rules
and processes favored by Beijing.

More broadly, the BRI is not a rule-of-law-based entity in that
the rules are flexible and determined according to a negotiation
between Chinese authorities and the participating entity. This
suits China as it is always the larger and more dominant part—
meaning BRI participants generally begin the negotiation from a
position of weakness or disadvantage. It is not surprising that,
according to the authoritative Center for Strategic and Interna-
tional Studies (CSIS) Reconnecting Asia database, 80 percent of
contractors participating in Chinese-funded projects are Chinese
firms. Only 7.7 percent are from the country in which the project
is taking place, and 3.4 percent are non-Chinese foreign firms.

It is obvious that the geographical area of relevance to the BRI
excludes the US. Despite the growing and maturing literature
covering the good, bad, and ulterior motives behind the initia-
tive, the BRI is not generally characterized as a Chinese decou-
pling or distancing strategy.

In fact, the BRI, which began in 2013 as a relatively modest
plan to revive the “ancient Silk route” through China’s west-
ern provinces by connecting them to Central Asia, has been
gathering pace as a proactive strategy to create a Sinocentric
economic order that deliberately locks out the US. While there
are purely economic benefits for China in advancing the BRI—
not least to provide guaranteed projects and external markets
for its large and lumbering capital-intensive infrastructure and
construction firms—there are overriding strategic benefits to
excluding the US. As Aaron Friedberg has argued, the CCP
objective to reemerge as the preeminent power in Asia pre-
ceded Xi. But Xi has seized upon the BRI as a means through
which to create an economic, political, and normative order
that not only excludes the US but also absorbs many of the
authoritarian values and interests of the CCP. In short, Eur-
asia and East Asia are to become a Sinocentric zone. The US
will not be prohibited from engaging economically within this
intended Sinocentric region but will do so on a playing field that
vastly suits Chinese rather than US firms. Rather than working
with the US to craft the evolving economic order, China seeks
to ensure the US will have little or no role in this context. In this
sense Beijing is seeking to reframe or renegotiate its economic
relationship with the US and the rest of the world by forcing
other countries to engage on Chinese terms while reducing re-
liance on the US as much as possible.

If the BRI is a decoupling initiative to serve Chinese strategic
and economic interests, one must still draw out what this Chi-
nese version of decoupling looks like. If it is part of Beijing’s
efforts to renegotiate or reframe the terms of its economic en-
gagement with the US, what are the BRI and related policies
striving to achieve more specifically? Stated differently, what
does economically “locking out” the US mean in practice, and
what is it designed to achieve?

First, the goal is to make a virtue out of geography. The idea is to
build regional Sinocentric infrastructure, platforms, and institutions
that will facilitate trade, investment, and other beneficial economic
exchanges between China and countries along the BRI. Consider
the six main economic corridors: China-Mongolia-Russia; Chi-
na-Indochina; China-Pakistan; Bangladesh-China-India-Myan-
mar; China-Central Asia-West Asia; and the New Eurasian Land
Bridge (which spans from the east coast of China to Holland). All
are designed to connect BRI corridor economies to China so that
the latter emerges as the central hub connecting them.

An example of this Chinese blueprint in operation was the seem-
ingly innocuous investment in the Greek port of Piraeus. China’s
COSCO Shipping Corporation had received over USD 26 billion
in 2017 from the state-owned China Development Bank to invest
in BRI-sanctioned projects. Following COSCO’s investment in,
and control of, Piraeus, the subsequent Chinese-controlled entity
signed an agreement with Shanghai International Port Group to cooperate in project planning, staff training, and information exchange. As part of the Piraeus deal, Chinese state banks provided loans to Greek shipping companies to build additional commercial vessels in Chinese shipyards. In other words, it is largely about stitching up deals between Chinese-owned entities within the BRI zone, whether they exist in Shanghai or elsewhere.

The point is that the immediate goal might have been to create external capital investment opportunities for Chinese firms. But the greater and grander purpose, which was developed from around 2015 onward, is to ensure that roads, rail, ports, cables, digital networks and infrastructure, etc., begin and end in Chinese provinces—and operate on terms favorable to Chinese interests.

Second, with the construction of a vast Sinocentric economic ecosystem within which Chinese firms and entities dominate, no other great power (i.e., the US) is in a position to prevent the negotiation of terms and conditions between China and individual countries that suit Beijing. Disputes and disagreements will be resolved not by recourse to pre-agreed laws and rules but through political negotiation (in which Beijing has the leverage) or through BRI rules and processes (which Beijing has drafted).

With a greatly reduced commercial presence in East Asia and Eurasia, US firms and authorities will have less ability to set or revise commercial and quality standards in all sectors since the most powerful stakeholders in that market generally determine such standards. Standards can also be understood as the "connective tissue" between products, services, and systems. They can be simple (such as size of rail gauges) or complex (such as guidelines ensuring interoperability of 5G networks). Once such commercial, technical, or quality standards are set, it is expensive and usually prohibitive for firms and economies to operate in a different economic ecosystem.

When combined with Sinocentric infrastructure, institutions, logistical networks, etc., BRI economies become captive to China while outsiders, such as the US, are in a much weaker position from which to enter.

Third, Beijing has long resented the "tyranny" of the greenback as the international currency it must accept. It hopes an expanding and strengthening Sinocentric geo-economic zone will allow the greater use and therefore regionalization of the renminbi (RMB), leading to decreased reliance on US dollar holdings and transactions. In Beijing's ideal world, this will proceed without the need to substantially open Chinese capital markets or make the RMB fully convertible. This would make the currency's value uncontrollable and unstable, which Beijing will not tolerate. So the BRI is explicitly designed to promote the use of the RMB for settling trade, conducting investment within the BRI platform or agreement, and issuing RMB-denominated bonds as part of BRI financing packages. This explains why China is frenetically signing currency swap agreements with BRI countries.

Fourth, understanding the decoupling aspects of the BRI requires understanding it alongside China's other economic or industrial plans, especially the MIC 2025 blueprint.

MIC 2025 did not arise in a vacuum. In 2006, Hu Jintao issued a fifteen-year plan to enhance "indigenous innovation" and identified seven strategic industries in which domestic firms should excel if China were to become an "advanced economy." MIC 2025 pursues the same central-planning and target-setting approach but is different and much more ambitious in important ways.

For example, MIC 2025 seeks control over, and dominance of, entire manufacturing processes, supply chains, and associated services supporting a dozen sectors. It specifies targets for the domestic content of core components and materials: 40 percent by 2020 and 70 percent by 2025.

The plan explicitly references the extent to which Chinese firms are to control various sectors when it comes to making core components. For Chinese technology, it also sets out indus-
try- and tech-specific targets and domestic and international market-share quotas. While Chinese state-owned firms will take the lead, all private indigenous firms are considered potential partners and participants in MIC 2025, and the state will offer these firms extensive financial, commercial, regulatory, legal, and political support and assistance.

Moreover, the MIC 2025 plan is much more ambitious and muscular than previous industrial upgrade blueprints. The explicit objective is not simply to ensure that China becomes an advanced and competitive economy. It aims to create the foundations that control global supply chains, innovation, and know-how so that Chinese firms dominate these sectors. By the end of 2018, authorities had issued over 450 major documents detailing MIC 2025 implementation measures. At least 30 MIC 2025 pilot cities have been established, with each given specific targets to hit relevant to meeting MIC 2025 objectives. These comprise over 50 sub-industries and 115 industrial sub-fields. Recently, China created the Shanghai Stock Exchange Science and Technology Innovation Board (Shanghai STAR Market) to be the Chinese equivalent of the tech-heavy NASDAQ exchange. By design, it provides domestic capital markets from which Chinese investors and businesses can draw to advance MIC 2025 objectives.

MIC 2025 identifies the high-value industries that will become increasingly important to national power and wealth. The BRI complements this effort by providing the required infrastructure, finance, logistics, and agreements between China and BRI partners to lay the foundations for national absorption of innovation, expertise, supply chains, etc. that Chinese firms require to eventually dominate MIC 2025 sectors. The Digital Silk Road, which is a formal component of the BRI, encapsulates much of this ambition.

The plan aims to ensure that Chinese firms dominate MIC 2025 sectors within China and in advanced economies, including the US. Unlike the BRI, which excludes the US, MIC 2025 seeks to ensure that Chinese firms prevail over US and other international firms and dominate advanced sectors in all global markets. So the state uses capital, market restrictions, infrastructure, and logistics; protects local innovation; and absorbs foreign innovation (through joint-venture agreements, acquisition of foreign firms, and intellectual property theft) to deny US firms the opportunity to even compete effectively in these sectors. This is about renegotiating and reframing the economic relationship with China in a manner that allows China to emerge as the dominant party.

Fifth, there is a significant normative element to the Chinese decoupling mindset. China is not only creating an exclusive economic region for itself but is also exporting a suite of alternative values and normative processes. This is most notable in the Digital Silk Road, where Chinese championing of “cyber-sovereignty” represents “the right of individual countries [or more accurately regimes] to independently choose their own path of cyber development, model of cyber regulation and Internet public policies.”

This aspect is apparent in the export of “Huawei cities,” which seeks to offer other regimes tools like those Beijing uses to keep Uighurs under surveillance and control. The point is that the decoupling from and ringfence against normative standards promoted by the US and other democracies is very much part of the mindset behind China’s exclusive economic zone.

To summarize, the CCP did not and does not use the term decoupling. Even so, what evidently began as an entrenched mindset in the previous two decades to shield the Chinese political economy from instability and pressures emanating from without has evolved. It now more proactively attempts to reshape economic interactions and the broader environment to prevent or restrict opportunities for the US while offering decisive advantages to Chinese firms. Such measures include some element of extreme decoupling and other aspects of disentangling Chinese supply and value chains from the US. Or they diversify away from reliance on US markets, technology, know-how, capital, and currency.
The purpose is not simply to ensure that China’s political economy and firms are more successful and better placed than the US equivalents in a future time. Instead, Beijing’s goal should be understood as part of its broader strategic rivalry or competition with the US. These Chinese efforts are designed to enhance all tools of national power (including through Beijing’s military-civil fusion approach, which eliminates the barriers between civilian and commercial sectors on the one hand and between military and defense industrial sectors on the other) at the US’s expense.

**Brief Assessment of Recent Chinese Progress**

Beijing has gained a significant head start on the US in forming a set of geo-economic objectives and allocating significant resources to advance them. Until the COVID-19 pandemic, it had considerable success in spreading and entrenching the narrative that a Sinocentric economic order in East Asia and much of Eurasia was all but assured and that the US (and its allies) would become significantly less relevant over time.

As the Chinese narrative goes, an inevitable Sinocentric economic order might disproportionately benefit China, but willing participants in it will still receive guaranteed material gains. Countries had better not support US moves to decouple or distance from China. They should hedge their economic bets by joining rather than resisting the structural trends toward Chinese economic dominance.

This narrative, backed by much-publicized resources and largesse being poured into the region, has been effective. For example, multiple regional surveys of elites and the general population suggest China is clearly seen as the most influential economic power even though most are concerned about its rising influence. More than one hundred countries have signed memoranda of understanding with China to participate in the BRI or have released formal statements supporting it. Few countries are prepared to openly rebuff Chinese plans, such as MIC 2025, with concrete measures such as banning Huawei from their 5G rollout. On the contrary, and notwithstanding widespread wariness of growing Chinese power, most of the countries in the planned Sinocentric zones are developing economies. Many have autocratic structures or are incomplete or highly flawed democracies. Elites in these countries tend to express admiration for the ability of China’s autocratic system to generate rapid growth in the earlier stages of development even if they have an enduring wariness of Chinese power. Indeed, most countries in the region have been more publicly critical of US plans to economically decouple or distance from China than they have been about Chinese plans to shut out the interests of the US and other countries.

Even so, we are only at the beginning of the struggle to decide the future terms of geo-economic engagement between the US and China. Serious flaws and significant weaknesses in China’s economic approach remain, which should inform the US approach.

For example, the ambition and geographical vastness of the BRI, combined with the top-down economic approach of the CCP, is an enormously expensive and wasteful approach. Given that around 95 percent of Chinese funding for BRI projects comes from its already over-leveraged state-owned banks, the project urgently needs to make adequate returns on its capital investments.

Yet, the “build it and they will come” approach to capital investment that mirrors China’s own domestic model creates enormous financial problems for both China and many of the recipient economies. Since the BRI was stepped up from 2017 onward, debt risk in low-income BRI corridor economies (i.e., the majority of corridor economies) has risen alarmingly. About 40 percent of these low-income economies are now at high or severe risk of debt distress, which is double the figure in 2013 when the BRI was first launched. The financing for most BRI projects takes the form of Chinese loans to the host government with the expectation that they will be paid back—which is a problem given
that the sovereign debt levels of about half of the BRI countries are rated as “junk,” while a third have no rating at all.57

In short, except for some commercially sound projects in the Southeast Asian maritime economies and a handful of Western European economies, most large-scale BRI projects run the high risk of becoming an oppressive burden for Chinese financial institutions—and ultimately for the Chinese government. In profitable subregions such as maritime Southeast Asia, Japan is the leading investor, followed by a few European countries and the US. There are some strong but many weak points, meaning that there is an enormous opportunity for the US to prevent the emergence of Sinocentric subzones in those areas that matter to the US and to force China to build its geo-economic plans on fragile ground.

When it comes to Chinese efforts to capture high-tech and high-value supply chains (and to deny these to the US), Beijing is still heavily dependent on global technology inflows and global supply chains that US, European, and Japanese firms dominate. This is especially true in industries such as robotics, aeronautics, semiconductors, and closed-circuit chips, which are essential to the MIC 2025 goals and plans for military-civil fusion objectives.58

More generally, growth and success in the high-tech sectors is generally predicated on four conditions: (1) investment at scale, (2) access to large and advanced markets, (3) a world-class domestic system to produce innovation, and (4) channels to acquire technology and know-how.

Enormous Chinese state resources have been poured into investment to achieve scale. However, China has problems with the other three conditions. The Chinese domestic crowding-out of the private sector in favor of SOEs and “national champions” is a serious drag on innovation.59

To advance in most of the sectors identified by MIC 2025, China still relies on the acquisition and adaptation of basic and applied research from abroad, including through forced intellectual property (IP) transfers or theft. It is significant that China is a net high-tech importer60 even as it has emerged as the leading manufacturing nation.

To be sure, Beijing has been successful at pouring state resources into helping its firms commercialize certain technologies and offer a more integrated and complete package to achieve first mover advantage in markets (e.g., in 5G). But for these Chinese firms to dominate and ward off competition from US firms, they need substantial access to advanced market economies like the US and EU. Without these, firms such as Huawei cannot truly become global champions.

**Conclusion**

The Trump administration framed many of China’s economic policies as unfair, predatory, non-reciprocal, and damaging to the proper function of economic globalization. Those accusations remain credible. But it would have been helpful to make the point that Chinese plans for “economic distancing” from the US—in the form of decoupling, disentangling, and diversifying—preceded the Trump administration. This would have assisted in appropriately casting more blame on Beijing as the provocateur and Washington as a responder in the early stages of cobbled together a plan.

Furthermore, as a matter of policy, it is critical that the US realizes it is not the only side considering how to enhance its economic strength and resilience. China is also seeking to economically decouple or distance under terms favorable to itself. Therefore, the Biden administration must consider both proactive policies and countermeasures to prevent China from realizing its economic objectives at the US’s expense.
If one examines much of the commentary about China prior to 2020, there was growing external dread (and rising Chinese confidence) that Xi Jinping had superbly positioned himself and China. Xi was well on the way to establishing himself as president for life, while China was using a potent mix of coercion and inducements to achieve its external objectives. As Xi and the CCP leadership argue, the world is witnessing “great changes unseen in a century” that will create unparalleled opportunities for “the great rejuvenation of the Chinese nation.” The phrase great changes refers to Xi’s apparent confidence that the balance of comprehensive power vis-à-vis the US is rapidly changing in China’s favor and that the next decade will be a decisive time in the contest between the two greatest powers.

The early days of the COVID-19 pandemic seemed to reaffirm this perspective. Although the world was enraged by the recklessness of the CCP in allowing the virus to spread internationally and shocked by its ruthlessness in preventing the spread of COVID-19 domestically, China also emerged from the early lockdowns relatively quickly and at a time when much of the world was embarking on a protracted struggle to lower infections in their communities. As some argued in the earlier days of the pandemic, China had emerged victori-
ouis and triumphant in the “competition between social systems.” Chinese authoritarianism might seem harsh to democrats, but it was effective and more successful at solving problems.62

If China has the advantage in the competition between systems, then it should presumably hold the advantage and leverage when it comes to the contest to decouple on its own terms vis-à-vis the US and other democracies.

Fast-forward to 2022, and the narrative is significantly different. As the advanced democracies are learning to live with COVID-19 on the back of highly effective vaccines (contra the unclear effectiveness of Chinese-developed and -produced alternatives), the CCP remains tied to the impossible task of eliminating COVID-19 from its communities.

Xi’s standing as a statesman and his strategic nous is being called into serious question due to the current war in Ukraine. Some two weeks before the invasion of that country, Vladimir Putin and Xi declared a no-limits friendship. This included Putin’s support for Xi’s self-declared right to take Taiwan, including through force, and Xi’s support for Russia’s claims with respect to Ukraine. Having met more than 30 times since 2013, the leaders of the two most powerful authoritarian countries openly pledged to oppose American global preeminence, weaken its alliances in Europe and the Indo-Pacific, and overturn the primacy of liberal democratic norms in place since the formal end of the Cold War in the early 1990s.

If Xi maintains loyalty to that pact, he joins Putin as a pariah while the cascading sanctions against Russia will eventually harm Chinese companies doing business with Russian entities. If Xi abandons Putin, he loses credibility with his most important authoritarian ally without winning back trust and friendship with democratic nations. Either way, Xi has ensured China will be in a lonelier position than if the no-limits friendship was never declared in the first place.

Moreover, the earlier Chinese hubris and more recent missteps and mistakes take place in the context of enduring and serious problems with the Chinese political economy. It struggles with realities such as enormous debt, the systematic misallocation of capital, and the ability to finance and resolve shortcomings in its social setup and civil society.

These problems have been extensively written about elsewhere.63 However, I raise them because Chinese notions of decoupling must be understood in the context of these profound and enduring domestic weaknesses—as well as within the strategic objectives discussed in the earlier sections. Indeed, the ongoing troubles at Evergrande, the country’s largest property developer, are indicative of the economic environment in which Chinese contemporary notions of decoupling evolve. Therefore, this section begins with a brief discussion of Evergrande’s woes before explaining the rationale and realities behind the Chinese approach to decoupling.

**Evergrande as a Metaphor for the Chinese Political Economy**

In the middle of 2021, business analysts offered increasingly alarming assessments about Evergrande, one of China’s two largest real estate developers. Evergrande’s approach was to achieve ever-increasing scale (rather than profitability) to move ahead of and crowd out commercial competitors. It amassed the largest land reserves of all Chinese developers, which were financed through extensive borrowing. By 2018, Evergrande held 822 pieces of undeveloped land in 228 cities, with a planned gross floor area of 3.28 billion square feet of new homes—the equivalent of 10 percent of Germany’s entire housing stock.64

Although Evergrande’s market share is only around 4 percent, its borrowings are striking. Its current balance-sheet liabilities amount to an estimated 2 percent of China’s GDP, while its off-balance-sheet liabilities could be another 1 percent of China’s GDP. This makes Evergrande the most indebted property developer in the world.65
The company is burdened by this debt, struggling to meet its interest and repayment obligations, and reliant on ever-increasing property asset values and sales growth to remain viable. The possible financial collapse of such a large entity is bound to have knock-on effects for the Chinese economy. However, the world has an unusually high interest in Evergrande because its woes are increasingly seen as symptomatic of those that the broader Chinese economy faces as it struggles with enormous levels of indebtedness and overreliance on the real estate sector.

Debt held by non-financial institutions in China has increased from about 115 percent of GDP in 2010 to around 160 percent of GDP currently. This is the most rapid and largest increase in a ten-year period for any major economy and is now one of the highest in the world. The real estate sector accounts for around 15 percent of GDP, while property services account for another 14 percent of GDP—the highest in any developing economy. The share of the real estate sector as a proportion of GDP was only about 4 percent in 1997 and 9 percent in 2008. Since 2008, up to a third of all domestic fixed investment went into real estate, and up to half of total national debt is linked to the real estate sector.

What Evergrande Reveals about the Chinese Political Economy

Evergrande’s distress is not just a financial or sectoral problem but one that goes to the heart of the resilience and robustness of the Chinese political economy and the competence of the CCP and its stewardship over the country’s state-led economy. In many respects, the remarkable rise of Evergrande is a microcosm of all that is impressive but also fragile and flawed about the Chinese political economy.

Evergrande was recently upheld as a company helping to fast-track the Chinese dream of homeownership in a rapidly urbanizing country. Indeed, Evergrande gained national recognition in 2009 after it managed to complete the full project development process—from government approval to land acquisition to construction to sales and then to owners moving in—within 12 months.

More broadly, many assumed Evergrande’s model of “three highs and one low” (high debt, high leverage, high turnover, and low cost) was ready-made for a period of rapid urbanization and that this rapid Chinese transformation from rural to urban was driving the enormous investments in real estate.

This is only partly true. With real urbanization advancing at a steady rate of only 1 to 1.5 percent each year, the massive recent increases in real estate construction have less to do with urbanization needs than one might expect. Instead, local governments have long raised revenue by appropriating rural land to rezone it for industrial or residential construction and use regardless of actual housing demand. 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 demands of urbanization. From 2001 to 2008, 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 (when China’s major export markets in North America and Europe stagnated due to the global financial crisis), proceeds from rezoning land from rural to urban dramatically increased—to 61 percent of local government income, and possibly 70 percent by 2014. Currently, the real estate sector is responsible for up to one-third of all local government revenues.

Such reliance on land sales and residential development was enhanced by local governments’ creation of an estimated 155,000 local government financing vehicles (LGFVs) to get around restrictions on debt. LGFVs became major recipients of the credit binge ordered by the central government,
and many of these entities (which are effectively local SOEs) forged commercial partnerships with property developers such as Evergrande 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 USD 1.19 trillion, an increase of 70 percent.71 By mid-2013, local government debt had reached an estimated USD 2.89 trillion.72 By the end of 2020, the official figure was USD 3.97 trillion, while the real figure (which includes hidden or concealed local government debt) is closer to USD 7 trillion.73

Regarding the Chinese real estate sector, by 2016, the total market value of Chinese real estate accounted for around 411 percent of GDP compared to a global average of 260 percent.74 In addition to the involvement of local governments and SOEs in the real estate market, the undeveloped nature of Chinese financial and corporate bond markets, which offer individuals and firms few attractive options in which to invest or park savings, means that real estate is widely treated as a speculative asset rather than as one based on fundamental value or traditional measures, such as yield. This means that price controls and restrictions on the numbers of properties that an individual is permitted to buy have proven to be only temporary speedbumps for China’s booming real estate markets.

Indeed, it is estimated there are presently enough empty homes to house 90 million people, which would meet the country’s urbanization needs for the next decade and beyond based on current urbanization rates.75

Another important factor is the link between this debt held by the large property development firms and the so-called shadow banking system, which is beyond the regulatory oversight 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.76

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. Banks could ramp up lending in a loose credit environment while still charging high—even exorbitant—interest rates, well above ceilings authorities imposed for formal bank loans.

Shadow banking also allowed banks to create off-balance-sheet wealth management products (WMPs) and trust products to sell to individuals and groups of investors. These offer short-term investment returns five to 15 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 private firms, SOEs, and LGFVs, it provided an easy way of acquiring additional financing to double and triple down and achieve rapid gains from the property market.

From 2008 on, shadow banking loans in China grew at above 30 percent each year and more than tripled in volume by early 2014. By 2016, shadow bank loans reached over 60 percent of GDP before falling to around 45 percent of GDP currently.77

The Tide Turns for Evergrande
The CCP loathes instability, unpredictability, and loss of control in all economic and financial contexts. Alarmed at the unprecedented growth in corporate debt and soaring real estate asset prices, Beijing attempted to deleverage its economy, such as by reducing shadow financing and cooling the property market, starting in 2015. The deleveraging campaign explains the rela-
tive decline in reliance on these unregulated sources of finance as a proportion of GDP from 2016 onward.

Local governments, private firms, and real estate developers were the primary beneficiaries of easy access to credit, and they bore the brunt of the central government’s deleveraging policies.\(^7\) To ensure continued access to sources for fiscal revenues and local projects, the central government allowed local governments to issue their own bonds to fund infrastructure and real estate projects. This accounts for the increase in local government bonds issued from about USD 2.5 trillion worth in 2015 to over USD 5 trillion currently. This meant that rising indebtedness merely shifted away from the formal banking and shadow banking sectors toward the local government bond sector. The central government implicitly guaranteed most of these bonds (which are off-the-books liabilities for state-owned banks). The bottom line is that local governments continue to be major players in financing the real estate bubble and profit from it.

For firms such as Evergrande, the central government’s attempts to restrict access to easy finance were potentially an existential threat to operations. Before the 2016 leverage clampdown, Evergrande was the most leveraged real estate developer in China with a gearing ratio more than double that of its major competitors.\(^8\) Evergrande evidently remained dependent on the shadow banking system, as it was revealed that USD 44 billion of debt from shadow lenders was due to be repaid in 2019.\(^9\)

In 2018, its financing cost was still over 8 percent\(^1\)—one of the highest among property developers in the country—which reflected assessments of the severity of its leveraged position and the deteriorating outlook for the property sector due to periodic government efforts to deflate the bubble. Real estate developers were also hit with supply-side restrictions imposed by Beijing on formal and shadow providers of credit. This meant that Evergrande became even more dependent on increasing scale and quickly selling even more built and off-plan developments to remain solvent.

**Beijing’s Dilemma**

Beijing’s objective of deleveraging the economy, such as by focusing on the overheated real estate sector, is understandable. The Chinese economy’s debt-to-GDP ratio is around 300 percent, and corporate debt of nonfinancial institutions is more than 160 percent of GDP (for comparison, it hovered around 90 percent of GDP for the ten years leading up to 2008). It is estimated that more than a quarter of that debt is directly linked to real estate.\(^2\) Chinese corporations have been defaulting on bond payments at the fastest rate on record. While 2021 is the fourth consecutive year for bond defaults totaling at least RMB 100 billion, that level of default was reached in April, compared to reaching it in the last quarter in the previous three years.\(^3\)

Evergrande is a major issuer of RMB-denominated bonds and has become China’s largest issuer of high-yield dollar-denominated bonds. In the last three months of 2021, Evergrande had interest payments of about USD 670 million due on the back of dollar-denominated bonds issued.\(^4\)

The problem for the CCP is that it has enabled the emergence of giant, inefficient, and debt-laden firms such as Evergrande. To understand how, consider the common and accurate description of the economic situation in China as “the state advances—the private sector retreats.”\(^5\) Under Xi Jinping, the previously unequal treatment of the private sector has been extended further: state-owned and well-connected private 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.\(^6\)

This is demonstrated by data showing that profits from the genuine private sector 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. The shift 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 that of 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 long-term challenges for Beijing in achieving sustainable economic growth and managing the debt and fiscal issues in the medium-to-long term. In the short term, it renders Beijing even more reliant on a booming property sector despite fears of where that might lead.

This is how Evergrande has risen. Although it is a private firm, its intimate connections with CCP elites and approach of “three highs and one low” make up the well-trodden pathway to growth and success under CCP rule. As chairman and founder Xu Jiayin once declared, “everything the company possessed was given by the Party.”

Like Evergrande, much of the Chinese political economy is driven by churn and forced activity rather than measurements such as return on capital or profitability to allocate resources and guide commercial decision-making. The state suppresses price and market signals in major sectors to achieve political objectives.

Until recently, Evergrande obtained cheap and abundant access to capital because it was favored by Chinese leadership, and lenders assumed that the firm was too big and important to be allowed to fail. Beijing needed a booming real estate sector to achieve growth and meet fiscal targets, and Evergrande was a huge and prominent part of that process. In this sense, lending to Evergrande was perceived as almost as secure as lending to a centrally backed SOE.

This goes to the heart of Beijing’s dilemma. Clipping Evergrande’s wings by indicating that the government will not bail out or assist the indebted giant will be treated as a universal signal to lenders that they need to find more profitable and worthy borrowers that are not in the real estate sector. That would cause lenders to fundamentally reconsider their lending to other large property developers as they did so largely on the basis that such developers were too big and important to fail and that they received implicit backing from the government.

On the demand side, growing distress among firms like Evergrande will increase fears that the era of guaranteed capital appreciation for real estate assets is over—as will perceptions that the cost of capital is due to increase and access to finance is tightening. This risks cooling the real estate boom too rapidly, which could lead to systemic failures in contexts beyond the sector achieving overall growth and meeting fiscal requirements. For example, purchases of existing and off-plan properties are used extensively as collateral for further borrowing, and any deflation in asset values could pose a profound risk to the entire economy. Households have also plowed much of their savings into real estate given the paucity of investment options. The real estate bubble has helped to underpin private domestic consumption, meaning deflating the property bubble negatively affects the capacity for private consumption to pick up the economic slack.

More broadly, rapid declines in real estate values would slow credit and increase capital costs for LGFVs and property developers, which would mean even more of them would be unable to meet their debt obligations and would face the same problems Evergrande encountered. Simultaneously, credit-issuing institutions, including those in the formal banking sector and the informal shadow banking sector, would suffer a growing number of borrower defaults, which in turn would affect their capacity to issue new loans. That would spell severe trouble for the entire Chinese model of growth, which relies heavily on the inefficient but rapid deployment of capital for fixed investment.
In this sense, the easily uttered sentiment that China will seek “high-quality” development rather than merely rapid growth is often associated with Xi Jinping’s attempts to address moral hazard by allowing giants to fail, reduce profligate lending, and dampen dangerously high asset prices. Rather than encouraging ever-increasing capital inputs, these limits would prioritize improvements in total factor productivity (i.e., using labor and capital inputs more efficiently and innovatively) and eliminate sources of systemic risk at the same time.

This would mean the repudiation of Xi Jinping’s “party-corporate conglomerate.” That is, it would reject a political economy that enables the CCP to exert control over the entire economic system, allows SOEs and national champions to flourish in key sectors at the expense of an independent private sector, and utilizes national economic activity and resources to achieve domestic and external political objectives.

In this sense, the problem regarding Evergrande is symptomatic of the diabolical problems facing the entire Chinese political economy. The CCP’s determination to tighten its hold on the reins and levers of economic power overwhelmingly created and exacerbated these problems.

To be sure, Beijing remains determined to ensure Evergrande’s problems do not lead to any greater systemic difficulties. The People’s Bank of China has been injecting billions into the state-owned banks to ensure liquidity. Beijing has been conducting thorough forensic investigations into the holders of bonds issued by Evergrande. It has been warning officials to brace for social unrest should Evergrande fall, leaving bond holders and purchasers of off-plan properties with nothing.

The strong odds are that China can avoid a situation reminiscent of the US Lehmann Brothers moment, the collapse of a giant that led to a severe liquidity crunch. The CCP can instruct state-owned banks to continue to lend to each other and to borrowers and force the rollover of loans and extension of bond interest payments to prevent defaults appearing on the ledger. That is the perverse resilience of the Chinese economy, even if it means kicking the can down the road and creating a more severe reckoning for future generations. The CCP also has ample coercive apparatus and powers to prevent anger from spiraling out of control.

Even so, and as a symptom of what ails the Chinese political economy, Evergrande’s plight is further strong evidence of the structural slowdown that China has been enduring since even before the pandemic.

**Chinese Decoupling in an “Interesting Time”**

A Chinese curse against one’s enemy is to wish that they would “live in interesting times.” Although probably apocryphal, the curse refers to a period marked by disorder and uncertainty. In China’s case, a combination of domestic economic weakness and fragility on the one hand, and the increase in geopolitical rivalry and disagreement with the world’s advanced democracies on the other, means that China is seeking to decouple on its own terms at a dangerously interesting time.

As earlier sections point out, the CCP was never committed to genuine globalization in the sense that it would offer open access to its market and technologies in return for proportionate access to other markets and technologies. For Beijing, it was about getting what it needed from the advanced democracies to build its comprehensive national power at the expense of the US and other advanced democracies. This equates to China seeking to decouple on its own terms when it comes to the nature and timing of decoupling. This is not to say that the democracies did not benefit from economic interaction and integration with China. But for the CCP, it was always about seeking relative gains over the US and others before maneuvering itself into a position of preeminence and eventually dominance.

This is the context within which one should understand Xi’s “dual circulation” policy (DCP), which was introduced in May...
2020 at a meeting of the Standing Committee of the Politburo. That the DCP was introduced during a trade war with the Trump administration led many to assume it was a reaction to the American reassessment of economic policy toward China. The Trump administration may have forced Beijing to accelerate its own economic plans to counter some of Trump’s policies against China. Even so, the DCP is better understood as an evolution in long-standing Chinese plans to decouple from the US on its own terms.

The Dual Circulation Policy
When the DCP was first introduced in May 2020, few details were offered. Earlier explanations focused on “internal circulation” and “external circulation” as the two pillars, and these were tied to domestic and external demand respectively. Xi also mentioned that using domestic resources and capabilities to promote technological innovation was essential and the pathway toward self-sufficiency in advanced areas. The declared objectives of the DCP are to achieve a per capita increase of 4.5 percent annually up to 2025, which would allow the country to reach “middle-income” status of at least USD 13,000 per capita, and to double national income by 2035.

In the months that followed, more information about the DCP was released. For example, Xi explained in August 2020 that rising domestic demand was to compensate for the structural reduction in the current account surplus. Part of this was a reiteration of an older exhortation to rely less on net exports to drive growth and put more emphasis on domestic consumption. He also mentioned the importance of adding more value in domestic production and supply to increase domestic wealth creation, and therefore domestic demand. Once again, this was based on China’s long-standing desire to move up the global value chain by securing an increasing share of value creation and profits in the production of goods and services. There was also growing recognition that services are becoming more important to the Chinese economy, as occurs in every maturing economy. A significant proportion of the services industry is not tradable or is less tradable. Services as a proportion of Chinese GDP are currently around 54 percent, and this is due to increase to 60 to 70 percent over the next decade. In the US and Japan, services as a proportion of GDP are about 80 percent and 70 percent respectively. Therefore, “domestic circulation” will become increasingly important as (low value) merchandise exports decline in relative importance.

It was not until the unveiling of the Fourteenth Five-Year Plan in March 2021 that the DCP gained global prominence. In the five-year plan, a full chapter was devoted to dual circulation with a special emphasis on internal circulation. It had become evident that external circulation was largely about diversification of Chinese trade, an important part of which is to diversify away from potentially hostile nations such as the US. This partially explains Chinese moves to quickly conclude multilateral agreements such as the Regional Comprehensive Economic Partnership (RCEP) and the Comprehensive Agreement on Investment with the European Union. China also applied to join the Progressive Agreement for Trans-Pacific Partnership (CPTPP) in September 2021. RCEP is a “low-quality” economic agreement that removes some transaction costs for trade but largely codifies and formalizes pre-existing arrangements with regional economies without tackling awkward trade issues such as behind-the-border or regulatory restrictions. The latter restrictions characterize many East Asian economies. RCEP aims to reduce these but does not propose effective enforcement or punitive mechanisms. Moreover, China is unlikely to meet the conditions to join the CPTPP. The necessary domestic reforms, such as those dealing with SOEs, would be unacceptable to the CCP. Even so, these moves have demonstrated Beijing’s intent to deepen relations with non-US economic partners. The point remains that types of circulation were linked to domestic and external policy, and the goals of self-sufficiency or self-reliance, diversification away from the US, and technological upscaling were put forward as the primary motivations.

One immediate reaction was that in a time of global disruption such as the ongoing pandemic, Beijing was merely doing what it
had always done in difficult times: shield itself from external uncertainty and seek to ensure that it could control its own destiny in the face of exogenous shocks. This occurred after the global financial crisis beginning in 2007 devastated China’s advanced export markets. This led to Chinese leaders deemphasizing net exports and focusing on domestic demand as a driver of growth for the first time since China became a manufacturing superpower in the 1990s. With the disruption of the COVID-19 pandemic, that same instinct to protect itself from the uncertainties of the external environment became apparent once again.

There is a great deal of truth in this understanding of the DCP. China was never a true champion of genuine globalization and interdependence. This was true from the moment it became a major participant in the global economic system, and even after it joined the World Trade Organization in 2001. Its goal was for the global economic system to serve Chinese objectives while China emerged as a participant in, rather than a defender of, that economic system and order.

Even so, the DCP was not simply a rerun of earlier Chinese mindsets and policies under a different name. The main difference is that the DCP was introduced in a time of mutual hostility between the US and China, a period that is likely to endure. Moreover, the Trump administration reminded China of the extent to which it was vulnerable to US and Western controls and sanctions. This was apparent in the extent to which US and allied policies were able to damage Huawei’s standing and presence in global markets, especially in the 5G sector. The US and the West were now reciprocating the CCP’s long-standing and hostile approach to them. Beijing believed that the US and others would increasingly seek to contain Chinese power, especially through restricting key inputs and technologies to its economy and to Chinese firms such as Huawei. Chinese dependence on imports of integrated circuits (i.e., a collection of electronic components built into a single piece of semiconducting material) was an example of deep Chinese economic dependence and vulnerability (see figure 2).

While the rapidity with which the Trump administration reversed decades of US policy to overtly treat China as a competitor and rival shocked Beijing, the American decision to do so was seen as an inevitability. In this sense, it has not surprised Beijing that the Biden administration has kept most of the Trump-era policies in place and in many instances extended such containment policies into other areas.

The DCP’s heavy focus on technological self-sufficiency needs to be put in its proper context. China understood that the US government would likely give itself even broader powers to block corporate and sales transactions between American and Chinese firms and the export of whole classes of products or certain technologies, such as semiconductors and aeronautical equipment (even if these powers are held in reserve most of the time). China also expected that a growing number of Chinese firms in the MIC 2025 sectors would eventually be included on the “restricted entity” list. It also anticipated that the US would threaten and apply ever harsher penalties against companies violating the restrictions; these penalties included enormous fines, revocation of US licenses,
blocking of US dollar transactions, and criminal penalties for executives.

The CCP was acutely aware of Chinese dependence on the US and other advanced economies through imports and joint ventures with these foreign firms. One estimate is that about 80 percent of private sector research and development money spent in China in 2015—about USD 44 billion out of USD 55 billion—was spent by multinationals.\(^{101}\) The Trump administration was already signaling that this was an increasingly unacceptable situation because it would help China emerge as the global leader in innovation and know-how. Therefore, US attempts to identify and capture a larger share of the supply and value chain across a growing number of emerging and enabling technologies and sectors and to deny these to China was only going to accelerate.

Indeed, Beijing realized that game-plan was already in play. An analysis of tariffs levied against Chinese goods by the Trump White House under Section 301 of the Trade Act of 1974 revealed that 80 percent (by value) of the targeted trade with China was in industries identified as “patent-intensive” by the Department of Commerce.\(^{102}\) These include computer/electronic products and machinery/equipment, which constitute about 30 percent and 22 percent, respectively, of Chinese exports to the US.\(^{103}\)

One of the justifications the US offered was that these are the industries that China heavily targets for forced transfers and IP theft. In addition to targeting Chinese-based firms in these high-value-creating and patent-intensive industries, the tariffs seem designed to make 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 broad 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 US are directly related to the business operations of America-based firms.\(^{104}\) In other words, around one-third form part of the current supply chain for America-based firms.

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, in theory, these firms do not have to base operations in China. In addition to concerns about IP transfers and theft, tariffs levied on China-based firms make it commercially less attractive for foreign-invested firms to base operations in China when the next or end destination for their product is the US. The idea is to minimize Chinese involvement—and therefore learning—in prized supply and value chains in certain sectors.

It should also be noted that Beijing was already immensely worried about China’s reliance on imports of high-tech components, machinery, know-how, and IP, which is why it pro-
duced the MIC 2025 blueprint in the first place (see figure 3). Using China’s 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 (which are current-generation technologies) are excluded.\textsuperscript{105} The other high-tech sectors include biotechnology and life sciences, opto-electronics, electronics, computer-integrated machinery, and aerospace materials and applications.\textsuperscript{106}

China’s reliance on foreign technology and know-how is also reflected in its net deficit in IP charges, which means it pays more for the authorized use of IP than it receives in IP charges. In 2017, China received USD 5 billion in IP charges and paid USD 29 billion. The corresponding ratios for other advanced economies, such as the US, Japan, Germany, and South Korea (in USD billions), were 128:51, 42:21, 20:13, and 7:9 respectively.\textsuperscript{107} In summary, the above data provides necessary context for comprehending the DCP in an era of domestic and external stress. To a large extent, it is an extension and evolution of earlier plans to lower reliance on external demand and boost domestic consumption. However, unlike previous approaches, the boosting of domestic demand will not simply come from fiscal and financial policies to boost spending power as this has had limited success (see table 1). It will come from supply-side reforms and initiatives to upscale the Chinese economy. Those improvements in value-added production and total factor productivity (i.e., increases in overall output from using capital and labor inputs more efficiently and innovatively) are designed to increase domestic corporate and household incomes, which should increase domestic consumption. In this sense, the DCP is typical of previous Chinese reform efforts to focus on supply-side enhancements in the hope that benefits will trickle through to the demand side of the economy.

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<tr>
<td>PCE/GDP</td>
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<tr>
<td>China</td>
<td>36%</td>
<td>37.1%</td>
<td>34.3%</td>
<td>34.3%</td>
<td>37.5%</td>
<td>40.3%</td>
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<tr>
<td>India</td>
<td>62.9%</td>
<td>61.2%</td>
<td>56.6%</td>
<td>54.7%</td>
<td>55.8%</td>
<td>56.2%</td>
</tr>
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<td>USA</td>
<td>64.6%</td>
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<td>67.4%</td>
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<tr>
<td>China</td>
<td>13.8%</td>
<td>16.5%</td>
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<tr>
<td>India</td>
<td>11.6%</td>
<td>11%</td>
<td>9.8%</td>
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<tr>
<td>USA</td>
<td>16.8%</td>
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<td>FCE/GDP</td>
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<tr>
<td>China</td>
<td>49.7%</td>
<td>53.6%</td>
<td>50%</td>
<td>48.9%</td>
<td>50.3%</td>
<td>52.9%</td>
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<tr>
<td>India</td>
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<td>72.1%</td>
<td>66.4%</td>
<td>65.7%</td>
<td>66.9%</td>
<td>66.8%</td>
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<tr>
<td>USA</td>
<td>81.4%</td>
<td>83.9%</td>
<td>83.1%</td>
<td>84.7%</td>
<td>82.1%</td>
<td>83.2%</td>
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More than this, the DCP recognizes the importance of high-tech and advanced sectors in achieving the country’s domestic and external objectives, which is why aspects of the DCP bear close resemblance to elements of MIC 2025. Both exhibit the same central planning and target-setting approach in seeking to implement an economic and industrial policy that improves capital allocation, policy coordination, and innovation throughout the political economy and in accordance with strategic objectives. China’s desire to avoid the so-called middle-income trap drives the DCP and MIC 2025 blueprint. This trap occurs when rising but still developing economies lose their competitive advantage due to factors such as rising wages, a declining supply of cheap labor, and less favorable demographics. At this point countries are unable to compete with more innovative and productive advanced economies.

As with MIC 2025, the state and state-controlled sectors will continue to lead but 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 all CCP programs and policies, and those firms pursuing the CCP’s agenda will be offered financial, commercial, regulatory, legal, and political support and assistance. Notwithstanding, one should bear in mind that the intent of any reforms associated with the DCP is still to make state-owned enterprises “stronger, bigger and better.”

It is also unsurprising that the DCP reads like a comprehensive blueprint for domestic reform to “upgrade” the entire Chinese economy. It is a whole-of-government and whole-of-economy plan to reform and enhance China’s capabilities in vital sectors. However, and like MIC 2025, the Chinese decoupling is intended to occur mainly on the supply side of the equation. In other words, the mindset is that China will lower or eliminate reliance on US technology and inputs while the US (and its allies) will have no option but to become more reliant on Chinese technology and inputs.

Finally, the DCP seeks to marry domestic and external policy with geopolitical strategy in a more tense and hostile environment. However, the DCP framework is far more proactive than earlier Chinese measures to simply shield the country from external dangers or minimize the consequences of these. The DCP is put forward to ensure China emerges as the eventual winner of the “managed” decoupling from the US. It serves as both a proverbial shield and a sword when it comes to economic competition with the US and attempts by both sides to contain the material capabilities of the other. It is a shield because the DCP seeks to reduce Chinese reliance on external attempts to restrict Chinese access to key technologies and markets. It is also a sword because the intended effect is Chinese dominance in the ownership and production of essential and cutting-edge products and technologies for both Chinese and external markets. In this context, Beijing hopes to be able to apply pressure and exercise leverage over the US in the same manner advanced economies have been able to do so against less developed and competitive nations.

Putting Meat on the Bones of the DCP

Some two years after the announcement of the DCP, we are in a better position to draw out related reforms and approaches in greater detail. The DCP consists of three interrelated pillars:

1. Increasing domestic demand or consumption
2. Strengthening self-sufficiency and national economic resilience, especially in high-tech and high-value-added sectors
3. Increasing the world’s dependence on Chinese markets, technologies, and supply chains

As mentioned, these three pillars are interrelated. For example, strengthening self-sufficiency and resilience is primarily a supply-side issue of Chinese state-owned and private firms being able to draw from vertically integrated supply chains within China for technologies and parts in critical and strategic sectors. These world-leading Chinese firms and the onshoring of related supply chains mean that more value is created inside China, which will raise the profits and incomes of corporate and individual entities within the country. Corporate entities will reinvest within the
country and increase trade with other Chinese (rather than foreign) firms, while individuals will have more resources with which to increase consumption. At the same time, Chinese firms will be in a better position to dominate regional and global markets. This has the twin benefit of not only creating new sources of external demand for Chinese goods and services but also increasing China’s economic (and therefore political) leverage over its economic partners. All the while, the US becomes increasingly isolated and uncompetitive, thereby enhancing Chinese comprehensive national power at the expense of America.

The following are key details and policies relevant to the fleshing out of China’s DCP. It is important to keep in mind that, as with other grand blueprints and overarching frameworks introduced and promoted by Xi such as the BRI, existing and planned policies are rebadged as “dual circulation” policies whether they were conceived with the DCP in mind or not.

High-tech Import Substitution and Self-sufficiency Policies.

The general idea of import substitution is that banning or restricting the imports of goods and services will increase domestic demand for identical or similar goods and services produced wholly within China. Import substitution has a fraught history and a flawed record of success. In China’s case, its rise in terms of GDP growth and emergence as a high-tech economy has been achieved on the back of foreign technologies and know-how. From this perspective, doubling down on the MIC 2025 mindset of decreasing reliance on external technologies and related supply chains and becoming self-reliant on Chinese technologies and supply chains is a risky departure from the strategy of the recent past (see table 2).

Under the DCP framework, many of the initiatives to lower the dangers and risks that befall almost all import substitu-

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Table 2. Comparing Made in China 2025 priority sectors with 14th Five-Year Plan priority sectors

<table>
<thead>
<tr>
<th>MADE IN CHINA 2025</th>
<th>14TH FYP</th>
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<tbody>
<tr>
<td>Next Generation IT Integrated Circuits</td>
<td>Quantum Information</td>
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<tr>
<td></td>
<td>Integrated Circuits</td>
</tr>
<tr>
<td></td>
<td>Beidou* Navigation Satellite System</td>
</tr>
<tr>
<td>High-End Computerized Machines and Robots</td>
<td>Major Technical Equipment</td>
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<tr>
<td></td>
<td>Smart Manufacturing and Robotics</td>
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<tr>
<td>Space and Aviation</td>
<td>Space and Aviation</td>
</tr>
<tr>
<td></td>
<td>Airplane Engines and Gas Turbines</td>
</tr>
<tr>
<td>Maritime Equipment and High-Tech Ships</td>
<td>Ships and Maritime Equipment</td>
</tr>
<tr>
<td>Advanced Railway Transportation Equipment</td>
<td>Advanced Railway Transportation Equipment</td>
</tr>
<tr>
<td>New Energy and Energy-Saving Vehicles</td>
<td>New Energy Vehicles and Smart (Connected) Vehicles</td>
</tr>
<tr>
<td>Energy Equipment</td>
<td>Advanced Energy Equipment</td>
</tr>
<tr>
<td>Agricultural Machines</td>
<td>Agricultural Machinery and Equipment</td>
</tr>
<tr>
<td>New Materials</td>
<td>High-End New Materials</td>
</tr>
<tr>
<td>Biopharmaceuticals and High-Tech Medical Devices</td>
<td>High-End Medical Equipment and Innovative Drugs</td>
</tr>
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</table>

Source: Simon Rabinovitch (@s_rabinovitch), “‘Made in China 2025’ is dead. Long live ‘Made in China 2025’! China’s new Five-Year Plan is not nearly as detailed as its controversial MIC 2025 plan, but it targets all the same sectors & technologies, plus a few more.” Twitter, March 11, 2021.
tion approaches concern efforts to ensure that “Made in China” means “Best in the World.” As Xi declared in a speech to the Chinese Academy of Sciences in 2018, China needs to become the world’s leading scientific country. This can occur only if it makes up enormous ground in basic research vis-à-vis the US and other advanced democracies. As Xi argued, China must ensure “key and core technologies” are “in [China’s] hands” to guarantee the country’s economic, defense, and national security.\textsuperscript{109}

Indeed, there has been a much greater emphasis on funding advances in basic science, and not only the application and commercialization of breakthroughs in basic science. Basic science is research aimed at understanding fundamental problems and making progress in fundamental scientific inquiry in various fields. In contrast, applied science is the application of basic scientific knowledge to solve practical problems. China’s relative weakness in basic science is significant. While China has nominally surpassed the US with respect to R&D spending, around 80 percent of China’s R&D system is geared toward using acquired knowledge and innovation to produce or improve products and services (“experimental” commercial development). Unlike other advanced economies such as the US, it devotes fewer resources to basic or applied research (see figures 4 and 5). This is reflected in a surprising finding that Chinese universities contributed to an average of only just over 9 percent of R&D activity between 1991 and 2016. There are poor linkages between Chinese universities and businesses; one report suggests that only 2.6 percent of research articles were collaborations between universities and industry.\textsuperscript{110}

The point is that the Chinese system to accelerate creativity and basic innovation lags those of other advanced economies, such as in North America, Europe, and Japan. China achieved its im-

\begin{table}[h]
\centering
\begin{tabular}{|c|c|c|c|c|c|c|c|}
\hline
\textbf{} & \multicolumn{2}{|c|}{\textbf{2019}} & \multicolumn{2}{|c|}{\textbf{2020}} & \multicolumn{2}{|c|}{\textbf{2021}} \\
\hline
\textbf{GDP} & \textbf{R&D} & \textbf{GDP} & \textbf{R&D} & \textbf{GDP} & \textbf{R&D} \\
\hline
All Countries & 137,773.6 & 2,370.8 & 133,628.8 & 2,325.2 & 140,484 & 2,440.5 \\
Top Ten & 61.5\% & 78.3\% & 62.5\% & 79.2\% & 62.7\% & 79.2\% \\
North America & 19.1\% & 27.2\% & 18.7\% & 26.9\% & 18.2\% & 26.4\% \\
US & 15.2\% & 25.2\% & 15.1\% & 25\% & 14.8\% & 24.5\% \\
South America & 5\% & 2.2\% & 4.7\% & 2.1\% & 4.6\% & 2\% \\
Europe & 19.2\% & 20.6\% & 18.6\% & 19.7\% & 18.5\% & 19.6\% \\
Africa & 3.5\% & 0.9\% & 3.5\% & 0.8\% & 3.4\% & 0.8\% \\
Middle East & 5.5\% & 2.4\% & 5.4\% & 2.3\% & 5.3\% & 2.3\% \\
Russia/CIS & 3.8\% & 2.7\% & 3.7\% & 2.7\% & 3.7\% & 2.6\% \\
Asia & 43.8\% & 43.9\% & 45.4\% & 45.4\% & 46\% & 46\% \\
China & 19.5\% & 22.5\% & 21.7\% & 24.7\% & 22.3\% & 25.5\% \\
\hline
\end{tabular}
\caption{Major R&D Spending, 2019–2021}
\end{table}

pressive advances in high-speed rail, quantum and high-speed computing, information and communications technology, artificial intelligence, electric vehicles, solar panels, and space on the back of acquired or stolen technologies and know-how from advanced economies. Advances driven by graduate students in these fields depend on their continued access to foreign universities and academics. Reports indicate that Chinese regulatory hurdles favoring state-controlled companies and private national champions, crowding out the private sector, and offering insufficient IP protections continue to adversely affect creativity and basic innovation in the Chinese political economy.111

When it comes to getting ahead in high-tech areas, China relies heavily on the process of acquiring and adapting basic and applied research from external sources (through forced transfers, acquisitions, or IP theft), pouring resources into building a presence in these sectors, blocking foreign competitors from entering these markets domestically, capturing and vertically integrating supply chains for products and applications, and funding the “going out” strategies of its domestic firms in order to underprice foreign competitors before eventually dominating these markets globally. It was the model China pursued to become a dominant supplier of solar panels and LCD panels to the world.

China is addressing this vulnerability. For example, the Fourteenth Five-Year Plan identifies the following as core technologies in which China must lead the world when it comes to basic research:

- next-generation artificial intelligence
- quantum information
• semiconductors
• neurosciences
• genetic research and biotechnology
• advanced clinical medicine and healthcare
• deep-space, deep-sea, and polar exploration

In the near term, China’s reliance on imports of semiconductors is seen as its greatest vulnerability. It is why Beijing significantly increased monies for the National Integrated Circuit Industry Investment Fund (which aims to support a local semiconductor production industry) from RMB 140 billion in 2014 to RMB 204 billion in 2019. In addition to existing generous tax incentives and subsidies to this sector, a company will receive a two-dollar tax deduction for every dollar spent on R&D in this sector. \(^{112}\)

The Medium- and Long-Term Plan for Science and Technology 2021–35 blueprint focuses on Chinese advances in foundational technologies, which is a contrast to the previous plan for 2005–2020, which largely emphasized applied science. \(^{113}\) The National Development and Reform Commission (NDRC), a key entity controlled by the State Council that exercises broad administrative and planning functions over the Chinese economy, issued an authoritative “guiding opinion” that identified sectors such as next-generation IT, biotech, high-end manufacturing, new materials, new energy, electric vehicles, environmental protection, and digital creativity as high-priority sectors within which basic scientific advances were to be achieved. \(^{114}\)

The guiding opinion issued numerous objectives and targets to ensure China leads the world in these sectors. It points to the importance of cascading or tiered industrial and scientific clusters within the Chinese economy. This includes developing 10 strategic emerging industrial areas with global influence to guide 100 strategic emerging industrial clusters that will be world class. This foundation will provide for 1,000 strategic emerging industrial ecosystems that will be interrelated but distinct.

Moreover, and based on global leadership in the basic science underpinning these industrial clusters, the numerous industrial ecosystems will draw Chinese state-owned and private firms into these clusters. The clusters will encompass those entities that link basic and applied scientific activity as well as entities that work with scientific bodies to commercialize the technologies and know-how. \(^{115}\)

The Fourteenth Five-Year Plan promises to increase spending on R&D by more than 7 percent annually. Significantly, it promised to ensure spending on basic R&D would increase by 10.6 percent in 2021 and the proportion of overall R&D spending devoted to basic research would exceed 8 percent over the next five years. Other Chinese government plans also refer to the “guarantee of funds” to assist entities engaged in these activities. For example, Beijing has created a “heads of industry value chains” system to supervise local governments and help them identify local firms and technologies essential to strategic value and supply chains that will boost development in that subregion. \(^{116}\) Local governments are to set up special funds for

Figure 6. GDP of the “New Economy”

Source: Alicia Garcia Herrero, “What Is Behind China’s Dual Circulation Strategy?,” China Leadership Monitor, no. 69 (September 1, 2021)
entities in these strategic sectors. The bodies responsible for raising capital and listing Chinese firms are to be given financial and regulatory incentives to support fundraising for relevant firms. Manufacturing firms engaged in these priority areas will have a tax deduction of 100 percent of R&D costs (rather than the existing 75 percent). In March 2021, the China Development Bank earmarked RMB 400 billion (approximately USD 60 billion) of loans to support strategic emerging industries and companies active in advanced manufacturing for that year.\textsuperscript{117} In considering figures for the “new economy,” the share of government subsidies increased from about 33 percent in 2015 to 45 percent in 2020.\textsuperscript{118} This accounts for much of the apparent “investment boom” in the newer and nontraditional areas of the Chinese economy over the past few years (see figures 6 and 7). The idea is for domestic entities to invest in China for China.

The CCP is also extending its influence over non-state sources of capital to help finance priority sectors and firms. For example, it has supported the establishment of “guidance funds,” which are formally non-state investment vehicles to support domestic firms. The idea is to form a fund at the behest of a government agency. The supporting government entity contributes an amount to the fund and seeks to raise up to 80 percent of the targeted amount from private investors, contributions referred to as “social capital.” While the fund is managed by the government entity, private entities are encouraged to invest on the basis that the guidance fund will be involved in sectors that enjoy government support and largesse—a significant factor in China’s state-led political economy. This offers both the promise of reliable returns and the satisfaction of advancing the CCP’s goals. One report indicates that the government had set up 1,741 guidance funds by the end of the first quarter of 2020. Although short of the target of RMB 11 trillion (approximately USD 1.55 trillion), these funds raised RMB 4.76 trillion (approximately USD 672 billion) from the private and state sectors.\textsuperscript{119}

In this context, phrases such as allocating resources according to market principles and optimizing investment and capital markets do not refer to financial liberalization as the US might understand these terms. In the Chinese context, they refer to creating financial, tax, and regulatory incentives for financial and government entities to fund firms engaged in these high-priority areas. To the extent that the market will impartially allocate resources, the intention is that firms engaged in these activities will enjoy unique advantages and be more profitable, meaning they will be the most attractive entities in which to invest.

Capturing and Onshoring Global Human Capital and Know-how

China has made a greater effort than any other country to bring human talent from abroad into the country to advance its economic upgrade and industrial objectives. This effort is part of the broader goal of becoming a global technological superpower by 2030 and the leading technological power by 2050.

China’s desire to draw in and capture leading scientists and researchers is encapsulated in the Thousand Talents Program, which is just one of more than two hundred similar recruitment programs. According to official government statistics, these talent recruitment programs attracted sixty thousand overseas

\begin{figure}[h]
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\includegraphics[width=\textwidth]{figure7.png}
\caption{Chinese Government Subsidies and Tax Rebates}
\end{figure}

\textsuperscript{Source: Herrero, “What Is Behind China’s Dual Circulation Strategy?”}
scientists and technology entrepreneurs to China from 2008 to 2016. The US is the largest target market, while other advanced economies such as the United Kingdom, Germany, France, Canada, Japan, South Korea, Singapore, Taiwan, and Australia are also important.

While many countries provide incentives for foreign talent to live and work in their country, the nature, scale, and intention behind the CCP’s efforts are incomparable. As Alex Joske observes:

Like other countries, China often recruits scientists through fair means and standard recruitment practices. It gains technology and expertise from abroad through accepted channels such as research collaboration, joint laboratories, and overseas training. However, overt forms of exchange may disguise misconduct and illegal activity. Collaboration and joint laboratories can be used to hide undeclared conflicts of commitment, and recruitment programs can encourage misconduct. Participants in talent-recruitment programs may also be obliged to influence engagement between their home institution and China. The Chinese Government appears to have rewarded some scientists caught stealing technology through talent-recruitment programs. In some cases, Chinese intelligence officers may have been involved in talent recruitment.

As Joske further explains, the Overseas High-Level Talent Recruitment Work Group was established in 2008 to oversee programs such as the Thousand Talents Plan and is answerable to the all-power Central Committee’s Organization Department. The recruitment objectives and orders are carried out by the Ministries of Human Resources and Social Security, Education, Science and Technology, Industry and Information Technology, Public Security, and Finance. Other entities involved include the People’s Bank of China, State-Owned Assets Supervision and Administrative Commission, Chinese Academy of Social Sciences, United Front Work Department, National Development and Reform Commission, Chinese Academy of Engineering, National Natural Science Foundation, Communist Youth League of China, and China Association for Science and Technology.

These entities coordinate efforts with an estimated six hundred overseas talent recruitment stations that help recruit or organize collaborations with overseas scientists, researchers, and entrepreneurs. Recruiters are given significant financial incentives for each person recruited, sometimes as much as USD 30,000.

As mentioned, utilizing overseas talent through recruiting or funding collaborations is not illegitimate in and of itself. The problem is that the CCP incentivizes its entities and members to steal foreign technologies through these recruitment efforts and collaborations, which it needs to advance China’s national, military, and economic goals. Furthermore, the theft of foreign know-how and the opaqueness of the operations are the problem. Recruits into the Chinese system are not made aware of how their research will be used and by which entities. Participants who sign agreements with Chinese entities but remain in their own country are obligated to share their research and discoveries only with China and cannot share them with their primary employer without Chinese permission. They are also given attractive incentives to recruit peers into the Chinese program under these same conditions.

China’s talent plans have successfully recruited participants around the world to work on key programs like military technologies, nuclear energy, wind tunnel design, and advanced lasers. Many elements of method and intent are illegitimate and detrimental to the interests of the US, its allies, and the broader principles of globalization and knowledge-sharing under international law and the liberal rules-based order (see figure 8). Observers should understand these recruitment and collaboration policies as intrinsically linked to MIC 2025 and DCP plans as well as applicable to China’s military-civil fusion framework. In other words, they are a critical part of China’s mission to decouple on its own terms.
The DCP and Foreign Economic Policy

China has the ambition to dominate other advanced economies in key technological areas, but it still needs the expertise and inputs of these economies at this stage of its development. In this context, Beijing has long encouraged external firms to operate in China if they can help upscale the Chinese economy. Indeed, the DCP will mean even more short- and medium-term reliance on sourcing basic and applied technologies from external firms. This explains measures such as those announced in the Ministry of Commerce’s five-year plan, which promises to increase the presence of foreign investors at the higher end of the value chain. The explicit intention is to fast-track the Chinese absorption of entire supply and value chains.

These plans for absorbing foreign technologies and know-how are buttressed by policies that promote the development of small and medium enterprises (SMEs) in strategic sectors that welcome foreign firms. The intention is to develop necessary scientific clusters within the country. For example, the DCP framework led to six ministries and agencies issuing joint guiding opinions to speed up the development of SMEs involved in high-tech and high-value sectors, many of which correspond to the priority sectors welcoming foreign investors.

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**Figure 8. How the CCP Acquires Foreign Human Capital and Expertise**

Entities such as the NDRC determine and promulgate priority sectors, and this commission released an updated 2019 Catalogue for Guiding Industry Restructuring for 2020 onward. This is a key document for government agencies to ensure fiscal, tax, credit, land, and import and export concessions target industries and sectors that will enhance China’s technological upgrade. The document exists parallel to an updated Catalogue of Industries for Encouraging Foreign Investment, and both exist to guide agencies regulating approvals and concessions for foreign investment in China. The purpose is to ensure those foreign firms operating in so-called encouraged sectors and with desired technologies and know-how are given smooth entry or privileged incentives to enter the Chinese market.

While there will be increased concessions or assistance for foreign firms setting up operations and investing in strategic sectors within China, there will be some significant differences from the last few decades. The threat of forced technology transfers and theft of corporate secrets will be ever present. Moreover, China continues to be heavily dependent on foreign firms when it comes to upscaling the domestic economy. For example, about one-third of Chinese exports are manufactured by foreign firms, while two-thirds of “high-tech” Chinese exports come from foreign firms. As Xi Jinping puts it, “Our dependence on core technology is the biggest hidden trouble for us… Heavy dependence on imported core technology is like building our house on top of someone else’s walls. No matter how big and how beautiful it is, it won’t remain standing during a storm.”

But unlike in earlier years, China is forcing foreign entities to become more like local entities in the way they are supervised and regulated. As one report puts it, “Foreign operations in China are de facto on a pathway to becoming more like a local Chinese entity rather than integrated in global networks. They are not decoupling from China, but rather decoupling their China operations from their global ones.”

This is apparent in how rules and incentives increase the number of Chinese staff at senior levels in these foreign firms, and in the privacy and “local content” rules and standards the firms must follow. For example, the 2021 Data Security Law demands that all Chinese and foreign firms remain subject to heavy restrictions on transferring data outside of China and that all handlers of data in China cooperate with Chinese public security forces. Indeed, Tesla announced in May 2021 that all data from its cars sold in China would be stored locally in a new data center as required by Chinese law. That government has forced other companies operating in China, such as IBM, Microsoft, Amazon, and Apple, to make similar concessions. All major economies exercise some form of regulation over locally acquired data and information, but the Chinese data framework is much more restrictive. While there is little transparency as to what Beijing will do with personal or business-sensitive data, the CCP is explicit that the Chinese state can use cyberspace, data, and information networks to advance its broader objectives where necessary.

Moreover, the state is compelling more foreign firms to establish CCP committees within their governance and executive structure. In 2011, about 47,000 foreign firms had CCP committees, and this number rose to an estimated 74,000 foreign firms, or about 70 percent of all foreign firms in the country, by 2016. In 2017, major foreign firms Samsung and Nokia confirmed the presence of CCP committees in their China operations. This provides some sobering context to the announcement in early 2020 that foreign firms would be granted “national treatment” under the new Foreign Investment Law. The law replaces three previous laws governing foreign investment and foreign invested enterprises. It reduces the regulatory and legal hoops external entities need to jump through and offers enhanced protections for external entities that come closer to what Chinese firms receive. Moreover, the new law offers some preferential policies for external entities engaged in sectors identified in the Catalogue for Guiding Industry Restructuring and Catalogue of...
Industries for Encouraging Foreign Investment as “Encouraged Industries” (i.e., strategic sectors that are essential to the Chinese economic upgrade). The catch is that foreign entities are expected not only to become more like Chinese firms but also to serve the CCP’s broader political and economic objectives.

Additionally, and once Chinese companies are globally competitive, foreign firms will integrate into Chinese ones or will gradually be squeezed out of the Chinese market. An example is the information and communications technology (ICT) sector. The rise of world-class firms such as Huawei and ZTE led Beijing to find ways to deliberately squeeze out foreign firms such as Ericsson, including by gradually denying it contracts during tendering processes. Ericsson had been a pioneer in the Chinese ICT sector.

Finally, the China Standards 2035 plan is an important blueprint to support the high-tech aspects of the DCP and was introduced in 2019. Beijing realizes that an essential pillar of continued American and European dominance in the global high-tech economy is the dominant role these entities have in defining technical and other standards, made possible on the back of American and European firms dominating high-tech industries and sectors. The intent of China Standards 2035 is to ensure China plays the leading role in writing standards associated with new and emerging technologies. Just as MIC 2025 seeks to dominate production of strategic and critical technologies, China Standards 2035 is trying to ensure China sets the foundational rules by which these technologies are defined, produced, transferred, sold, and used.

For Beijing, the first step is to ensure that Chinese firms dominate the intellectual property, know-how, and supply chains of strategic and critical technologies. At the same time, the Standardization Administration of China (under the authority of the State Council) will work with Chinese industry to define standards for the country and impose them domestically. Importantly, the state (rather than industry) will play the leading role in setting standards, which is a reversal of what tends to occur in Western economies.

The next step is for China to use its dominance to internationalize these preferred standards through platforms and blueprints such as the BRI. Bilateral agreements, especially with developing countries, will also internationalize Chinese standards. Note that controlling standards leads to direct economic benefits. Chinese entities would receive royalties or license fees for standard essential patents that are necessary for compliance with technical standards. Other benefits include operation and maintenance. For example, communication infrastructure requires operation and maintenance, and it is difficult and financially prohibitive for countries and foreign firms to remove technologies once they are embedded in power grids, communication networks, etc. As countries increasingly depend on Chinese technologies that comply with Chinese standards (which have become globally accepted), Chinese firms hold the advantage in securing operations and maintenance contracts.

This Chinese approach is evident in Huawei’s construction of the telecommunications infrastructure in Laos, which is integrated with highways and railways. Huawei has provided ICT platforms and management systems for the China-Laos Expressway, which will be integrated with Chinese 5G mobile communications infrastructure. Chinese firms are also building a railway running from the China-Laos border to Vientiane. This Kunming-Vientiane link is intended to connect with a railway link to Bangkok in Thailand, and southward along the Malay peninsula to Singapore.

In summary, the Digital Silk Road elements of the BRI that aim to dominate standards, infrastructure, and markets are being repurposed to support the external circulation elements of the DCP.

A “New Type” of Urbanization
A section above explained that Beijing seeks to increase domestic income, and therefore demand, through a dramatic
technological upgrade and upscale of the economy. The state is also using a “new type” of urbanization to drive up domestic consumption (i.e., internal circulation).140

Urbanization is seen as a key solution to China’s problems because those in urban areas consume significantly more than citizens in rural China. In 2021, urban Chinese consumers earned about three times more than their rural counterparts and consumed about twice as much (see figure 9).141 This disparity has remained at similar levels over the past decade.

In 2021, around 60 percent of the population lived in cities, and the target is 65 percent by 2025 according to the Fourteenth Five-Year Plan. This amounts to around 10 million people moving to cities each year.

One problem is that urbanization causes extreme upward pressure on home prices in mainly first-tier cities. As the Evergrande episode demonstrates, rapidly rising home prices lead to even more speculation on residential property, resulting in more serious financial risks to the Chinese system. The biggest risks are in so-called first-tier cities (Beijing, Shanghai, Guangzhou, and Shenzhen, as well as 15 emerging new tier 1 cities), which is why the CCP has been trying to suppress residential price growth in these cities over the past few years.

The CCP has responded by putting restraints on residential home price rises in tier 1 cities, such as VAT increases on sales of homes within given years of purchase, strict controls on credit used to buy residential assets, and increases in deposits under some circumstances. These measures aim to dampen
speculation in the residential market and to incentivize rural citizens to move to tier 2 and 3 cities.

There have also been efforts to relax the registration or *hukou* system in tier 2 and 3 cities. The system denies working migrants and their families (mainly from rural China) the right to own property and access services, such as health care and education, in the cities they work in. The Fourteenth Five-Year Plan flags the abolition of the *hukou* system in cities of up to three million people, while it will loosen the registration system in cities of three to five million people.

The idea behind fast-tracking urbanization in tier 2 and 3 cities is to create additional centers of economic growth away from the richer coastal mega-cities (see figure 10). This coincides with plans to ensure that the technological upscaling of the country occurs throughout China and not primarily in the tier 1 coastal cities. If tier 1 cities continue to enjoy the lion’s share of benefits from the upscaling, then the already severe problems of income inequality between tier 1 cities and other places will worsen. At the same time, such income inequality will stifle the targeted increases in domestic consumption that “internal circulation” requires.

Enlarging the RMB financial ecosystem. Earlier, I mentioned the Chinese discomfort with their dependence on currencies issued by the US and its allies, a discomfort that has become more acute following the cascading financial sanctions against Russia after its invasion of Ukraine. It is also easy to see why Beijing would like to change this global financial structure. About 60 percent of its reserves are held in dollars, and most of its external transactions are conducted in that currency. Currently, alternatives are nonexistent. For example, Beijing would need to increase its holdings of gold from about 3,000 tons to 35,000 tons to replace its US dollar assets.

I also noted that the BRI will promote greater use of RMB in various ways. It may use RMB to settle trade, accelerate RMB swaps with other currencies to ensure liquidity in the relevant currencies during settlement of trade, conduct investment within the BRI platform or agreement, and issue RMB-denominated bonds as part of BRI financing packages. These include BRI-specific domestic bonds, “panda” bonds in RMB that are 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 that are issued by Chinese and international companies in Hong Kong but denominated in RMB.

This is already occurring with many 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 had signed bilateral swap agreements, which in turn helped to deepen trade and economic integration between these countries and China by a statistically significant 30 percent.143

In recent times, the use of RMB has increased to over 3 percent of global transactions for the first time, driven largely by an increase in foreign purchases of Chinese bonds (see figure 11 and table 3). It is estimated that RMB 700–800 billion of Chinese bonds will be sold to external buyers in 2022.144 China has also inked ad hoc agreements with US rivals, such as Russia, to bypass their mutual reliance on the greenback. For example, Gazprom Neft, the third-largest oil producer in Russia, agreed in February 2022 to be paid in RMB rather than US dollars for refueling Russian planes at Chinese airports.145

Even so, the RMB continues to stubbornly lag far behind the currencies of the US, EU, and UK as a percentage of global transactions.

In April 2021, China announced a limited launch of its digital currency electronics payment, or DCEP, the world’s first sovereign digital currency. Electronic transactions already account for four out of five payments in the country, and there are more than 850 million mobile payment users, a number that is rising rapidly.

Interestingly, the RMB digital currency was developed and rolled out to counter and weaken the duopoly on virtual transactions within the mainland enjoyed by Ant Group and Tencent, which have about 95 percent of the market. The CCP is explicit that the DCEP will allow the regime to seize back control over private finance to reduce “financial instability and risk.” With their user-to-user private network of payments and finance, Ant Group and Tencent were also threatening the roll-out and adoption of the RMB digital currency domestically and externally, threatening Beijing’s ambition to expand the RMB financial ecosystem.

Bear in mind that growing use of the RMB digital currency will enable the instantaneous monitoring of transactions, movements, and behaviors of users. This allows the CCP to integrate the regulation (or prohibition) of the domestic digital currency use with its ever-expanding Social Credit System and Corporate Social Credit System. These are nationwide data-gathering efforts to regulate individual and corporate activity through a system of rewards and punishments based on the extent to
which one abides by CCP rules and regulations and pursues the Party’s objectives. In other words, it is about the CCP’s unprecedented visibility and control and individuals’ shrinking private and confidential space.

Beijing also hopes that the gradual rollout of the DCEP will reduce Chinese reliance on the SWIFT (Society for Worldwide Interbank Financial Telecommunications) payments platform, which is overseen by Western economies and has been used to enforce US financial sanctions and sever sanctioned entities from using the platform. Similarly, Chinese officials have argued that the DCEP could reduce Chinese reliance on CHIPS (Clearing House Interbank Payments System), an American private-sector money transfer system used for electronic payments in US dollars.

Such plans were already formulated before the DCP. In 2015, China launched a new payments system, the Cross-Border Interbank Payment System (CIPS), that uses RMB for international transactions. Beijing also announced the creation of the China International Payment Service Corporation (CIPS Corp.). These platforms enable firms outside China to clear RMB transactions directly with Chinese counterparts, bypassing Western-controlled systems such as SWIFT. In this sense, the DCP has given added purpose to the long-standing Chinese plan to strengthen financial autonomy and resilience vis-à-vis the US.

Summary

Taken separately, almost no elements of the DCP are new. For at least two decades, China has been grappling with the problems of systemic misallocation of resources, over-investment, over-capacity, declining return on assets and investment, excessive debt, declining productivity, inadequate domestic demand, unequal distribution of income between citizens and across provinces, overreliance on external technology and foreign sources of innovation, and an aging demographic. At the same time, the Trump administration reminded the CCP of the importance of greater independence from and resilience against the US, although Beijing was already thinking this way prior to the Trump-era economic measures against China. The COVID-19 pandemic accelerated these mindsets. From this perspective, the DCP is a continuation and evolution of preexisting policies and approaches rather than a break from them.

Even so, the DCP is a significant advance in Chinese attempts to decouple on its own terms. The CCP’s pronouncements over the past few years represent somewhat of a shift away from the overriding importance of high-economic-growth targets to economic control and political economic resilience. To put it another way, the DCP demonstrates decisive acceptance that growth is no longer the primary guarantor of Chinese political economic success.

The DCP approach is built on four fundamental pillars:

1. Lowering dependence on foreign countries and firms for critical technology and products
2. Accelerating the dominance of state-owned and private domestic firms in critical technologies and products as well as in the Chinese market to enhance value creation and productivity (and therefore increase domestic income and demand)
3. Tightening the CCP’s control over all firms to ensure they serve the regime’s objectives
4. Translating that domestic technological dominance into regional and global dominance by increasing foreign dependency on China while decreasing Chinese vulnerability to American actions

The first three comprise “internal circulation,” while the fourth is “external circulation.” As with the circulatory system of the human body, both types of circulation are linked and essential to each other’s proper and healthy functioning.
In a long speech in January 2021 to senior CCP cadres, Xi Jinping attempted to put the contemporary policies in a grander and broader ideological context. He explained that socialism with Chinese characteristics can be divided into different historical stages, the first “being undeveloped socialism and the second more developed socialism.” In the 1980s, China was still in the “primary stage,” but the country had not reached a “New Development Stage.” According to Xi, China’s “economic strength, scientific and technological strength, comprehensive national power, and people’s living standards have jumped to a new great level.” In this way, the DCP is a natural evolution for the country.

Xi ended the speech triumphantly by declaring:

The world today is experiencing the greatest change unseen in a century. In recent times, the world has been mostly characterized by one word—乱 ("chaos"), and this trend looks set to continue. The response to the pandemic of COVID-19 has been a test to the leadership and institutional excellence of countries, and the results—which are good, which are bad—are obvious. Time and momentum are on our side, and this is where our determination and confidence lie.
SECTION D: DECOUPLING CHALLENGES FOR CHINA

It is easy to become carried away with the scale and ambition of Chinese plans and pronouncements and to conclude that the CCP has carefully conceived plans that are meticulously implemented—a seeming contrast to policy formulation and execution in the US and other democracies. However, the CCP faces significant challenges to realize its vision of decoupling on its own terms.

Mixed Success for the BRI and the Creation of a Sinocentric Economic Order

Although there are critical domestic priorities that gave rise to the BRI, the initiative is the overarching external-facing Chinese blueprint to create a Sinocentric economic order. The macro-statistics of the BRI region are impressive. For example, the BRI corridor economies accounted for over 40 percent of global trade in 2018, compared to 15 percent in 1990 and less than 25 percent in 2010. In 2018, these economies accounted for over one-third of all global foreign direct investment (FDI).

However, combining the corridor economies conceals massive differences with respect to their regional and global importance. For example, the decisive East Asian region dominates global exports, while South Asia and Sub-Saharan Africa are far less significant. Even when one considers the Middle East and.
North Africa, half the exports of corridor economies were accounted for by Saudi Arabia and the United Arab Emirates. In South Asia, India’s exports are more than nine times the value of those of Bangladesh, which is the second largest exporter in that grouping.

The point is that many corridor economies are poorly integrated into global and regional markets and supply chains. Most of these economies are low-income per capita nations with policies that do not welcome broader and deeper economic integration with neighbors and the region. Tariff, behind-the-border, and FDI restrictions are generally far more austere in developing BRI corridor economies than in high-income economies, whether they are within the BRI or outside it. Even allowing for trends over the past two decades, deeper integration is occurring for the corridor economies within East Asia, Europe, and Central Asia, where intraregional trade is dominant. But integration between corridors remains slow, while enduring political and policy settings suggest the benefits of increased connectivity between corridors will mostly prove disappointing even if there is a burst of infrastructure investment in the poorer economies. Most of the corridor economies are not attractive destinations for commercially oriented entities to invest.

It is worth noting that since 2013, the volume of Chinese outward investment in non-BRI countries has increased more rapidly than the volume of investment in corridor economies. The notable exception is Chinese construction projects in BRI economies, which have exceeded Chinese construction projects in non-BRI countries. This suggests two things: first, Chinese construction companies are the most enthusiastic supporters of the BRI as it allows them to quickly deploy excess capacity outward; and second, the BRI is pursuing a speculative and high-risk “build it and they will come” approach to economic development in many less-developed areas of the BRI. With respect to the latter point, the “build it and they will come” approach mirrors China’s domestic economic development approach from the mid-1990s onward, in which fixed investment drove economic activity whether demand for that investment was evident or not.

Bear in mind that while one can point to potential benefits for these nations and their increased relevance to other trading economies from increased investments in many of these corridor nations, the effort of managing the cost of new infrastructure would outweigh the gains for many of these low-income economies. Using World Bank accountability methodologies, it appears that less than one-third of BRI countries have fiscal mechanisms in place to manage public-private partnership (PPP) liabilities, and about one quarter of countries can reliably reflect and integrate PPP in sovereign balance sheets. In this sense, widely quoted statistics, such as the Asian Development Bank’s statement that developing Asia needs USD 1.7 trillion in infrastructure investment per year up to 2030 to maintain present levels of growth, must be taken with a grain of salt.

Compounding the risks factors of overinvestment, the sovereign debt levels of almost 43 percent of countries listed under the BRI were recently rated as “junk” by the three main ratings agencies, while 32 percent have no rating at all. Reliable estimates are that debt risks in low-income corridor economies (which constitute the majority of the BRI corridor economies) have risen substantially in recent years. Those low-income BRI economies at high risk of debt distress account for about 40 percent of BRI economies, double the number in 2013 when Xi first began his BRI push (see figure 12). Another study suggests that 12 out of 43 low-income corridor economies would experience a considerable deterioration in the medium-term outlook for debt sustainability if they took part in large-scale infrastructure projects. This is the case even when allowing for models suggesting that BRI investments could boost growth in those economies. A third study suggests that after removing countries in the BRI zone rated as “investment grade” or “near investment grade” by one of the three major ratings agencies, 23 countries still remain at risk of serious debt distress.
In short, there are enormous obstacles to the BRI becoming the all-encompassing platform for an expansive Sinocentric economic order. Additionally, the share of BRI investment in East Asia has been declining over the past few years even if total BRI investment has remained steady according to reported figures. This is important because the maritime economies in East Asia are essential to Chinese hopes of constructing a Sino-dominated economic ecosystem from which it can decouple from the US in a position of strength.

Instead, the Middle East and North Africa have been the highest growth areas for Chinese investment over the past two years. Most of the growth has occurred in the construction and energy sectors (see figures 13 and 14). Some of these investments might well prove to be commercially sound, and they do help strengthen Chinese presence and influence in these subregions.
They also alleviate Chinese fears related to energy insecurity. Indeed, investment in oil projects in 2021 amounted to USD 6.4 billion, compared to USD 1.9 billion in 2020 and USD 3.7 billion in 2019. The main recipients were Iraq, Tanzania, Kuwait, Ecuador, and Uganda. Chinese investment in gas-related projects amounted to about USD 4.5 billion in 2021, up from USD 1.8 billion in 2020. Most of these contracts were made in Iraq, the Russian Federation, Uzbekistan, and Thailand. However, the point remains that China cannot achieve its geo-economic objectives without dominating the Indo-Pacific, and East Asia is the heart and epicenter of the Indo-Pacific.

Regarding East Asia (especially Southeast Asia), the perception of Chinese economic ascendancy moves far ahead of current reality. For example, the authoritative State of Southeast Asia Survey, which engages with regional elites, indicates that while around one-third of respondents are “worried about China’s regional economic influence,” more than three-quarters already view China as “the most influential economic power” in the region (see figure 16).159

This is despite a reality in which the Chinese economic importance to the region is real but often overestimated, while the US and allied role is widely underestimated and underappreciated. This is apparent in how the US and its allies far outpace China as the leading sources of FDI in Southeast Asia (see figure 17).

Moreover, the fact that China is the leading trade partner of the ASEAN states by volume needs further examination. The difficulty with properly interpreting trade statistics lies in the complex nature of supply and production chains in which much of the trade between Asian nations is “processing trade”: raw

---

**Figure 14. Growth/Decline of BRI Investment in Different Subregions, 2015–2021**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Sub-Saharan Africa</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Construction</td>
<td>15%</td>
<td>-10%</td>
<td>-2%</td>
<td>-33%</td>
<td>32%</td>
<td>-42%</td>
<td>-21%</td>
</tr>
<tr>
<td>Investment</td>
<td>-2%</td>
<td>-43%</td>
<td>-41%</td>
<td>150%</td>
<td>63%</td>
<td>-81%</td>
<td>156%</td>
</tr>
<tr>
<td><strong>Arab Middle East and North Africa</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Construction</td>
<td>9%</td>
<td>59%</td>
<td>-23%</td>
<td>43%</td>
<td>-28%</td>
<td>-44%</td>
<td>116%</td>
</tr>
<tr>
<td>Investment</td>
<td>742%</td>
<td>85%</td>
<td>11%</td>
<td>52%</td>
<td>-96%</td>
<td>361%</td>
<td></td>
</tr>
<tr>
<td><strong>West Asia</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Construction</td>
<td>84%</td>
<td>-46%</td>
<td>41%</td>
<td>-45%</td>
<td>20%</td>
<td>-56%</td>
<td>-3%</td>
</tr>
<tr>
<td>Investment</td>
<td>51%</td>
<td>-46%</td>
<td>-49%</td>
<td>84%</td>
<td>42%</td>
<td>-48%</td>
<td>-70%</td>
</tr>
<tr>
<td><strong>South America</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Construction</td>
<td>-4%</td>
<td>-28%</td>
<td>-76%</td>
<td>84%</td>
<td>-67%</td>
<td>-33%</td>
<td>643%</td>
</tr>
<tr>
<td>Investment</td>
<td>-94%</td>
<td>242%</td>
<td>-66%</td>
<td>2,187%</td>
<td>-52%</td>
<td>-39%</td>
<td>-61%</td>
</tr>
<tr>
<td><strong>East Asia</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Construction</td>
<td>17%</td>
<td>31%</td>
<td>-14%</td>
<td>24%</td>
<td>-13%</td>
<td>-15%</td>
<td>-33%</td>
</tr>
<tr>
<td>Investment</td>
<td>114%</td>
<td>-49%</td>
<td>78%</td>
<td>-9%</td>
<td>-4%</td>
<td>-40%</td>
<td>-56%</td>
</tr>
<tr>
<td><strong>Europe</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Construction</td>
<td>-85%</td>
<td>560%</td>
<td>22%</td>
<td>12%</td>
<td>46%</td>
<td>-11%</td>
<td>106%</td>
</tr>
<tr>
<td>Investment</td>
<td>-3%</td>
<td>-62%</td>
<td>55%</td>
<td>-39%</td>
<td>-38%</td>
<td>-44%</td>
<td>-56%</td>
</tr>
<tr>
<td><strong>North America</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Construction</td>
<td>17%</td>
<td>0%</td>
<td>119%</td>
<td>119%</td>
<td>-94%</td>
<td>44%</td>
<td>22%</td>
</tr>
<tr>
<td>Investment</td>
<td>-100%</td>
<td>-100%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

materials, parts, and components are imported from abroad, processed and assembled, and re-exported before final assembly. Processing trade accounts for around 70 percent of global trade. It can involve many countries, and only the final country of assembly is indicated on the product with the ubiquitous “Made in Country X.” Traditional trade statistics can...
be misleading because much of the value added throughout the international supply chain is not captured in these figures. Instead, traditional trade statistics attribute the full value of a good or service to the final country in the production chain even if that country has added minimal value to the final product. This explains the contemporary emphasis now given to “trade in value added” (TiVA).161

Regarding China’s trading relationship with many Asian nations, more of the processing trade has moved away from ASEAN and into China over decades. This is reflected in figures suggesting that China’s share of foreign value-added exports incorporated into ASEAN exports has risen from about 5 percent in the 1990s to about 17 percent currently. At the same time, China’s share of ASEAN valued-added exports incorporated into other countries’ exports has risen more slowly, from about 4 percent to 12 percent over the same period.162 In other words, more of the processing trade has moved from ASEAN to China during this time.

Trade statistics become more important when we disaggregate where value is created or added. Consider the all-important

**Figure 16. Survey of Southeast Asian Elites on Most Influential Economic Power (left) and Attitudes Toward Economic Powers (right)**

![Survey of Southeast Asian Elites](source)

Source: Sharon Seah, Joanne Lin, Sithanovray Suivanaphakdy, Melinda Martinus, Pham Thi Phuong Thao, Farah Nadine Seth, and Hoang Thi Ha, The State of Southeast Asia: 2022, Singapore: ISEAS-Yusof Ishak Institute, 2022

**Figure 17. Top Ten Sources of FDI into ASEAN Economies, 2019–2020**

<table>
<thead>
<tr>
<th>ECONOMY</th>
<th>2019</th>
<th>ECONOMY</th>
<th>2020</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td>34.6</td>
<td>United States</td>
<td>34.7</td>
</tr>
<tr>
<td>Japan</td>
<td>23.9</td>
<td>Singapore</td>
<td>14</td>
</tr>
<tr>
<td>Singapore</td>
<td>15.7</td>
<td>Hong Kong, China</td>
<td>12</td>
</tr>
<tr>
<td>Hong Kong, China</td>
<td>12.9</td>
<td>Japan</td>
<td>8.5</td>
</tr>
<tr>
<td>Canada</td>
<td>10.1</td>
<td>China</td>
<td>7.6</td>
</tr>
<tr>
<td>China</td>
<td>9</td>
<td>Korea, Republic of</td>
<td>6.8</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>7.9</td>
<td>Thailand</td>
<td>5.5</td>
</tr>
<tr>
<td>Korea, Republic of</td>
<td>7.5</td>
<td>Canada</td>
<td>5.2</td>
</tr>
<tr>
<td>Switzerland</td>
<td>4.2</td>
<td>Switzerland</td>
<td>4.6</td>
</tr>
<tr>
<td>Thailand</td>
<td>3.8</td>
<td>Netherlands</td>
<td>4.6</td>
</tr>
<tr>
<td>Top 10</td>
<td>129.5</td>
<td>Top 10</td>
<td>103.6</td>
</tr>
<tr>
<td>Share of Top 10 (%)</td>
<td>71.2</td>
<td>Share of Top 10 (%)</td>
<td>75.4</td>
</tr>
</tbody>
</table>

electrical and electronics (E&E) sector, which adds about USD 270 billion to the GDP of the ASEAN economies, employs more than 2.4 million workers in relatively high-paying jobs, and accounts for the largest share of ASEAN total exports (about 27 percent or USD 380 billion).163

Over time, China has emerged as the largest contributor of added value to ASEAN exports (see figures 18 and 19). However, ASEAN as a whole is the most important creator of value-added exports for the ASEAN economies, while Europe as a whole exceeds the importance of China in this context. Moreover, about one-third of the E&E sector in China consists of foreign firms, mainly from the advanced economies of the US, EU, Japan, South Korea, and Taiwan. Taken as a group, the US and its allies are much more important to the regional economies’ added value and upscaling than is China.

The fundamental driver of trade is final or net demand. If there is weak demand for final goods and services, there is little momentum behind trade between nations.
As supply chains for many goods and services have become more regional, East Asia recently surpassed the West as the final destination for East Asian exports (excluding China), while China recently surpassed the US as the final export destination for East Asian exports (excluding China; see figure 20). Bear in mind that advanced-economy firms with regional operations continue to maintain a major presence in almost all major export categories throughout East Asia, while key sectors such as E&E remain heavily dependent on input and technologies from the US, EU, and other advanced economies.

The point is not to ignore or understate China's obvious importance in the region. It is to make the case that the perception of Chinese economic dominance in the region is far ahead of the reality, which is much more contested. In important respects, the US and its allies continue to maintain enormous advantages when it comes to their relative strengths and relevance in areas such as finance, value-added inputs, and FDI while maintain-

Figure 19. Sources of Value-Added Exports to ASEAN in the E&E Sector, 1990–2017

Figure 20. Final Destination for East Asian Exports (left) and Comparison of US-China as Final Destination for East Asian Exports (right)—Both Excluding China

ing their position as indispensable markets of final demand for East Asia. When it comes to the emergence and construction of “Factory Asia”—a subregion where supply chains, value chains, and manufacturing processes are increasingly integrated—China is as much a competitor as a driver of prosperity for the rest of the region.

Moreover, while China is becoming more important to other Asian economies as a source of final demand for Asian (excluding Chinese) exports, Chinese exporters remain heavily dependent on American final demand (figure 21). This means the Chinese export sector, which is a significant driver of Chinese household prosperity and therefore of the Chinese consumer market, remains heavily dependent on the American consumer as well as on consumers in allied economies such as the EU. This is an awkward reality for a CCP seeking to gradually lock the US out of a Sinocentric economic region on the back of an increasingly economically dominant China. A dramatic decline in US demand for Chinese exports will not be replaced by a commensurate rise in demand for Chinese exports elsewhere.

In summary, the CCP is a long way from creating the external conditions needed for Chinese decoupling on its preferred terms. Much still depends on whether China can achieve its domestic objectives and overcome the internal weaknesses and problems that the DCP is intended to alleviate and resolve.

**Structural Factors Suppressing Chinese Domestic Demand**

China seeks to rely less on external or global demand and much more on domestic demand to enhance the resilience and sustainability of its political economy. Increasing the share of domestic private consumption or demand is a sensible priority (see figure 22). Without increasing household or private demand, China will remain too heavily reliant on external demand. This means continued reliance on the net export growth model, which leaves the country vulnerable to external economic and geopolitical shocks in the form of loss of access to those markets or declining demand in those economies.

Over the reform period from 1979 onward, the country’s share of domestic private consumption as a proportion of GDP has fallen steadily from over 50 percent in the 1980s to over 40 percent in the 1990s to around 38 percent currently. This has changed little from five years ago and is only a few percentage points higher than a decade ago.

According to a comparison of 150 countries for which sufficient economic data is available, China ranks 145, above only Singapore, Luxembourg, Qatar, Ireland, and Brunei. To offer further comparisons, the US, Japanese, and Indian figures are around 67 percent, 58 percent, and 53 percent respectively.

There are compelling reasons why the political economic structure and the decoupling policies are unlikely to significantly raise Chinese private consumption levels to meet CCP expectations.
and requirements. The key is to dramatically increase household wealth as this should lead to rapid increases in private consumption. However, serious headwinds and structural barriers may prevent this from occurring.

Prioritization of Production Rather Than Consumption

A major problem is that the fundamental growth strategy and structure of the Chinese political economy are designed to prioritize production with the unintended consequence of suppressing consumption. For example, the Chinese economic approach elevates state- and policy-directed investment in nominated sectors and provinces over commercial virtues such as labor productivity and capital efficiency. In layperson’s terms, China’s model is largely based on throwing enormous amounts of cheap capital into nominated sectors for political and policy reasons.

The permanent stimulus of offering politically driven cheap and accessible capital to firms in nominated sectors and demanding that they meet growth targets also means that a higher priority is given to growth in market share and revenue growth than to worker wages. This is reflected in calculations showing that in 2020, the share of wages as a proportion of GDP had not increased since 2016 and remained lower by this measure than in the mid-1990s and early 2000s (see figure 23). Indeed, the Chinese approach depends on suppressing wages to an important extent to subsidize production.

A further downside of the Chinese approach of allocating huge amounts of capital to meet political and policy targets is reflected in declining growth in total factor productivity (TFP), that is, growth that cannot be accounted for by increased capital or labor inputs. The higher the share of TFP in driving growth, the lower the relative share of other inputs. In advanced economies and those rapidly modernizing, increasing TFP tends to lead to commercially driven higher demand for labor, lower cost of capital, and eventually higher wages.166

With respect to China, at just over 2 percent, TFP growth has been declining since around 2009.167 This is about half the av-
Indeed, China has not been able to find a way to achieve rapid growth apart from increasing capital inputs, which then exacerbates the already severe problems of overproduction, excess capacity, and dangerous levels of indebtedness (see figure 25). The same political and policy approaches drive the MIC 2025 plan and DCP framework, and throwing money at import substitution policies makes the problems of excess capacity and indebtedness even worse. These policies include directing central and local government entities as well as the country’s financial and lending institutions to allocate capital and opportunity to firms in sectors that Beijing believes are necessary to upscale the entire economy, with the hope this will increase wages and consumption. This approach will enjoy only limited success in terms of increasing productivity and eventually leading to higher wages and disposable income throughout the broader economy.

The evidence so far supports the less sanguine assessment. As mentioned, wages as a share of GDP are stagnant even as GDP growth is declining, which suggests that rising private power in 2012. The point is that declining TFP growth is another factor suppressing wage growth.

Indeed, the Xi Jinping era of reversing any partial moves toward macro- and microeconomic liberalization has worsened the systemic misallocation of resources, which was severe before he assumed average TFP growth prior to 2009 (see figure 24).
consumption on the back of rising wages is not taking up the slack as the Chinese economy attempts to deleverage (by slowing down credit for fixed investment, especially in the property sector). Incidentally, and in the immediate and medium terms, growth in Chinese private consumption is largely driven by growth in residential house prices. This is unsurprising since the lion’s share of household wealth is in residential homes (see figure 26).

Some studies suggest that on average, a 10 percent increase in the price of one’s home leads to a 3 percent increase in consumption. This means that Chinese attempts to deleverage the economy and suppress rises in residential home prices will threaten a key pillar of DCP—increased reliance on domestic consumption.

Impacts of Technological Upscaling on the Chinese Workforce

One must interrogate Beijing’s assumption that upscaling the economy leads to across-the-board wage rises and therefore a rapid increase in domestic private consumption. China was already quickly transitioning from a low- to middle-cost country when it comes to wages. The fastest recent increase in average urban wages occurred earlier this century, when China emerged as a manufacturing and export superpower. As wages have risen, an increasing share of lower-skilled manufacturing jobs have shifted to lower-cost economies such as Bangladesh, Indonesia, India, and Vietnam. In fact, lower-skilled manufacturing has been declining in China since around 2013.

As China’s economy modernizes, more low- and semi-skilled jobs are being taken by machines with advances in automation, robotics, artificial intelligence, and other technology. This is leading to a clear trend in which working in the formal economy is declining in relative terms while working in the informal economy is increasing (see figure 27). As a result, those employed in the informal sectors earn less (see figure 28) and have higher saving rates due to poorer access to safety nets such as health

---

Figure 25. Capital-Output Ratio in the Chinese Economy, 2004–2018

<table>
<thead>
<tr>
<th>Year</th>
<th>Capital-Output Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>2004</td>
<td>2%</td>
</tr>
<tr>
<td>2006</td>
<td>3%</td>
</tr>
<tr>
<td>2008</td>
<td>4%</td>
</tr>
<tr>
<td>2010</td>
<td>5%</td>
</tr>
<tr>
<td>2012</td>
<td>6%</td>
</tr>
<tr>
<td>2014</td>
<td>7%</td>
</tr>
<tr>
<td>2016</td>
<td>8%</td>
</tr>
<tr>
<td>2018</td>
<td>9%</td>
</tr>
</tbody>
</table>

Source: International Monetary Fund, “People’s Republic of China.”

Figure 26. Assets of Chinese Households, 2019

<table>
<thead>
<tr>
<th>Type of Asset</th>
<th>Value (USD Trillions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-Financial</td>
<td>$35.83T</td>
</tr>
<tr>
<td>Housing</td>
<td>$33.32T</td>
</tr>
<tr>
<td>Automobiles</td>
<td>$2.00T</td>
</tr>
<tr>
<td>Farming Equipment</td>
<td>$0.50T</td>
</tr>
<tr>
<td>Financial</td>
<td>$46.59T</td>
</tr>
<tr>
<td>Currency</td>
<td>$0.92T</td>
</tr>
<tr>
<td>Deposits</td>
<td>$16.06T</td>
</tr>
<tr>
<td>Loans</td>
<td>$0.20T</td>
</tr>
<tr>
<td>Insurance</td>
<td>$1.86T</td>
</tr>
<tr>
<td>Bonds</td>
<td>$0.39T</td>
</tr>
<tr>
<td>Stock and Equity</td>
<td>$24.40T</td>
</tr>
<tr>
<td>Securities Investment Funds</td>
<td>$2.76T</td>
</tr>
<tr>
<td>Total</td>
<td>$82.42T</td>
</tr>
</tbody>
</table>

insurance and pensions. These workers subsequently consume significantly less than those employed in the formal sectors.

The dramatic upscaling of the Chinese economy could drive even more low-skilled jobs overseas to lower-cost economies and force more Chinese workers into the informal economy at the same time. In other words, upscaling the economy will benefit high-skilled workers but could threaten the employment or wages of lower-skilled workers, who make up a large majority of the Chinese workforce.

Inconsistency between Higher Wages and the Export-Driven Model of Growth

The awkward reasoning in the context of the DCP about higher wages driving consumption growth is also worth noting. Wages are the major source of disposable income for Chinese households (see figure 29). Beijing is trying to upend classical trade economics by simultaneously achieving rising wages across the board in China and dominating exports of high-tech and high-value products and services. This goes against China's
own experience, in which it became an exporting superpower due to lower cost inputs than those of its competitors. It suggests the emphases on dramatically increasing wages by upscaling the entire economy and becoming the dominant exporter of related products are inconsistent.

China's domination of solar panel exports provides both an illustration and a possible Chinese counter to this problem. It was recently estimated that China accounts for the production of 97 percent of global silicon wafers, 79 percent of solar photovoltaic (PV) cells, and 67 percent of polysilicon. China is also the world's largest supplier of solar cells and light-emitting diodes.\textsuperscript{171}

China achieved this dominance by making and selling these products cheaper than competitors in advanced economies through enormous subsidies, cheap credit, and low input cost (such as labor and land). Instead of paying taxes, Chinese solar companies in the designated "strategic sector" received tax credits. Between 2008 and 2013, China's then fledgling solar-electric panel industry dropped global prices by 80 percent in what was then an extremely competitive market.\textsuperscript{172} This occurred even though the US invented much of the technology and held most of the patents for it.

The solar sector also demonstrates China's well-worn game plan. Chinese entities with the support of the government and lending institutions bought international solar companies or invited leading foreign firms to establish operations in China. The government implemented schemes to attract leading global solar experts to Chinese firms. It developed vertically integrated supply chains inside China, often at great expense. The Chinese strategy is to acquire, develop, or steal world-class technology and capabilities, support the creation of entire supply chains inside the country, eliminate overseas competition, and dominate domestic and global markets in the target sector. If the latter objective is achieved, then even higher wages are not enough to erode entrenched Chinese advantages.

China’s MIC 2025 and DCP plans seek to apply the Chinese solar sector strategy to a broader range of strategic and critical sectors. The problem is the impossibility of escaping the iron laws of economics. The solar industry was established in China at a time when wages were much lower than those of competitors but were hugely expensive nonetheless.\textsuperscript{173} The massive assistance that the government provided to Chinese firms led to a predictable oversupply of solar panels. Even though most Chinese panels were made for export, an estimated two panels were made for every one export order.\textsuperscript{174}

When the global financial crisis hit advanced economies in 2008, there was a massive decrease in global demand for panels. As global demand fell, Chinese companies were forced to continue to ramp up production of panels to remain in business (see figure 30), and this was possible only due to even more subsidies worth billions of dollars. In short, China
achieved its objective of dominating the global solar panel industry. But applying this approach to an ever-expanding list of strategic and critical sectors will worsen the problems of over-capacity, indebtedness, and inefficiency that MIC 2025 and DCP are designed to alleviate—and that are all made worse by rising wages.

China Inc. vs. the Private Sector and Households
The most important structural factor inhibiting the emergence of a sufficiently large Chinese domestic consumer economy is the nature of the country’s political economy and the resulting winners and losers within it. China’s political and policy-directed economy involves the central government setting broad and far-reaching priorities for the entire economy; setting fiscal, lending, regulatory, taxation, and other policies to advance these priorities; and compelling local governments and the state-owned and private sectors to implement these measures in furthering CCP-determined policies. MIC 2025 encapsulates this state-led approach, and the DCP framework extends it further.

Under this approach, state-owned firms are the primary beneficiaries as they are uniquely placed to achieve CCP objectives. National champions and other private firms advancing Beijing’s agenda also benefit from the special advantages they receive from central and local governments. In turn, they further benefit by being better placed to access cheap credit from banks and other lending institutions because those offering credit are obliged to support preferred firms on political and policy grounds. At the same time, firms operating in sectors nominated by the CCP as strategic or critical are considered safer and more reliable borrowers because they are favored by the government.

This effect is clear when examining the first five years of the Xi Jinping era, during which loans to state-owned nonfinancial enterprises constituted 83 percent of all lending, while only 11 percent went to the private sector (see figure 31).

As explained earlier, over the past few years, China is governing and regulating private firms more like state-owned firms and giving privileges to firms that advance Beijing’s objectives with less regard for ownership structure. This practice is leading to an increase in the number of private firms on the list of the top

![Figure 31. Loans to Nonfinancial Entities by Ownership, 2010–2016](source)


![Figure 32. Share of Aggregate Revenue of Top 500 Chinese Firms by Ownership, 2004–2020](source)

500 Chinese firms by revenue. Whereas only 15 private companies appeared on 2005’s top 500 list, 130 appeared in the 2021 ranking. Even so, the rise of private firms began from a very low base, and state-owned firms continue to dominate the list of the largest firms in the country.

For well-connected individuals and firms or firms operating in strategic and critical sectors, a mutually reinforcing cycle gives them substantial advantages over most private firms. The Chinese private sector firms denied assistance from the regime are leaner and more efficient, and they outdo favored firms on all standard measures, such as return on capital, return on assets, profitability, and productivity (see figure 33). It is estimated that the private sector contributes to 60 percent of GDP, 70 percent of innovation, and 80 percent of urban employment and provides 90 percent of jobs. However, the perverse result is that the lion’s share of capital and opportunity is given to less deserving but favored firms.

This political economic structure has direct relevance to Chinese efforts to increase domestic consumption as a driver of growth, which is required for successful decoupling. As is the case with corporate debt, Chinese household debt is already at dangerous levels (see figure 34). It would not be feasible for households to simply borrow substantially more to increase national private consumption to levels sufficient to meet even modest Chinese GDP growth targets.

Moreover, significantly more Chinese citizens need to be able to rise into the ranks of the “consumer class,” which is commonly associated with adults who have a net wealth of USD 100,000 to USD 1,000,000 (see figure 35). This need is often tied to the requirement for China to emerge from the so-called middle income trap.

To achieve China’s goals, households (and not the privileged state-owned and well-connected private sector) need to emerge as the primary beneficiary of rising national wealth. The most effective way to dramatically increase broad-based household wealth is to increase wages or to transfer more economic opportunity from the state-owned sector to the genuine private sector.

Earlier, I explained the downward pressures on wage growth as well as the contradiction between higher wages and successful decoupling. Regarding dramatically increasing consumption,
Another key is to spread economic access and opportunity to the more than 20 million private firms and estimated 83 million individual businesses (owned solely by one person) and away from the estimated 266,000 central and local SOEs and other privileged national champions. This is because China’s state-led and politically directed political economy is the primary reason for both worsening and dangerous inequality (as it privileges a relatively small group of politically connected insiders) in addition to suppressed household incomes (as too much commercial opportunity is allocated to too few firms). Both of these effects work against the emergence of a consumption-driven growth model.

This causal connection between a bottom-up approach to economic growth—allowing independent private entities the freedom to make commercial decisions and allowing the market to determine price and allocate resources and opportunity—and higher household share of wealth and consumption levels is apparent in China’s own recent economic history following the reforms in December 1979.

From 1980 to 1989, the primary driver of Chinese economic growth was domestic consumption—a result of land reform that gave rural residents free license to use their plot of land in any way they wanted and dramatically raised across-the-board household incomes. From 1992 to early this century (after the so-called Tiananmen Interlude from 1989 to 1992, when Chinese leaders were paralyzed from the countrywide protests), export manufacturing took over the mantle of primary driver of growth. The period dominated by state-led fixed investment growth began in the 2000s and dramatically accelerated after 2008, when the global financial crisis shook China’s advanced economy export markets. Around the early 2000s, consumption as a proportion of GDP began to decline alarmingly (see figure 36).
One assessment is that household wealth must increase its share of GDP by 10–15 percent to bring China closer to the levels of consumption as a proportion of GDP in other developing countries. Another measurement compares China’s net household wealth (i.e., assets minus liabilities) with the US’s. The former was an estimated USD 64 trillion at the end of 2019 compared to the US figure of USD 118 trillion.

The “liberalization” of the political economy and changes in government priorities would have immense political consequences that are intolerable to the CCP. The emergence of a corporatist state tied to the future of the CCP is a feature of contemporary China. Without controlling or dispensing the lion’s share of commercial opportunity, the CCP would lose status and relevance. That was the lesson learned from the Tiananmen Interlude and national upheavals in 1989, when the emergence of a genuinely independent middle class dared to challenge the regimes in Russia and Eastern Europe and those regimes lost the support of economic and social elites.

Moreover, without directing economic and commercial opportunity, Beijing would be unable to implement top-down plans such as MIC 2025 and the DCP. Left to animal spirits and the hidden hand of market forces, the CCP would be unable to utilize Chinese firms to pursue its political and strategic ends.

Prioritization of the Corporate State over People

Rapid Chinese GDP growth over many years can give the incorrect impression that there is enough expanding national wealth to solve most problems. Since the late 1990s, Chinese leaders have prioritized state-led corporatism and acceleration of the economy’s productive capacity over public and social goods.

One ramification of this hyper-corporatist model and the prioritization of economic capacity is suppressed household income and wages. Another is the lower emphasis on public and social goods. For comparison, the US spends around 19 percent of GDP on public social welfare, while the figure for China is about 8 percent.

The average across the OECD is around 20 percent. This ratio has barely changed even as government resources allocated to defense, domestic security, and industry (subsidies, guaranteed loans to SOEs, etc.) have increased more rapidly than GDP growth.

Beijing’s prioritization of national material power (e.g., defense, public security, fiscal stimulus for the corporate sector, subsidies, etc.) over social safety nets goes a long way toward explaining the high household savings rates. For China, the average level of savings as a percentage of GDP over the past two decades is just under 42 percent. The 2020 figure was almost 45 percent, which is the fourth highest in the world (behind Brunei, Zambia, and Vanuatu). The world average in 2020 based on 134 countries is 22.73 percent.

The stubbornly high savings rates work against CCP plans to rapidly increase domestic consumption. In this sense, there is an inconsistency between the hyper-corporatist approach of plans such as MIC 2025 and the DCP and the hoped-for rapid increase in domestic consumption.

This inconsistency is manifested in a related context. The high savings rate is partially due to widespread anxiety about the inadequacy of pension provisions and their enforcement by central and local governments. All companies are obligated to contribute to social insurance, which covers pensions, medical funds, unemployment safety nets, maternity leave, and work injuries for employees. 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 or the inability of companies to meet these obligations.

However, the government prioritizes allowing firms to reinvest profits to drive corporate growth over forcing firms to meet their pension obligations to workers. Firms in key sectors such as telecommunications, machinery production, computers, military applications, and electronic equipment will likely suffer the biggest hit to their profits if the government properly enforced
these reforms (see figure 37). These are the same sectors that Beijing highly values for strategic reasons.

In 2020, it was estimated that the national pension plan covered only about 71 percent of the urban workforce and that only 47 percent had unemployment insurance. Even then, Chinese pension funds (into which firms are obliged to contribute specified amounts and which are overseen by the government) will peak in 2027 (at about USD 1.04 trillion) and could be exhausted by 2035.

In the context of China’s rapidly aging society (see figure 38), inadequate pension funding will have an even more pronounced impact on the ability and willingness of Chinese citizens to increase discretionary consumption.

**Geopolitical Tension**

The external circulation element of the DCP involves Chinese exports dominating global markets in high-tech and high-value sectors. Developing economies will be important partners in the Sinocentric supply chain, including as a source for raw materials. But the most important and lucrative export markets for China will be advanced economies.

Over the past decade, export growth in China has been declining markedly (see figure 39). Moreover, the percentage of total Chinese exports bound for developing economies has increased significantly, while the percentage of total Chinese exports to developed economies has declined significantly (see figure 40). Much of this represents China increasingly dominating regional supply chains for the production and export of traditional merchandise goods. It also reflects a global trend in which the supply chains and production of traditional merchandise goods are becoming more regional (i.e., located closer to the end consumer).

China has correctly identified the opportunities ahead. A dramatic rise in Chinese exports to developed economies will oc-
cur on the back of high-tech and high-value goods and services. The external circulation of the DCP depends on China leading in these sectors when it comes to know-how and supply chains and on the advanced economies becoming reliant on these Chinese exports. That will occur only if there is a stable and pragmatic relationship between China and these advanced democracies.

It is in this context that Xi Jinping has been a counterproductive leader for advancing China’s standing and reputation in the world, especially vis-à-vis advanced democracies. In the latest Pew Survey of American attitudes toward China, 82 percent of Americans have an unfavorable view of China, the highest ever recorded (see figure 41). Further, 67 percent view China as a threat, which is also an all-time high.188 These views are consistent with surveys of many other advanced economies. In Australia, the United Kingdom, Germany, the Netherlands, Sweden, South Korea, Spain, and Canada, negative views of China are at their highest levels since the Pew surveys began polling on this topic more than a decade ago (see figure 42).
Figure 42. Views of China in Select Advanced Democracies, 2002–2020

Source: Silver, Devlin, and Huang, "Unfavorable Views of China."
A growing number of political and strategic elites in these democracies share the worsening public perception of China. Importantly, governments in these countries have taken measures to punish China for illegitimate economic behavior or, more commonly, to protect their economies from overexposure or vulnerability to Chinese economic coercion and arbitrary policies.

For example, the US measures against China that began during the Trump administration, and that have been maintained and extended by the Biden administration, are well known. The European Union has suspended the ratification of the EU-China Comprehensive Agreement on Investment following China’s decision to declare a no-limits friendship with Russia shortly before the Russian invasion of Ukraine and Beijing’s subsequent refusal to condemn Moscow. The recent decision by the Group of Seven to mobilize USD 600 billion in infrastructure funding for the developing world over the next five years demonstrates Europe’s willingness to publicly recognize China as a challenge and threat and its preparedness to commit resources to offer material alternatives to developing nations. Enduring its third year of cascading economic punishments for implementing policies that have displeased Beijing, Australia is in the process of taking policy and practical measures to lower its economic reliance on China.

Xi Jinping’s hubris and potential overreach are also evident in changing attitudes toward the BRI among developed economies. While 18 EU members have formally endorsed the BRI, there is emerging and growing wariness of Beijing’s intentions. Most of these countries now agree with a 2018 assessment by the ambassadors to China of all EU nations (except Hungary) that the BRI “runs counter to the EU agenda for liberalizing trade
and pushes the balance of power in favor of subsidized Chinese companies.  

Moreover, and given the CCP’s control over the Chinese political economy and its extensive authority over all aspects of commercial activity, the comprehensiveness of military-civil fusion in the Chinese system, the increasing repressiveness of the regime, and the willingness of Xi Jinping to reveal Chinese plans to dominate future technologies, the industrial and high-tech competition in some key sectors is already well underway.

This competition has played out most prominently in increasingly coordinated efforts among a growing number of advanced democracies to exclude Chinese firms such as Huawei and ZTE from their 5G infrastructure and networks. While Huawei is the leading firm in the 5G sector in many developing countries, its momentum in rich democratic nations has stalled and is sliding backward. It is unlikely that Huawei will have a significant presence in the 5G sectors in advanced economies as seemed inevitable several years ago (see figure 43).

Certainly, competition for dominance of 5G is only the beginning when it comes to China and the advanced democracies. There will be other sectors, and Xi Jinping has unwisely boasted to the world the technologies that China will seek to dominate in. This is a problem for Beijing because China’s goal is to decrease its dependency on the US and increase advanced democracies’ dependency on China. Xi is running the risk that the advanced democracies will more effectively coordinate their counterstrategies against it long before it can achieve a dominant position.
There are three related strategic priorities for the US and its allies:

1. Counter China’s objective of acquiring strategic support states.

2. Counter elements of China’s technological upgrade strategy that are designed to help it surpass the advanced democracies.

3. Counter Chinese plans to dominate high-tech and high-value global export markets in high-tech and high-value sectors.

These priorities are related because Chinese success in one aspect leads to success in the others. For example, the emergence of China as a dominant technological power will deepen regional dependency on Chinese technology and supply chains. This will strengthen Beijing’s leverage over regional capitals. At the same time, China will be in a better position to dominate global exports while shutting imports out of the Chinese economy.

The emergence of a regional Sinocentric economic system within which Chinese firms and entities dominate would mean such firms are in a position of insurmountable strength as they negotiate the conditions of any arrangement—with an American or other foreign firm or entity. Disputes and disagreements will not be resolved by preexisting laws and rules but through negotiations in which Chinese political and economic leverage

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Caption: President Joe Biden speaks with the President of the People’s Republic of China Xi Jinping virtually in the Roosevelt Room at the White House on November 15, 2021. (Photo by Demetrius Freeman/The Washington Post via Getty Images)
is brought to bear, or according to rules and processes drafted by Beijing.

Additionally, with a greatly reduced US commercial presence in East Asia and Eurasia, the capacity for American firms and authorities to set or revise commercial and quality standards in all sectors is greatly diminished. Once such standards are set, it is expensive—usually prohibitively so—for firms and economies to operate in a different economic ecosystem. When regional economies become tethered to Sinocentric infrastructure, institutions, logistical networks, etc., Chinese political and strategic capture will be difficult to prevent. At the same time, outsiders such as the US will be in a much weaker position to enter what Beijing hopes will be the most important economic zone in the world, stretching from East Asia to South Asia, from Central Asia to Western Europe, and from the Middle East to Africa.

In short, China’s vision of decoupling on its preferred terms is to create a Sinodominant Asian region and to gradually decouple it from the US in ways that suit China and disadvantage the US. The US should take the following measures to counter Chinese dominance and achieve the three strategic priorities listed above.

**Compete in Commercially Profitable Economic Zones**

The US will have limited capacity to compete in landlocked economic zones like Central Asia and parts of continental Southeast Asia. But it is well placed to work with economic partners to prevent the emergence of a Sinocentric economic order in maritime Southeast and South Asia, the South Pacific, and Europe. These maritime economies and regions will be the primary determinant of the distribution of power and prosperity throughout Asia.

Part of the US approach over the next 10 to 20 years should encourage these economies to take the following steps:

1. Disentangle or diversify their supply chains in critical and strategic sectors away from China—especially important for advanced economies on China’s periphery, such as Japan, Taiwan, and South Korea.
2. Agree on common industry rules, standards, and export controls for high-value and high-tech sectors.
3. Link common market access to adherence to legal, regulatory, and human rights rules and standards.
4. Seek sources of external (non-Chinese) financing that do not impose oppressive debt burdens or unreasonable restraints on a country’s sovereignty or domestic decision-making.
5. Work with the US to reform or build institutions that can better resist illegitimate or predatory Chinese economic practices, and even punish China for them.

In most economic interactions, the objective is to prevent these economies from becoming too dependent on the Chinese economy in terms of supply chains, production processes, or access to finance. That over-dependency comes from focusing solely on pursuing the guaranteed absolute economic gains from China with insufficient regard for the possibility of handing China too much leverage and the strategic consequences of doing so.

This is particularly important with respect to high-value and high-tech sectors, or sectors of critical or strategic value. Maritime Asian states cannot be allowed to become trapped in the Chinese ecosystem. Once they are in any high-tech or high-value ecosystem, it becomes difficult or prohibitively costly to leave. In this sense, the US needs to work with other advanced economies to develop and spread high-tech and high-value ecosystems that are far more appealing than China’s.

Bear in mind that ASEAN economies are already deeply integrated into US and global production networks. FDI from Japan, the US, the EU, South Korea, Australia, and Singapore
far exceeds that from China. That trend needs to continue into the next decade and beyond, forcing China’s less efficient and productive firms to allocate capital to less attractive and less important landlocked BRI corridor economies—which are also less strategically important to the US. This will further help ensure Asian supply chains and productive processes are not overly dependent on China.

Most broadly, the Chinese hopes of shrinking the US’s operating ground and easing it out of Asia can be achieved only if maritime East Asia becomes a Sinocentric and China-dominated subregion. That nightmare scenario begins with overreliance on a closed Chinese economic system. It is better for the US (and advanced-economy firms) to maintain and expand their footing on grounds that are strategically vital and economically attractive, and that play to the strengths of the superior US (and allied) private sector.

**Seek Membership in the CPTPP**

In May, the US and a dozen counterparts launched the Indo-Pacific Economic Framework for Prosperity (IPEF). The framework lists four policy pillars: connectedness, resilience, clear or environmental friendliness, and fairness. IPEF puts special emphasis on the importance of the digital economy, supply chain resilience, decarbonization, and fairness in the context of firms paying their expected share of taxes in the appropriate jurisdictions.

IPEF presents a principled approach to economic interaction between members who are free to join in and work with the US on any or all four of the pillars. IPEF will appeal strongest to the advanced economies in the region. These economies are best able to utilize and implement principles and standards related to the digital economy, environment, and labor.

However, and like the broader framework of the free and open Indo-Pacific, laudable frameworks do not provide countries with guaranteed and immediate gains. This is especially important vis-à-vis low- and middle-income economies. As argued earlier, China’s advantage is that it can offer (although not always deliver) immediate and guaranteed gains even if such arrangements disproportionately benefit Chinese entities.

In this context, the most direct and effective way forward is for the US to seek membership in the CPTPP. Doing so would offer members enhanced access to the US market while allowing the US greater ability to shape the principles and standards that IPEF targets. Indeed, the CPTPP is modeled on standards that the US advocated for in the first place.

Moreover, China’s application to join the CPTPP will be much easier to resist with the US as a member. As part of the CPTPP, the US will be able to help countries collectively withstand that pressure. An additional benefit of membership is that the US will be able to support Taiwan’s application, which would have strategic and economic benefits to the US and its allies. More broadly, US membership in the CPTPP will make it extremely difficult for China to decouple Asia from the US on Chinese terms.

It is commonplace to hear the assessment that it is not politically feasible for the US to seek membership in the CPTPP in the foreseeable future. While the Obama administration expended little political capital on ratifying the then TPP, the Trump and Biden administrations have not made serious efforts to join the CPTPP.

Even so, the sense of fatalism is unwarranted. Just as sentiment changed quickly against the TPP during the 2016 presidential campaign, it is conceivable that sentiment can be reversed in favor of the CPTPP. Efforts by the last two administrations to convince Americans and those in the Indo-Pacific that the US will remain fully engaged in the region receive broad and bipartisan support, as do US policies to balance and counter Chinese activities. As in many regional countries, American views of China have become more unfavorable over time as the latter becomes more aggressive and explicit regarding its regional and global ambitions (see figure 44). A new effort channeled toward
explaining the importance of US membership in the CPTPP and its benefits for the US would offer the maximum strategic and economic bang for the buck. Just as many once dismissed the political and policy feasibility of selectively decoupling from China more generally, or executive orders imposing tariffs on Chinese imports more specifically, the case for the US joining the CPTPP has not been properly made. Concluding that membership is infeasible is premature and unnecessarily defeatist.

Convince Europe to Reject a False Dichotomy between Strategic Success and Economic Opportunity

The communique following the NATO summit in Brussels in June 2022 described China as posing “systemic challenges” and accused Beijing of working with other authoritarian powers, such as Russia, to “undercut the rules-based international order” in ways that “run counter to our values and interests.”

This is a clear-eyed expression of the challenge China poses. It represents a hardening of the EU’s approach to China even though NATO is a collective security organization and cannot be conflated with the EU. Even so, the NATO communique is only an early step. There is still a tendency among Europeans to separate their security from their economic interests in lamenting that a hardening security posture toward China will lead to a proportionate deterioration of Europe’s longer-term economic prosperity.

The true situation is far more complex, and China is both a security and economic threat to the EU in the longer term. Indeed, Europe has a special role as either part of the solution or the problem when it comes to addressing the economic challenge posed by China as raised in this monograph.

To begin, it should not be lost on Europe that the BRI excludes the US but extends to Europe. Indeed, Europe is key to the success of the BRI and to Chinese efforts to favorably decouple from the US and emerge as the globally dominant economic entity more generally. This is apparent in two ways.

First, the EU represents about 16 percent of global GDP. Importantly, it is also the second-largest consumer market in the world and around double China’s size by that measure. Although the consumer markets in Southeast Asia and India are predicted to grow rapidly, Europe will remain the most important destination for finished goods throughout the BRI in the foreseeable future.

Second, China needs the technology transfers that come from joint ventures with advanced-economy firms, especially from Europe (and the US). In this context, some commentators have referred to the EU as a “technology piggy bank.” Chinese investment in Europe increased tenfold from 2009 to 2015 and another 76 percent in 2016 before declining in more recent years.

Of greater interest is what Chinese capital is seeking to acquire in Europe. While funding for large infrastructure projects has declined since its peak in 2016, Chinese firms are increasing their stakes in European companies engaged in areas such as health
care, pharmaceuticals, biotech, robotics, AI, advanced materials, cutting-edge engineering, and semiconductors. It is revealing that Europe’s two most advanced economies in Germany and the United Kingdom have attracted the lion’s share of Chinese investment since 2016. It is also significant that greenfield investments in especially advanced EU economies increased by 51 percent in 2021 from the previous year, some 240 percent above the average level of Chinese greenfield investment in the EU between 2015 and 2019. Greenfield investments are often subject to weaker regulatory scrutiny while they can be used to fast-track tech and know-how transfers to China. For example, Chinese firms Huawei and Contemporary Amperex Technology Company are seeking to use greenfield investments in Europe to enter R&D collaborations with European universities, research institutes, and industry.

It has only been in the past couple of years that countries such as Germany have started blocking, on national security grounds, applications by Chinese firms to purchase local firms. They have delayed this step despite studies suggesting Germany (and South Korea) will be the economies most negatively affected by MIC 2025. Germany has tightened screening powers and standards for foreign investment in “security-relevant” sectors such as AI, robotics, semiconductors, and autonomous vehicles. France has done similarly for defense, energy, and the high-tech and biotech sectors. Even then, existing controls on foreign investment in or export of strategic or dual-use technologies have not prevented significant leakages of such technologies to China. Many European decision-makers and regulators are still reluctant to use existing powers to take a stricter approach when scrutinizing Chinese investments.

There are unique institutional barriers to coordinated and decisive action by the EU. Positions on industrial and security policies are effectively left to individual members to implement even if there is an agreed framework. Regulations and laws within individual countries are not coordinated, which results in varying levels of robustness and compliance. Even where there is growing consensus, such as for an EU-wide mechanism to deal with considerable increases in Chinese investment in advanced EU firms since 2015, the lowest-common-denominator approach prevails. This means there is more progress in information sharing with respect to what China is doing than in specific and decisive policies to deal with an issue.

China has also been executing a divide-and-conquer approach to Europe. Its main method is the China-initiated 17+1 group, which includes 17 Central and Eastern European states plus China. Eleven countries in this group are also EU members. In late 2016, China announced it had established a USD 11.1 billion Central and Eastern European (CEE) Fund to finance projects in the grouping to support the BRI. Its primary motive is to create an economic investment zone that will decide on investments according to China’s rules and processes rather than following the EU standards preferred by most Western European states.

Outside the EU zone, European firms (and many firms headquartered in other advanced economies) are also falling into the trap of thinking that setting up firms in China for the Chinese market as largely self-contained entities will help them avoid conflicts of interest or cross-border problems. For example, Volkswagen produces 95 percent of vehicles for the Chinese market in China and reinvests about 90 percent of the profits in Chinese operations.

The problem is that setting up Chinese operations for Chinese markets and reinvesting heavily in them helps advance Beijing’s plans for dominance in the supply and value chains for these sectors without providing many benefits to the European economy. In this sense, the narrower commercial interests of the multilateral firm in China are not necessarily aligned with the national interest.

The Chinese approach is to leverage and acquire European technology and know-how to entrench Chinese dominance in
these sectors before dominating European markets. This would significantly reduce a long-standing pillar of European prosperity and advantage, which is built on the strength of its high-tech and high-value exports to the world.

In this context, the US should take the following measures:

6. Use all multilateral platforms (such as the Group of Seven) and its regular bilateral interactions to convince Europeans of the false dichotomy between pursuing their strategic and economic interests. Given the way China’s political economy is set up and the objectives of MIC 2025 and the DCP, there is no genuine win-win with Beijing. China is obtaining greater relative gains in its interactions with Europe in the high-tech and high-value sectors and will seek to entrench this dynamic to usher in a sustained era of Chinese economic dominance.

7. Work with European regulatory, screening, and trade bodies to arrive at common rules and principles that apply specifically to China as the latter is a unique economic challenge and threat. This will make it more difficult for Chinese entities to circumvent or exploit non-discriminatory regimes. It will also reduce the possibility that the EU (or the US) will use screening regimes and punishments intended for Chinese entities as a form of ad hoc industrial protectionism against non-Chinese entities or each other. A common allied regime should treat Chinese private entities as if they are state-owned or government entities in all regulatory decisions.

8. Work with the EU (and other advanced economies) to guide and, in some circumstances, regulate the Chinese operations of multinational firms headquartered in the US, EU, and other liberal democracies. There needs to be a set of principles to minimize activities by multinational firms that help entrench Chinese technological and supply chain dominance in important sectors.

The EU and other advanced economies will increasingly seek to avail themselves of instruments with which to retaliate against or respond to illegitimate or coercive economic policies of other countries—similar to the Section 301 powers that the Trade Act of 1974 gives to the Office of the United States Trade Representative.

For example, the European Commission is proposing an anti-coercion instrument (ACI) to counter coercive economic measures against it. Such measures might include the suspension of tariff concessions, import and export restrictions, restrictions against participation in public procurement projects, export controls, FDI restrictions, restrictions on IP protections, and restrictions on access to capital markets and the banking system.²⁰⁴

While China is not the only conceivable target of the possible ACI, it is Chinese actions (e.g., against Lithuania after it allowed the opening of a de facto Taiwanese embassy) that have given rise to this EU discussion.

The US needs to work with the EU to ensure such instruments are designed as an effective counter to Chinese economic coercion, specifically as such Chinese coercion has been used against economies that have stymied Chinese plans for regional dominance in particular sectors, such as 5G.²⁰⁵

The US, EU, and other allied economies contemplating such instruments should also align and coordinate the principles and rules for their use such that these powers are directed toward illegitimate Chinese behavior rather than toward each other for narrower protectionist purposes.

It is worth noting that while the value of German goods exported to China was roughly equal to the combined exports of all other EU economies to China, Europe’s largest economy and exporter is still much more deeply integrated in economic terms with the US than with China.²⁰⁶ US FDI stock and flows into Germany and all other European economies (except Portugal) also exceed Chinese stock and flows by a
considerable margin. In the high-tech and high-value sectors, US firms have a far larger presence and stronger foothold than Chinese firms.  

While older EU regulations and restrictions were conceived to keep US dominance of the EU economy in check, it is becoming clear to Europeans that China is the main problem when it comes to issues such as IP theft, lack of reciprocity, and illegitimate erosion of European competitiveness and know-how. The EU seeks “strategic autonomy,” defined by the European Council as the “capacity to act autonomously when and where necessary and with partners wherever possible.” It also seeks “economic sovereignty,” which is defined as maximization of control over its economic future and affairs.

There is a strong European notion of wanting to be a neutral third center of power between the US and China. The EU is gradually facing the reality that it cannot remain equidistant between the US and China as the latter is the more egregious violator of laws, rules, and norms that serve European interests. The US is also far more important to Europe in economic terms than is China and is the much more trusted partner. The point is that partnership with the US vis-à-vis China is of much greater importance to the EU’s current and future prosperity and security (see figure 45).

## Pursue a Realistic Supply Chain Strategy for Traditional Merchandise Goods

When it comes to traditional and current-generation merchandise goods, the current administration and future ones will find it difficult to persuade American firms to relocate supply chains back to the US when goods are being produced for markets in Asia and elsewhere outside North America.

Supply and value chains for traditional and current-generation merchandise goods will continue to become more regional, especially in East Asia, which comprises China, Japan, South Korea, and the Southeast Asian economies. The rapid pace of technological progress in manufacturing-related technologies—such as robotics, automation, artificial intelligence, and 3D printing—will help this trend. These technologies will interact with each other in ever more sophisticated ways, and they will encourage businesses to locate the production and assembly of merchandise goods closer to the end consumer.

However, the declining importance of direct labor inputs and even land costs resulting from these technological developments mean that it is far more feasible to locate supply and value chains in the US when producing products for US consumers. The value and impact of investment in such technologies are already proven. For example, more than one-third of global installations of robots are in China—Japan and South Korea fill out the top three. These countries benefit disproportionately at the expense of oth-
er regional manufacturing economies as they are where the most advanced regional manufacturing plants are based. The best and most advanced industrial robotics companies are headquartered in the US, Japan, and Europe. Yet the US is only the fourth-largest robot installer in the world and the seventh-largest when it comes to robot density (per 10,000 workers).21

While it does not make sense for the US to compete for low-paying global manufacturing jobs (and it will fail if it tries to do so), the emphasis should be increasingly on encouraging advanced manufacturing plants serving American consumers to be based in the US—by far the world’s largest domestic consumption market. This will create more high-paying and skilled jobs in manufacturing services, logistics, marketing, etc., where much of the value will reside and be created.212

The US government should offer incentives to American firms and to those from advanced like-minded entities such as Japan, South Korea, the EU, and Australia to invest in these technologies and capabilities within the US when serving North American markets.

The objective should be to nurture a booming North American production and assembly zone for an increasing number of merchandise goods designed and dedicated to serve North American consumer markets while lowering advantages for and reliance on China-based firms, whether these firms have headquarters in China or elsewhere.

One cannot prevent China-based manufacturing firms from increasing their share in the Chinese consumer market as Beijing will offer these firms substantial assistance. But this is different from allowing entrenched advantages for Chinese firms serving external consumer markets.

**Adopt an Effective Defensive Strategy**

The most consequential contest will be in the high-tech and high-value sectors. Without Chinese dominance of these sectors, Beijing cannot dominate Asia or decouple from the US on its preferred terms. The US will want to ensure China is not in a position to dominate key technologies, set standards, and assume the box seat to dominate supply and value chains for these emerging and enabling technologies and sectors.

Leadership and dominance in these technologies and sectors are generally predicated on four conditions:

1. Investment at scale
2. Access to large and advanced markets
3. An effective system to drive innovation and competition
4. Channels to develop or acquire technology and know-how

China’s state-led approach and economic size allow it to fulfill the first condition, albeit in an extremely inefficient manner. However, the US and its allies have considerable agency in ensuring the other three conditions become far more problematic for China.

China needs to have access to large and advanced markets, develop an effective system to drive innovation and competition, and find channels to develop or acquire technology and know-how.

Supply chains in high-tech sectors are becoming more global and centered around advanced economies even as supply chains in traditional merchandise goods are becoming more regional. Most of these advanced economies are liberal democracies and US allies, while China is the outlier. In this sense, “globalization as usual” suits China since it benefits disproportionately from strategic competitors and rivals (i.e., the US and its allies). In the current and emerging period in which Chinese notions of decoupling have raised the stakes, China cannot be allowed to benefit at the expense of the US and its allies.

The US needs to oversee an increasingly difficult decoupling
from China in the high-tech and high-value sectors—but on US terms when it comes to content and timing. Just as China does not draw a distinction between military and civil use in its military-civil fusion framework, the identification of problematic Chinese entities and technologies should not be directed only to those Chinese entities primarily working with the military. All technologies identified by the MIC 2025 plan and in the DCP framework should be considered appropriate and legitimate battlegrounds. China has ensured there is too much at stake to do otherwise.

Below are some defensive principles and suggestions that the US can apply to the high-tech and high-value sectors.

Using Reciprocity as a Sword and Shield
For the US, demands for “reciprocity” should be used as both a sword and shield in diplomatic and tactical terms.

The Chinese lack of reciprocity is so stark and is such an entrenched feature of the Chinese political economy that the demand for genuine reciprocity will most likely never be met. But demanding reciprocity will put China on its back foot and help the US dictate the pace and nature of bilateral or mini-lateral negotiations given long-standing failures by the World Trade Organization to resolve many of these issues.213

The demand for reciprocity is not simply a negotiating tool. In sectors and areas that are purely economic rather than genuinely strategic, American companies should be able to sell as freely in China as the Chinese can in the US. Likewise, in non-sensitive areas, American firms should be able to invest as freely in China and with the same protections as China enjoys in the US.

However, in strategic sectors such as enabling technology, reciprocal treatment and protection of rights include measures that would entail deep reforms of China’s economic and legal institutions and practices, without which reciprocity would be impossible. As Beijing will be unlikely or unable to offer acceptable ground on such reforms or to do so in a timely manner, the US needs to justify to China (and to domestic stakeholders) why many Chinese purchases of US technology companies ought to be blocked, and to do so in a way that provides more than generalized justifications that the two countries are engaged in a strategic and technological competition or rivalry.

Bear in mind that the US needs time to organize its legal and regulatory response and should therefore be able to dictate the pace of negotiations with China. The Committee on Foreign Investment in the United States (CFIUS) is necessarily a flexible and adaptable regime that should consider changing realities and new challenges to the national interest. It will take some time for CFIUS to develop effective frameworks vis-à-vis China and for supporting legislation, such as the 2018 Foreign Investment Risk Review Modernization Act (FIRRMA), which came into effect in February 2020, and reforms to the Export Control Act, still to be considered and passed.214

Moreover, it will also take some time for the US (and other key allies and partners) to coordinate legislative and policy responses that involve scrutinizing and potentially blocking Chinese purchases of technology assets. FIRRMA previously recommended that CFIUS establish a process for exchanging information with allies and partners to help coordinate action with respect to FDI policy that poses national security risks, especially in the technology sectors.215

The principle of reciprocity will also be used to prevent or limit unintended or illegitimate technological leakage from the US to China. For example, the legislative and regulatory frameworks for FDI will increasingly consider allowing Chinese investment in sensitive sectors only if those sectors are open to foreign investors in China. Since virtually all these sensitive sectors in China are closed or restricted, this gives the US a strong reason to knock back any Chinese investment that might prove problematic. Science and technology cooperation with China should be
reciprocal. A tit-for-tat restriction by one against the other suits the US because cooperation has become far more beneficial to Beijing than to Washington. In this context, documents such as the US-China Agreement on Cooperation in Science and Technology should be rewritten to reflect the principle of reciprocity.

Following a Targeted Denial Strategy
The US has a broad range of executive, legislative, and regulatory powers to prevent or slow Chinese technological advances (see table 4).

Denial strategies need to be targeted to minimize unintended costs and disruptions. The US needs to forensically identify key technological chokepoints and vulnerabilities when thinking about how best to prevent China from acquiring, transferring, or stealing key capabilities and know-how.

The semiconductor industry is an instructive example. Semiconductor production consists of three main processes: integrated circuit (IC) design, IC fabrication, and IC packaging and testing. Since the 1990s, these processes have become highly fragmented. American firms such as Qualcomm lead the IC design process, while Asian firms such as Samsung and Taiwan Semiconductor Manufacturing (TSCM) lead IC fabrication. It is only in the relatively labor-intensive IC packaging and testing element that China is a major player. Incidentally, US firm Intel is one of the few companies able to perform all three processes.216 Chinese firm Semiconductor Manufacturing International Corporation (SMIC) is the fifth-largest IC fabrication firm. SMIC was a start-up with investment from Silicon Valley that succeeded by acquiring advanced machinery from the US. However, it is significantly behind Samsung and TSCM when it comes to the industry standard 14-nanometer chip, while it is relentlessly seeking capital and support to produce a 7-nanometer chip like those offered by TSMC, Samsung, and Intel. Similarly, China cannot match the innovation and capabilities of international firms such as Qualcomm and Nvidia when it comes to IC design.

The point is that China's relative backwardness and vulnerabilities are in IC design and IC fabrication. Special focus and attention need to be given to protecting technology leakage or theft in these areas and processes. Tariffs, export control laws, IP safeguards, banned entity lists, prohibited Chinese investment, and prohibitions on locating or transferring technologies from US and allied firms into China should focus on these specific Chinese vulnerabilities in any denial strategy.

There is less reason to focus on prohibiting or restricting Chinese access to technologies and processes at which China is already proficient. The highest priority of the denial strategy is to prevent China from becoming self-sufficient or emerging as the leading player in terms of hosting or having access to a complete supply chain for the technologies that will shape national power in the years ahead.

While there will be disagreement about how tough or how far restrictive policies should go, this report suggests that any Chinese technological capability and advancement ought to be treated as if they can be utilized to advance the objectives of the Chinese state, which include achieving a permanent advantage and leverage over the US in that sector.

Note that the position of this report is much harsher than a so-called centrist approach to technology controls, which is often summarized as the "small yard, high fence" approach of applying a denial strategy only to the most sensitive and strategic areas, especially military and dual-use civilian technologies.217 The problem with that approach is that the existing US notion of "sensitive and strategic areas" is far narrower than the Chinese one. A denial strategy should consider not just US thinking about what is important but also China's approach, and it should effectively counter that thinking. For example, those in the US advocating only a moderate response by focusing on a relatively small number of key technologies argue that "many in Beijing believe that the United States is intent on destroying the Chinese technology system, and Chinese domestic narratives
Table 4. Available US Defensive Measures

<table>
<thead>
<tr>
<th>Category</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>INVESTMENT RESTRICTIONS</strong></td>
<td>Committee on Foreign Investment in the United States (CFIUS)</td>
</tr>
<tr>
<td></td>
<td>• CFIUS activity increased</td>
</tr>
<tr>
<td></td>
<td>• Foreign investment Risk Review Modernization Act passed</td>
</tr>
<tr>
<td></td>
<td>• Non-SDN Chinese Military-Industrial Complex Companies List created</td>
</tr>
<tr>
<td><strong>TELECOMS LICENSING AND EQUIPMENT AUTHORIZATION</strong></td>
<td>• Carrier public interest certificate</td>
</tr>
<tr>
<td></td>
<td>• Submarine cable landing licensing</td>
</tr>
<tr>
<td></td>
<td>• Radio frequency equipment authorization (technically based)</td>
</tr>
<tr>
<td></td>
<td>• Secure and Trusted Communications Networks Act created the FCC's Covered List</td>
</tr>
<tr>
<td></td>
<td>• Team Telecom formalized</td>
</tr>
<tr>
<td></td>
<td>• Chinese carrier and cable landing licenses denied or revoked</td>
</tr>
<tr>
<td></td>
<td>• Secure Equipment Act banned radio frequency equipment on national security grounds</td>
</tr>
<tr>
<td><strong>VISA RESTRICTIONS</strong></td>
<td>• Section 212(a)(3)(C) of the Immigration and Nationality Act (INA)</td>
</tr>
<tr>
<td></td>
<td>• Section 212(f) of the INA</td>
</tr>
<tr>
<td></td>
<td>• Visa ban instituted for graduate students and researchers tied to military-civil fusion</td>
</tr>
<tr>
<td></td>
<td>• Certain Huawei employees barred</td>
</tr>
<tr>
<td></td>
<td>• Chinese Communist Party members restricted</td>
</tr>
<tr>
<td><strong>IMPORT RESTRICTIONS</strong></td>
<td>• Antidumping duties</td>
</tr>
<tr>
<td></td>
<td>• Countervailing duties</td>
</tr>
<tr>
<td></td>
<td>• Section 337 of the Tariff Act of 1930</td>
</tr>
<tr>
<td></td>
<td>• Broad-based tariffs imposed under a revived Section 301 of the Trade Act of 1974</td>
</tr>
<tr>
<td></td>
<td>• Steel and aluminum tariffs imposed under a revived Section 232(b) of the Trade Expansion Act</td>
</tr>
<tr>
<td></td>
<td>• DJI drones and Hytera radios excluded (the former later rescinded)</td>
</tr>
<tr>
<td></td>
<td>• Xinjiang-made goods presumptively banned</td>
</tr>
<tr>
<td><strong>FINANCIAL SANCTIONS</strong></td>
<td>• International Emergency Economic Powers Act and National Emergencies Act</td>
</tr>
<tr>
<td></td>
<td>• Specially Designated Nationals (SDN) List</td>
</tr>
<tr>
<td></td>
<td>• Global Magnitsky Act</td>
</tr>
<tr>
<td></td>
<td>• Chinese actors placed on SDN list for human rights abusers, corruption, and Hong Kong repression</td>
</tr>
<tr>
<td></td>
<td>• US Innovation and Competition Act passed Senate (would mandate further sanctions on Chinese actors)</td>
</tr>
<tr>
<td><strong>TECHNOLOGY TRANSACTION RULES</strong></td>
<td>• International Emergency Economic Powers Act and National Emergencies Act</td>
</tr>
<tr>
<td></td>
<td>• “App bans” attempted on Tik Tok, WeChat, and others “later rescinded”</td>
</tr>
<tr>
<td></td>
<td>• Bulk power system order instituted (later rescinded)</td>
</tr>
<tr>
<td></td>
<td>• Information and communications technology or services (ICTS) supply chain security rule enacted</td>
</tr>
<tr>
<td><strong>FEDERAL USE AND SPENDING RESTRICTIONS</strong></td>
<td>Various</td>
</tr>
<tr>
<td></td>
<td>• Drone use and purchase restricted</td>
</tr>
<tr>
<td></td>
<td>• Section 889 of the 2019 National Defense Authorization Act restricted government and contractor use of Chinese tech</td>
</tr>
<tr>
<td></td>
<td>• ‘Remove and replace’ rule enacted.</td>
</tr>
<tr>
<td><strong>LAW ENFORCEMENT</strong></td>
<td>• Federal investigation and prosecution</td>
</tr>
<tr>
<td></td>
<td>• China Initiative announced (later ended)</td>
</tr>
<tr>
<td></td>
<td>• Nontraditional collector cases persecuted</td>
</tr>
</tbody>
</table>

about tech competition have become increasingly nationalistic. A particularly harsh U.S. restriction, or the overall accumulation of controls, may cause China to step up its responses or broaden into new areas. Alternatively, Beijing might overreact due to misperceived U.S. intentions.\(^{218}\)

This perspective inaccurately depicts China as the passive bystander or responder to U.S. current and future actions. As previous sections argue, China seeks technological decoupling on its own terms and in the timing of its choosing. Beijing has long planned to permanently eclipse and sideline the U.S. when it comes to technological prowess and the economic benefits from it. China is already engaged in a technological war with the U.S., and the primary risk for the U.S. is not overreaching but doing too little to prevent the Chinese plan from eventuating.

In this sense, the U.S. should allow research or technological cooperation or a softer application of the above denial powers and rules only if it stands to gain a relative advantage or a net benefit—or if certain restrictions will isolate the U.S. economy or harm friendly economies and the net benefit to U.S. interests is consequently negative.

Restricting and Regulating US R&D in China

Chinese innovation and know-how depend heavily on joint ventures with foreign firms. One estimate is that about 80 percent of private-sector R&D money spent in China in 2015—about

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**Figure 46. US foreign R&D and employment by location, 2018–2019**

<table>
<thead>
<tr>
<th>COUNTRY</th>
<th>2018 FOREIGN R&amp;D</th>
<th>2019 FOREIGN R&amp;D</th>
<th>2018-2018 % CHANGE</th>
<th>R&amp;D EMPLOYMENT INTENSITY*</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>TOTAL R&amp;D</td>
<td>FOREIGN EMPLOYMENT</td>
<td>TOTAL R&amp;D</td>
<td>FOREIGN EMPLOYMENT</td>
</tr>
<tr>
<td>Total</td>
<td>$100.4B</td>
<td>10,700</td>
<td>797</td>
<td>$104.5B</td>
</tr>
<tr>
<td>UK</td>
<td>$11.3B</td>
<td>695</td>
<td>68</td>
<td>$11.8B</td>
</tr>
<tr>
<td>India</td>
<td>$9.5B</td>
<td>867</td>
<td>173</td>
<td>$9.8B</td>
</tr>
<tr>
<td>Germany</td>
<td>$8.4B</td>
<td>454</td>
<td>47</td>
<td>$8.9B</td>
</tr>
<tr>
<td>China</td>
<td>$7.9B</td>
<td>457</td>
<td>73</td>
<td>$8.2B</td>
</tr>
<tr>
<td>Canada</td>
<td>$6.1B</td>
<td>457</td>
<td>40</td>
<td>$6.9B</td>
</tr>
<tr>
<td>Israel</td>
<td>$5.1B</td>
<td>57</td>
<td>23</td>
<td>$6B</td>
</tr>
<tr>
<td>Switz.</td>
<td>$4.4B</td>
<td>71</td>
<td>10</td>
<td>$4.5B</td>
</tr>
<tr>
<td>Ireland</td>
<td>$4B</td>
<td>116</td>
<td>14</td>
<td>$4.2B</td>
</tr>
<tr>
<td>Japan</td>
<td>$4B</td>
<td>200</td>
<td>22</td>
<td>$4.1B</td>
</tr>
<tr>
<td>France</td>
<td>$3.3B</td>
<td>263</td>
<td>21</td>
<td>$3.3B</td>
</tr>
</tbody>
</table>

*R&D employment intensity = (foreign R&D employment/foreign employment) x 100

Source: Francisco Moris, “Foreign R&D Reported by IT-Related Industries Account for About Half or More of US-Owned R&D Performed in India, China, Canada, and Israel,” NSF 22-328, National Center for Science and Engineering Statistics, National Science Foundation, April 28, 2022
Figure 47. US Foreign R&D by Industry and Host Country, 2019

<table>
<thead>
<tr>
<th>INDUSTRY</th>
<th>TOTAL OUTSIDE US</th>
<th>UK</th>
<th>IND</th>
<th>GER</th>
<th>CHN</th>
<th>CAN</th>
<th>ISR</th>
<th>SWITZ</th>
<th>IRE</th>
<th>JPN</th>
<th>FRA</th>
</tr>
</thead>
<tbody>
<tr>
<td>ALL INDUSTRIES</td>
<td>$104.5B</td>
<td>$11.8B</td>
<td>$9.8B</td>
<td>$8.9B</td>
<td>$8.2B</td>
<td>$6.9B</td>
<td>$4.5B</td>
<td>$4.2B</td>
<td>$4.1B</td>
<td>$3.3B</td>
<td></td>
</tr>
<tr>
<td>MANUFACTURING</td>
<td>$64.4B</td>
<td>$5.6B</td>
<td>$4.5B</td>
<td>$6.9B</td>
<td>$5.9B</td>
<td>$3.6B</td>
<td>$3.9B</td>
<td>$2.9B</td>
<td>$2.3B</td>
<td>$2.7B</td>
<td>$2.1B</td>
</tr>
<tr>
<td>Chemicals</td>
<td>$18.6B</td>
<td>$2.2B</td>
<td>$0.4B*</td>
<td>$1.1B</td>
<td>$1B</td>
<td>$0.8B</td>
<td>$0.3B</td>
<td>$1.8B</td>
<td>$1.5B</td>
<td>$1.2B</td>
<td>$0.7B</td>
</tr>
<tr>
<td>Pharmaceuticals</td>
<td>$15.9B</td>
<td>$2B*</td>
<td>$0.4B*</td>
<td>$0.8B</td>
<td>$0.8B</td>
<td>$0.7B</td>
<td>$0.2B</td>
<td>$1.7B</td>
<td>$1.5B</td>
<td>$1.1B</td>
<td>$0.6B</td>
</tr>
<tr>
<td>Machinery</td>
<td>$4.3B</td>
<td>$0.4B</td>
<td>$0.4B</td>
<td>$0.7B</td>
<td>$0.4B</td>
<td>$0.1B</td>
<td>$0.4B</td>
<td>$0.2B</td>
<td>$0.02B*</td>
<td>$0.2B</td>
<td>$0.4B</td>
</tr>
<tr>
<td>Computer, electronic products</td>
<td>$25.5B*</td>
<td>$1.4B</td>
<td>$3.2B</td>
<td>$2.1B</td>
<td>$2.5B</td>
<td>$1.8B</td>
<td>$3.1B</td>
<td>$0.3B</td>
<td>$0.5B</td>
<td>$0.8B</td>
<td>$0.5B*</td>
</tr>
<tr>
<td>Semiconductors, other electronic components</td>
<td>$13B*</td>
<td>$0.4B</td>
<td>$1.5B</td>
<td>$0.8B</td>
<td>$1.5B</td>
<td>$0.7B</td>
<td>$2.2B</td>
<td>$0.1B</td>
<td>$0.3B</td>
<td>$0.3B</td>
<td>$0.2B</td>
</tr>
<tr>
<td>Electrical equipment, appliances, components</td>
<td>$1.7B</td>
<td>$0.1B</td>
<td>$0.1B</td>
<td>$0.3B</td>
<td>$0.4B</td>
<td>$0.3B*</td>
<td>$0.0-0.02B</td>
<td>$0.1B</td>
<td>$0.01B</td>
<td>$0.1B</td>
<td>$0.1B</td>
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<tr>
<td>Transportation Equipment</td>
<td>$7.8B</td>
<td>$0.9B</td>
<td>$0.2B</td>
<td>$2B</td>
<td>$1B</td>
<td>$0.3B</td>
<td>$0.001B</td>
<td>$0.01B</td>
<td>$0.01B</td>
<td>$0.1B</td>
<td>$0.2B</td>
</tr>
<tr>
<td>Motor Vehicles, bodies, trailers, parts</td>
<td>$7B</td>
<td>$0.7B</td>
<td>$0.2B</td>
<td>$1.9B</td>
<td>$1B</td>
<td>$0.2B</td>
<td>$0.04B</td>
<td>$0-0.01B</td>
<td>$0.1B</td>
<td>$0.1B</td>
<td>$0.1B</td>
</tr>
<tr>
<td>Aerospace products, parts</td>
<td>$0.6B</td>
<td>$0.2B</td>
<td>$0-0.02B</td>
<td>$0.01B</td>
<td>$0-0.01B</td>
<td>$0.04B</td>
<td>$0.08</td>
<td>$0-0.01B</td>
<td>$0.0B</td>
<td>$0.004B</td>
<td>$0-0.05B</td>
</tr>
<tr>
<td>NONMANUFACTURING INDUSTRIES</td>
<td>$40.1B</td>
<td>$6.2B</td>
<td>$5.4B</td>
<td>$2B</td>
<td>$2.3B</td>
<td>$3.3B</td>
<td>$2.1B</td>
<td>$1.6B</td>
<td>$1.9B</td>
<td>$1.4B*</td>
<td>$1.2B</td>
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<tr>
<td>Information</td>
<td>$19.1B</td>
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<td>$3.2B</td>
<td>$0.6B</td>
<td>$1.2B</td>
<td>$1.9B</td>
<td>$1.4B</td>
<td>$1B</td>
<td>$0.9B</td>
<td>$0.2-0.3B</td>
<td>$0.5B</td>
</tr>
<tr>
<td>Publishing</td>
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<td>$0.7B</td>
<td>$1.4B</td>
<td>$0.2B</td>
<td>$0.7B</td>
<td>$1B</td>
<td>$0.5B</td>
<td>$0.1B</td>
<td>$0-0.3B</td>
<td>$0.1B</td>
<td>$0.2B</td>
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<td>Software Publishing</td>
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<td>$0.7B</td>
<td>$1.4B</td>
<td>$0.2B</td>
<td>$0.7B</td>
<td>$1B</td>
<td>$0.5B</td>
<td>$0.1B</td>
<td>$0-0.3B</td>
<td>$0.1B</td>
<td>$0.2B</td>
</tr>
<tr>
<td>Data processing, hosting, related services</td>
<td>$5.9B</td>
<td>$0.6B</td>
<td>$1.5B</td>
<td>$0.2B</td>
<td>$0.3B</td>
<td>$0.6B</td>
<td>$0.4B</td>
<td>$0-0.2B</td>
<td>$0.3B</td>
<td>$0.04B</td>
<td>$0.2B</td>
</tr>
<tr>
<td>Professional, scientific, and technical services</td>
<td>$14.6B</td>
<td>$2.5B</td>
<td>$1.3B</td>
<td>$0.7B</td>
<td>$0.8B</td>
<td>$1B</td>
<td>$0.6B</td>
<td>$0.5B</td>
<td>$0.3-0.5B</td>
<td>$0.7B*</td>
<td>$0.6B</td>
</tr>
<tr>
<td>Computer systems design, related services</td>
<td>$5.4B</td>
<td>$0.4B</td>
<td>$1B</td>
<td>$0.3B</td>
<td>$0.3</td>
<td>$0.5B</td>
<td>$0.5B</td>
<td>$0.1B</td>
<td>$0.2-0.4B</td>
<td>$0.1B</td>
<td>$0.1B</td>
</tr>
<tr>
<td>Scientific research, development services</td>
<td>$9B*</td>
<td>$2B*</td>
<td>$0.3B*</td>
<td>$0.4B*</td>
<td>$0.4B</td>
<td>$0.5B</td>
<td>$0.1B*</td>
<td>$0.4B</td>
<td>$0.1B*</td>
<td>$0.6B*</td>
<td>$0.4B</td>
</tr>
<tr>
<td>R&amp;D in Biotechnology</td>
<td>$2.8B</td>
<td>$1B</td>
<td>$0.1B</td>
<td>$0.1B</td>
<td>$0.2B</td>
<td>$0.1B</td>
<td>$0.02B</td>
<td>$0.4B</td>
<td>$0.04B</td>
<td>$0.1B</td>
<td>0.1B</td>
</tr>
<tr>
<td>R&amp;D in physical engineering, life sciences (except biotechnology)</td>
<td>$6.2B</td>
<td>$1.1B</td>
<td>$0.2B</td>
<td>$0.3B</td>
<td>$0.2B</td>
<td>$0.4B</td>
<td>$0.05B</td>
<td>$0.03B</td>
<td>$0.1B</td>
<td>$0.4B</td>
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*50% of the estimate is a combination of imputation and reweighting to account for nonresponse. Note: An estimate range may be displayed in place of a single estimate to avoid disclosing operations of individual companies.

Source: Moris, “Foreign R&D Reported by IT-Related Industries.”
USD 44 billion out of USD 55 billion—was by non-Chinese multinationals.219

When it comes to US-headquartered firms, China is the fourth-most-important international destination for R&D by expenditure after the UK, India, and Germany (figure 46).

About three quarters of US R&D in China goes into manufacturing, traditionally for export to the world but increasingly to the Chinese consumer market. Most of the R&D in China is not relevant to high-tech competition, which is the subject of this report.

However, the US should better examine some aspects of foreign R&D related to manufacturing (e.g., advanced materials, robotics, machine learning, and AI) that feed directly into China’s MIC 2025 and DCP framework. Some discrete categories—such as computer systems design, biotechnology, and life sciences—also need to come under much greater scrutiny, including possible regulation or prohibition (see figure 47).

More generally, it is certain the US government will give itself ever broader powers to block corporate and sales transactions between America- and China-based firms and the export of whole classes of products or certain technologies (even if these powers are held in reserve most of the time).220 There should be much stronger guidance and regulation when it comes to US-headquartered firms’ R&D activities inside China or who their joint-venture R&D partners can be.

Regulating and Restricting Portfolio Investment in China

US portfolio investment (investment in Chinese securities and debt) in China begins from a low base compared with FDI in China. For example, while 2017 figures show that US entities have significant holdings in equities listed in advanced-economy stock markets around the world, American holdings of Chinese equities amount to less than 3 percent of Chinese listed securities (see figure 48).

However, in recent years, US portfolio holdings have increased at significantly faster rates even as US FDI in China is generally declining from the peaks of 2018 (see figure 49). From 2011 to 2019, the value of foreign portfolio investment in China increased 5.5 times, compared to 1.7 times for the value of FDI.221

Ceteris paribus, one would expect portfolio investment in China to grow even more rapidly. As earlier sections explain, the severely indebted Chinese economy needs external capital to fund Beijing’s ambitious industrial and technological plans. Beijing will increasingly rely on portfolio investment to obtain that capital in the form of foreigners buying Chinese equities and purchasing central and local government bonds. That this is a deliberate strategy is affirmed by significant changes over the
past few years that smooth the way for foreign portfolio investment in China at a time when the CCP is putting more emphasis on accelerating its industrial and technological ambitions.

For example, the Shenzhen-Hong Kong Stock Connect was launched in 2016 and provides foreign investors with access to many of the high-growth technology firms listed in Shenzhen. At the same time they launched of the Shenzhen Connect, authorities removed quotas for both the Shanghai and Shenzhen Stock Connect programs. In April 2018, they quadrupled the daily quota amount for the stock connects. They implemented similar changes for Chinese bond markets to enable foreign entities to buy Chinese bonds more easily.

Moreover, changes by major indexes such as the MSCI All Country World Ex-US Investable Market Index, FTSE Russell, and S&P Dow Jones, as well as by pension funds such as the Thrift Savings Plan's International Stock Fund to give a heavier weighting to Chinese firms, have led to hundreds of billions of “passive” portfolio investments in China. Inclusion and a heavier weighting in these indexes provide these firms with flow-on advantages such as access to cheaper capital and "captured" institutional investors, given the need for benchmark or passive funds to own these stocks. In 2019, an estimated USD 400 billion of new investment in Chinese equities was driven by changes in these benchmark indexes alone, and the figure is likely to be around a trillion dollars currently. The inclusion and greater weight given to Chinese bonds in relevant indexes have resulted in an additional USD 100 billion according to some estimations.

This is a problem because the Chinese firms included are largely SOEs and national champions that are central to Beijing’s MIC 2025 and DCP plans. Similarly, an increasing share of Chinese government bonds (including local bonds) is being used to fund Beijing’s broader industrial and technological plans. In this context, portfolio investment is a considerable loophole for Chinese entities to obtain much-needed foreign capital when other actions by the US are seeking to restrict these and other advantages for these same Chinese entities. It also means more American entities are sleepwalking their way toward holding more and more Chinese assets that carry sovereign and political risk that is not being sufficiently priced into them by either those determining the constituents of the indexes or the passive investors.

Like the Trump administration, the Biden administration has continually added to the list of Chinese firms in which US entities are prohibited from investing. This has led to a steady stream of Chinese firms being removed from major indexes.

Most Chinese firms on the entity list are involved in the defense industry, are engaged in violation of human rights (e.g., use of forced labor), or are major contributors to China’s authoritarian surveillance capabilities. Given the comprehensive Chinese military-fusion framework and the ambition and strategic challenge of Chinese plans to dominate high-tech and high-value sectors, the entity list ought to include all major Chinese firms engaged in the priority sectors identified by plans such as MIC
2025 and the DCP. Exceptions should be made only if there is a net benefit for the US in doing so.

Reimagining Globalization

Business as usual in the global economy is no longer possible. However, rather than a retreat into fortress America, it requires a reimagining of globalization. Just as former Google CEO Eric Schmidt predicts there will be two internets—a freer version and a Chinese version—supply chain and end users in high tech might well exist in one of two ecosystems. The Chinese alternative will be guided by certain principles and governed very differently from the US and allied one.

The previous section about a defensive strategy is critical, but merely preventing or slowing China’s progress is not sufficient. Tech leadership and dominance are possible only with extensive collaboration between entities and individuals from many countries. The process of innovation and successful commercialization requires input from and access to many markets. The US needs to seek every advantage for its preferred ecosystem and to nurture and protect that ecosystem. In this sense, the US should seek deeper interdependencies within its preferred ecosystem to maximize innovation and efficiency gains between the advanced economies. This will help ensure the US-led ecosystem is a more attractive one in technological, commercial, and ethical terms than a Chinese-led one.

In the US-led ecosystem, competition between countries and firms for technologies, patents, talent, and markets should be intense as befits a private-sector-led open economy. However, the objective is to create a rules-based and level playing field within this ecosystem while minimizing structural and relative advantages available to the Chinese-led ecosystem. Put differently, one must make the distinction between competition within the US-led ecosystem and competition between the US-led and Chinese-led ecosystems for technology, capital, markets, talent, and participants. Within the US-led ecosystem, winners and losers are determined largely by the market and will change and evolve over time. Between the US-led and Chinese-led ecosystems, the competition is to entrench guaranteed advantages for one at the expense of the other.

Work with Big Tech

Half of the largest technology companies in the world by revenue are American. Companies such as Alphabet (Google) and Meta (Facebook) spent USD 31.6 billion and USD 24.7 billion on R&D in 2021 respectively, which accounts for 12.3 percent and 21 percent of their respective revenues. Meta is working with another giant American company, Nvidia, on projects such as the development of an AI research supercomputer.

In the context of competition with China’s state-owned giants and national champions, proposals to break up America’s big tech companies or to prevent them from growing or undertaking further acquisitions risk undermining them when they are needed to give the US-led tech ecosystem decisive advantages. Size and market dominance are not evidence of uncompetitive behavior per se. Rather than suppress or break up big tech, the US needs to regulate some of its activities—those that are genuinely anticompetitive or involve practices and partnerships that transfer advantages to the Chinese economy and Chinese firms.

It does not serve US interests to specifically target big tech on the bases of size and market dominance rather than behavior that violates existing antitrust law. Arguments by American business entities that specifically targeting big tech will hurt America’s capacity to win the tech wars might be self-serving, but they are correct. What is good for big tech is not necessarily good for the US. But hampering the ability of US big tech to compete with Chinese competitors is almost certainly bad for the US.

Indeed, big tech needs to work with the US government and other stakeholders on missions that are in the national interest. The most recent example of deep collaboration was Operation
Warp Speed, which aimed to develop, manufacture, and distribute an effective vaccine for COVID-19, one of the most ambitious scientific endeavors in history.

Operation Warp Speed involved multibillion-dollar partnerships between government and the private sector. Equipment and raw materials were sourced from around the world for use by the best scientific minds in the private and research sectors. Cybersecurity and physical security operations were established to protect the work being done. The government offered financial backing and strong commercial incentives for private firms, and risks were managed and shared.

The COVID-19 pandemic created unique and existential incentives for Operation Warp Speed to succeed. Such activity cannot be reproduced easily or frequently, but it is a recent example of mission-based activity in the national and international interest. It would not have been possible without the existence of world-leading firms with enormous capabilities and resources. Operation Warp Speed also demonstrates America’s advan-

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<th>WARFARE</th>
<th>ACTIONS</th>
<th>PURPOSES</th>
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<td>Psychological</td>
<td>Use or dissemination of specific information or arguments to affect the psychology and subsequent behavior of the enemy. Focus on the psychology of ‘coercion’ (compelling a subject to behave in certain ways); ‘mystification’; or ‘obfuscation’ (spreading confusion and uncertainty of facts or issues); ‘division’ (encouraging and exploiting disagreement amongst enemies); and ‘defense’ or ‘resilience’ (ensuring the same cannot be done to Chinese entities).</td>
<td>Encourage a potential adversary to be cautious about joining an action (including war) against China. Encourage the enemy to base its policies and actions on false or irrelevant information to dilute the effectiveness of their decision-making. Enhance the CCP’s capacity to control the nature and pace of escalation through manipulation of how the enemy calculates costs/benefits and understands risk. Undermine the enemy’s will to resist or endure costs/losses.</td>
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<tr>
<td>Public Opinion</td>
<td>Dissemination of disinformation through media (newspapers, radio, television, the internet, films, books, and social media) to affect discussion and shape desired narratives in an enemy’s environment.</td>
<td>Degrade the resolve of the public to oppose CCP policies and actions. Shape not only public opinion but how the public thinks and talks about an issue (such as Taiwan, human rights, or Chinese history). Create social licence to support and propagate the CCP’s view of history and deny others the social licence to oppose the CCP’s view of history.</td>
</tr>
<tr>
<td>Legal</td>
<td>Use of legal and pseudo-legal arguments to redefine notions of legality and legitimacy. Development of favorable norms and processes in international organizations.</td>
<td>Redefine legality and legitimacy to justify Chinese actions. Increase the sphere of ‘legitimate’ coercive and subversive Chinese actions. Use threat of legal action to intimidate or silence, or to impose financial or reputational costs on entities and individuals promoting views antithetical to Beijing’s interests.</td>
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Table 5. The Three Warfares

tage over authoritarian political economies such as China. The US needs to incentivize and unleash its big tech companies in the national interest rather than inhibit them.

**Conclusion**

The Chinese Communist Party instructs the People’s Liberation Army to engage in information and influence operations that are commonly known as “political warfare.” Sometimes referred to by Chinese strategists and military thinkers as the sixth domain of warfare, political warfare is being used by the CCP and PLA to shape or even control the enemy’s thinking and decision-making.234

The PLA’s most developed doctrinal and operational framework of “cognitive domain operations” is the Three Warfares—psychological, public opinion, and legal—which was first formulated in 2003 (see table 5).

Political warfare is raised in this context because American and global perspectives of China and its role in the global economy are major targets of CCP and PLA information operations.

For example, China frames decoupling as an illegitimate American initiative driven by the latter’s insecurity and fear that its economic and technological dominance is being eclipsed. Beijing is also eager to tell the world that China is too indispensable to the global economy for US-led decoupling to occur or succeed and that other economies ought not to support or join such US actions. Doing so would only harm their own prosperity for no possible gain. Instead, it would be better for the world to accept globalization as usual and pocket the absolute (if unequal) gains that come from existing interactions with China. In short, Chinese economic and technological dominance is inevitable and beneficial. One would do better to accept and internalize Chinese economic and predatory behavior rather than resist it.

As in all effective influence efforts, some elements of truth or fact are interwoven in this strategic messaging. China is indispensable to the global economy, and countries do gain from interacting with China—albeit in more absolute than relative terms. Complete decoupling is likely impossible, and attempts to achieve it would be enormously costly and disruptive.

Indeed, China urges the rest of the world to pursue moderate policies toward it even as Beijing accelerates efforts to decouple the Chinese and regional economy from the US on Chinese terms. Beijing knows that if it can coax others into inaction and lead them to focus only on the costs of action, then it can gradually transform economic relations in ways that permanently entrench privileges for China.

This report makes the following arguments and conclusions:

1. On the back of a preexisting mercantilist political economic structure, China has been explicitly pursuing economic decoupling from US and allied economies on Chinese terms for at least one decade.

2. While the US seeks to decouple some aspects of economic activity from China, the latter is seeking to dominate vast segments of the Asian economy and to decouple them from the US.

3. The most important segments are the high-tech and high-value sectors. These sectors are where competition is the most consequential and where decoupling on US terms needs to occur.

4. China is facing increasingly serious problems and obstacles related to its decoupling strategy. Many of these arise out of structural weaknesses inherent in its political economy.

China hopes the US and its allies will adopt a cautious, gradualist, and ineffective approach to countering Beijing’s objectives. The CCP knows the US and other advanced economies still have the advantage despite clever Chinese messaging to the contrary. The US and its allies continue to enjoy considerable leverage and remain well placed to partially decouple from China on their preferred terms, but they need to act quickly, collectively, and decisively.
## ENDNOTES


3. Figures from the SIPRI Military Expenditure Database, https://sipri.org/sites/default/files/Data%20for%20all%20Countries%20from%201988%E2%80%932020%20in%20constant%20%282019%29%20USD%20%28pdf%29.


25 NUS Faculty of Arts and Social Sciences, "Bilahari Kausikan on Singapore Foreign Policy (3): Origins II—ASEAN: Vital but Limited," FASS90 Political Science Lecture Series on the Practice of Foreign Affairs at the National University of Singapore on March 13, 2019, YouTube video (June 9, 2019), 59:25, https://www.youtube.com/watch?v=V0GxY731xhA.


40 See Jonathan E. Hillman and Matthew P. Goodman, *China’s Trojan Ports*, (Washington, DC: Center for Strategic and International Studies, Reconnecting Asia Project Database, May 14, 2021, https://reconnectingasia.csis.org/database/initiatives/one-belt-one-road/fb5c5a09-2dba-48b9-9c2d-4434511893c8/). In contrast, 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.

41 Center for Strategic International Studies, *Reconnecting Asia Project Database*, May 14, 2021, https://reconnectingasia.csis.org/database/initiatives/one-belt-one-road/fb5c5a09-2dba-48b9-9c2d-4434511893c8/. In contrast, 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.


See Lund et al., Globalization in Transition.


See “China Evergrande Group: Strategic Repositioning toward a Sustainable Growth Model.”


See “China Evergrande Group: Strategic Repositioning toward a Sustainable Growth Model.”


See Dong et al., “Why Everyone Is Talking about Evergrande.”


96 Note that at the time of preparing this report, the EU has suspended ratification of the agreement.


105 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 15 percent combined. China is merely the primary assembler of devices, and thus much of the value of each device is not produced or captured there. For example, China adds only 4 to 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, it 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, Michael McAdoo, Antonio Varas, Jacob Koch-Weser, and Raj Varadarajan, “Unpacking the US-China Tech Trade War,” Boston Consulting Group, June 5, 2019, https://www.bcg.com/en-au/publications/2019-us-china-technology-trade-war.aspx.

106 Zenglein and Holzmann, “Evolving Made in China 2025.”


110 “Is China a Global Leader in Research and Development?,” Center for Strategic International Studies China Power Proj-
See Roth, Seong, and Woetzel, Gauging the Strength of Chinese Innovation.


Joske, Hunting the Phoenix.

Joske, Hunting the Phoenix.


In the two catalogues, the “encouraged” category refers to advanced technologies, equipment, products, and industries that play an important role in promoting high-quality economic and social development and need to be encouraged. The “restricted” category refers to backward technologies, equipment, and products that are not in line with the industry access conditions and relevant regulations and need to be reformed. The “obsolete” category refers to backward technologies, equipment, and products that do not comply with the relevant laws and regulations, do not have conditions for safe production, seriously waste resources and pollute the environment, and need to be phased out. The catalogue version enumerates 48 industries and 1,477 industry items, including 821 items that are encouraged for development in China, 215 items that will be restricted, and 441 items that will be phased out.


Lysenko, Hanemann, and Rosen, “Disruption.”


See Tim Nicholas Ruchling, Technical Standardization, China,


143 See Johnston, “The Belt and Road Initiative.”


148 Xi Jinping, “Grasp the New Development Stage, Implement the New Development Concept, and Build a New Development Pattern,” speech delivered January 11, 2021, at a seminar on the study and implementation of the spirit of the Fifth Plenary Session of the 19th Central Committee of the Party for leading cadres at the provincial and ministerial levels, http://www.qstheory.cn/dukan/qz/2021-04/30/c_1127390013.htm.

149 My calculations using IMF figures.

150 See Ruta et al., Belt and Road Economics, 3–8.


152 Ruta et al., Belt and Road Economics, 20–21.


155 See Deloitte, “Embracing the BRI Ecosystem in 2018.”

156 See Bandiera and Tsipouroulos, “A Framework to Address Debt Sustainability.”

157 Ruta et al., Belt and Road Economics, 6–7.


To offer a trivial analogy, consider the inconvenience and cost of leaving the Apple ecosystem for personal devices. This is the same captured customer approach China is using with far more menacing ramifications.


205 See Lee, “How China Overreached in Australia.”


219 Januzelski, Staack, and Chwalik, “Will Stronger Borders Weaken Innovation?”

220 See Swanson and McCabe, “Trump Effort to Keep US Tech Out of China.”


226 Schoenfeld, “Americans Are Investing More in China.”


