HOW SHOULD THE WEST RESPOND TO CHINA’S APPROACHING TROUBLES?

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March 2019
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The Issue

From the Editor: China’s political and economic rise over the past generation has been closely watched and widely debated. Will it eventually surpass the United States as a global power? Does the emerging multipolar world now taking shape presage greater or lesser stability? Is Russia or China the greater challenge to the West? CEPA’s Andrássy Fellow Miklós Lázár examines these questions and finds that the road ahead for Beijing may be rockier than the recent past.

China, long viewed as an ascendant global superpower, has a faltering economy, faces pressures from major trading partners, and its overextended foreign policy is causing tension with both the United States and the European Union. Should these problems continue, the most probable threat to international stability would not be China’s dramatic rise, but the consequences of Beijing’s inability to maintain the very momentum which made China a significant power. Since China is a crucial driver of the global economy, western nations should cushion themselves against the consequences of the challenges facing Beijing by taking steps that would strengthen their resiliency. These include pushing for the reform of global trade and hedging away from long-term trade with China.
Encouraged by China’s economic and diplomatic successes following the 2008 crises, Beijing has ended up with a bad case of strategic overstretch by focusing on enhancing international stature to the detriment of overdue domestic economic reforms. As a result, China is facing a period of long-unprecedented macroeconomic uncertainty and diplomatic turbulence which foreshadow even slower GDP growth and possible domestic discontent.²

In itself, the slowing of China’s economic growth is a fact which is by no means unexpected given its size and current level of development.³ The recent 6 percent annual GDP growth rates are still impressive.⁴ Nonetheless, a distinction must be made between a carefully executed deceleration and sudden policies that could lead to a grinding halt. China’s problem is that the likelihood of the second option has been steadily growing over the past few years.

There are three additional challenges which require further consideration. First, as China’s problems become apparent, investors are less likely to believe the habitually over-optimistic financial and economic expectations of the international business community.⁵ In the past, such optimism has functioned as a self-fulfilling prophecy and allowed China to borrow at reasonable rates. The country’s notable resilience after the global financial crisis in 2008 helped cement the reputation of China’s leaders as competent stewards of the country’s economy. As the IMF has recently warned, however, the local government’s debt landscape in China is very different today than a decade ago.⁶,⁷ Large portions of China’s sub-national and private debt is in danger of becoming temporarily unsustainable due to China’s slowing real growth and the relative performance of the U.S. dollar to China’s national currency.⁸ Thus, China’s government will be soon tested and may be forced to choose between fiscal responsibility and security concerns.⁹,¹⁰

Second, the current level of U.S. tariffs and the ongoing trade war with the United States have slowed down China’s trade and overall economic performance in Q1 and Q2 of 2019 (not to mention the aftereffect from the pre-tariff stock-up of Q4 of 2018).¹¹,¹²,¹³,¹⁴,¹⁵ The Trump administration appears to be quite comfortable with the present tense situation and seems willing to wait for China to come around to its point of view.¹⁶ Beijing has responded by seeking to address some U.S. concerns and rushing economic reform legislation to meet key foreign investor demands.¹⁷ At the same time, Beijing has diverted financial resources to mitigate U.S.-driven blows to its economy and notable Chinese analysts are already discussing strategic retrenchment.¹⁸ In the meantime, the bulk of Beijing’s financing assistance continues to flow to state-owned enterprises (SOEs) while private actors increasingly struggle with the less-promising business environment.¹⁹

Third, business-operational efficiency is becoming a very serious concern throughout the developed parts of China, as the industries which benefited from recent growth trends the most (e.g. automotive, construction, and telecoms) can no longer expect expansion to continue at the previous pace.²⁰ The emergence of stricter competing conditions also coincides with big data-led government efforts to engineer spending incentives and
actively encourage strategic or frugal customer behavior and household savings. Moreover, international investors also have flagged long-term worries, suggesting that the slowdown in China will render it difficult to support the aging population in the future. Meanwhile, China’s middle class is still expected to grow at the previously projected pace on the assumption that the government can somehow secure the uninterrupted development of third and fourth-tier cities in the poorer western and central parts of the country.

In summary, Beijing’s growth projections for this year are hardly tenable, if reliable at all. China’s leaders may be able to avoid a crisis or Japanese style ‘lost decade’ of near zero percent growth, but China’s transition to more sustainable and reasonable GDP growth rates (around 3 percent annually) will be very difficult in the relative absence of working market principles across strategic sectors (e.g. construction, steel, finance) and effective efficiency-driving reforms (e.g. transparent tendering, progressive urban property taxation).

THE GEOECONOMIC BACKDROP TO SHIFTING CHINA-WEST RELATIONS

From the perspective of Brussels and Washington, Beijing remains an essential partner. China is the EU’s biggest source of imports and its second most important export market. According to an April 2018 European Commission report, Chinese trade with Europe is more than €1 billion per day. EU-China trade in services amounts to more than 10 percent of total trade in goods. The EU’s exports of services make up 19 percent of the EU’s total exports of goods. While the EU has a trade deficit with China, its overall trade balance up to 2018 was positive. Until recently, the EU has been patient with China in comparison to the United States, but with tensions high over market access and intellectual property theft, the attitudes of economic powerhouses such as Germany is hardening.

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China also is the third-largest destination for U.S. goods and services. Two-way trade between these two countries amounted to $772 billion by 2017. The United States is China’s largest export market. However, the U.S. trade deficit in goods with China grew to $375 billion in 2017—a figure which was completely unacceptable to the current U.S. administration. This development also has raised concerns in the United States about external trade imbalances and reignited discussions on investment and employment trends by catapulting such issues on top of the current economic and foreign policy agendas of the United States.

Beijing’s unique status as an unapologetic communist government trading with liberal
nations, and the resulting advantages that status provides essentially western-led international institutions, causes major distorting effects for global trade (e.g. massive state subsidies for exports, dumping). Thus, many of the West's current problems with China stem from Beijing's unrequited access to the key institutions of liberal order. However, China can be also viewed as the victim of the current trading system. Its introduction into that order was conducive to the West's Cold War era geostrategic imperatives and perhaps good for international business and development, but the anomalies stemming from China's special position are hardly sustainable in the long run and will continue to generate political and ideological conflict.30

CALIBRATING WESTERN RESPONSES

In the past, Beijing could benefit from these advantages by counting on the self-restraint and patience of western leaders with regard to trade and intellectual property abuses. But this is unlikely to continue in the context of intensifying geoeconomic and geostrategic competition (e.g. with South Asia, Africa, East and Central Europe). Indeed, as the on-going trade war seems to suggest, using more sticks than carrots in bilateral negotiations can result in notable concessions in the short run.

However, more radical 'my way or the highway' approaches by the West are likely to backfire. For instance, should the West fail to establish long-term institutional incentives for reform and mutual conformity, Beijing could soon find ways to circumvent the bilaterally-imposed obstacles to their trade or perhaps choose to bear the increased bilateral trade costs indefinitely in exchange for greater sovereignty on the home front.

The heightened competition and likely reversal of the relative defense and economic capabilities of the U.S. and China may constitute the most worrisome geopolitical scenario of the next decade, but the global consequences of overestimating China's current financial and macroeconomic resilience could prove to be just as dire and mutually devastating near the end of this one. In other words, Europe and the United States are right in leveraging their positions of relative strength vis-à-vis China at this opportune moment, but the diplomatic and economic toolbox of the West should be used circumspectly, as Beijing's actual grasp on the macroeconomic situation could be less solid than first meets the eye.

For the time being, the chief goal of the West toward China is clear. Too large to be ignored, China’s peaceful and complete transition to our shared values and common principles is crucial to securing global order and economic stability. Correspondingly, the West should continue not only to uphold its commitment to human rights, free trade, and freedom of navigation, but also promote them with Beijing.

Currently, economic inefficiency is the chief obstacle to China’s further development. However, throwing money at China’s macroeconomic problems will not achieve these goals. In fact, the Chinese leadership has enough resources, but still cannot solve the key issue—the general lack of objective and independent feedback from vested and responsible stakeholders.

In the long run, the Chinese government must adapt to the radical transformation and quickly-changing priorities of the Chinese economy. From the Western perspective, it is evident that Beijing’s current institutional approach is obsolete. Beijing, to avoid experimenting with
western democracy, seeks to leverage big data for “smart population management” instead.\(^{31}\)

However, regardless of the prospects for democracy in China, the strengthening of corporatist institutions and inclusive decision-taking models would be both plausible and timely. The same would apply for the principle of subsidiarity. Nevertheless, by supporting such ideas, Europe and the United States can effectuate China’s transition from inefficient central planning and ingrained state bureaucratic routines to more democratic and efficient forms of organization.

**THE HIDDEN OPPORTUNITIES BEHIND CHINA’S DIFFICULTIES**

Given Beijing’s domestic problems, maintaining or increasing entanglement with China will carry additional risks in 2019 and onward. Western nations should revise their previous policies towards China and prepare for substantial financial and economic outfall during the year ahead. The current U.S. administration is hawkish on China; slow or partial disengagement with Beijing could prove to be the safer option for the United States and likewise Europe.

However, a higher equilibrium is also plausible. The exploration of new (bi- or trilateral) deals between the EU, the United States, and China could still yield better alternatives for maintaining stability, advancing good governance, and safeguarding the strategic interests of the West in the long run. Correspondingly, western decision-makers need consider the following points:

- If this year’s negative trends continue, China’s economy—and especially its private sector—might be unable to outgrow bad domestic debt in time. Otherwise, given the scarcity
of efficiency-driving reforms, the notion of economic crisis may linger for years—China’s own *Sword of Damocles*—and provide further opportunities to the West to wrestle Beijing for concessions.

Beijing’s openness to constructive dialogue ought to improve concomitantly with China’s macroeconomic difficulties. However, power concerns and economic pragmatism cannot become the exclusive drivers of Western policy. The West’s deals with China will work better upon more reliable and democratic foundations.

If the race for China’s domestic market transforms into long-term competition, the average return-on-investment (ROI) rates in China will come to resemble Western levels. As a result, Beijing will find it harder to incentivize lucrative new private-public alliances with major American and European investors unless China can commit to further liberalization and market concessions.

Most critically, Beijing will compensate for any shortcoming by means of spending. China will wield economic favors via the BRI and various banks to divide the West. However, those instruments will depend on the general state of China’s economy, so their capacity to compensate will decline with every economic blow.

A dynamic new Coordinating Committee for Multilateral Export Controls (COCOM) could be the West’s strongest card yet to achieve its goals. Protection for intellectual property and growing cyber security capacities in the West would encourage China to rethink Xi Jinping’s geostrategic vision and come to a new understanding about our common future, therewith inducing Beijing to open doors.

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“Slow or partial disengagement with Beijing could prove to be the safer option.”

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that we continue to push Beijing towards greater transparency and (more) democracy before providing large-scale economic assistance on any account.

China’s authoritarian ethos makes it difficult for China’s leaders to recognize and admit errors in judgment. Beijing probably would resist any attempt to curb Chinese sovereignty or the Communist Party’s control. Therefore, Western signaling efforts must not only be clear and unequivocal, but vastly overwhelming.

Critically, without normalizing China’s behavior, ring-fencing around its economy will always be difficult for the West. Strong commitment to this cause will be paramount lest China eventually learn to hedge its bold economic bets globally and IMF leverage its economic vulnerability as a double-edged sword vis-à-vis the West.
Endnotes


China’s Troubles, 7


